FINANCE
Armstrong Investment Managers

# Armstrong Investment Managers: investment outlook Q4 2016

The global macroeconomic environment is clearly exhibiting signs of slow growth, given the political uncertainty across many regions.

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As well as the upcoming elections in the US, Europeans counties such as Spain, Netherlands and France will also go to the polls, where the focus seems to be more on national identity and immigration than economics.

### GLOBAL MACRO ENVIRONMENT

Additionally, Italy is adding to this uncertainty with its own referendum on constitutional reform. If Brexit taught us anything, it is that the markets tend to react at the last minute.

Efforts to boost growth via monetary policy transition mechanisms appear to be weakening and the focus has shifted to fiscal policies. GDP across developed economies is approx. 2% and emerging economies at 4.5% - neither disappointing at all, but with further room to grow for at least a couple of years before a slowdown. Consumer spending will be key while business investment and trading figures are low.

Watching how monetary policy evolves in the real economy will be important. Multipliers are at relatively low levels post-crisis and this could be for a number of reasons including high debt levels, tighter regulation and the aforementioned modest economic growth. Diversification across asset classes is proving difficult, as markets that are disconnected from fundamentals are increasingly exposed to central bank policy. Correlations between traditional asset classes are hovering around 0.75 and constantly changing. Asset allocation has never been as challenging!

In the US and UK (and other developed markets), equities are preferred to bonds – supported by increasing inflation and growth. Liquidity injections to boost the equity markets have brought down volatility, and with asset price valuations this high it's clear that fundamentals are not currently driving the markets.

The low rate environment has not boosted investment globally and the power of monetary policy seems to have thus been weakened. Low and negative rates are leading to tighter lending conditions and this will be interested to watch going forward.

### UNITED KINGDOM

The Bank of England's Term Funding Scheme (TFS) initiative was announced as part of a three-pronged monetary policy launched in the wake of the Brexit vote, and is designed to help the impact of low rates on the household sector, particularly for commercial banks who are feeling the squeeze on their profitability.

After cutting rates to 25bps in August, they gave an indication that they will cut rates further at some point later in the year. Further cuts (to a level of 10bps) would continue hurting (commercial) banking profits, and the TFS scheme provides just such a cushion for this. Overall, therefore, this is a positive policy for the banking sector and, more importantly, the UK household sector and property markets. The MPC have suggested increasing the scope of TFS to between £150bn and £200bn. Additionally, the Gilt purchases programme could be enhanced to levels of over £100bn to allow for further easing on the market, with growth forecast set to fall to 0.8% in 2017 but then rebounding to over 1.5% in 2018 onwards.


### EUROPE

Inflation forecasts across the euro zone seem not to be exceeding 1.5% and therefore it's increasingly unlikely that the ECB will be hiking rates anytime soon.

There was a significant increase in lending in Europe, from 0.5% to 1.4%, but it appeared to be somewhat fragmented since most new loans have been going to households and businesses in France and Germany. Mario Draghi claims that banks have no solvency problems. He does however say there may be problems with future profitability, and that profitability will require much higher volumes of loan transactions. Demand for credit however has been plagued by political uncertainties and the lack of uniformity in monetary policy mechanisms across member nations

The IMF and ECB have made repeated reference to growth-friendly fiscal policy, which has translated to fiscal easing in Europe for the first time since 2010. This has had a positive effect on fiscal balances in Europe, moving from -6.3% of GDP in 2009 to currently around -2%. Most of the benefits from the latest fiscal easing have been allocated to refugee aid packages and increased pensions. Ahead of the elections next year, we do not expect much to change from their fiscal stability packages.

Juncker has cited plans to deploy EUR 315b into EU-based projects over the next 30 years, but this will have little impact on near term GDP. It's also worth bearing in mind that it can take anywhere between 5 and 10 years to get the relevant approvals, given the regulatory and political frameworks in place.

On the whole, anti-establishment sentiment has been hindering investment and the longer term outlook is somewhat uncertain. However, despite the Brexit vote, the euro area has shown much resilience due to strong levels of consumption and investment.

### UNITED STATES

The US economy appears to be in advanced stages of the cycle, but with further room to grow for at least a couple more years before the impending slowdown. Financial stress in 2016 was likely caused by more than just the rate hike in December 2015. Factors such as declining oil prices; fears of US recession; concerns of China capital outflows and negative rates from Bank of Japan have all had a contributing effect.

With the level of political uncertainty where it is, the probability of a December 2016 rate hike is roughly 50%, with Treasuries providing a hedge against this uncertainty. With such low rates, financing has become cheap enough to support the US economy, with borrowers reducing their debts and issuers refinancing at lower levels. From 2004-2006, term premiums and yields were negative due to foreign institutions and foreign central bank purchases. These days, foreigner institutions are net sellers of Treasuries, with US domestic institutions being the buyers.

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Why are they paying a premium to secure long term positive yields? Inflation expectations are built in to the yields on short and long term debt, while inflation uncertainty is built in to term premiums. But, correlations between inflation uncertainty and term premiums are low. Another explanation is perhaps that US investors are investing for the long term and now insuring themselves against even lower returns in the future. Negative nominal yields are occurring worldwide and may come to the US, regardless of internal US factors.

There are many imbalances at play in the US – lower profit margins; increased M&A activity and debt; close to full employment. Regardless, inflationary pressures have still not become apparent and, ultimately, the US is still leading against most developed economies, while the emerging markets are repaying their debts.

### CHINA

Two words on most people's mind when it comes to China are: property and bubble. There seems to be uneven demand for properties across the region, with the government propping up prices in some areas and trying to slow them down in others. In some regions, policymakers have been lifting the down-payments required on second homes. More and more permits have been offered to migrant workers, totalling roughly 300 million in major Chinese cities, signalling their hope that as their economy advances, it builds the infrastructure and human capital to follow suit. Resulting productivity gains will lead to higher consumption across the economy. Issues may arise with the advent of new technologies that are making some sectors less capital intensive, while there is a more effective global division of labour and higher living standards.

China's total debt to GBP is hovering around the 250% mark, making it one of the most leveraged economies in the world. State-Owned Enterprises are some of the biggest underperformers, with debts of over 100% of GDP and much in the way of excess capacity. However, they still face far easier and cheaper access to credit than private enterprises.

Non-performing assets currently make up around 7.5% of total bank assets, and represent up to 22% of Chinese GDP. Current margins seem to be reflecting the stage of the business cycle they are in. At first, companies look to strengthen margins through M&A activity and increasing leverage. As the cycle advances, profit margins come under pressure from increased labour costs, and subsequently job cuts become more widespread.

Both the BoJ and PBoC are maintaining their current monetary policies but, while capital outflows from China are somewhat contained by capital control measures, due attention will undoubtedly be on asset price bubbles – particularly on the housing markets in major cities.

### OIL

The rebalancing process in the global oil markets is under way. The oil markets have transitioned from huge global oversupply between Q2 2014 and Q1 2016 to more of an equilibrium now. The next transition, from rough equilibrium to a larger global supply deficit, is expected by the end of 2017.

Due to the falling US supply and reasonable global demand, any such deficit should be bullish for prices next year. Global demand if forecast to grow, driven by emerging markets — especially China, India, and other non-OECD Asia. China is undoubtedly an important driver of commodity prices but not the only factor. There should be as much focus on supply side factors and the on-going currency revaluations taking place. EG

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