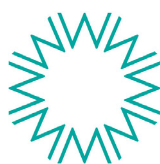
# MARKET PERSPECTIVES

## OCTOBER 2017

## THE LAST QUARTER...

- Equity markets continue to make progress, led by Continental Europe (up nearly 7% in US dollar terms).
- The euro and sterling are strong (though the latter briefly touched an 8 year low against the euro in August before rebounding strongly); the yen and the US dollar weaker.
- The S&P500 Technology index finally surpasses its 2000 high.
- US September ISM purchasing managers index (PMI) reaches its highest level since 2004.
- Greece issues a bond for the first time in 3 years – at an interest rate of 4.6%.
- The UK jobless rate falls to the lowest level since 1975.
- Norway's wealth fund tops $1trillion.

> "Hitherto, the rights and wrongs had seemed so beautifully simple."
>
> George Orwell, *Homage to Catalonia* (1938).



WAVERTON

INVESTMENT MANAGEMENT

# OUTLOOK FOR INTEREST RATES

Synchronised world economic growth...

For all the doom and gloom pervading the United Kingdom at the present time – which is a matter not just of poor Brexit sentiment and paralysis in the Conservative party, but of hard economic downgrades – on a global basis, the economic recovery is undeniably gathering pace. For the first time since 2007 none of the 45 major economies tracked by the OECD is contracting and global trade is at last growing at a meaningful rate. Indicators such as purchasing managers' indices and Bank of America Merrill Lynch's 'Global Wave' (a proprietary composite of a number of leading indicators) point to GDP growth of between 3 and 4 per cent for both 2017 and 2018. We highlighted in the March issue of *Market Perspectives* how well corporate earnings estimates were holding up compared with the relentless downgrades of prior years. This trend has continued such that the aggregate estimate for 2017 global earnings growth is now higher, at 17%, than it was a few months ago. In financial markets parlance – the reflation trade is on.

...means higher interest rates.

This marks a big change in fortunes. Only last year the consensus was that we might be entering into a dangerous period of deflation and central banks around the world were so concerned by this that they cut interest rates to previously unheard of negative levels; bond yields followed and the banking sector started to look very sick. Negative overnight rates were brought about in a conscious effort to shore up the system, but the distortions they cause are extremely unhelpful for the banking sector and the accompanying deflationary narrative turned out to be very damaging to confidence. So we should welcome the fact that short term interest rates have started to rise (led by the US Federal Reserve) and that bond yields have been backing up in sympathy.

Inflation can be almost entirely benign...

The remarkable thing about this turnaround from a deflationary mindset to a inflationary mentality is that the rate of change in consumer prices (CPI) around the world has only moved about 1%. A year ago, CPI in the United States was 1.1% and today it is 1.9 %; in the euro area it has moved from 0.4% to 1.5%. This reinforces what we have often said – namely that the difference between deflation and inflation is much more fundamental than what is happening to consumer prices: it is quite possible to have high CPI combined with a climate of economic and / or asset price deflation (e.g. during the 1970s); similarly, falling retail prices can come at a time of economic inflation (e.g. the 1880s). Whilst it is rational to assume that consumer prices will increase with economic expansion and that interest rates will rise in tandem, it is not necessarily always the case and the example of the last few years has caught out most economic theorists.

...but 'goldilocks' has its drawbacks.

On the face of it, economic expansion and rising asset prices accompanied by subdued CPI and ultra-low borrowing rates sounds like a golden scenario. For investors at least, it is; however, for those who are not on the asset price ladder (i.e. neither own their home, nor have a pension fund) and rely exclusively on wages for their advancement, 'goldilocks' looks like a disappointment. Capital wins at the expense of labour – until such time as either labour revolts or the owners of capital ensure that it can pass it down the line in an orderly and constructive fashion.

We remain cautious on bonds.

We do expect global consumer price inflation to tick up with the present economic expansion as unemployment levels fall and capacity utilisation rises. However, the long term deflationary forces of demographics, technology and globalisation will keep the lid on CPI numbers. As central banks have repeatedly said that they would like to take interest rates back to more normal levels well in advance of the next downturn and because no-one wants to risk retail prices running away, it must follow that short rates will go up as the world economy reflates even if CPI itself is not seen as getting out of control. *Ergo*, bond yields must also go up to preserve the term premium as the price of money rises and fears of deflation fade (albeit there will no doubt be some yield curve inversion in advance of the next downturn, as discussed in the June edition of *Market Perspectives*). Therefore, we see no reason to change our very cautious stance on government bond markets.

