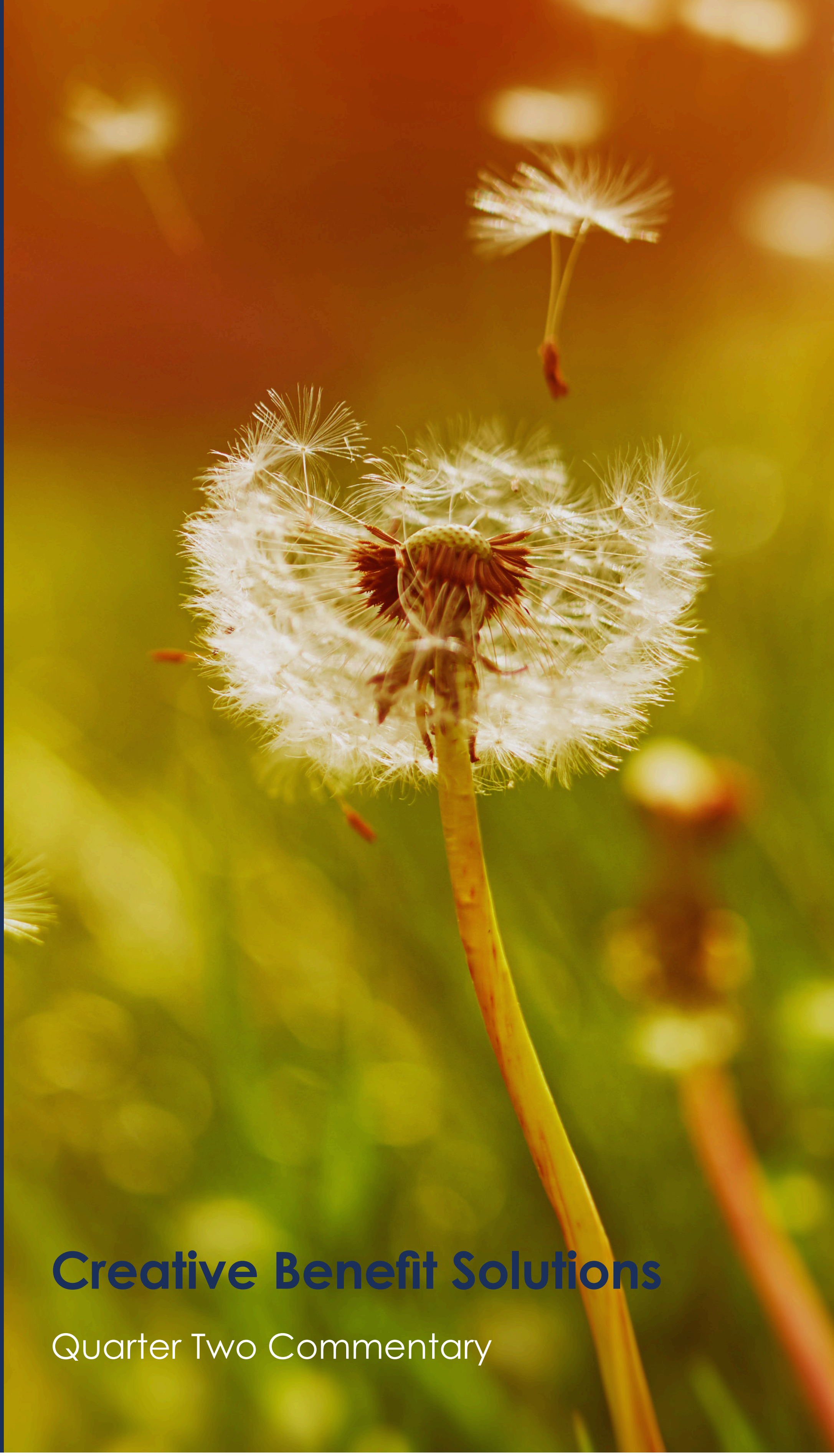
Investments



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Quarter Two Commentary

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INTRODUCTION

We left you at the end of March with President Trump two months into his term of office and France awaiting Presidential elections. In the UK, Theresa May was in power with a slim, but workable, majority and had just triggered Article 50, giving notice of the UK's intention to leave the EU. World stock markets had generally made a promising start to the year.

