Investments

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Quarter Four Commentary

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INTRODUCTION

Welcome to our December Quarterly Report, with all the facts and figures complete to the end of December 2017.

On the world's stock markets the last three months of the year were good ones: only one of the markets on which we report fell, and that only marginally. Two markets – the US and Japan – enjoyed double digit growth in the last quarter of the year, the former despite being battered by Hurricanes Harvey, Irma and Jose. However, good as their performance was, it wasn't enough to secure our 'stock market of the year' title.

Let's look at all the various regions and countries in more detail.

UNITED KINGDOM

As I make the notes for this report throughout the quarter the UK always generates more 'saves' than any other section – so come the end of the quarter it is very much a case of sorting what's really important from news items which only seemed important at the time.

One of my earliest notes was the news that Monarch Airlines had collapsed. October started with the company which has whisked so many of us off to sunnier climes going bust, leaving 110,000 people needing to be brought back to the UK. Britain's 'biggest peacetime rescue mission' duly cost the taxpayer £60m.

More worrying in the long term was the news that UK productivity was down for the second quarter in a row, and is now 15% below the average for the G7 group of the world's largest economies, making us less productive than Germany, France, the USA and Italy.

Would the Chancellor tackle the problem in his November Budget speech? If he can increase UK productivity it will provide a huge boost to the nation's finances. He duly leapt to his feet on Wednesday 22nd and pledged to "grasp the opportunities of Brexit" and build an economy "fit for the future." In truth there were no major announcements except the abolition of stamp duty for the majority of first-time buyers. You are never going to get a dramatic speech from the current Chancellor, but he sat down after an hour with his job far more secure than when he had started speaking. (And he did receive a boost on productivity in early January, as the Office for National Statistics reported that hourly productivity in the third quarter of last year was up 0.9% - the biggest rise since 2011.)

One area where there was good progress was on unemployment, which continued to fall throughout the quarter. There were steady reductions each month and the last reported figures in December showed unemployment down to 1.43m and the jobless rate holding steady at 4.3%.

In fact there was plenty of good news for UK plc by the end of the year. UK factory activity grew at its fastest pace for more than four years in November, with the Purchasing Managers' Index hitting 58.2 – its best level for 51 months. Official data for 2016 showed that inward investment into the UK had also hit a record $145bn, although this was boosted by some large takeover deals. UK manufacturing also expanded for the sixth month in a row, helped by record car production.

In addition the UK economy was shown to have grown at a faster rate than had previously been thought. Revised figures from the ONS showed that the economy had grown by 1.7% in the third quarter, compared to the original estimate of 1.5%.

As always – as we comment below – there was gloomy news for the retail sector and wages continue to lag behind inflation, which held steady at around 3%. But let's be optimistic as we go into the New Year. The UK was named the best place in the world for business by the US media group Forbes. In its annual ranking the UK leapt from fifth to first, scoring especially well on technological readiness and the education of its workforce.

UNITED KINGDOM

Continued

How did all this translate onto the stock market? The FTSE-100 index of leading shares didn't do as well as some other markets during 2017 but nevertheless it was up by 8% for the year as a whole. The stock market rose 4% in the final quarter to end the year at 7,688. The pound rose by 1% against the dollar in the three months to December, ending the year at $1.3504 – up 9% for the full year.

WHAT'S IN STORE FOR 2018?

It is traditional at this time of year to gaze into the crystal ball and see what might be in store for the coming year. We looked at the predictions of the experts – and added a few of our own…

THE UK WILL FALL A PLACE IN THE WORLD ECONOMIC LEAGUE TABLE

A fairly safe one to begin with. In 2016 the value of the UK's GDP (that is, the value of all the goods and services the country produces) was $2.65tn (£1.95tn), which put the UK just ahead of France ($2.47tn) and India at $2.26tn. But with Asian economies continuing to grow at a much faster pace than those in the West, 2018 will see India – with GDP growth above 7% in 2016 – overtake both the UK and France, bumping us down a place into sixth.

MONEY

For most of us, 2018 is going to be another tough year. Inflation is running at or around 3% and that means 'real' wages will at best stand still. Interest rate rises are forecast in the US and it is likely that having had our first rate rise in ten years (from 0.25% to 0.5%) there will be another rate rise at some point in 2018 as the Bank of England looks to bring UK inflation back to its target rate of 2%.

