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CAERUS Market Commentary – May 2016

A lacklustre month – is political uncertainty to blame?

Market overview

May was a lacklustre month for equity markets, with the FTSE World index rising by just 0.87%. Buoyed by some positive economic figures, the US stock market was the best performing asset class (up 3.7%) followed, interestingly, by UK gilts, which rose by 2.4%, perhaps seen as a safe haven Investment in the run up to the EU referendum. Emerging Markets fell in the month (approx. 2%) but remain, year-to-date, one of the best performing asset classes, with a rise of 5.8%, just behind that of the US stock market, which has risen by nearly 6%. Other major markets recorded sub 1% rises in the month.

There now appears to be a divergence of monetary policy amongst economies, with the US contemplating a rise in interest rates whilst the Eurozone, Japan and Switzerland actually have negative rates. The UK may be described as sitting in the 'middle', with a small positive interest rate but no signs of a rise, yet.

UK

June could be a fascinating month for the UK markets. The forthcoming EU referendum is likely to dominate the headlines over the next few weeks and the result may have profound effects not only for the UK, but also for the rest of Europe. The polls indicate that the two camps are now much closer than previously. Watch the value of sterling over the month, as it may gyrate a lot in expectation of the result, and that has implications for inflation and, perhaps, the future course of interest rates.

The uncertainty around the aforementioned EU referendum is blamed for the lacklustre growth in the first quarter of 2016 (GDP up only 0.4%), as business Investment fell as companies chose not to invest until the Brexit vote is determined. Looking into the components of GDP growth, the economy remained dependent upon the services sector and consumer spending, whilst manufacturing output fell.

US

There is a rising expectation, this month, of a hike in interest rates. The US economic recovery appears to be progressing, with both consumer spending and inflation up. Although, during the past year, there has been talk of a rate rise only for it not to happen, on this occasion, the Federal Reserve has dropped heavy hints that a rise, this month, is on the cards. Consumer spending is increasing (more than two thirds of economic activity), supported by stronger employment markets and rising house prices.

US politics has also become more interesting, with the strong likelihood that Donald Trump will become the next Republican presidential candidate. This was not expected, even a couple of months ago, so expect much commentary on what a Trump presidency might look like. Protectionism, increased defence spending, who knows? Markets hate uncertainty and, at the moment, politics is providing plenty of it.

Europe

Although out of the news for some time, Greece came to an agreement with its creditors and received another tranche of loans, with repayments due to commence in July (Greece still owes its creditors 180% of its GDP). The good news is that Greece may have longer to repay the loans and the interest rate paid may be capped. Elsewhere, the bigger problem for the Eurozone remains the threat of deflation (falling prices), not helped earlier in the year by the fall in oil prices. The European Central Bank (ECB) has an inflation target of 2%, however the lack of any pricing pressures reflects the weakness in demand across the region, largely due to the lack of progress in reducing the high level of unemployment observed across many parts of the EU. For example, Greece and Spain have rates upwards of 20%, which contrasts meaningfully with Germany at less than 5%.

Elsewhere, a less commented danger is that of Italian banks. Nearly 20% of all lending by the banks are non-performing i.e. borrowers have fallen behind on their repayments. Watch this space.

Japan

Doubts remain about the effectiveness of 'Abenomics' (low interest rates, government spending and market reforms), as retail sales have now fallen for two months in a row and inflation remains moribund. This has led to a postponement of a rise in sales tax until 2017, for fear this may hinder consumer spending. The reality continues that the average Japanese household remains more inclined to save than consume, which the authorities are finding hard to break. Nonetheless, from a sustainability perspective, tax does need to rise in Japan as the country has a high debt level and its ageing population will cost more to look after in the future.

In this respect, some good news was provided by the economy growing in the first quarter of the year, after a contraction in the final quarter of 2015. This meant that Japan, technically, did not fall into recession (defined as two continuous quarters of decline) and that tax receipts should have been buoyed as a result. Meanwhile, the introduction of negative interest rates, earlier in the year, will hopefully encourage spending by consumers and companies alike, rather than make no money on their cash.

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Emerging Markets

With an expected rise in US interest rates and thus the possibility of a stronger dollar, Emerging Markets have struggled of late, after a good start to the year, as value reappeared in various Emerging-Market stock markets. A US rate rise would be expected to attract monies to the US in search of a higher yield and raise the prospect of outflows from some Emerging-Market countries, especially those which rely upon overseas monies for finance. Similarly, with the rise in the US dollar, overseas debt issued by Emerging-Market companies is likely to encounter rising repayment costs, which are likely to be felt most acutely amongst those countries facing budget and trade deficits. Therefore, for Emerging Markets to resume their positive ascendancy, the US dollar is likely to need to avoid rising too much, commodity prices stabilise and Chinese growth maintain relative stability, with the latter of particular importance, given the contribution of trade to GDP amongst many countries within the Emerging-Market asset class.

CAERUS Sentiment Indicator

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