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Global Market Strategy – June 2017

"Anybody who prefers bonds to stocks is making a big mistake" - Warren Buffett, May 2017

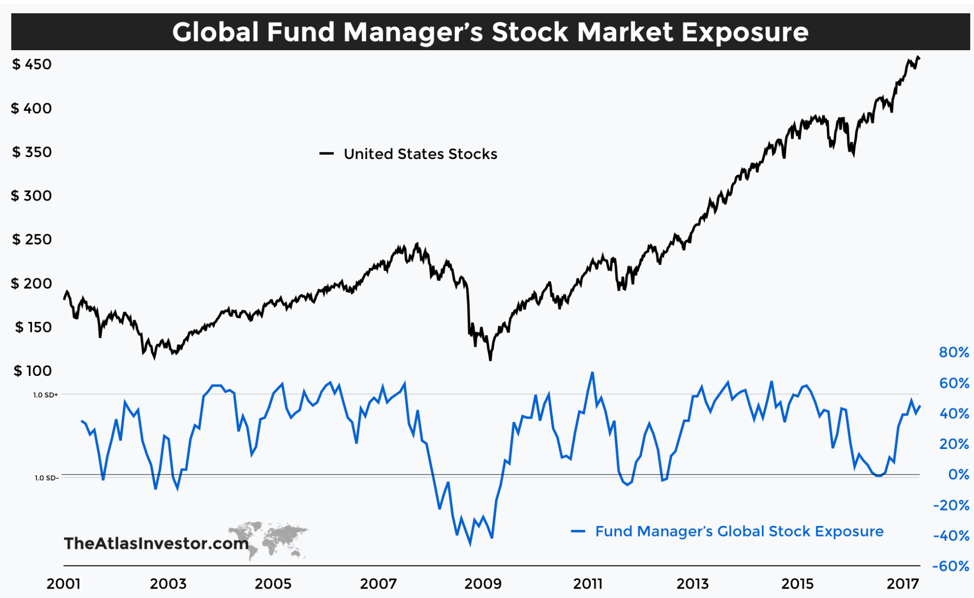
"If interest rates are destined to stay low for a prolonged period, not necessarily this low but low compared to their 50 year average, it makes any stream of earnings [from corporates] worth more money. It's a huge bargain to buy stocks now, if you think rates stay low for 10 or 15 years", said Warren Buffett on CNBC last month.

Former chair of the Federal Reserve Bank, Ben Bernanke, was also on CNBC recently, prior to Buffett, and he said he expected rates to remain at around the 3% mark for "a considerable period".

"The [US] economy is doing well now", said Buffett, "…low rates mean more [M&A] deal competition". Buffett continued: "I will pay more for businesses once I become used to [what appear, currently, to be expensive stocks]… Anybody who prefers bonds today to stocks is making a big mistake… Stocks can bounce around a lot more and they can go down 50%, but a 30 year bond can go down too 50% at these rates. Bonds are a terrible choice against stocks and it's dictated by mathematics."

You can't get plainer than that. Bonds will provide some measure of comfort and balance when stocks do face a tremor, either from a trade war, military conflict or some other left field event, but a heavy bond weighting for a portfolio will impact it adversely - which goes back to the dilemma discussed recently in this bulletin facing pension fund trustees.

European, Asian (including Japan) and EM stocks still represent most value, however investors are understandably cautious about committing cash to equities after the run of the last 18 months, especially if they look at the degree of exposure to equities of some fund managers. Is it excessive and complacent, or is it common-sensical given the economic outlook? The chart below, courtesy of Tiho Brkan (www.theatlasinvestor.com), is telling, but the fall off in exposure to equities during 2015/16 is the major surprise, and it shows not only how sentiment dived post-Brexit, but also how strongly it recovered with Trump's election victory, renewed hope of sustained global growth, and less of a threat of a series of interest rate hikes in the US this year. It can be seen that the bullish trend in fund managers' global stock exposure has retreated of late, amid concerns over Trump being impeached, Trump's plans for tax reforms being delayed, and the outcome of the UK and, particularly, the later Italian elections.