The second quarter of the year has been rather more dramatic. President Trump has been flexing his muscles whilst managing to fall out with more or less everyone in Washington. Emmanuel Macron – 12 months ago a virtual unknown – has swept to power in France; the UK has had a chaotic General Election and has begun the Brexit negotiations with the Government in a parlous position. The President of Brazil has been accused of corruption and companies and organisations across the globe have suffered two significant ransomware attacks. World stock markets have mainly done well in the quarter. South Korea has been the best performing market of the ones we cover in this Report: the wooden spoon is en route to Russia.

So plenty to report on: let's make a start...

UNITED KINGDOM

How Mrs May must sigh and think, 'Why didn't I just decide I needed a new pair of boots instead?' At Easter, she went on a walking holiday with her husband. She came back and called a General Election for 8th June, seeking her own mandate and a five year term in office with a very healthy majority. But – after what most political commentators are calling the most inept campaign in British electoral history – she only succeeded in losing the majority she had. The Conservatives won 318 seats, while Labour – under a resurgent Jeremy Corbyn – won 262. The Conservatives were eventually forced to agree a 'confidence and supply' deal with the 10 Democratic Unionist MPs, who had shuffled uneasily into the limelight.

At the time of writing,Theresa May remains Prime Minister but her personal popularity is plummeting and – presumably with the exception of her husband – she appears friendless. However, there seems no great rush to replace her and our view is that she is still likely to be Prime Minister by the time of the Conservative Party Conference.

Away from the madness of politics, what else has happened in the UK? The Office for National Statistics (ONS) released figures for the first quarter of the year, confirming that UK growth was just 0.2% for the January to March period. This put the country next to Italy as the slowest-growing in the league table of the world's advanced economies. The ONS also confirmed that inflation for May had risen to 2.9% and – with a figure in excess of 3% forecast for later in the year – most people are now suffering a fall in real wages. Not surprisingly, the ONS also confirmed that the UK savings ratio – the proportion of disposable income which households save – was at a record low, falling to 1.7% in Q1, down from 3.3% in the previous quarter.

It would therefore be easy to conclude that voting to leave the EU was a mistake and that continuing uncertainty – over both the political situation and the Brexit negotiations – will act as an ongoing brake on the UK economy. Except that there is also some very good news on the economy: a recent CBI survey showed manufacturers' order books at a 29 year high, with food, drink, tobacco and chemicals leading the way. The same survey showed export orders at a 22 year high: CBI Chief Economist Rain Newton-Smith said, "Britain's manufacturers are continuing to see demand for 'Made in Britain' goods rising. Total and export order books are at highs not seen for decades, and output growth remains robust."

This was reinforced when the World Bank upgraded their forecasts for UK growth over the next three years, increasing their estimate for 2017 to 1.7% from the 1.2% they had forecast in January. Growth expectations for 2018 and 2019 are 1.3% and 1.5% respectively.

These are figures for the whole of the UK, however, and they mask some significant regional variations. Clearly, London and the South East continue to flourish: one area which has emphatically not flourished is Scotland. The EY Scottish Item Club has predicted 'below-par' growth of just 0.9% in 2017 – roughly half that of the UK as a whole. In particular, it sees the Scottish retail sector being hit hard as pressure on consumer spending grows. It also expects employment in Scotland to fall – down 0.1% this year followed by decreases of 0.5% and 0.3% in 2018 and 2019 respectively. As The Scotsman gloomily pointed out, Scotland has missed out on the UK jobs boom, with wages and the employment rate still lower than they were before the financial crash ten years ago.

UNITED KINGDOM

Continued

What did the FT-SE100 index of leading shares make of it all? Having closed March at 7,323 and then briefly risen above 7,500 in the quarter, the index closed June at 7,313 down just ten points. For the year as a whole, the stock market is up by 2.38%. The pound rose 4% against the dollar during the second quarter, ending June at $1.3026.

