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INVESTMENT OUTLOOK

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The vote in the British referendum to leave the EU was a major shock at the end of the quarter, and the implications of this vote will have effects for months and even years to come. Markets were positioned for continuity and when the result came through sterling fell more than 10% in six hours against the dollar, a huge move. After a rapid plunge most equity markets stabilised, though the sectors most exposed to economic uncertainty are still heavily down, most notably European banks. This protest vote ultimately has its roots in the 2008 financial crisis and can be seen as a ferocious rejection of the Establishment. The trend towards anti-elitism is a global phenomenon and similar protests can be seen in the US, Brazil and South Africa. These revolts are all driven by people suffering from widening income inequalities, stagnant living standards and disillusionment with conventional politicians who have failed to respond adequately to 2008. Indeed many see the policies since then as rewarding those who brought about the crisis, and further harming those who have been forced to pay for it.

The Brexit situation throws Europe into confusion as it puts the collective spirit of the EU under greater strain. As growth struggles and debt problems mount each country looks to its own problems rather than the whole. The immigration issue has become a critical factor now because it is stoking the rise of populist politicians which threatens the great achievement of the EU which has been the establishment of free cross border flows of goods and people. Now almost every country in Europe is becoming more protective of their borders. Even without the immigration crisis tensions were building in Europe as the performance of various countries diverged. This can be seen most starkly in contrasting Germany and Italy. Italy’s unemployment is increasing and now approaches 12% which is 4% higher than in 2011 when the Eurozone crisis started. In Germany unemployment fell to 6% which is 1% below the level of five years ago. Italian manufacturing has been contracting, and imports are 30% below their 2008 peak and exports 20% lower. While Greece has been a manageable problem for the ECB, Italy is nine times larger. The concern in Europe is exemplified by Italy because as the economy stagnates they have no mechanism to devalue or set interest rates. With Italian Government debt at 132% of GDP the dysfunctional nature of the single currency is causing more friction. While all attention is on the fallout from the UK’s vote the deeper problem is the EU’s failure to deliver prosperity across the economic bloc. Growth rates have been poor for years, unemployment is high in many places and especially so among the young, and the EU still has no trade agreement in place with the US, Japan, China or India. Politics will be front and centre in Europe over the next year as Italy, France and Germany all have elections, besides the question of how the UK’s exit will be arranged. These elections will force politicians to confront these issues.

The reaction of the bond market to Brexit was to rise even higher. 10-year German bonds now have a negative yield for the first time. The Swiss yield curve out to 2064 is negative. At the end of June Fitch calculated that almost $12tn of sovereign debt has a negative yield (adding $1.7tn in June alone). Only about $2tn of sovereign debt in the developed world has a yield above 2%. In effect this implies that the bond market is not expecting any interest rate rise for the next decade in these countries, which makes sense only if we have a decade of economic stagnation. It creates a desperate situation for financial companies and pension funds. Zero or negative interest rates are strangling the banks. Deutsche Bank's shares have crashed this year and stand at a level half that of 1990. Banks make much of their money from the spread between deposit rates and the rate at which they can lend which is set by the yield curve, so when the yield curve flattens this net interest margin shrinks. Banks are being enfeebled by the endless erosion of margin and the burden of regulation that has been imposed on them in recent years. Zero rates and quantitative easing now seem to be exhausted policies which are doing as much harm as good. By drugging the market with liquidity Central Banks have kept alive companies with unnaturally low cost of capital, and such low rates have created an incentive to create more debt so the debt bubble keeps expanding. Markets have become dependent on this liquidity and we have reached the absurd situation where economies have so much debt they can only afford it with rates at zero. It is a recipe for capital misallocation and supporting zombie companies by perpetuating excess capacity.

Are such low interest rates justified? It seems hard to believe even allowing for the extreme risk aversion that investors feel at present. Brexit is a big shock but most economies round the world are growing. Global GDP growth is still expected to be about 3% this year and next, and even the Eurozone economy is expected to grow. While there are significant deflationary forces from excess capacity in some sectors, like steel, shortages are growing in other areas. Labour markets are tightening. In the US unemployment has fallen under 5% and in Japan it is approaching 3%. Stronger employment is leading to rising wages. The misallocation of capital in recent years may also lead to bottlenecks, for example, in oil and commodity production where the price crash cut capital expenditure which will eventually lead to price rises. So even with lacklustre growth some inflation can re-appear. The downward distortion of bond prices through QE, the need for financial institutions to shore up their balance sheets with the highest rated bonds, and the desperate hunt for yield by insurers has led to yields which look inconsistent with the outlook. This may be creating a false aura of safety in what are supposed to be risk free assets. Pension funds, bond funds or other financial vehicles that are full of these 'safe' assets may be far less safe than their holders realise. The inflated valuations extend into equities that display bond-like characteristics. After the Brexit vote these stocks rose as the market huddled into the safest names. The danger is an unexpected reversal. In the same way that the market was positioned one way in expectation of a Remain vote in the UK, and was caught completely off guard, so with the idea that inflation is not on the horizon, bonds and defensive equities are vulnerable given the extreme degree of positioning towards these traditionally safe areas. All Central Banks remain massively stimulus focused. The unravelling could be nasty if their efforts finally pay off.

