

Weekly Digest

week ending 29 January 2017

Was Mark Carney's post Brexit cut precipitous?

A couple of weeks ago the December print for UK Consumer Price Index came in at 1.6% annualised compared to 1.2% a year earlier. Overall this seems to be a positive development for the UK and underlines the surprisingly cheery tone of the UK economy following the Brexit vote. Inflation at this level takes us a long way away from the dark days of perceived economic stagnation and the spectre of deflation that market participants were becoming anxious about a couple of years ago. Falling prices can quickly evolve into a deflationary spiral as consumers put off spending that they do not need to make in the anticipation that prices will be lower in the future, whereas in an inflationary environment customers are incentivised to bring spending forward wherever possible. Clearly, therefore, central bankers aim for a positive but comfortable level of price inflation wherever possible.

Other factors that have pushed up inflation include the weakness of sterling following the Brexit vote and a simultaneous increase in the cost of a number of commodities that are key for the UK economy, most notably crude and the energy complex as well as industrial metals. In fact commodities such as these had a double impact because their prices in US dollars have increased over the past 12 months, a move that has been exacerbated by the weakness of sterling which makes dollar priced imports such as these even more expensive.

There are other less direct factors that are also impacting the UK's inflation level. For example, China has been a powerful deflationary force for some time until last year when its producer price inflation moved back into positive territory. This means that input costs of production have increased and, in time, some or all of that will ultimately be passed onto consumers of the end product. While this inflation has been offset for most by a weakening Chinese currency, sterling's fall has been greater meaning that imports are still more expensive today than a year ago.

In the US much has been made of President Trump's reflationary policies and this, combined with already solid economic performance and a tightening employment market across the Atlantic has led to the market anticipating a couple of rate increases this calendar year. The UK could well follow suit as the UK moves into a post referendum state where the

economy remains on an even keel and if inflation remains elevated for a number of quarters it will be difficult for the Bank of England to ignore the data for too long. The managers of our core portfolios have taken the view a number of times post financial crisis that central banks will err on the side of inflation rather than deflation (not least because it makes the ocean of outstanding government debt easier to service) and such a backdrop makes Bank of England Governor Mark Carney's decision to cut interest rates in the UK post the vote to leave the EU look increasingly precipitous.

All this sets up an interesting interest rate dynamic amongst some of the world's largest economies in 2017. The US seems highly likely to increase interest rates a number of times this year and the UK may well take a similar (but less pronounced) direction by undoing the post Brexit cut. However, European growth is still under pressure and the number of major elections in the region and the growth of political dissatisfaction make it unlikely to see a hawkish ECB stance this year even if economics required it (which they don't at the moment). Furthermore, it was about a year ago that the Bank of Japan moved into negative interest rates for the first time and that experiment was in part unwound in September last year, so the direction of travel of the BoJ is still somewhat unclear. The stakes remain high for central bankers and on the whole they have done a solid job post the financial crisis, but 2017 may be the year that the extraordinarily loose monetary policy that has been a consistent and growing feature since 2008 finally starts to be unwound.

The Marketplace

- US economic growth disappoints as Dow Jones reaches 20,000
- Trump's executive orders fail to stir markets
- UK High Court: Parliament must vote to trigger Brexit
- UK economy grows 0.6% in Q4
- Weaker yen boosts Japanese exports

Market Focus

US

- In the final quarter of the year US growth slowed to an annual pace of 1.9%, down from the 3.5% annualized growth in the third quarter. This left the final GDP growth number for 2016 at 1.6%, its lowest in five years. A reduction in net exports was the primary culprit, subtracting 1.7% from output over the quarter. This comes after the dollar's 7.1% appreciation over the period.
- In his first week as US President, Donald Trump signed thirteen executive orders, which enable him to enforce laws without the approval of Congress. The most controversial include: dropping out of the Trans-Pacific Partnership trade deal, approving construction of the controversial Dakota Access Pipeline, and enforcing a 90-day ban, affecting around 134 million people, on citizens from seven Middle Eastern and African countries from entering the US.
- Trump's policies have caused severe unrest in and outside of the US, but the market's reaction has been muted, with the VIX volatility index now at its lowest level since 1993.
- US equities gained 1.0% in total for the week, which included the Dow Jones Industrial Average index reaching the symbolic 20,000 point milestone.

UK

- On Tuesday, members of the UK's Supreme Court ruled eight to three in favour of forcing Prime Minister Theresa May to hold a vote of MPs and peers to determine if Article 50 can be triggered to formally begin the EU exit process.
- Sterling fell up to 0.9% against the dollar immediately following the announcement, but recovered quickly as reports suggested that MPs would likely vote to trigger Article 50 before the end of March deadline. Sterling went on to appreciate

1.3% against the dollar over the week, to reach USD 1.256, its highest weekly close since 9th December.

