Market Review

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WEALTH MANAGEMENT

Climbing a wall of worry?

Markets remain relatively calm despite heightened political risk, the most damaging Atlantic hurricane season in a decade, and a shift by central banks towards reversing quantitative easing stimuli and raising interest rates. We comment on these issues below before reviewing our strategy and considering whether markets can continue to climb a "wall of worry".

Central bank tightening

Following the release of higher than expected inflation data in the UK (the consumer prices index has spiked back to 2.9%, equaling the recent four-year high), the Bank of England has issued its strongest guidance yet that it is about to raise interest rates from the current low of 0.25%. At the central bank's September meeting, a majority of members signalled that some withdrawal of monetary stimulus is probable over the coming months unless there is a sudden string of bad economic data. This suggests that a 0.25% rate rise is now likely by the end of the year and puts the Bank of England on the same tightening course as two of the world's other major central banks, the US Federal Reserve and the European Central Bank. In the US, the Federal Reserve has confirmed it will start to scale back quantitative easing and most policymakers have stuck with forecasts for another rate rise in 2017 as well as three further increases next year. In Europe, the European Central Bank has also signalled that it will decide in October how to phase out its €60bn-per-month quantitative easing stimulus, meaning that all three Central Banks could be in tightening mode (i.e. reversing quantitative easing stimuli and/or raising interest rates) by the end of the year.

> "our emphasis on quality, value and diversification leaves our portfolios well prepared"

The extent to which this tightening can continue will depend on the ability of the underlying economies to withstand it. In the UK it is now 10 years since the Bank of England last raised interest rates. At the time, wages were growing at 3.6% and the Bank of England decided to raise rates from 5.5% to 5.75% to cool the economy – not knowing that the financial crisis was just weeks around the corner. The problem a decade on is that a 0.25% rise will effectively double the interest base rate and therefore hit household finances relatively hard at a time when they are already fragile and carrying high levels of debt. It therefore seems likely that the road back up to "normal" interest rates will necessarily be a long one. In the short term, we feel that the UK economy is strong enough to withstand a couple of rate hikes – not least because most households already borrow at rates considerably higher than the base rate (typical mortgage rates are significantly higher and credit card rates much higher still). As such, a doubling of the base rate to 0.5% will translate to a far more modest percentage rise in typical household interest costs.

Brexit pains

Prime Minister Theresa May has used a speech in Florence to set out the UK's position on how to move Brexit talks forward. In short, she struck a softer tone and was explicit about the need for an "implementation period" of around two years after the UK leaves the EU (effectively putting Brexit on pause until 2021). She also went further than ever before in spelling out the UK's future contributions and is initially expected to offer approximately €20bn towards the EU budget.

However, hopes that the speech could help to progress negotiations have been dealt an early blow by Michel Barnier, the EU's Brexit chief negotiator. At the opening of the fourth round of talks in Brussels he made clear that his mandate excluded discussing a transition until sufficient progress had been made on citizen rights, Ireland and a financial settlement. The tough line will no doubt raise tensions and is a blow to hopes of opening trade talks any time soon.

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German election results

The German Chancellor, Angela Merkel, has won a fourth term but now faces drawn-out coalition negotiations and a splintered parliament thanks to a substantial shift in voting towards the right. Indeed, the far-right, anti-immigration AfD made a historic breakthrough, winning 13.5% of the vote – a result that will make it the first overtly nationalist party to sit in the Bundestag in 60 years.

However, the outcome was not unexpected and has had little immediate impact on financial markets. Clearly, Eurosceptic sentiments are still running high in the European electorate and this will surely slow down a Franco-German drive to promote deeper Eurozone integration. Merkel's weakened position is also unlikely to help Theresa May's push for a softer line on Brexit.

Trump & North Korea

Recent missile and nuclear tests have made it clear that Kim Jong Un has dramatically increased the speed and scope of Pyongyang's nuclear weapons programme since he came to power in 2011. Along with a startling escalation of heated rhetoric between North Korea and the US, this has greatly increased tension in the region.

Most analysts believe that any US military action against North Korea would provoke massive retaliation, primarily aimed at Seoul - and Jim Mattis, US defence secretary, has said that war would be "catastrophic". As such, it seems the only practical option for the US is one of containment, despite the grandstanding rhetoric. For North Korea's part, its leader's incentive is to retain power via the present status quo of threats, sanctions and deterrents – not to start a nuclear war that would ensure the country's destruction. We expect tensions will remain high, but do not expect military aggressions to spiral out of control.

Hurricanes

Devastating tropical hurricanes have left a dreadful trail of destruction and tragedy across the Caribbean, Texas and Florida. The full impact of hurricanes Harvey, Irma and Maria will not be known for some time. From a financial perspective, early estimates from economists suggest there will be a sizable negative impact on third-quarter US growth numbers – although a subsequent boost is expected as rebuilding begins. At the margin, US policymakers may decide to hold off from another interest rate rise until the financial impact of the hurricanes is better known, but the US economy was projected to grow at a healthy 3% before the hurricanes hit and they are not expected to have a meaningful long-term impact.

Strategy

Uncertainties and political risks remain high and, if anything, are increasing – all at a time when equity valuations are no longer cheap. In the short term, this leads us to be more cautious when investing cash. In practice, this means investing new cash that is given to us a bit more gradually and, for mature portfolios, gently allowing cash balances to accumulate until clearer value opportunities arise.

In the long term, we remain convinced that a) equities will continue to deliver attractive long-term returns from this point, and b) our emphasis on quality, value and diversification within equity markets leaves our portfolios well prepared to deal with a wide variety of eventualities. We do not believe that trying to time markets is possible and so do not do so in anything other than a small way. Moreover, it is quite possible that equity markets will continue to push upwards in the short term. Equity yields remain relatively attractive, global growth looks set to continue at 3% or so, and the prevailing uncertainties and risks are well known, leaving plenty of room for investors to turn more optimistic. Indeed, equity "bull" markets tend to "climb a wall of worry" and usually end on a note of optimism, not pessimism.

In the fixed return part of portfolios we remain firmly tilted towards short duration and index-linked securities on the basis that interest rates must eventually rise back to pre-crisis levels. It may yet take a long time due to high levels of global debt, but when interest rates do increase, bond yields will increase and therefore bond prices will fall. Equities may also see valuations fall under this scenario, but interest rates will only rise when inflation is seen as a greater threat and equities will conversely benefit from higher inflation.