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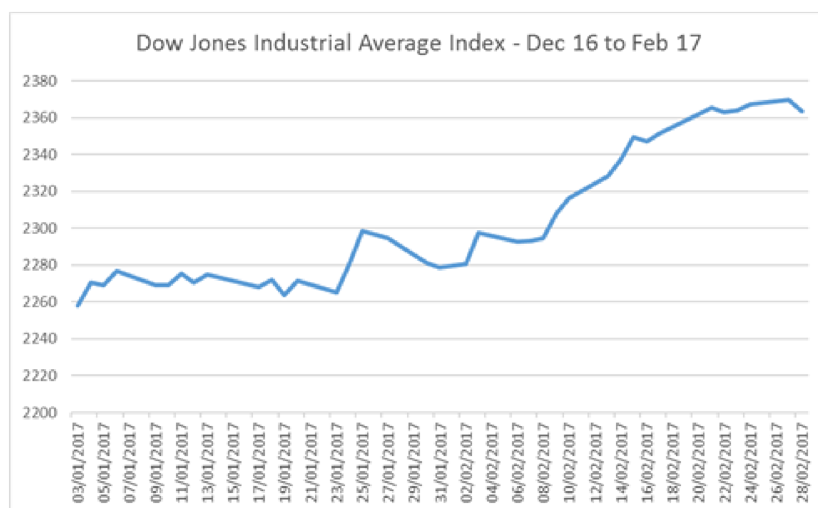
February 2017 – Market Commentary

Equity markets were off to the races in February. In a continuation of sentiment from January, and late 2016, equity markets continued to rally on the reflation trade from President Trump's policies. The major US indices continued to hit new all-time highs throughout the month, spurring equities around the world to rally strongly. Economic data announced in January was encouraging, particularly in consumer demand and manufacturing. However, it was the continuing optimism in the reflationary policies expected from the US, coupled with increasing inflation figures that helped spur the market along. Towards the end of the month, the expectations of a rate increase from the US Federal Reserve rose, pushing the dollar up with it. On the last day of the month, Mr Trump addressed both houses in Congress, although markets were disappointed with the lack of policy detail in his speech.



Source: Bloomberg

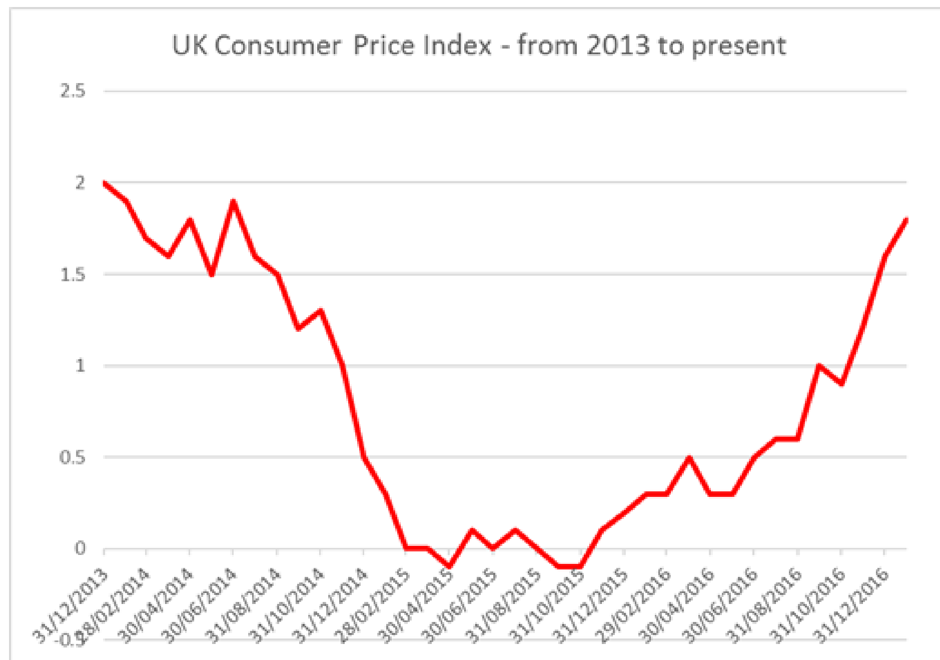
Outside of the US, political developments once again dominated news stories. The UK moved closer to starting negotiations to leave the EU, as the bill to trigger Article 50 progressed through Parliament. Although the Government was defeated on an amendment in the House of Lords over protection for EU citizens living in the UK after Brexit, it was a minor amendment and the bill is expected to pass without any major problems. In the EU, the markets are watching the forthcoming elections. In the Netherlands, opinion polls for the election on the 15th of March show the incumbent, Mark Rutte, taking a slender lead over right wing Geert Wilders, although the new government will be run by whichever party manages to secure a coalition. In Germany, the opinion polls narrowed between Merkel's CDU party and the SDP party led by Martin Schulz for the September election.