It is also likely to be another turbulent year for the virtual currency Bitcoin. This time last year Bitcoin was just breaking through $1,000. By Christmas it was hovering around $15,000 before it fell following a crackdown by the South Korean authorities amid threats to close virtual currency exchanges. More authorities are likely to follow suit in the coming year as fears grow about Bitcoin being used for money laundering purposes. (And as I write South Korea has just announced plans to ban trading in the crypto-currency, which will only add to the uncertainty.)

RETAIL

Without question traditional British retail – the national high street – will continue to struggle in 2018. Next reported good trading figures over Christmas but the headlines also included 'Debenhams shares slump after profit warning.' If you work in an office you cannot have failed to notice the reception desk swamped with Amazon deliveries in the run-up to Christmas, with some companies having to ban deliveries at work. High street bank branches are also going to close at an increasing rate as more and more customers bank exclusively online. This will deal a further blow to high streets up and down the UK.

UNITED KINGDOM

Continued

PETROL AND OIL

Petrol prices have risen to their highest level for three years on the back of stronger oil prices and experts expect the trend to continue throughout 2018. Oil prices rose throughout 2017 as the members of OPEC agreed to restrict production to cure a global glut, and the RAC report that oil prices have
made a strong start to 2018, with Brent Crude currently trading at just under $70 a barrel. Petrol prices are up 6.8p a litre compared to July, which means that the average family is now paying £3.73 more for a tank of fuel than six months previously.

BREXIT

I seemed to spend all of 2017 writing, 'Little real progress has been made in the Brexit negotiations' or words to that effect. At the end of September Theresa May had flown to Florence to give a speech on Brexit and subsequently met other European leaders in Brussels.

There were plenty of warm words, with both Angela Merkel and Emmanuel Macron making conciliatory noises, but the message from the EU remained the same. The divorce bill must be resolved before any talks on trade can begin.

But – finally – by December it looked like a deal had been reached, as the UK's 'divorce bill' seemed to have been agreed. You don't have to look far to find a high ranking official (on both sides) who will ominously mutter, 'Nothing is agreed until everything is agreed,' but – to use Winston Churchill's phrase – while this may not be the beginning of the end, it may just be the end of the beginning.

Will we now see a flurry of agreements as the trade deals are ticked off one by one? You would doubt it, given that 27 countries have to agree to the deal and – as the delay caused by Walloon in the EU/Canada agreement showed – there is the potential for regions, never mind countries, to derail negotiations. But by the end of this year the UK will – in theory – be just 88 days away from leaving the EU. One way or another, progress in the negotiations has to be made.

EUROPE

The quarter started with civil unrest in Europe, following Catalonia's declaration of independence, equally swiftly followed by the imposition of direct rule from Madrid. No-one rushed to recognise the newly independent nation and for now the situation is under control. Most Catalans do not want to break from Spain but a significant minority do, and simmering discontent will undoubtedly remain. This has unnerved several major companies, who have relocated their headquarters from Catalonia to 'mainland' Spain.

September had seen Angela Merkel win her fourth term as German Chancellor, but in November talks aimed at forming a coalition government in Germany collapsed, leaving Merkel facing her biggest challenge in 12 years as leader.

While Angela Merkel was negotiating a coalition the EU bureaucrats finished negotiating a trade deal with Japan which will – subject to ratification by EU members – create the world's largest open economic area. The agreement is seen as a challenge to the protectionism of Donald Trump, with a joint statement saying that the EU and Japan are "committed to keeping the world economy working on the basis of free, open and fair markets … fighting the temptation of protectionism."

On the stock markets both major European indices enjoyed a good year. The German DAX index was up just 1% in the final quarter to 12,918 but enjoyed a 13% rise in the year. The French stock market barely moved in the last three months of the year, but was still up by 9% for the year as a whole at 5,313. And an honourable mention for Greece: the country survived for another year and the Athens stock market duly celebrated by rising 25% in the year to 802.