BREXIT

As many of you will know, Theresa May formally triggered Article 50 of the Lisbon Treaty on 29th March, meaning that the UK is on course to leave the European Union on 29th March 2019. In future editions of this Report we will, therefore, introduce a specific 'Brexit' section, bringing you up to date on the progress of the negotiations. So far, those negotiations have been little more than early skirmishes: little of substance is likely to happen until after the summer holidays and the elections in Germany, due in September. We have therefore used the first of the 'inserts' in the Report to introduce you to the two main protagonists. You are going to hear rather a lot of these gentlemen over the next 21 months…

BREXIT: THE NEGOTIATORS

Negotiations with the European Union began 11 days after the General Election, on Monday 19th June. Leading the negotiations for the UK is David Davis, the Secretary of State for Exiting the European Union. Davis is an interesting man: he is far from your typical Conservative, having been born to a single mother and then – when she re-married – he was brought up in a 'slum' in Wandsworth and then on a council estate in Tooting. Having worked in the sugar industry and been a member of the Territorial Army, Davis entered parliament as the MP for Boothferry at the age of 38. When he was defeated for the leadership in 2005 by David Cameron, he must have thought his career was over – but Theresa May brought him back to lead the Brexit negotiations in her Cabinet changes of July last year.

His principal 'opponent' will be Frenchman Michel Barnier, whose main claim to fame – until now – was being instrumental in France staging the 1992 Winter Olympics. In theory, Barnier is a top EU official but – as Politico points out – he is at heart a politician, having been elected as a centre-right pro-Europe MP in the 1970s. He has a reputation as a tough negotiator who knows what he wants – and what he wants is to preserve the unity of the EU27, not what is fair, amicable or reasonable for the UK. Barnier is 66, two years younger than David Davis.

BITCOIN EXPLAINED

Last week, another ransomware attack hit companies and organisations worldwide. To recover all your files safely and easily, said the ransom demand, submit the payment and purchase the decryption key. Send $300 worth of Bitcoin to the following address…

Bitcoin – the virtual currency - is becoming increasingly well known. But what is it? Will it ever take over from real currencies? And with its price rising so much, is it a shrewd investment?

UNITED KINGDOM

Continued

WHAT IS IT?

Bitcoin is a digital currency – sometimes called a cryptocurrency – which is created and held electronically. It became the first decentralised digital currency in 2009, thanks to an unknown software developer (or, more probably, a group of developers) under the name Satoshi Nakamoto.

The system is peer-to-peer, so that transactions take place without an intermediary. Bitcoin can be exchanged for currencies, products and services in both legal and black markets. If you ever go shopping on the so-called 'dark web', you're going to need your bitcoin wallet.

As far back as 2015, it was estimated that at least 100,000 merchants worldwide accepted Bitcoin, and an article on Bitcoin.com suggests that 260,000 stores in Japan will accept Bitcoin by the summer of 2017. Research by Cambridge University indicates that there are up to 6 million unique users of a cryptocurrency wallet, most of them using Bitcoin. Don't be surprised to see Bitcoin debit cards and Bitcoin ATMs become increasingly common in the future.

WILL BITCOIN EVER TAKE OVER FROM REAL CURRENCIES?

It is more likely that Bitcoin will run alongside 'traditional' currencies. Cash remains an integral part of many people's lives, but as Bitcoin becomes more widely accepted – and people become more knowledgeable about it – so we are likely to find prices quoted in both traditional and cyber currencies. Experts suggest that we are around five years away from Bitcoin being mainstream enough to be used alongside physical, 'traditional' currencies.

IS IT A WISE INVESTMENT?

First and foremost, you should never read this Quarterly Report as investment advice. Right now, Bitcoin is an extremely volatile currency. The current value of a Bitcoin is around £1,965 but as a senior analyst at eToro – the 'social trading investment network' – said, "Bitcoin could easily crash to $100 (£78) a coin or surge to $10,000 (£7,800) a coin or go anywhere in between."