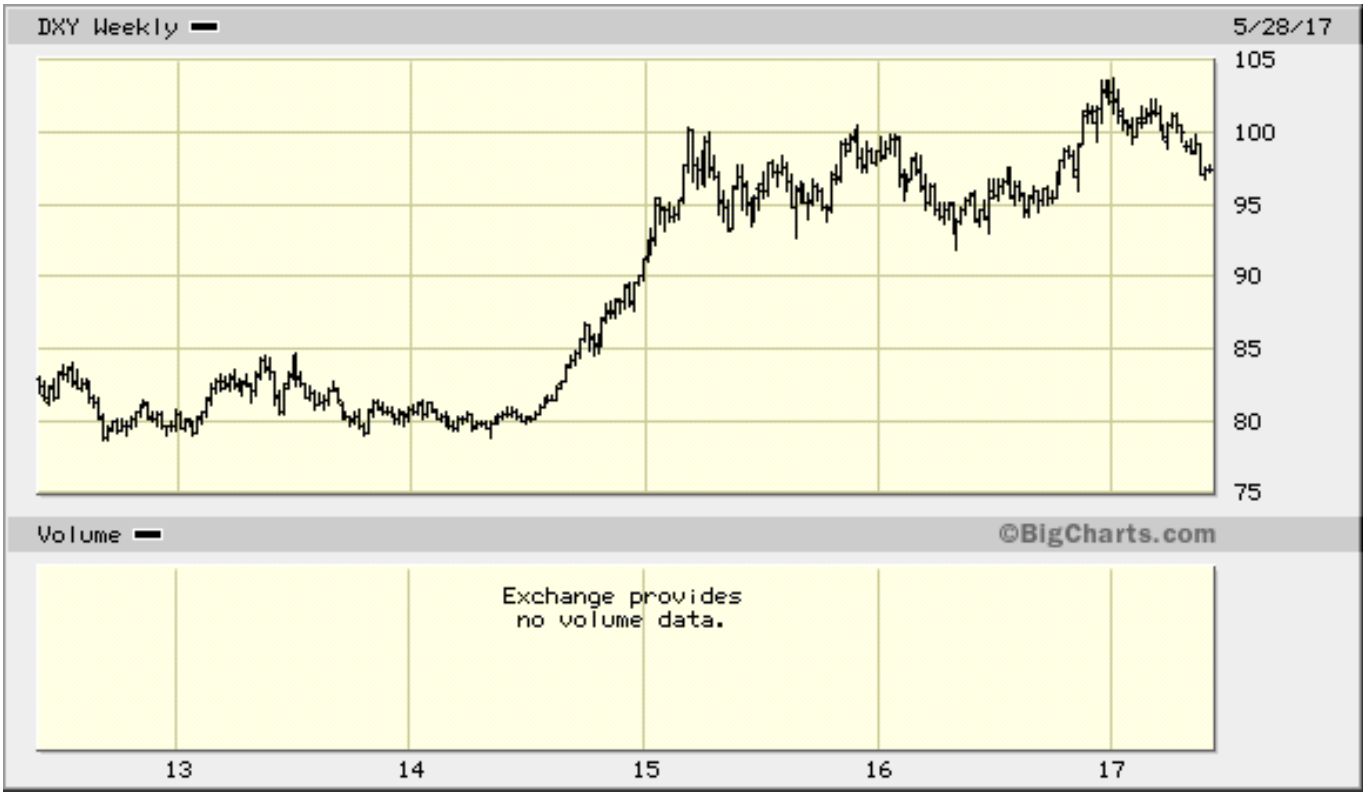
The interesting thing is that US data for the first quarter 2017, shows growth to have been slow. This could be seasonal, as the data replicated recent previous first quarters in the US, which could be down to the fact that China almost shuts down for a two week period for the Chinese New Year. Signs for the second quarter are already more optimistic but the bond market is suspicious, with yields again retreating as buyers return (yields falling as prices rise). The bond market's positioning ironically builds a case for equities, since, if correct, if weak growth continues to be a feature, there will be no need for a further rate hike by the Fed, no need for bond buying to cease in Europe, and a greater likelihood of investors buying yield through the equity markets.

Earnings in the US have been strong for the second quarter, up 14% when the expectation was for a 10% rise. Corporate earnings elsewhere in the world have been decent also, so on the basis that investors buy stocks for profits growth as well as yield, equities and corporate bonds look to have strong underlying valuation support at current levels and may even be underpriced. Leon Cooperman, formerly of Goldman Sachs and now head of Omega Advisors in the US (who have a large exposure to Facebook, Amazon, Apple, Netflix, Nvidia and Google/Alphabet, the so-called 'FAANNG' stocks), feels it is unlikely the equity bull market will end anytime soon. "Rates are low, energy prices are low and wage inflation is low", he says.

Andrew Milligan of Standard Life Investments, sees the only hiccup to equity valuations as being an overly aggressive Federal Reserve. However, the only things that could prompt the Fed to act quickly with interest rate rises, would be a sharp uptick in core inflation (goods and services) and in wage inflation, but there is nothing to suggest these are about to escalate dramatically, and the Fed is unlikely to want to be seen to act too soon and snuff out the gentle shoots of economic growth which are emerging.

In any case, the dollar could be about to do the Fed's job for it, if the technical charts are anything to go by.

The super-strong dollar has not been so super-strong of late, helping to ease the path for equity investors since the start of 2017. The dollar is traditionally seen as a headwind for US companies who are dependent on much of their income from overseas, once the dollar index exceeds 80, but this rule of thumb was despatched with aplomb by first, quantitative easing, and second, the threat of QE being wound down or removed, and hence a gradual raising of interest rates toward 'normalisation'.



Dollar Index (DXY), 5 years (Source: BIgCharts.com)

As can be seen from the chart, dollar strength has weakened from 103.82 at the turn of the year to its current level of 97. The pound touched $1.30 very briefly before an election poll showing a rebound in Labour's fortunes put paid to that, and the pound now sits at around the $1.28 mark - and that could be the end of any momentary sterling strength and dollar weakness, according to the 'Fibonacci Queen', technician Carolyn Boroden (www.fibonacciqueen.com). Ms Boroden has seen trends in line with famed Leonardo Fibonacci ratio symmetries which can be seen over and over in both nature and in stockmarket charts, and these suggest the dollar could be about to resume its longer term rally. She interprets the data as determining the dollar has already seen the low in its recent downtrend, and the index could now move to 105, which would be a significant move for a currency, and would precipitate a slew of earnings estimate cuts among many US companies. Providing the dollar index does not fall below its level of 93 12 months ago, the analysis predicts any further weakness in the US dollar is over for many months. This would hurt the advance not only of US equity prices, but also and especially EM and commodity stocks. Japanese equities on the other hand should prosper.

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) 20%, 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%

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