The US economy has been expanding for 86 months which is one of the longest growth periods since 1945. Employment has been increasing steadily for the past four years and is starting to push wages higher, and people in continuous employment are seeing their wages rise 3.5%. The US is also seeing the introduction of minimum wages with fifteen states mandating increases in their minimum wages in 2016. In April California passed a law that will see the minimum wage rise from $10 to $15 an hour between now and 2022. New York will boost its minimum to $15. Walmart, McDonald's and Costco among others are all raising their wages, and Walmart is spending $2.7bn over the next two years on increased wages and training. In what remains a low growth environment these wage pressures will hurt margins. The significance of Donald Trump's surprising success in his bid for the Presidency is his appeal to the worker who has not participated in the recovery, and his success will force all politicians to push for a better deal for labour. Yet complicating this is a larger trend which is the increased sophistication of robots to do mundane tasks. Even burger flippers can be automated. In May the former boss of McDonalds said: 'It's cheaper to buy a $35,000 robotic arm than it is to hire an employee who's inefficient making $15 an hour bagging French fries….it's very destructive and it's going to cause a job loss across the country like you're not going to believe.' Imposing higher wages on companies facing stagnant revenue growth would be a disaster for profits, so how companies adapt to these technologies will be critical. There may be a stark divergence between the winners and losers as a result of these changes.

Emerging markets have been poor performers for the last five years and the slowdown in China has become an increasing concern among investors. The sheer size of China and its enormous influence on many parts of the world, particularly commodities, means that it gets most of the headlines and sets the tone for all of the emerging market complex. China is the world's second largest economy and its banking sector has assets equivalent to 40% of global GDP. Over the past year there has been an increasing sense that China's growth miracle has become unbalanced and unstable. China's debt to GDP has risen from 150% to 260% in less than a decade and such surges in debt in emerging markets have almost always been followed by a financial crisis or an abrupt economic slowdown. China has managed to contain its problems though the bad loans in the banking system may be far worse than acknowledged. The real challenge will come when bank loans reach or exceed the deposit base from customers and the banks become increasingly dependent on money market borrowing. China has thrown a huge new credit stimulus at the economy in the past year which has had mixed results. Some of the stimulus is magnifying already bloated areas, and just aggravating the debt and mal-investment problems. One of the adjustment mechanisms that China has used is to depreciate their currency which has fallen 7.5% against the dollar from the middle of 2015 to the middle of 2016, meaning that in US dollar terms their economy has shrunk slightly in the past year. Wages have been rising which benefits consumption but it does not help profit margins. China is the reverse of the US in this as the benefits of growth have gone to labour not shareholders. This policy has the government's backing because in the end what the Chinese Communist Party cares about most is social stability. Select companies can perform well in this environment but it is not a situation in which the general stock market flourishes.

A better prospect is presented in Vietnam. After a boom bust in 2006/07 the Vietnam economy has stabilised and is now growing again. Inflation is stable and it has a current account surplus. With wage costs half those of China it is enjoying a boom in foreign direct investment as global manufactures locate their factories there. The government has a large privatisation program planned and has been increasing the limits on the amount that foreigners can buy. Many companies offer decent yields and sell at reasonable levels compared to their growth rates, and the return on equity that they are generating. Vietnam remains a marginal market but in a low growth world these qualities will increasingly attract investors.

Markets are in a fragile state as a result of the uncertainty on the economic front, from the slowdown in China and the opacity of the European banking system. Politics is an added destabilising influence, and a critical one given how important the authorities' interventions have been to supporting markets over the past few years. Brexit is just one more additional uncertainty. Investors' reaction to this situation has been to run into the bond market regardless of prices, to the extent that they accept negative yields. In equities they have crowded into an already crowded trade in the companies who offer 'safe' dividends driving their prices to ever higher levels. The generalised uncertainty will probably mean that interest rates stay lower for longer, but eventually negative interest rates are unsustainable. When the tide turns these overcrowded positions will unwind and may be precisely the wrong place to be, and be offering only the illusion of safety. Where should investors look? The momentum trades have left plenty of value behind which offers opportunities for the stock picker. Emerging Markets have endured a five year bear market and value is beginning to emerge as many problems have been discounted. Indeed for all the problems in Emerging Markets they are starting to look relatively stable compared to some places in Europe. Commodity stocks, and particularly precious metal stocks which love negative shocks, have enjoyed a spectacular rebound from their lows in February, largely because they became so oversold. A similar situation is developing in bank stocks. Not all banks will go bust and when they turn their performance will be equally spectacular. Finally there are those companies that have been ignored by investors because they did not fit the current mania of providing large dividends, or were perceived to have too much exposure to emerging markets. The reasons that investors have been fearful of these value situations may be the reason that they are the safest area.

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