Market review

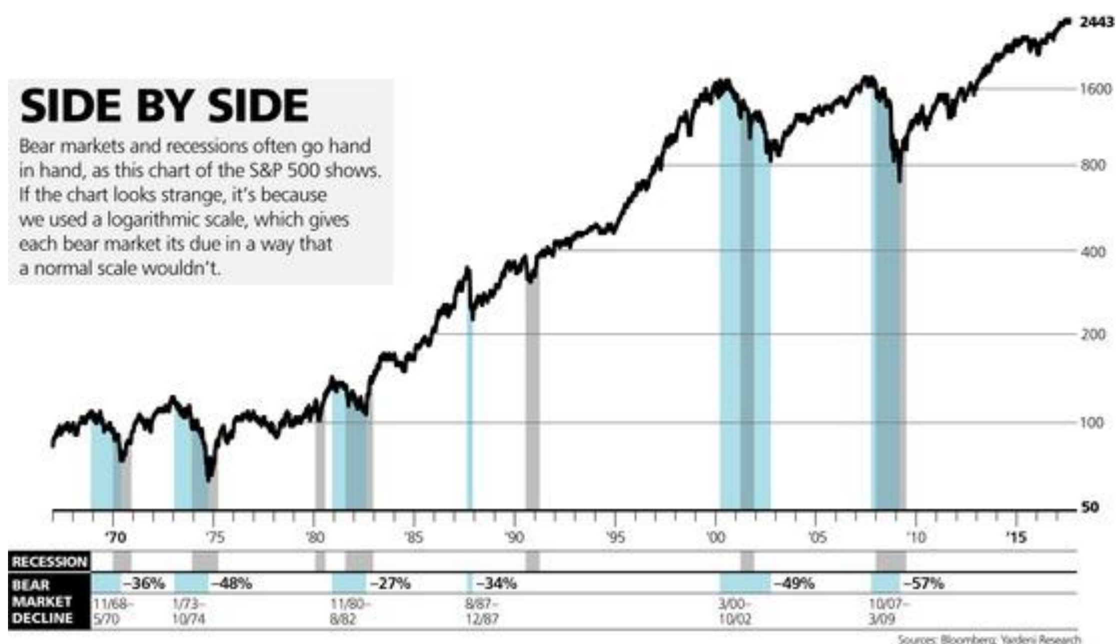
In our last market review we discussed - within the context of the current global bull market – equity market valuations in certain global market sectors. We concluded that selective investment in sectors currently representing reasonable value, as opposed to passively buying the entire market, may work as an investment thesis going forward.

As we begin the New Year, our thought process in respect of this selective approach is driven primarily by those factors (if any) which could potentially shape the outcome of the current global equity bull market.

Economic Slowdown aka "Recession"

A primary catalyst which could bring the current bull market to a halt is a global economic slowdown.

Bear markets are generally (but not always) accompanied by economic slowdowns; the financial crisis of 2008, the technology bust in 2000 and the bear market of 1973-74 were all accompanied by economic slowdowns. The key to today's market therefore is the underlying health of the global economy.



In simplistic terms, economic recessions are caused by a loss of business and/or consumer confidence. As confidence recedes, so does demand. This is the tipping point in the business cycle, that is the cycle of economic expansion and contraction. It's where the peak market level occurs, often accompanied by irrational exuberance (unsustainable investor enthusiasm that drives asset price up to levels that aren't supported by fundamental valuations), and the market moves into contraction. This loss of confidence makes businesses and/or consumers stop buying or intending to buy, and move into a defensive mode.

Once a critical mass of investors begins to sell assets and this theme becomes evident, panic sets in and creates a destructive downward spiral. In short order mass layoffs and rising unemployment become evident, which in turn lead to a slowdown in retail sales. Manufacturers cut back in reaction to falling orders, further increasing layoffs, and so the downward cycle becomes entrenched.

To restore confidence, both the government and central bank usually step in with conventional policy measures such as interest rate cuts, or non-conventional measures such as Quantitative Easing.

In short, a recession is defined when businesses cease to expand, Gross Domestic Product (GDP) diminishes for two consecutive quarters, the rate of unemployment rises, and house prices decline. Many factors can contribute to an economy's fall into recession, but the major cause is usually inflation.

Where are we now?

The adage goes that when the United States (which along with China is a major driver of global economic expansion) sneezes, the world catches a cold.

In the US the National Bureau of Economic Research (NBER) is the official organisation tasked with declaring recessions. The NBER uses the following variables to evaluate the potential for a recession:

Nonfarm Payroll Employment: (i.e., any job excluding farm work, unincorporated self-employment, employment by private households, the military, intelligence agencies and the self-employed)

This figure is released monthly by the US Department of Labour as part of a comprehensive report on the state of the US labour market. Increases in employment signal that businesses are hiring, implying that they are growing and that newly employed people have money to spend on goods and services, which in turn fuels economic growth. The opposite of this is true for decreases in employment.

The headline figure, that is the change in the total number of nonfarm payrolls compared to the previous month, is used as a primary gauge of economic health.

In November 2017, the latest available period, nonfarm payrolls rose by a seasonally adjusted 228,000 to 147.2 million. The change marks the 86th straight month of job growth;

The Industrial Production Index (IPI): This is an economic indicator published by the Federal Reserve Board of the United States that measures the real terms production output of manufacturing, mining, and electric and gas utilities. It is compiled monthly to bring to attention any short-term changes in industrial production.

It measures movements in production output and highlights structural developments in the economy. Growth in this Index from month to month serves as an indicator of industrial growth overall.

