TOREVELL & PARTNERS

Economic Background – September 2018

The FTSE 100 index ended September at 7,510 having started the year at 7,687, a fall of 2.3% in capital terms. When dividends are taken into account, the UK market has produced a modest positive return of 1%. Whilst the market index is little changed overall, the first nine months of 2018 have seen a high degree of volatility. The FTSE 100 index fell to a low of 6,867 in March, before reaching a new all-time high of 7,904 in May. The last three months have seen the FTSE fall slightly (by 0.7%) with the index fluctuating between 7,800 in mid-August and 7,220 in mid-September.

The majority of global equity markets have also struggled to find a clear sense of direction. The significant exception has been the US stock market where the S&P 500 and Dow Jones indices were trading close to their all-time highs at the end of September. The S&P 500 index has generated a positive return of 8.9% in the last quarter and is up by over 14% since the start of the year. The S&P 500 has not fallen by 20% (a bear market) for more than a decade, making this the longest bull market in US and global markets since records began.

In contrast the MSCI Europe ex UK index is up by 3% in the last quarter but losses in the first half of the year reduced the total return for the first 9 months of the year to 1.3%. The MSCI Asia Pacific ex Japan index is showing a loss in both capital and total return over the last quarter and since the start of the year with the Chinese Shanghai index falling by 20% from February to September.

UK

With less than six months to go before the UK's exit from the EU, Brexit has tended to dominate political and economic debate. Given the close nature of the referendum result it is not surprising that both major political parties are split on the issue: the Conservatives are struggling to reconcile their pro and anti EU factions, whilst the Labour party has adopted the contradictory stance of respecting the referendum, whilst demanding conditions that are impossible to achieve unless we remain inside the EU.

September saw the leaders of the EU dismiss Theresa May's Chequers proposal as unworkable, and the potential of a disorderly Brexit has increased. In response to events in Salzburg and the increased likelihood of an untidy exit from the EU, the Pound fell, and internationally oriented UK shares rose in value in response. It is still far from clear what arrangements (if any) will be put in place for next March but it would be remiss of us not to be thinking about the implications for our clients' portfolios.

We believe that the global nature of the UK stock market should provide some protection to investors in the wake of Brexit. We saw this behaviour following the EU referendum in June 2016 and the reaction of stock markets in September provided further support for this, albeit at a lower level.

It remains difficult to make meaningful projections about the UK economy until more detail of Brexit is known. This uncertainty has led to a fall in the relative prices of UK domestically oriented shares and by some measures these UK shares now appear to be available at very attractive prices. If a workable compromise is reached, or a hard Brexit is not as disastrous as feared, these stocks could perform well.

US stock markets

The US stock market represents something of a conundrum. The US economy continues to expand, helped by the tax cuts and expansionist policies announced by Donald Trump. US household debt continues to rise and has now reached levels last seen in mid-2008 (immediately before the global financial crisis), but at the same time credit scores for US consumers have also hit a record high. This positivity has enabled the US Federal Reserve to continue to increase interest rates, with the current target rate between 2% and 2.25%. The market expects a further increase in December and a further three increases in 2019 with interest rates projected to reach a target of around 3.5% in 2020.

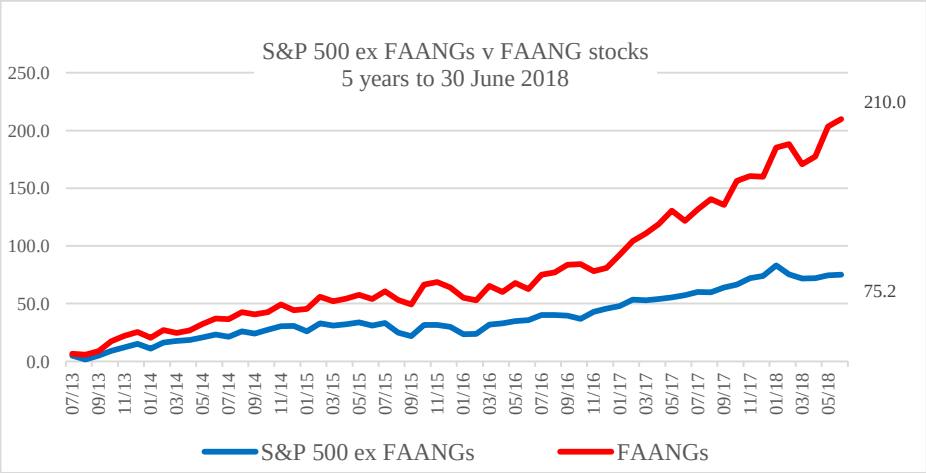
The strength of the US economy and the ability of the Federal Reserve to increase interest rates appears in stark contrast to the emergency interest rates still in force in the Eurozone and Japan.

The rise in the US stock market over the last few years has also been driven by the performance of a relatively small number of technology stocks. Two of these FAANG companies, Apple and Amazon, are now valued at more than $1 trillion. Both companies are enormously profitable, but a number of tech stocks are now trading on multiples not seen since the technology bubble in early 2000. Netflix has seen its share price double over the last year and the company's valuation of over $165 billion is now trading at a multiple of more than ten times revenues. To put this valuation into context, Netflix had reported revenues of less than $3.9 billion and a negative operating cash flow of $0.5 billion for the second quarter of this year.

Share buybacks have been a significant feature of the US stock market for many years. Over the last decade S&P 500 companies have bought back $4.4 trillion of shares, with Apple alone buying back $227 billion of its shares over the period. Over the last year, part of these share buybacks have been financed by the tax changes introduced by President Trump that have encouraged US companies to repatriate profits to the US. A recent report by JP Morgan estimated that $124 billion or 46% of the $270 billion repatriated in the first half of 2018 was used to repurchase shares (this represented over a third of the total value of buy backs in the period). Just under half of the amounts repatriated have been used to strengthen corporate balance sheets, for example by retiring corporate debt. More notably only 5% of the amounts repatriated have been used for capital investment which does not harbinger particularly well for the future growth.