The main focus, however, surrounded the French Presidential election. The Republican candidate, François Fillon, is embroiled in a scandal surrounding payments to his wife and his support has suffered as a result. Sections of the party have called for former Prime Minister, Alain Juppé, to take over as their candidate, however that now seems unlikely. This has allowed independent candidate, Emmanuel Macron, and National Front leader, Marine Le Pen, to remain favourites for the 2nd round, with polls suggesting that Mr Macron would emerge victorious. The first round is to be held on the 23rd of April so there is plenty of time for the polls to change however the markets are beginning to price in a substantial amount of risk, with the spread between French and German bond yields increasing to the widest in over 4 years. Outside of politics, increasing inflation and GDP growth figures in Germany continue to highlight the divergence between core and peripheral Europe, which could become a major factor in 2017.

UK

Brexit continues to move steadily along to its (almost) guaranteed foregone conclusion; it seems extremely likely that Article 50 will be triggered in March. The Brexit Bill has been passed by the House of Commons, and currently sits in the House of Lords for debate and possible amendment. The government has already been defeated on a House of Lords amendment, concerning the protection of EU citizens post-Brexit, and there may be more amendments before it returns to the House of Commons for final approval and eventual Royal Assent. Sterling, the main barometer of Brexit risk over the last year, was down over 1% over the month against the US Dollar, although it was up slightly against the Euro, suggesting that Brexit is effectively priced-in. Outside of the usual Brexit debates, the government also produced a long awaited white paper on housing. This paper is intended to boost the housing market in England and included measures to speed up the development of available land, particularly in the speed of planning approval, forcing developers to start building within two years of securing planning permission. Analysts and industry experts were sceptical of the plan so it will remain to be seen whether it will improve the current housing situation in the UK.

In economics, the UK's GDP numbers showed the largest growth of any of the G7 nations (although this was surpassed by German GDP growth later in the month). The Bank of England also raised their GDP growth forecasts for the UK. Inflationary expectations continue to increase with YoY Consumer Price Index increasing at 1.8% (core CPI was +1.6% YoY), approaching the 2% target rate set by the BoE. Retail sales figures disappointed analyst expectations and the services sector also showed a surprise slowdown in February, raising concerns about continuing GDP growth, as the economy is heavily dominated by services. The market awaits the budget speech from Chancellor of the Exchequer Philip Hammond on the 8th of March.



Source: Bloomberg

There was plenty of company specific news to keep markets interested. Unilever became the target of a merger with US conglomerate, Kraft Heinz, and jumped over 13% as a result. The merger was pulled shortly after, as Kraft Heinz felt it was too difficult to negotiate a deal following the public disclosure of the merger. Unilever's share price fell as a result, but then recovered as investors woke up to the idea of reforms within the company being able to realise future growth. Elsewhere, the banking sector earnings season also dominated headlines. Lloyds was a particular standout, announcing profits higher than analyst expectations, and a special dividend, on reduced provisions for PPI mis-selling. RBS, on the other hand, continued to disappoint the markets with posting an almost £7bn loss for 2016. Both companies are part-owned by the tax-payer following the 2008 financial crisis, although the recovery of the two banks since then could not be more stark.