UNITED STATES

As expected President Trump appointed Jerome Powell, a Republican who supports low interest rates and is open to de-regulation of the financial sector, to replace Janet Yellen as Chairman of the Federal Reserve. Irrespective of the new Chairman's position on interest rates December saw the Fed raise rates by a further 0.25% - the third rise in 2017 – as it projected growth of 2.5% for 2017 and 2018, expecting the US economy to be stimulated by the President's tax cuts. At the moment the Fed is targeting a range of 1.25% to 1.5% for US interest rates, but further rises are expected next year, with most forecasters expecting a base rate of around 2%.

The tax cuts – agreed by both houses of Congress in December – have been described as the biggest overhaul of the US tax system for 30 years, with corporation tax falling from 35% to 21% and the highest rate of individual income tax coming down from 39.6% to 37%. Democrats have argued that the cuts will only favour the rich, while the Joint Committee on Taxation has suggested they will add $1.4tn to the $20tn US national debt over the next 10 years.

By and large the news on the US economy was good in the final quarter, as the south of the country recovered from the impact of the hurricane season and the jobs figures largely beat the forecasts, with the unemployment rate holding steady at 4.1%. Growth for the third quarter was confirmed at 3% - ahead of most expectations.

The rise and rise of the tech giants continued, with Facebook, Google and Amazon all posting impressive figures. The subsequent rise in Amazon's share price helped Jeff Bezos replace Bill Gates as the richest man in the world.

On Wall Street the Dow Jones index followed Amazon's lead, rising by 10% in the last quarter of the year. It ended 2017 at 24,719 where it was up 25% for the year as a whole.

FAR EAST

October brought us arguably the most important speech of the year, as President Xi Jinping used the Chinese Communist Party Congress to set out his plans for China's economic dominance of a large part of the world.

China already has a domestic population approaching 1.4bn – nearly one-fifth of the world population of 7.5bn. The UN estimates that the population of the world will increase to 11bn by the end of this century, with most of that growth coming in areas China intends to reach and trade with through the massive infrastructure project known as 'One Belt, One Road.'

The initiative was first mooted by Xi Jinping around 2013, and sees China's push into global economic affairs extending through a land based Silk Road Economic Belt (SREB) and the Maritime Silk Road (MSR), with the focus being on infrastructure investment, construction, railways and highways, automobiles, power and iron and steel. These initiatives will extend Chinese influence through South East Asia, Oceania and North Africa. More than 65 countries, 4.4bn people (63% of the world's population) and 29% of the world's GDP are in its path. Importantly the countries it reaches are those poised for rapid growth – and many have been eager to accept China's offer of help with infrastructure projects. What does China get in return? Not least, access to the vast mineral resources it will need for future growth.

November saw Donald Trump make his much-heralded visit to the Far East, spending 12 days in the region and apparently doing $300bn of trade deals, including the first major investment by a Chinese energy firm in the US.

Black Friday and Cyber Monday are now key parts of the retail calendar in the West, but they are eclipsed by 'Singles Day' (November 11th) in China. Showing the rest of the world how it should be done Alibaba – China's answer to Amazon – recorded Singles Day sales of $25.4bn (just over £19bn) and clocked up its first $1bn within two minutes of Singles' Day starting.

We have reported separately on Japan in the special section below. Currently the economy there is enjoying its longest growth streak since 2001, having now expanded for seven quarters in a row. Official figures released in November confirmed that gross domestic product had expanded by 1.4% for the quarter ending in September, with the growth rate subsequently being revised upwards to 2.5% in December. This does, however, come after four continuous years of economic stimulus from the government: as we discuss below, the question is whether this stimulus is sustainable in the long term.

On the region's stock markets it was a positive quarter for three of the major markets. China was the only one to slip back with the Shanghai Composite falling 1% in the last three months of the year to close at 3,307 where it was up 7% for the year as a whole. The Japanese market rose 12% in the quarter to 22,765 – up 19% for the year as a whole – and South Korea was up by 3% to 2,467, recording an even more impressive rise of 22% for the full year. But pride of place goes to Hong Kong. Having started the year at 22,001 the Hang Seng index rose 9% in the final quarter of the year to 29,919 to record a rise of 36% for the full year.

JAPAN

A sign of things to come?