Source: CPB World Trade Monitor

# OUTLOOK FOR EQUITY MARKETS

Low bond yields generally represent a degree of risk aversion among investors as return <u>of</u> capital trumps consideration of the return <u>on</u> capital. However, at the same time as bond yields have fallen to ultra-low levels investors appear to have become complacent about the security of bonds relative to equities; demand for the asset class remains extremely high in spite of global reflation. Accordingly, the bond market looks frothy and the threat to bond returns that will come from both rising CPI and higher short interest rates is being overlooked; new bond issues which were inconceivable a few years ago are getting away at prices which on any long term view are eye-wateringly expensive given the risks attached. Iraq, Ukraine and Tajikistan have all tapped the markets during the recent quarter and Austria has recently issued a E2.5bn century bond with a coupon of 2.1%. The duration of this bond is 43 years: if the interest rate demanded from the Austrian state increased from 2% to 3%, the capital value of the bond would fall by 31%.

**Risk taking in the bond markets has implications for equities.**

All of this has implications for equities. Firstly, considering investor flows into bonds and equities over the last few years it seems that a renewed appetite for risk has manifested itself much more quickly in junk bonds than it has in shares. In other words there are lots of investors who can stomach the additional risk of higher yielding bonds, but are still too nervous to go into equities. Secondly, this phenomenon enables companies to borrow money at highly advantageous rates. For good companies this is a boon and enables them to expand their capital base (by building factories or buying other companies), buy back shares or pay out special dividends at very low cost: for example Apple is able to borrow 10 year money at 3% in dollars; Unilever (as well as Apple) can borrow at 1% in euros. The problem is that bad companies are also able to borrow at quite low rates: the yield on European corporate high yield bonds is at an all-time low. It is entirely rational for companies to behave in this way when there is such a large disparity between the cost of equity and the cost of debt, and shareholders in good companies will no doubt benefit handsomely from this once-in-a-lifetime ability to secure finance at minimal cost. However, for the system as a whole it is dangerous: the next downturn will see a lot of the bad companies wiped out, and it will not just be the equity holders who lose everything; supposedly risk averse bond holders (e.g. banks and life assurance companies) could come unstuck in a way which seriously threatens the stability of the system.

**Good and bad companies alike find it easy to get finance.**

From the point of view of equity investors, it may not be until the next recession that it becomes entirely apparent which are the good companies and which are the bad companies in this dynamic – by which time it will probably be too late. It is for this reason that we stick to our 'quality growth' ethos: 'quality' because the balance sheet, management and return on capital will be able to withstand adverse conditions, 'growth' because companies which are innovative and adaptable compounders have a greater chance of navigating difficult economic conditions and coping with technological revolutions which can render some lower quality 'value' plays obsolete or in terminal decline. The snag is that, at first sight, quality growth stocks look expensive: the MSCI World Growth index is on a price earnings multiple of 21 times. However, in the long run 'cheap' value stocks may present the greater pitfall and in the meantime we believe that global economic expansion accompanied by low CPI growth will mean that growth stocks continue to command a high (or possibly even higher) rating as their attractions come to be appreciated by more investors – many of whom are apparently sheltering in high yield bonds.

**Growth stocks should prove resilient in the long run.**

A final word on corporate indebtedness. There is no doubt that corporate leverage is very high, both in absolute terms and relative to GDP. It is reassuring that default rates are very low, but that is hardly surprising given how low interest rates are and, of course, default rates often are benign towards the end of an expansionary period. Time will tell whether current levels of gearing will fall naturally thanks to GDP growth and asset price inflation or whether they will come down as a result of a mass of defaults. In the meantime, looking at the US, the investment grade arena is of much less concern in terms of leverage (1.4 times) and interest cover (11 times) – in both absolute terms and relative to the past – than the high yield area (where leverage is about 4 times). If the economic expansion continues there will be a large transfer of wealth from investment grade bond investors to the equivalent equity investors. On the other hand, if there is a downturn the outlook for this end of the market is no more worrying than usual. It is at the cosmetically cheaper end of bond and equity markets that the fundamental risk is greater.

