Global Market Strategy – July 2017

Market booking profits at the end of the quarter

Under the headline, "The unique advantage off equities", fund manager **Terry Smith** penned an article in the financial press recently, explaining how equities can compound in value over time in a way investments in other asset classes, such as bonds and real estate, cannot.

"The reason is simple", he says, "companies retain a portion of the profits they generate to reinvest in the business".

On average, companies pay out about half their profits as dividends, with the remainder reinvested for further growth. If you own a bond, you receive an interest payment which is not, in the majority of cases, automatically reinvested in the bond. Similarly, if you own real estate, you receive rental income but little or none of it is reinvested in property.

So the profit reinvestment factor of equities sets them apart, and is a valuable source of compound growth. For example, the average company in the S&P500 last year earned a return of 13% on its equity capital employed last year. If it can retain half its earnings (with the other half paid out to its stock holders) and can continue to invest it at its current rate of return as its business grows, that half should also earn 13%. What makes it even more attractive is that on average the companies in the S&P500 trade on three times book value, so for every dollar of earnings they retain, they create $3 of market value, although of course this can change. (Note the difference: that dividends are reinvested by purchasing shares at market value - at three times book value on the S&P - whereas each $1 of retained earnings is reinvested at book value, so it is the reinvestment of retained earnings, not dividends, which provides the majority of growth in the value of equities.) What is appealing to many investors is if instead of simply owning an index and seeing the companies in that index reinvesting retained earnings at an average rate of return, they can find a way of investing only in companies which achieve a high return on capital and which as a result manage to translate each $1, £1 or €1 of retained earnings into a market value that is a much higher multiple of book value. This is, of course, what Terry Smith has consistently done for investors in his funds, and speaks to the value which a good active manager can bring to an investor, over passive tracking.

Equity markets have had a great run since the start of the year, so it's not surprising to see some booking of profits by fund managers at the end of the last quarter and at the halfway point for the year.

The S&P500 is up 15% over the last 6 months. Tech stocks have propelled it, with Facebook up 31%, Apple up 25% (most of which was in the first quarter), Alphabet up 18%, Amazon up 30% and Netflix up 21%, despite the sell-off in the sector during the past week. Apple is down 8%. It fell in April 2016 to $94, which was huge buying opportunity, and many analysts foresee it going to $200 from its current level of $145, within the next 6-12 months.

The current market unease, where bonds and equities have more or less equally sold off across the board, is being put down to a run of central bankers suggesting the bond buying program of the ECB in particular, but also of the Federal Reserve in the US, is more or less at an end. Profits were taken from the technology sector, and bond yields rose as prices fell in anticipation of a likely increased speed in the rate of interest rate rises, although the dollar weakened, largely because anticipation of a turn in the interest rate cycle in Europe, Canada and the UK was suddenly more front-of-mind than rate rises in the US. Despite a weaker dollar however (the dollar index is now lower at 95.73 than it was on the day of the US presidential election in November), gold is weaker, and currently stands at $1244 per troy ounce. Nevertheless, there is plenty of support for gold in these times of geopolitical and economic uncertainty.

