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Portfolio Management

CAERUS Market Commentary – June 2017

Market overview

Markets have been quiet over the past month. The Vix Index, which tracks US equity market volatility, fell to just 8.3, with similar levels of calm seen in other indices. This translated into minimal movement in most equity markets.

The dollar index has continued its decline since Trump's election. A weaker dollar was a key election promise, albeit delivery seems to be the product of his failure on the remaining agenda. Despite the market re-evaluation of Trump's reflation plan, the end of June saw policymakers in Europe and the UK attempt to pick up the baton with hints of a more hawkish stance, albeit subtle and understated ones. Bond and currency markets lapped this up and in the face of limited new news, talk of increasing rates has taken centre stage.

How far this story runs will be interesting – is it another false dawn on the road to global interest rate normalisation, or has inflation finally taken off?

June Indices

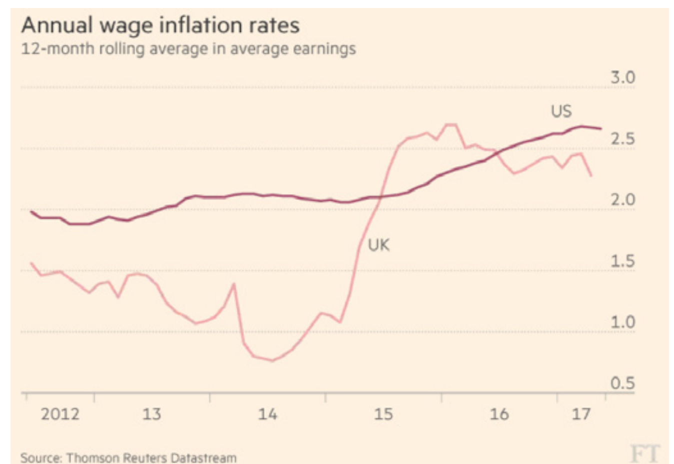
Index	June Return (£ base)
FTSE World Index	-0.15%
FTSE USA TR GBP	0.02%
FTSE Europe ex-UK TR GBP	-1.35%
FTSE Japan TR GBP	0.48%
FTSE 100	-2.44%
FTSE all share	-2.47%
FTSE EM	-0.06%

Source FE June 2017

Past performance is not an indication of future returns. The value of investments and any income from them is not guaranteed and can go down as well as up.

United States

June saw the Fed raise rates by a further 25bp. It also set out plans for trimming the $4.5tn asset reserves created by QE. Inflation figures in the US continue to come in below expectation, with the core rate falling to 1.7% last month. Despite very strong employment figures, wage growth has continued to stall. Further concern surrounds a fall in retail sales coinciding with slower growth in consumer credit.



One signal under ongoing attention is the continued fall in the steepness of the yield curve. The spread between the two year and thirty year US Treasury bonds is at its lowest point since 2007. Historically, an inverted yield curve (when short-term rates are higher than long-term) has been a strong predictor of impending recession.

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Source Bloomberg.com June 17

Auto loans are a further topic of excitement for the bears. US auto credit has shown a marked deterioration over recent quarters, with newly "delinquent" (overdue) loans at a post-recession high of $23bn for Q416, while "seriously delinquent" loans touched $8bn. The deterioration, as expected, sits mostly with subprime loans, which make up 25% of total auto lending. While being a mere 2% of the $12.6tn US consumer credit market, in a period of record low-interest rates and unemployment, this is a signal of distress to be watched carefully.

United Kingdom

By the time the polling booths closed, it was clear that Theresa May had made a mistake calling an election and that Corbyn had embarrassed her on the campaign trail. As it turned out, not only did she fail to achieve a strong mandate to negotiate a hard Brexit, she also managed to lose her majority. A hastily funded deal with the DUP allows her to continue in government, but her 'strength and stability' has deserted her. Labour's revival came from a surge in voting by the young and coincides with a countrywide split in opinion on the benefits of Europe and the type of Brexit preferred.

While confusion and political weakness tends to imply currency underperformance, the pressure on our Brexit negotiators, from a precariously weak majority, has seen markets cross their fingers for a softer approach.