**Leverage in low grade credits is a concern.**

AAP

Source: Bloomberg, Barclays, Waverton

# TOTAL RETURN INDICES TO 30TH SEPTEMBER 2017

| STERLING ADJUSTED | 3 MONTHS | 6 MONTHS | 9 MONTHS | 1 YEAR |
|---|---|---|---|---|
| Markit iBoxx £ Gilts Index | -0.4% | -1.7% | -0.1% | -3.7% |
| Citigroup World Govt Bond Index | -1.4% | -2.4% | -2.0% | -5.8% |
| MSCI United Kingdom All Cap Index | 2.3% | 3.6% | 7.8% | 11.9% |
| MSCI United Kingdom Index | 1.8% | 2.6% | 6.5% | 11.0% |
| MSCI AC World Index | 1.8% | 2.2% | 8.0% | 14.9% |
| MSCI AC World (ex UK) Index | 1.8% | 2.2% | 8.1% | 15.1% |
| MSCI AC World (ex US) Index | 2.8% | 4.7% | 11.6% | 15.8% |
| US Dow Jones Industrial Average | 2.2% | 2.3% | 6.3% | 21.5% |
| S&P Composite Index | 1.2% | 0.4% | 5.2% | 14.8% |
| MSCI Europe (ex UK) Index | 3.5% | 8.0% | 15.8% | 21.4% |
| Tokyo TOPIX Index | 1.2% | 3.2% | 7.3% | 12.6% |
| MSCI AC Asia Pacific ex Japan Index | 2.6% | 4.9% | 16.9% | 16.8% |
| Waverton Growth Index | 1.4% | 1.7% | 6.3% | 10.8% |
| Waverton Balanced Index | 1.1% | 1.3% | 5.2% | 8.4% |
| Waverton Cautious Index | 0.8% | 1.0% | 4.2% | 6.0% |
| Waverton Defensive Index | 0.6% | 0.7% | 3.2% | 4.4% |
| Return on Cash £ (1 month deposit rate) | 0.0% | 0.1% | 0.2% | 0.3% |
| Inflation - UK CPI | 0.5% | 1.3% | 1.9% | 2.6% |
| Gold Price (£956.9) | 0.0% | -4.1% | 2.2% | -5.9% |
| £ vs US$ | 3.3% | 7.3% | 8.6% | 3.3% |
| £ vs Euro | -0.4% | -2.9% | -3.1% | -1.8% |
| £ vs Yen | 3.5% | 8.4% | 4.8% | 14.8% |

| US DOLLAR ADJUSTED | 3 MONTHS | 6 MONTHS | 9 MONTHS | 1 YEAR |
|---|---|---|---|---|
| Markit iBoxx £ Gilts Index | 2.9% | 5.4% | 8.5% | -0.6% |
| Citigroup World Govt Bond Index | 1.8% | 4.8% | 6.4% | -2.7% |
| MSCI United Kingdom All Cap Index | 5.7% | 11.1% | 17.0% | 15.6% |
| MSCI United Kingdom Index | 5.2% | 10.1% | 15.7% | 14.6% |
| MSCI AC World Index | 5.2% | 9.7% | 17.3% | 18.6% |
| MSCI AC World (ex UK) Index | 5.2% | 9.6% | 17.4% | 18.9% |
| MSCI AC World (ex US) Index | 6.2% | 12.3% | 21.1% | 19.6% |
| US Dow Jones Industrial Average | 5.6% | 9.8% | 15.5% | 25.5% |
| S&P Composite Index | 4.5% | 7.7% | 14.2% | 18.6% |
| MSCI Europe (ex UK) Index | 6.9% | 15.9% | 25.7% | 25.4% |
| Tokyo TOPIX Index | 4.5% | 10.7% | 16.5% | 16.3% |
| MSCI AC Asia Pacific ex Japan Index | 5.9% | 12.5% | 26.9% | 20.7% |
| Waverton Growth Index | 4.0% | 7.7% | 13.4% | 13.9% |
| Waverton Balanced Index | 3.4% | 6.5% | 11.2% | 11.1% |
| Waverton Cautious Index | 2.7% | 5.4% | 9.0% | 8.3% |
| Waverton Defensive Index | 2.1% | 4.3% | 7.1% | 6.3% |
| Return on Cash $ (1 month deposit rate) | 0.3% | 0.6% | 0.8% | 0.9% |
| Inflation - US CPI | 0.2% | 0.7% | 1.7% | 1.7% |
| Gold Price ($1283.83) | 3.2% | 2.9% | 10.9% | -2.9% |
| US$ vs £ | -3.2% | -6.8% | -7.9% | -3.2% |
| US$ vs Euro | -3.5% | -9.5% | -10.8% | -4.9% |
| US$ vs Yen | 0.2% | 1.0% | -3.5% | 11.2% |

* All MSCI benchmarks are net of tax

Source: Thomson Reuters DataStream

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