Despite heightened political risk, 2017 turned out to be a good year for equity markets. This was in large part thanks to accommodative monetary policy and a supportive economic environment of low inflation and steady growth. In this edition of the Market Review we look back at the key topics of 2017 before considering our outlook and strategy going forward.

1. Heightened political uncertainty

In the UK, Theresa May has managed to cling on to power having unexpectedly lost her parliamentary majority in June’s General Election. However, her authority remains in doubt and this heightens the possibility that a resurgent Jeremy Corbyn will trigger a change of government and/or a shift towards policies that the market perceives as business-unfriendly and risky.

In Germany, Angela Merkel won a fourth term as German Chancellor in September but is still struggling to form a coalition government thanks to a substantial shift in voting towards the right. Merkel’s weakened position is unlikely to help Theresa May’s push for a softer line on Brexit negotiations, where there has at least been some progress. European leaders confirmed in December that agreement has been reached on the first phase of Brexit negotiations concerning the Irish border, Britain’s divorce bill and the rights of EU citizens in the UK. This now paves the way for trade talks to start, although there is clearly still great uncertainty as to the final outcome.

Further afield, companies and investors have had to get used to the less predictable and more idiosyncratic leadership of President Trump. One aspect of his “America first” approach is that it increases the likelihood of conflict and protectionism.

The former was exemplified in September when North Korea’s nuclear program and missile launches provoked an alarming escalation of heated rhetoric between Mr Trump and Kim Jong-un. The latter has been demonstrated via threats to pull out of NAFTA (the North American Free Trade Agreement) and get tough on China. This is a problem insofar as a tougher US approach on trade could pose a major threat to global free trade.

2. Central Bank policy

Ever since the financial crisis 10 years ago, the World’s foremost Central Banks have for the most part been loosening monetary policy (i.e. lowering interest rates and/or expanding quantitative easing programmes) in an attempt to stimulate economies. However, towards the end of 2017, there was a substantial change in Central Bank rhetoric, with broad guidance that monetary accommodation would begin to reduce (i.e. that quantitative easing stimuli would be reduced and/or interest rates raised). In the UK, for example, the Bank of England raised interest rates in November for the first time in 10 years, from 0.25% to 0.5%.

The reason this is important is that interest rates have a fundamental role in determining the price of assets. All other things being equal, rising rates are a hand brake on asset prices. The problem that Central Banks face is that on one hand they want to raise rates to keep inflation under control and leave room for a rate cut when the next recession happens. On the other hand, excessive debt levels and weak household finances mean that any rate rises risk pushing the economy into recession as debt costs rise.

3. Global debt levels continue to rise

Historically low interest rates and quantitative easing have pushed borrowing costs down and thereby promoted the accumulation of debt. According to the Institute of International Finance, total global debt levels (including household,
government and corporate debt) continued to rise in 2017, both in absolute terms and relative to GDP. It highlights that total global debt has reached a record high of $217 trillion (327% of GDP) compared to $149 trillion in 2007 (276% of GDP). Specifically, the data highlights that emerging markets (and China in particular) have allowed their debt levels to climb rapidly in recent years, prompting concerns about their financial stability. The problem with high levels of debt is that it ultimately raises the risk of a financial crisis or a prolonged slowdown in growth.

4. Improving economic backdrop and strong equity markets

In contrast to the uncertainties discussed above, it is refreshing to report that the global economic backdrop improved in 2017. Indeed, there has been ample evidence that global growth is now at its strongest since the Financial Crisis of 2008 and that a prolonged but muted recovery is at last turning into synchronised global growth. According to the International Monetary Fund, 94% of countries have growing economies and 61% of countries have growing and accelerating economies. With global growth neither too hot to cause excessive inflation, nor too cold to derail consumer spending and profit growth, investors are currently enjoying “Goldilocks” economic conditions and this has in turn contributed to a strong year for equity markets.

Outlook

Our overriding view is that the ultimate solution to excessive debt will be inflation. Central Banks and governments are well aware that the only acceptable way to reduce excessive debt burdens is to keep inflation running ahead of interest rates. The alternative of deflation and default is extremely unattractive in comparison. In the absence of an economic shock, we therefore expect interest rate rises will be modest and gradual so as not to choke off recovery whilst allowing higher but controlled inflation. This would be a positive backdrop for equities. In the event that there is an economic shock, we expect Central Banks and governments will between them print and spend enough money to maintain inflation, forming a backstop of sorts for markets. So how does this affect our asset allocation and strategy?

Strategy

We retain the opinion that equities will deliver the best long term returns compared to the alternatives of cash and fixed return. There are two main reasons for this. First, starting dividend yields are very attractive on a relative basis. The FTSE All Share, for example, yields approximately 3.6% at present. In contrast, interest on cash savings remain anchored to very low interest rates and 10 year government gilt yields a miserly 1.3%. Second, equity dividends should continue to grow from this attractive starting point thanks to underlying economic growth. The global economy looks set to continue to grow at around 3% per annum and, whilst there will at some point be another recession or crisis, growth over the long term is remarkably robust thanks to rising populations and consistent innovation and productivity improvements.

Having said this, we would apply the following important caveats:

- **Equity returns will moderate.** Global equities are up nearly 200% since reaching a post Financial Crisis low in March 2009, driven by economic recovery, monetary stimulus and a starting point of cheap valuations. However, it seems unlikely that these strong returns will be repeated over the next ten years. This is because the starting point is less attractive. Compared to 2009, debt levels are higher, valuations are higher, and monetary policy has started to tighten.

- **Short term risks are elevated.** There appear to be valuation bubbles in certain parts of the market at a time of heightened political risk.

So how do we manage the risk of these two caveats? First, we do not advise making financial plans based on extrapolating equity performance since 2009. Second, we manage short term uncertainty for our clients via asset allocation and diversification. For clients that need their portfolio to grow and are willing and able to stay invested for the long term, our investment solution will likely be a portfolio comprising almost entirely of equities. For clients that are more sensitive to short term volatility (either because they expect to need to withdraw capital from their portfolios and/or are less willing to be exposed to it), we introduce an appropriate amount of fixed return assets into the portfolio. These assets have a low correlation to equities. As such, they are likely to reduce long term growth but provide capital stability when stock markets are weak. The key to equity ownership is to ensure you are never in the position of being a forced seller when markets are weak - a suitable asset allocation helps achieve this.