In November 2017, total US industrial production was 106.4 percent of its 2012 average and was 3.4 percent above its year level in November 2016;

Real Personal Income, excluding transfer payments: This is an indicator of consumer or household income less Social Security, Medicare & Medicaid, Unemployment Assistance, and other benefit payments adjusted for inflation.

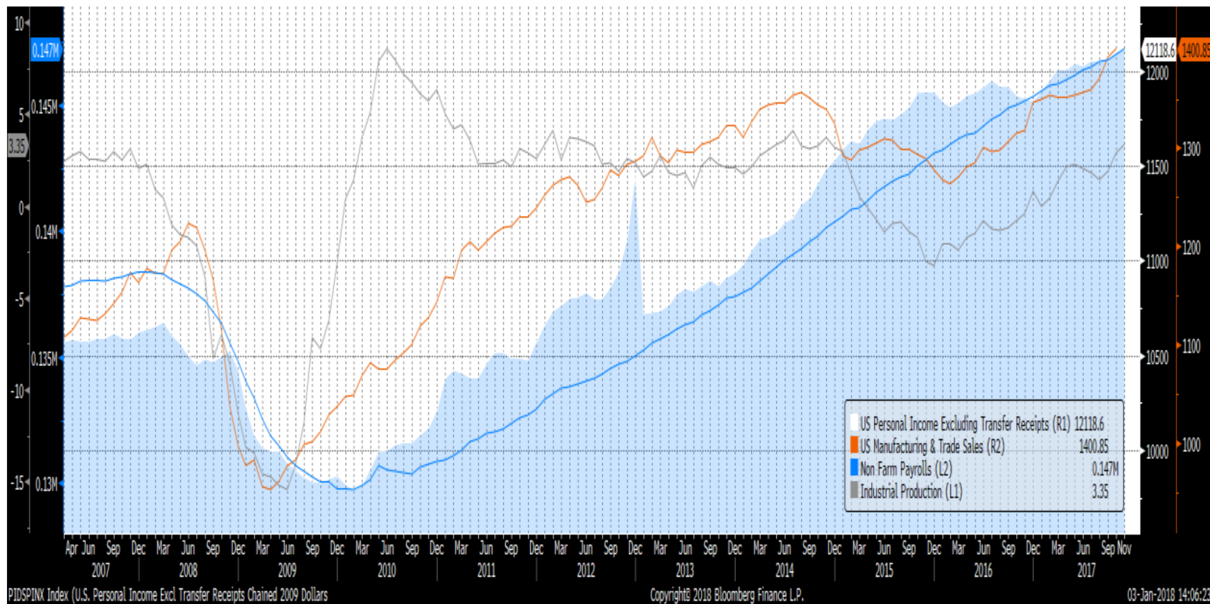
This metric is compiled and released by the Bureau of Economic Analysis and currently indicates that trend growth in household real organic income seems to be have been constant over the past eight or so years, which has been roughly the period of recovery following the Great Financial Crisis;

Real Manufacturing and Trade Sales data: This metric tracks sales in the US wholesale and retail trade sectors plus manufacturers' shipments of goods to third parties: this measure also shows constant growth.

The following chart illustrates the four economic measures mentioned above.

What can be seen and as previously noted, is that US employment continues to rise and that in the period from January 2016 onwards industrial production and US manufacturing and trade sales have also continued to expand. Furthermore, from December 2013 both household and consumer income levels have grown consistently.

The Big Four Economic Indicators 2007 to the Present



Source: Bloomberg

What this shows is that monetary reflation measures in the form of prolonged Quantitative Easing stimulus provided by the US Federal Reserve, have successfully lead to profits growth which has then encouraged additional corporate spending and payroll expansion. Judging by the increases in these four economic indicators, the present moment does not indicate any likelihood of a recession in the US over the next 12 months, indeed we expect above-trend global economic growth to continue in 2018.

<u>What about Inflation?</u>

As mentioned above, in a perfect economic cycle strong liquidity growth driven by a downward trend in interest rates, and the existence of QE, leads to a strong upturn in profits which then drives increased corporate investment and job growth, all of which then start to eliminate slack in the wider economy and/or create supply shortages.

The consequent emergence of pricing power in the corporate sector usually flags the arrival of the inflation cycle, which is the cue for policy interest rates to start rising.

The investment team at MPL believe that this is where we are now, and whilst we feel that there will be low and gently rising inflation this year, the positive and negative implications of this situation will drive our selective asset allocation approach going forward.

<u>Investment Implication</u>

As mentioned above, we expect above-trend global growth in 2018 and as such we will maintain exposure to equity and credit markets, this focused on deep cyclical (economically sensitive) companies such as basic resources, materials, energy and commodities companies, which should all continue to benefit in this environment. Indeed, the FTSE-100 Index has a reasonable exposure to these areas, while interest rate sensitive companies in the financial sector should also continue to benefit as policy interest rates rise.

Whilst the IT sector appears to be expensive by some measures, earnings continue to grow in this area hence exposure will be maintained here - albeit with a very close eye as any company whose earnings miss expectations could be punished.

We remain negative on sovereign fixed interest owing to the prospect of interest rate rises going forward, although ultra-short-term treasury bills will be utilised in the event of any need to raise liquidity.

In this environment commercial property yields could be impacted if there are any increases in interest rates; however as property is a real asset, any increase in inflation could counter any capital loss resulting from an increase in interest rates.

With kind regards

*figures courtesy of Bloomberg & MPL

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