In the bonds space, as the month drew to a close, Carney opened the door to a rate rise. The pound jumped higher while the two year rate moved above 25bps for the first time in nine months. Carney's warning that continued economic growth would eventually lead to higher interest rates is markedly different to his tone just a week earlier where he stated 'now is not yet the time' to raise interest rates. One of the three 'hawks' who voted for a rise at the last meeting, is leaving the monetary policy committee this month, and will be replaced by the Bank Economist, Andy Haldane, who has voiced his support for a rate rise this year.

UK economic data was mixed in June, with good construction figures but weak services PMI, while Consumer Price Inflation rising to 2.9% continues to hurt as those on average pay have yet to experience wage growth since 2008.

Europe

Initial market reaction to Draghi's speech at the end of June, suggesting that "deflationary forces have been replaced by reflationary ones", lifted the Euro strongly. Qualifying comments from ECB members a day later attempted to moderate this positivity, tempering the expectation that the ECB may look to taper QE. Even so, Europe appears to be taking over from the US as the region to look to for encouragement on growth.

Consistently improving data from the core and peripheral economies has helped generate strong equity returns, and a CAPE ratio of 15.6x implies Europe remains relatively cheap. Corporate earnings growth has struggled in recent years, with low inflation and worries over the periphery.

The recent earnings seasons have been more positive and this month we saw confidence returning in peripheral banks, a further sign that investors are putting faith in the recovery.

Japan

Toshiba held its annual meeting just days after the Tokyo Stock Exchange confirmed its demotion to the second tier of the Tokyo Stock Exchange. The company is staring at an estimated loss of $8.9bn with negative shareholder equity of circa $5bn making its demotion automatic, despite potentially occupying 10% of its new index. Aside from the embarrassment, the impact of falling out of a leading benchmark could see 10% wiped off the share price as passive funds adjust their holdings. While the problems stem directly from the purchase of a now bankrupt Westinghouse nuclear unit in the US, the failings run deeper and highlight the lack of corporate governance systemic across Japanese businesses.

In 2015, it was revealed that Toshiba had been investing profits to the tune of $1.3bn over the previous seven years, and while this figure seems paltry next to the $6.3bn write-down from Westinghouse, the underlying governance issues continue to persist, with PWC Aarata failing again to sign off their accounts for the year to March. Toshiba is fighting hard to sell its chip business with the aim to plug the hole in its finances, that will not only avoid delisting completely but, more importantly, avoid bankruptcy. Given the backdrop of Abe's push for cultural change at a corporate level, Toshiba stands as perfect motivation to continue this difficult path to enlightenment.

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Emerging Markets

In June, Argentina issued a 100-year bond for $2.75bn, maturing in 2117. While this created quite a stir, given the assumed increased risk from such a long dated security, the practical differences to a more conventional 30yr bond are limited. The interest rate sensitivity is only marginally more, despite the far greater maturity. Further, given the market-implied-risk of default for a 30yr Argentina bond is up at 90%, there is very little further downside to default remaining. Consequently, investors are receiving a decent yield for a much more limited increase in risk than it appears, at first glance.

Also occurring last month was MSCI's announcement of its decision to include China A-shares in its benchmark emerging market indices with a 5% inclusion factor spread over 222 qualified stocks. While a small step, it is the path to what will surely represent a larger influence for global investors. Initially, at least it will bring $10-15bn of inflows from passive and active funds benchmarked to the MSCI.

Implied volatility in June has fallen to its lowest level on record, down 78% since it peaked in 2011 at over 60%. The most recent contraction is largely due to positive price action. However, it still exists in the face of many political tensions across both the developed and developing world.

Despite the sell-off in commodities last month, specifically crude oil, emerging markets held flat, holding on to the strong performance this year. While in 2010 commodities were a large factor in the EM index, today they account for just over 10% while Technology makes up over 25%. This implies that an investment in EM has become far less a play on the commodities demand of a rapidly growing China than a decade ago and far more a play on manufacturing and consumer demand currently making Asia the world's fastest growing region.

Source Bloomberg.com June 17

*All performance data quoted in this article is derived from FE Analytics

CAERUS Sentiment Indicator

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