EU

European politics continued to dominate the markets attention in February. The forthcoming Dutch election, on the 15th of March, is the first inflection point. Opinion polls show a tight race between the ruling party, the People's Party for Freedom and Democracy (VVD), and their incumbent Prime Minister Mark Rutte, and the Party for Freedom (PVV), the far-right anti-immigration, euro-sceptic party, led by Geert Wilders. The Netherlands is based heavily on coalition politics and it is unlikely that either party will gain enough seats to form a government on their own. All the main parties have already ruled out forming a coalition with Wilders and PVV, suggesting that the likely outcome is for Mr Rutte to continue in power, albeit with perhaps different coalition partners. The opinion polls suggest that support for euro-scepticism is waning slightly, so markets will focus on the PVV result to determine whether this is the case. Similarly, in Germany, polls suggest the support for the euro-sceptic party, AfD, is falling. The SPD party has enjoyed a resurgence in support following the choice of Martin Schulz as leader, and they are now neck-and-neck with Merkel's CDU party for the September elections.

The main focus is, however, on the French Presidential election. The first round is due on the 23rd of April, with the second-round run-off between the top two candidates due on the 7th of May. Republican candidate, François Fillon, the Republican candidate, is embroiled in a scandal surrounding payments to his wife for work that she allegedly did not do. Mr Fillon now faces a formal investigation into the affair, due on the 15th of March. His support in the polls has dropped significantly and there were calls from sections of the Republican party to have him replaced by previous Prime Minister, Alain Juppé. This is unlikely to happen and Mr Fillon will now need to focus on clearing his name and recovering his lost support. In the meantime, it has allowed his two main rivals, Marine Le Pen of the National Front, and independent Emmanuel Macron, to consolidate their support, and it looks likely that they will progress to the second round, with Ms Le Pen winning the first round, but Mr Macron prevailing in the run-off. French voters will have a stark choice between a continuation of centrist liberal policies under Mr Macron, or a populist, anti-immigration euro-scepticism under Ms Le Pen. There is, of course, plenty of time for the polls to change and, as we saw last year, no guarantee that opinion polls accurately reflect what the outcome will be. Markets are reacting and currently pricing in a period of uncertainty. French equities have underperformed German equities year to date. The spread between French and German bonds have also increased to the highest level in four years, as markets are indicating the additional risk involved in holding French assets.

Source: Bloomberg

Outside of politics, perhaps a more interesting and pertinent concern is what is happening in the European economics. As with the UK and the US, inflationary expectations are picking up across the continent. The German Consumer Price Index increased 2.2% YoY in February which was higher than expectations and the highest level for 5 years. As you would expect, inflation figures are divergent across the continent, with inflation increasing at a much faster rate in countries such as Germany and Spain, than in France and Italy. Similarly, GDP growth is also divergent across the EU, with German GDP growth outperforming French and Italian growth. This could present the European Central Bank (ECB) with a problem. They could start to increase rates, or reduce the level of Quantitative Easing (QE) in order to stem inflationary pressures, but this may impact an economic recovery, particularly in the weaker economic countries, possibly increasing tensions between core and peripheral EU nations. This is at a time when the Greek debt crisis is coming back into focus, as their next repayment is due in July. The ECB could have a difficult path to tread.

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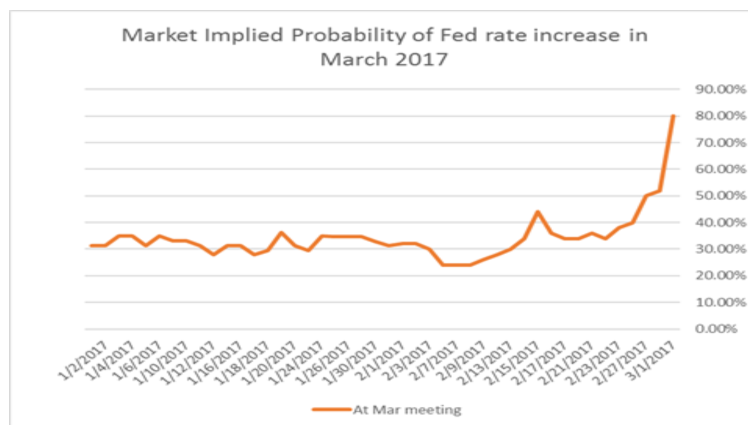
US