EUROPE

When we wrote our last Report at the end of March, the French Presidential election was shaping up to be a straight fight between Emmanuel Macron, leader of the new, Centrist En Marche party and Marine le Pen of the Front National. So it proved, with Macron easily beating le Pen and then seeing his new political party gain a very comfortable majority in June's parliamentary elections. In both elections, though, there was a low turnout and – especially in the Presidential election – a large number of spoiled ballot papers. Macron may have won, but there remains deep dissatisfaction with politicians in France.

Macron's win was, of course, greeted with sighs of relief around Europe and stock markets duly moved up but – as always – the effect was relatively short-lived. Nevertheless, the economic indicators look much more promising for Europe, with the European Central Bank recently lifting its growth forecasts for the Eurozone. It has increased its forecast for 2017 to 1.9% from the 1.8% it forecast in March. Growth is expected to be 1.8% next year and then 1.7% in 2019. ECB President Mario Draghi also forecast that Eurozone inflation will be 1.5% in 2017, down from an earlier forecast of 1.7%.

As ever, the driver of the European economy continues to be Germany, with the country remorselessly producing a trade surplus every month: the latest figures for April confirmed a surplus of €18bn. Even more significantly, employment in Germany is now at its highest level since reunification: an extra 650,000 people were employed in May, taking the total in work to 44.1m.

But not everything in the European garden is rosy. Greece continues to stagger from bailout crisis to bailout crisis. The latest agreement from the EU will see €8.5bn handed over, largely to avert a debt crisis in July when a repayment of €7bn becomes due. For those of you that struggle to keep up with the Greek economic miracle, it is now part of the way through its third Eurozone bailout programme, with this one worth up to €86bn.

Many pundits have long taken the view that if the EU is to fall apart it will be the Italian banks that are ultimately the catalyst. Maybe that day has moved a step closer, as the Italian government has just been forced to rescue two banks in the Venice region, after the ECB warned that Banca Popolare di Vicenza and Veneto Banca were likely to fail. The bill was €5.2bn – not significant by bailout-a-bank standards, but perhaps a straw in the wind.

It wasn't wind so much as tumbleweed that blew around the two major European stock markets in the quarter, with both the French and German indices virtually unchanged. The German DAX index ended March at 12,313 and was just 12 points higher at the end of June: the French index was even more somnolent, declining by all of two points over the three months, to close the quarter at 5,121.

UNITED STATES

Donald Trump had campaigned on drastic tax reform to stimulate the US economy, simplifying the tax system for individuals and slashing US corporation tax from its current level of 35% to just 15%. In April, Treasury Secretary Steve Mnuchin appeared to pave the way for this reduction, calling it "the biggest tax cut ever."

Whatever the promises, the quarter did not get off to the best start as figures for March showed the US economy added only 98,000 jobs in March – far fewer than economists expected and only half the number for January and February. Despite this, though, the unemployment rate fell to 4.5%, the lowest since May 2007. Perhaps the low number of jobs created was a function of the US economy growing by only 0.7% in the first quarter of the year – the slowest rate of growth since the first quarter of 2014 and leaving the President some way to go to meet his election pledge of raising growth to 4%.

Clearly determined to do his bit to achieve the growth target, the month of May found the President in Saudi Arabia signing trade deals which were worth an initial $110bn and may ultimately rise to $350bn. He also signalled the start of renegotiations of NAFTA – the North American Free Trade Association. As widely expected, President Trump has also pulled the US out of the Paris climate deal. Many US firms (Facebook, Goldman Sachs, Disney) reacted with horror to this latest demonstration of America First, but the coal industry welcomed the move, saying it would protect jobs and ease regulation.

US jobs figures continued to disappoint: in May, payrolls increased by 138,000 against the anticipated 180,000 – but this still resulted in unemployment falling further to 4.3%.

This perhaps prompted the Federal Reserve to raise interest rates for the second time this year, increasing them by 0.25% to a target range of 1% to 1.25%, the highest level since 2008. Chairman Janet Yellen said, "Our decision reflects the progress the economy has made and is expected to make."

The IMF remained unimpressed and – citing 'uncertainty about White House policies' – trimmed its forecast for US growth to 2.1% for both 2017 and 2018, down from 2.3% and 2.5% respectively and well below the figure the White House is targeting.