As we have just reported, the last quarter of the year was a very good one for the Japanese stock market and a 19% rise for the year as a whole is acceptable by anyone's standards. But Japan is an interesting country: in many ways it is already facing some of the problems we in the UK are going to face in the years ahead. Aside from a good stock market performance, are there any other lessons we can learn from Japan?

Shinzo Abe came to power in Japan five years ago, committed to getting the country out of a two decade long slump: the Japanese stock market actually reached its all-time high of 38,957 in December 1989. Abe's weapons were the 'three arrows' of what became known as 'Abenomics:' government spending, monetary easing and widespread reform of the economy as he sought to combat three specific problems.

LOW UNEMPLOYMENT

Traditionally, low unemployment leads to higher pay – it is a simple product of supply and demand. And right now in Japan companies are facing the most severe staff shortages since the early 1990s, with unemployment at a two-decade low of 2.8%. But wages are not rising significantly, thanks to the ever-increasing number of people on short-term or part-time contracts. The traditional Japanese idea of the 'job for life' is rapidly disappearing, with 37.5% of total employment on these types of contract. With the rise of automation posing a threat to millions of Japanese jobs, this is an exact parallel with the UK as wages stubbornly lag behind inflation.

AN AGEING WORKFORCE

In 50 years' time 25% of the UK's population will be over 65, and the state pension age is gradually inching up to reflect that fact. An increasingly elderly population brings huge problems: the increasing cost of pensions plus medical and social care, especially as more and more people live alone. In Japan people are already working longer: one technology company in Tokyo reports that 10% of its workforce are over 60, with the oldest full-time employee still going strong at 78.

THE DANGER OF DEFLATION

Falling prices are superficially attractive but ultimately they lead to deflation – as customers put off purchases and businesses delay investment. That is not a problem in the UK at the moment, but a prolonged period of stagnant wage growth could lead to deflation. Shinzo Abe has tackled the problem in Japan with ever more government spending, a path our current Chancellor seems determined to follow. The problem, though, is long-term debt: Japan's debt has already risen to 200% of GDP thanks to Abenomics and – as the Government needs to spend more and more to drive the economy, and on its increasingly old population – is projected to reach 600% of GDP by 2060. Is that sustainable? Only time will tell – but politicians in the UK should be watching with interest.

EMERGING MARKETS

We report on the world's three major emerging markets in this section – but in the last three months of the year the real drama was taking place in Venezuela, where the country with the largest proven oil reserves in the world finally ran out of money and defaulted on its sovereign debt. While a tragedy unfolded for the country's citizens – the government advised them to eat their pet rabbits for food – a temporary deal was agreed with Russia, allowing Venezuela to re-structure $3.15bn of debt. But with the country owing an estimated $140bn to foreign creditors the year ahead for ordinary Venezuelan citizens looks unremittingly bleak.

In December President Nicolas Maduro announced the creation of a new currency in a bid to ease the country's economic crisis. A new virtual currency – the Petro, supposedly a rival for Bitcoin – will apparently be backed by Venezuela's oil, gas and diamond reserves. Opposition leaders poured scorn on the plan, pointing out that the President had already mortgaged the reserves several times over. It seems a fairly safe prediction that Venezuela will lurch from one crisis to another in 2018.

As we have already seen in the 'predictions' section, India is emphatically not lurching into crisis as the economy continues to grow. On the stock market 2017 was another good year for India, as the market rose 9% in the final quarter of the year to 34,057 – meaning that it was up 28% for the year as a whole. The Brazilian stock market also enjoyed another good year, rising by 3% in the final quarter and by 27% for the full year (following a rise of 39% last year) to close 2017 at 76,402. The only market to fall significantly during the year was Russia: having started the year at 2,233 it was down to 1,879 by the end of June. It recovered to end the year at 2,109 helped by a rise of 2% in the final quarter, but was still down by 6% for the whole of 2017.

CONCLUSION

With that we will leave you for another quarter. The Report will return in the first week of April – hopefully not too many of our predictions will have fallen by the wayside by that point – and, if it is not too late, it only remains for us to wish you a very healthy and happy New Year. We look forward to working closely with you again over the next 12 months.

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