There is some evidence to suggest that the flow of money being repatriated is slowing down. This in turn is likely to reduce the amount available to companies to buy back their own shares and reduce one source of support for US shares.

The US stock market makes up around half of the MSCI world index and hence the performance of a small number of technology stocks has had a disproportionate impact on global equity indices.



Whilst technology stocks have tended to rise, a number of other companies have struggled. The chart above shows the divergence of the FAANG and non FAANG stocks over the last 5 years. As an example, GE is down by 12% since the start of the year and down by 50% over the last year. Its shares were trading above $30 in early 2017 but now trade below $12. It is interesting to note that passive funds that bought GE when it was a larger part of the US market would now be reporting a major loss on the share. The same logic would apply to holders of passive funds if Amazon, Apple or any of the other large technology stocks were to fall from favour.

Global trade

The OECD has warned that global economic growth has peaked. Part of this reflects the escalation of trade disputes between the US and China over recent months. The US imposed tariffs on a further $200 billion of Chinese goods from 24 September, with China pulling out of trade talks in response. More constructively, the end of September saw a last-minute agreement to revamp NAFTA with a new trade agreement between the US, Mexico and Canada, and more encouraging sounds from trade talks between the US and Japan and the EU.

US exports account for only around 13% of US GDP and, as result, the imposition of tariffs can be argued to have a relatively manageable economic impact on the US economy than for many other countries.

Asia Pacific markets

Asia Pacific shares have struggled since the beginning of the year, reflecting concerns about the trade disputes with the US. Emerging markets as a whole have fallen since the start of the year with the Shanghai stock market index down by 20% since early February.

Chinese technology companies have been more volatile than their US peers. The Chinese "BATs" (Baidu, Alibaba and Tencent) have seen their share prices fall by 25% to 35% over the last few months.

There have also been a number of troubling stock market collapses in Hong Kong which are suggestive of relatively weak corporate governance. Grace Wines gained a listing in Hong Kong in July through an IPO but the last week of September saw its shares drop by nearly 75%. Shuang Yun Holdings, a Singaporean road construction company saw its share price fall by 83% at the beginning of September, whilst Wuzhou International Holdings (Chinese real estate) and Hosa International (swimwear) saw their share prices fall by 86% and 89% over a few days of trading earlier this year. In addition to concerns over stock market regulation and oversight, the Greek listed jewellery group Folli Follie (better known in the UK through its trading arm of Links of London) announced this month that its sales in Asia (audited by a small Hong Kong accounting firm) were being revised down by 90%.

Global debt

We believe that debt remains a significant risk for global investment markets and for investors. Whilst European and Japanese central banks are continuing to depress yields by their ongoing asset purchase programmes, the US Federal Reserve has started the process of gradually unwinding its balance sheet and the benchmark 10 year treasury yield has risen to 3.1%.

In contrast Japanese (and Swiss) 10 year government bond yields remain near zero whilst German 10 year bonds yield around 0.4%. UK 10 year government bonds yield 1.6% having been as low at 1.3% in late August. The yields on Italian government bonds rose sharply following the populist government's announcement that they would breach the EU's budget rules.

Returns from fixed income investments have been flattered by a sustained fall in global interest rates over the last 30 years. We believe rates are likely to rise over the next decade and, when this happens, we would expect the prices of government debt, and related corporate debt to fall. In addition the substantial growth in the assets held in fixed income assets (especially through synthetic instruments including ETFs) is likely to exacerbate any market movements if investors try to exit their investments over a short period.

In short we believe that fixed income investments offer an unattractive combination of a potentially illiquid market and relatively low yields, with artificially high valuations with the potential for permanent capital loss.

UK property

UK property typically represents a significant part of our clients' wealth, and in all but very few cases the property is showing a healthy increase in value over the last few years.

The latest report from Deutsche Bank on long term asset returns estimates that, since 1939, UK house prices have risen by around 8% per annum (or around 3% per annum when adjusted for inflation). The report goes on to explain that the recent period of growth appears to be very much the exception, rather than the norm as in the previous 649 years the real value of a house almost halved in value.

Perhaps the most important aspect of the study is the suggestion that house price inflation on the scale enjoyed by recent generations is unlikely to continue indefinitely.

Outlook

Our outlook remains cautious. Recent months have seen investment markets rise despite increased signs of protectionism and a slowing global economy. Against this background we expect uncertainty and volatility to continue over the coming months.

In the decade after the global financial crisis we have seen equity markets rise to new highs, helped by an unprecedented injection of liquidity from the world's central banks. This same liquidity has also driven the price of fixed income investments higher even though the global economy is far more indebted now than it was in 2008. We struggle to see how fixed income assets can generate positive returns over the next few years and if interest rates return to historical levels these assets are likely to fall in value.

In the UK attention will continue to be focused on Brexit with the Chancellor, Philip Hammond, bringing his budget forward to Monday 29 October, ahead of crucial talks with the EU. In America, November sees the mid-term elections which could change the complexion of the US government. In total, 33 of 100 Senate seats and all 435 seats in the House of Representatives are up for re-election.

Against this background we believe that well managed equity funds continue to offer the best prospects for real capital growth. Cash remains an unpopular asset to hold as it generates little income and typically loses value over the long term, but in current conditions it provides a potentially valuable source of liquidity which can be used to weather or take advantage of any short term stock market volatility.