In company news, Facebook continued to advance as it reported profits of just over $3bn in the first quarter – up 76% year-on-year – and passed 2 billion users worldwide.

There was, however, gloom for the US retail sector – or at least that part of it which trades from bricks and mortar stores. US retail sales were up 4.5% compared to a year ago, but all the growth was online with the US Commerce Department reporting an 11% year-on-year increase. In contrast, 'traditional' retailer JC Penney reported a 3.5% fall for the first quarter, with Macy's and Nordstrom also reporting declining sales.

All this resulted in a solid performance on Wall Street, with the Dow Jones index advancing 3% in the second quarter to close June at 21,350.

FAR EAST

The second quarter got off to a promising start in China, with figures for Q1 showing that growth had beaten expectations. Growth was 6.9% according to official figures, compared to a target of 6.5% for the year as a whole. State-led infrastructure investment, demand for new property and an increase in consumer spending were all responsible for the higher growth rate, with retail sales in February up 10.9% on the same period in 2016. News in May was less good, as it was confirmed that output had slowed in the country's factories and mines.

Perhaps of more long term significance was the launch of China's 'belt and road' trade plan – an investment of $124bn in an ambitious economic plan to rebuild ports, roads and rail networks. The plan – which aims to expand links between Asia, Africa and Europe – was first unveiled in 2013 and has been described as a new Silk Road.

We have though, written previously about China's potential debt problems and credit ratings agency Moody's – worried by the 'debt mountain' and the amount of corporate debt – cut China's credit rating for the first time since 1989. For the technically minded, it was cut by one point from A1 to Aa3.

Elections were held in South Korea, which saw Moon Jae-in become the new president, but sadly it was someone not bothered by trivialities like elections that captured the headlines. North Korea launched a successful missile test in May, to the widely photographed delight of Kim Jong-un. This put immediate pressure on President Moon, who had campaigned for better relations with the North.

Finally, there was more bad news for troubled Japanese conglomerate, Toshiba. Its woes continued as it admitted that losses for 2016 may be even greater than previously forecast – perhaps up to £7bn from a previous estimate of £6.5bn.

On the Far Eastern stock markets, South Korea led the way, with an impressive 11% rise in the quarter to 2,392. The Hong Kong market was up 7% to 25,765 and Japan up 6% to break through the 20,000 barrier and close June at 20,033. The only market to decline was China, down just 1% at 3,192.

EMERGING MARKETS

Just when it was all going so well for Brazil... New President Michel Temer had come to power on the impeachment of previous incumbent Dilma Rousseff, promising to wipe out corruption and modernise the country. The stock market responded with a gain of 39% last year and the first quarter of 2017 finally saw Brazil emerge from the longest recession in its history. Helped by a record harvest of soya beans, the Brazilian economy grew by 1% in the first quarter and everything appeared on course...

Then, the increasingly bitter war between the judiciary and the politicians saw President Temer formally accused of corruption – specifically, that he accepted a $150,000 bribe. The case will now go to the lower Chamber of Deputies, who must decide if the case has any merit.

This inevitably acted as a drag on the Brazilian stock market, which fell 3% in the quarter to 62,900. The other two major emerging markets which we cover – India and Russia – saw very different stock market performances for the quarter, with the Russian market continuing to fall and the Indian market going in exactly the opposite direction. The Russian stock market fell by 6% in the quarter to 1,879 and is now down by nearly 16% this year. The Indian market rose 4% to 30,922 and is now up by just over 16% for the year as a whole.

CONCLUSION

By any standards, it has been a turbulent three months. It is tempting to think that the period from July to September will be more peaceful with Europe, at least, on holiday for a large part of it. However, as we write, North Korea is reporting another successful missile test, this time of a long range intercontinental missile, one apparently capable of reaching the USA. Then, there is the continuing political uncertainty at home, the Brexit negotiations and the German elections in September.

Whatever happens, rest assured that we will be here to interpret it for you and advise you accordingly. Don't ever hesitate to contact us: we are never more than a phone call or email away. Enjoy your summer, and we will be back to you in the first week of October.

Craig Harrison FPFS IMC
Chair of the Investment Committee