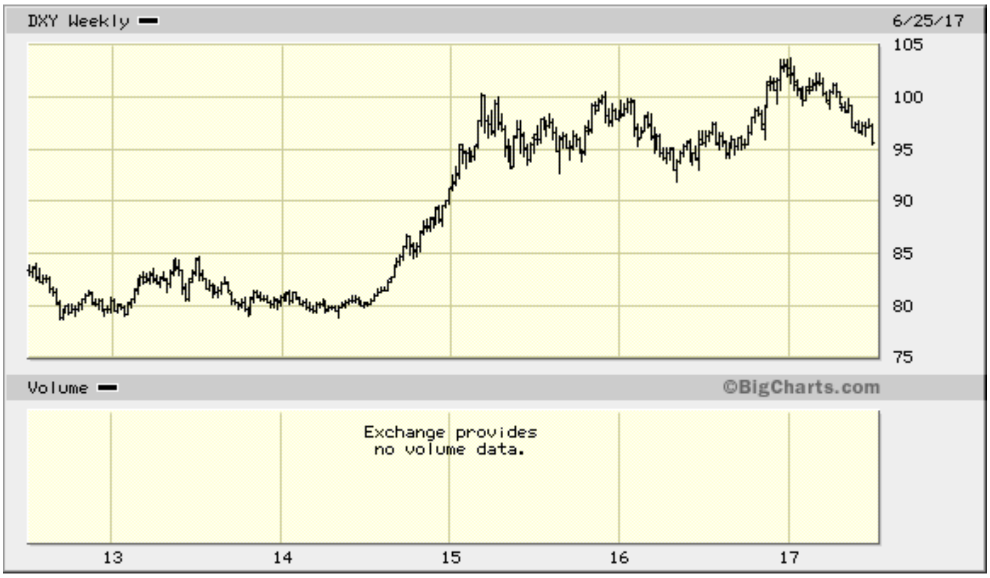
The current feel to the markets is similar to the momentary but uncomfortable 'taper tantrum' which took place in 2013 when equity values fell quickly due to an exaggerated fear of rate rises and less liquidity, and exacerbated by algorithmic trading. The reality of the current world economic position is that recent comments by the ECB, the BoE and the Bank of Canada are yet again nothing more than jawboning [successful] attempts to take exuberance out of the equity markets, and peg them back a little with the threat of rate rises and the withdrawal of bond-buying liquidity. The International Monetary Fund last month warned that global growth would likely fall from 2.3% to 2.1%. This could mean that the dollar index will fall to 90 by the end of the year (because fewer rate rises are likely). If it does, it will be no bad thing. Traditionally, equities have performed poorly when the dollar index has risen above 85, but we are not in a traditional market; the dollar index has risen above 100, and still equities perform well, but a weakening of dollar strength will be a huge relief to emerging markets, much of whose debt interest has to be repaid in dollars, and whose equity markets still offer investor value.

A weakening dollar has seen the pound return to $1.30. Many analysts expect the pound to come under continued pressure against the euro because of Brexit negotiation uncertainty. Sterling's position will not have been helped by Mario Draghi's hints last week that bond buying by the ECB will soon reduce or cease, amid an improving eurozone economy, but be sure that Draghi will not jeopardise what renewed optimism his actions to date have been successful in encouraging.

Despite sterling's rally against the dollar last week, Britain's political mess is causing some to fear parity for sterling against both the dollar and the euro at some point over the next two years. Teresa May's 'brilliance' in extracting defeat from a position of victory is one thing, but David Cameron's campaign 'skill' in promising a referendum on Europe as part of his 2015 electoral manifesto is leaves a very bitter aftertaste.

Notwithstanding the UK's political upheavals, investors have every reason to expect the second half of the year to produce further equity gains, especially in Europe and the US, not to mention Asia if the dollar continues its trajectory. Such inclination is supported by history. Without exception, in any year when the S&P500 has risen more than 6% in the first half of the year, it has gained in the second half. The Nasdaq index has had its best first half since 2009, and although its second half is unlikely to be as strong as the first, it should still appreciate, particularly as its masthead, Apple, is cheap in comparison to its peers on price earnings, has over $200bn in net cash, and provides a near 2% dividend. More generally, expect a greater rotation into financials. Financials have already experienced something of a turnaround this year, especially in Europe, due to healthier lending conditions since early 2016. According to perma-bull, Ken Fisher, eurozone banks leant more eagerly during the 2002-07 equity bull market, and eurozone stocks outperformed US counterparts by 182% to 61% during the period. "Eurozone leadership [following recent elections] is only just starting", says Fisher. "Europe's credit cycle is young. Banks have ample room to expand balance sheets and improve non-performing loan ratios. Spanish and Italian banks [are] hated for no good reason".

Ken Fisher is not the only bull. Last week BlackRock published their outlook for the second half of the year under the headline "Momentum's rally has legs", though they slotted in a caveat: "Sustained above-trend economic growth and solid earnings prospects could help extend the gains, but it may be a bumpy ride". BlackRock point to an oversupply in the oil market and a consequent low oil price, as helping economic performance across the globe.



Dollar index chart, 5 years (Source, bigcharts.marketwatch.com)

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) 15%, Global Equity 18%, US smaller cos 2%, (Other) US equity 8%, UK equity 5%, Germany 5%, (Other) European equity 9%, India 5%, (Other) Asia 18%, Pharmaceuticals 9%, Energy 1%, Precious metals 5%

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