In February, US markets witnessed a continuation of the performance from January and late 2016. Equity markets rallied as the reflationary policies of newly inaugurated President Trump sparked optimism about future growth. Investors are expecting a range of policy proposals, such as increased fiscal spending. infrastructure projects and tax reform, to increase economic growth in the US. As at the end of the month, details of these policies still remain scarce. In fact, the market expected Mr Trump to use his address to both houses of Congress on the 28th of February to outline policy specifics, but they were ultimately left disappointed by the lack of detail. The policy that sparked most interest, and controversy, was the decision to ban entry into the US for citizens of a selection of Muslim-dominated countries. This caused political wrangling in the US, with the decision overturned by a Federal judge, setting the legislature and the judiciary on a collision course.

The markets also focused on another Trump policy proposal, a reform of the Dodd-Frank regulations. This was something that he campaigned for during the election and he signed an executive order at the beginning of February as a first step to reduce financial services regulation. Of course, Dodd-Frank regulations have to be revised in Congress rather than a Presidential executive order, but showing his determination to reduce regulation so early in his term was welcomed by equity markets; the financial sector rallied as a response. The other major event that helped financials to rally was an increased expectation of an interest rate increase by the US Federal Reserve. Over the month, members of the US Fed gave indications that a March rate hike was more likely than the market had been pricing in. At the beginning of the month, the markets gave a 30% change of a March rate increase. This increased to over 50% towards the month end, before expectations increased dramatically so that a March rate increase is now fully priced into the market, with possibly another two rate increases in 2017. The dollar rallied as markets came to terms with a faster move towards interest rate normalisation than they had previous expected.

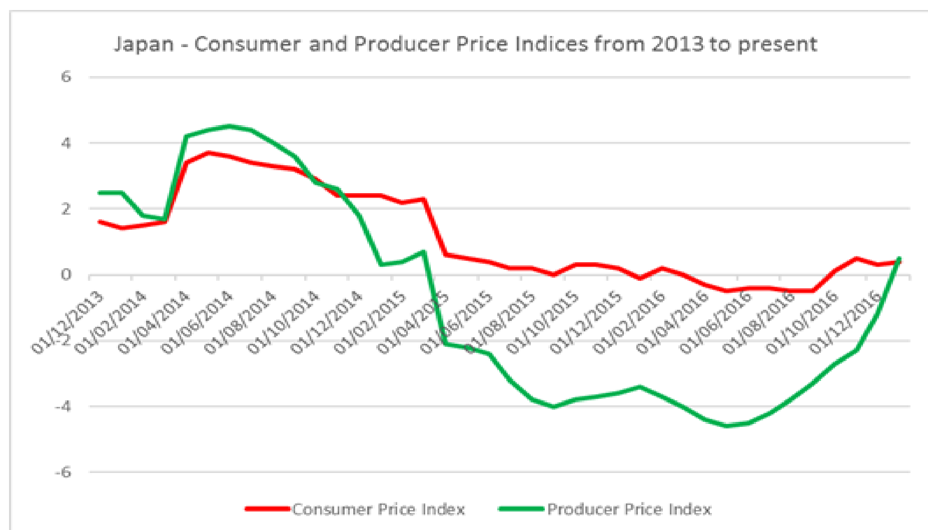


Source: Bloomberg

One of the main reasons for increasing interest rates is to control inflation. Figures released in February show inflationary pressures increasing in the US, with the Consumer Price Index (CPI) up 2.5% YoY, and Core CPI (which excludes food and energy) up 2.3% YoY. An increase in wage inflation is also evident. These are the highest inflation figures in the US since 2012. At the same time, GDP growth in the US came in slightly below expectations, at 1.9% YoY, however this is still a pick up from GDP growth in mid-2016. Equity markets rallied strongly during the month, reaching all-time highs in the S&P 500. Markets are attempting to weigh up the benefits of proposed tax reforms and infrastructure spend without specific policy details, while trying to determine how economic data and increased Fed rate increase expectations impact future growth.