- First estimates of GDP growth from the Office for National Statistics reported UK output growing by 0.6% over the fourth quarter. This resulted in growth of 2.0% for 2016 as a whole, making the UK the fastest growing G7 economy.
- Growth in Q4 was driven by the services sector, which comprises 79% of the UK economy, expanding by 0.8%. Industrial production was unchanged from the previous quarter, whilst construction and agricultural production grew by 0.1% and 0.4% respectively.

Japan

- Japanese exports rose 5.4% in December compared to the same month a year earlier, marking the first year-on-year rise in monthly exports in fifteen months.
- The increase is somewhat attributable to the Japanese yen's depreciation of 13.4% against the dollar over the last quarter of the year.
- Japanese equities gained 1.0% over the week.

James Klempster (CFA) & Oliver Bickley

Asset Class/Region	Currency	Currency returns			
		Week ending 27 January 2017	Month to date	YTD 2017	12 months
Developed Market Equities					
United States	USD	1.0%	2.6%	2.6%	23.7%
United Kingdom	GBP	-0.1%	0.7%	0.7%	24.9%
Continental Europe	EUR	0.9%	1.6%	1.6%	11.5%
Japan	JPY	1.0%	2.0%	2.0%	13.1%
Asia Pacific (ex Japan)	USD	2.1%	6.4%	6.4%	26.4%
Australia	AUD	1.0%	0.9%	0.9%	20.7%
Global	USD	1.2%	3.0%	3.0%	20.2%
Emerging Market Equities					
Emerging Europe	USD	3.7%	3.2%	3.2%	40.0%
Emerging Asia	USD	2.5%	6.4%	6.4%	25.2%
Emerging Latin America	USD	3.8%	9.0%	9.0%	58.5%
BRICs	USD	2.9%	7.2%	7.2%	38.4%
MENA countries	USD	2.5%	2.8%	2.8%	29.1%
South Africa	USD	0.5%	3.3%	3.3%	37.6%
India	USD	3.5%	5.3%	5.3%	17.6%
Global emerging markets	USD	2.5%	6.2%	6.2%	31.0%
Bonds					
US Treasuries	USD	0.0%	0.1%	0.1%	-0.6%
US Treasuries (inflation protected)	USD	0.2%	0.8%	0.8%	4.7%
US Corporate (investment grade)	USD	0.1%	0.2%	0.2%	6.3%
US High Yield	USD	0.4%	1.5%	1.5%	21.6%
UK Gilts	GBP	-0.3%	-2.4%	-2.4%	5.0%
UK Corporate (investment grade)	GBP	-0.2%	-1.3%	-1.3%	8.8%
Euro Government Bonds	EUR	-0.6%	-2.0%	-2.0%	-0.2%
Euro Corporate (investment grade)	EUR	-0.1%	-0.6%	-0.6%	4.0%
Euro High Yield	EUR	0.1%	0.8%	0.8%	11.9%
Japanese Government	JPY	-0.2%	-0.7%	-0.7%	2.3%
Australian Government	AUD	0.1%	0.2%	0.2%	1.6%
Global Government Bonds	USD	0.0%	0.0%	0.0%	0.1%
Global Bonds	USD	0.1%	0.1%	0.1%	1.1%
Global Convertible Bonds	USD	0.6%	2.1%	2.1%	7.6%
Emerging Market Bonds	USD	0.3%	1.5%	1.5%	11.3%

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Asset Class/Region	Currency	Currency returns			
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Property					
US Property Securities	USD	-1.0%	-0.2%	-0.2%	12.1%
Australian Property Securities	AUD	1.5%	-3.8%	-3.8%	3.5%
Asia Property Securities	USD	1.1%	5.2%	5.2%	22.1%
Global Property Securities	USD	0.1%	0.8%	0.8%	13.8%
Currencies					
Euro	USD	-0.2%	1.5%	1.5%	-1.9%
UK Pound Sterling	USD	1.3%	1.5%	1.5%	-11.9%
Japanese Yen	USD	-0.5%	1.6%	1.6%	3.0%
Australian Dollar	USD	-0.1%	4.8%	4.8%	7.4%
South African Rand	USD	0.7%	1.4%	1.4%	21.8%
Swiss Franc	USD	0.2%	1.9%	1.9%	1.5%
Chinese Yuan	USD	-0.5%	0.7%	0.7%	-4.7%
Commodities & Alternatives					
Commodities	USD	-0.2%	1.1%	1.1%	21.5%
Agricultural Commodities	USD	-0.3%	3.8%	3.8%	7.5%
Oil	USD	0.1%	-2.3%	-2.3%	67.7%
Gold	USD	-1.8%	3.2%	3.2%	5.7%
Hedge funds	USD	0.6%	1.1%	1.1%	6.9%

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