Global Market Strategy - January 2017

US dollar to weaken gradually during first half 2017
Emerging Markets, Europe, Precious metals to rally

Every five years, life expectancy increases by one year. Every day, the global population grows by 200,000. Global birth rates have halved in the last 66 years but we are all living longer. By 2050, those aged over 60 will represent 21.1% of the population, according to the United Nations 2015 estimate. The average cost of a care home in the UK is £28,000 per annum; it is £36,000 for full-time in-house care.

Only 3% of the world's water is fresh water, and 75% of this is locked within glaciers.

Global investment is having to move toward the ideal of sustaining our planet and caring for a growing and aging population, as well as catering to the immediate necessities of everyday living. Once the decision is made by investors to draw on capital and savings, for retirement or to supplement earnings, what is a safe percentage withdrawal rate in order to preserve capital?

In 1994 William Bengen conducted research in the US which found that 'assuming a continual need for capital over a 30 year period', clearly encompassing various and varying economic circumstances, an income of 4% per annum of the capital value could be sustained without making inroads into capital.

In 2010 a gentleman called Wade Pfau published his own findings, under the title "The Demise of the 4 Percent Rule", based again on 30 years of needed access to capital but this time based on a heavy exposure throughout to the UK market of equities, bonds and property, and he found not only that a safe figure for withdrawal from capital was 3.43% per annum, but that by increasing the withdrawal figure to 5%, 55% of the fund would be exhausted at the 30 year mark.

Some investors would say that they could tolerate a 55% diminution of capital over a 30 year period, since after all, that's what the capital is there for - to be used. However, for many it is unnerving to see capital reducing continuously over time. For them, Morningstar's latest analysis published during 2016, again assuming a 30 year constant need for capital withdrawal from a heavily weighted UK exposed portfolio, and assuming a 1% pa portfolio fee, found that just 2.5% of the capital value is the safe annual 'income' figure in order to sustain capital throughout the ups and downs of the economic cycle, based on a 'balanced' risk investment portfolio.

The Swiss based research company EValueServe (https://www.evalueserve.com/company-overview/) conducted their own similar research in 2016, however they broke down the sustainable withdrawal rate according to the risk being adopted by the investor. They found more generously than Morningstar, that a speculative investor at the top end of the risk scale, adopting an allocation of 10% UK equities, 65% international equities, 15% specialist equity (commodities, hedge funds), 10% property, would sustain a withdrawal rate of 3.36% pa over 30 years, however, most interestingly, ***a cautious investor adopting an asset allocation of 45% government bonds, 15% corporate bonds, 35% UK equities and 5% international equities, would be able to sustain a withdrawal of 3.80% pa***. No other risk profile matches or exceeds that of the cautious risk investor in EValue's research.

Much depends on the precise underlying content of the asset allocation but EValue's findings provide food for thought about whether taking on more risk to try to enhance returns is ultimately worth it.

Typically, the worst performing and the second-worst performing indices or sectors in one calendar year are among the best the following year, and so it proved in 2015 and in 2016. It's a naive strategy for investment but it is interesting to reflect that 2015's worst performers were Brazil and Russia; in 2016 they were the best, rising 33% and 47% respectively. The three worst performing indices in 2016 were China's SE Composite, the Hang Seng and the Eurofirst 300, respectively falling 14%, 3% and 1%. On the basis that the US dollar has been impeding their advance, the three indices should do better in 2017. Unless we expect two or three hikes in interest rates by the Federal Reserve to quash a roaring US economy, the greenback's advance should be finished, and if it weakens, emerging markets should continue the turnaround they saw in 2016. Thailand and Argentina made good gains in 2016, up 18% and 32% respectively, but conversely India's market struggled, rising just 2.6% over the last 12 months, not helped by a steady rise in oil prices. Great things are expected of India's economy, as it seeks to clamp down on corruption, introduces ID cards and demonetises old style 500 and 1000 rupee banknotes in a bid to cut counterfeiting.

Like Trump, Prime Minister Modi was elected on a pro-business ticket but ironically GDP growth of 7.3% in 2015 impeded the stockmarket in 2016 for fear of monetary and fiscal tightening, and a strong dollar has not done the country any favours either. However, a median age of 30 for India's populace makes a compelling long term growth story.

China's picture is also a attractive one. It's demography and rising pursuit among the young of a healthier diet and better lifestyle make it a territory difficult to exclude from an investor's portfolio, however the country's huge debt and the unpredictability of its leaders in their measures to deal with it, and other economic (property bubble) and geopolitical (South China Seas territorial disputes) make it a hot potato. China A Shares are up 87% in local price terms over the last decade but Chinese shares traded in Hong Kong (largely by foreigners) are up only 11% over the same period.

Donald Trump's election victory caused gold to fall from $1369 to $1125 in five weeks, however the falls of underlying miners were far heavier. In the last week they have modestly recovered, however their recovery will quicken if the dollar weakens. The trade will not be easy, faced with the threat of the new President's supposed infrastructure inflation.

What of Europe and the euro? Many are predicting a turnaround story in European equities. Like the FTSE100, the Dax, Cac, Ibex and others, have been stuck in a rut. For 38 straight weeks between February and October, investors withdrew capital from Europe-exposed equities. The FTSE100 may have struck a new record high of 7143 in the last week, helped by banks' anticipation of higher interest rates (but these are unlikely in 2017), and better earnings for the listed commodity companies, but other European indices are way off their highs. Ideally, they need a weaker euro to asset them, and they may well get it in the year ahead, with the Dutch, French and Germans all going to the polls. Ironically, Spain is now the fastest growing economy in Europe but the Ibex is down 46% over the last decade; this compares to Italy, down 65% over the last 10 years, Portugal, down 70% and Greece, down 97%. Unable to loosen monetary policy, it's no wonder the respective economies have struggled during a period of world recession.

In contrast, US large caps and small caps have risen 97% and 98% respectively over the last decade, far outpacing the rest of the world (up 7.8% according to the Morgan Stanley Capital Index), Europe (up 6.3%), and Emerging Markets (up 19% - source: Financial Times). David Kelly, head of investment at JPM, recommends investors steer clear of highly priced US equities in the coming year, suggesting international equities, small and mid-cap shares and exposure to the infrastructure and technology sectors would be better areas on which to concentrate. Small caps are dangerous ground however, promising much but largely under-delivering. Neil Woodford's Patient Capital Investment Trust is a case in point.

Favoured investment plays:

Nil risk:	USD cash (in preference to Euro cash)
Cautious risk:	AAA Corporate
Balanced risk:	Managed / Multi-asset funds / Long-Short Absolute Return funds
Market risk:	UK**,** European equity
Adventurous risk:	**Japan, Asia, Germany,** US equity, UK/European/US smaller company sector
Speculative risk:	Water, Technology, **China, India, Other EM, Natural Resources**

Disclosure:

Nicholas Chappell has the following personal investment exposure: Technology (US) 17%, Global Equity 9%, US smaller cos 2%, (Other) US equity 10%, UK smaller cos 11%, Germany 4%, (Other) European equity 8%, Japan 13%, (Other) Asia 15%, Pharmaceuticals 7%, Natural Resources 1%, Cash 3%