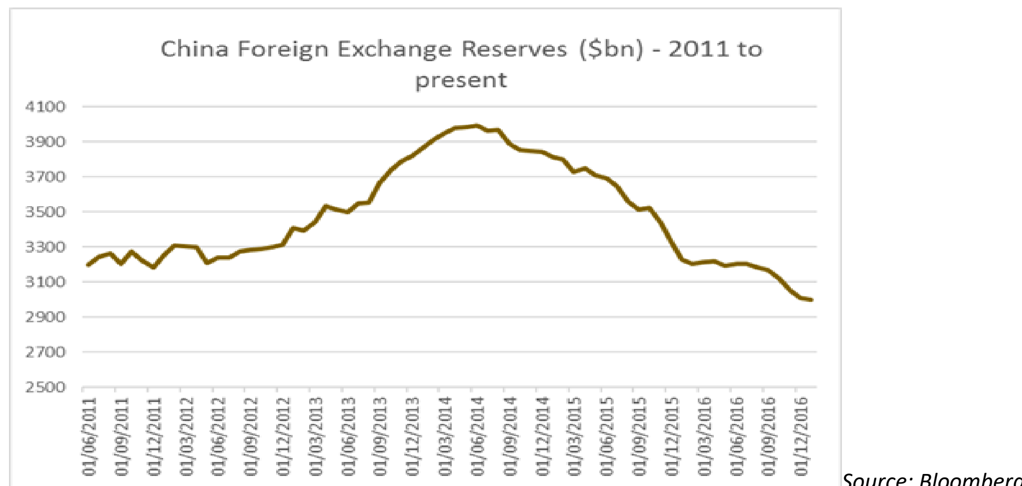
Asia Pacific and Emerging Markets

In Japan, equity markets were up 0.4% on the month, underperforming US equities. The Yen strengthened about 1% against the Dollar and over 2% against Sterling and the Euro. The main story is the steadiness in the Japanese economy. GDP growth in the country was 1% (QoQ annualised). Consumer confidence remains robust. The unemployment rate continues to fall, now at the lowest rate since 1994. The jobs-per-applicant ratio is also at decade highs, which suggests that there could be pressure building on wages. This would help increase inflation. We can already see an increase in the Producer Price Index (PPI) and Consumer Price Index (CPI). 10-year yields in Japanese Government Bonds (JGB) continue to remain in positive territory, above the Bank of Japan (BoJ) target rate of 0%. The BoJ may have to consider changing their target rate should inflation reach their target rate.



Source: Bloomberg

In China, the focus remains on controlling capital from leaving the country. There were some small policies in February designed to reduce capital outflows. At the start of the month, shortly after the end of the Chinese New Year holiday, the Peoples Bank of China (PBOC) announced an increase in short-term interest rates. They were modest increases buy signal the PBOC's intention to control capital flight but it also indicates that they may be looking to control the amount of borrowing in the country. This was backed up by regulators drafting a consultation paper aimed at reducing financial leverage in the economy. Other measures included the authorities encouraging companies to borrow from the international bond market rather than from domestic investors. This would help to support the currency as they convert their borrowings back into CNY onshore. In the meantime, the PBOC continue to reduce their foreign reserves to help bolster the CNY. The reserves fell below $3 trillion, the lowest level since 2011.



Source: Bloomberg

Elsewhere, in Emerging Markets, equities continued to rally strongly and inflows are beginning to up. Emerging Markets funds saw their biggest weekly inflows in over 6 months. Not all emerging markets participated in the rally. Russia, for example, had a particularly difficult month, with the main equity index (MICEX) down over 8%. This was mainly due to a sharp decline in natural gas prices which resulted in a sell-off in the Russia's energy and resource related names that dominate the economy and the index. Markets are now back to the levels they were at the US Presidential election and highlights the divergence that can occur within different constituents of the Emerging Market space.

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