August 2016 – Market Commentary

August was a relatively calm month in the markets. Equity markets in the UK and US reached all-time highs, while market volatility in both of these markets were at extremely low levels. Sterling remains the barometer of risk for Brexit. The pound weakened against the major currencies mid-month, reaching as low as 1.285 against the US dollar, but strengthened towards the end of the month on economic data which indicated that the UK was faring better than expected. The market still needs to determine whether this stronger than expected performance was due to a robust economy, pessimistic analyst expectations, or a “phoney war” where the real Brexit impact on the economy is still to come. Theresa May has continued with the “Brexit means Brexit” mantra, however she hasn’t provided any clarification in what that actually means. In the meantime, the Labour leadership election continues as ballot papers are issued to party members, with Jeremy Corbyn holding a substantial lead over challenger Owen Smith. The result is due on the 24th of September.

Source: Bloomberg
Outside of the UK, the US Presidential election continues. Hillary Clinton has a lead over Donald Trump in the polls however both candidates are under increased media scrutiny. Mrs Clinton is playing down issues with her health, suspicions over her charity, the Clinton Foundation, and the ongoing private email use issue. Mr Trump, on the other hand, is continually under scrutiny due to his inflammatory rhetoric, particularly on the immigration issue which culminated with a meeting with the Mexican President at the end of the month. Economically, “Fed watch” is back on the agenda for the markets, with the annual Jackson Hole conference at the end of the month being analysed for any hint that the Federal Reserve will increase rates in September. The markets were fairly muted during the traditional holiday month as volumes were low, news flow was quiet and the world watched as Brazil hosted the Olympics.

UK

“Brexit means Brexit” is still the name of the game for Prime Minister Theresa May however we still do not know exactly what “Brexit” actually entails. As the markets and political commentators still try to thrash out what is likely to happen, the Bank of England actually did act, lowering the base rate by 0.25% to the lowest in its history, and launched a series of further stimulus measures, such as restarting bond purchases. BoE governor Mark Carney said there was a “clear case for stimulus” due to a series of economic indicators that suggested the UK was heading for a recession. The pound fell against most currencies and bond yields fell to their lowest ever rate, with 10yr Gilt yields reaching 0.518% at one point. The bond buying programme quickly ran into some trouble, however, when there were insufficient bonds available at the tenure at which the BoE targeted their initial purchases. This was because pension funds and insurance companies were unwilling sellers as they need to keep decent yielding assets to match their longer term liabilities. The stresses on pension funds are substantial at present, as the low yield environment makes it tougher for them to meet their guaranteed future liabilities for the policyholders.
As we approached the end of the month, economic data suggested that the BoE were perhaps a little hasty in their actions. Firstly, the residential property sector didn’t look as bleak as the markets were suggesting. While mortgage approvals fell to an 18-month low, the Nationwide House Price Index showed that prices were up in August. Inflation numbers started to pick up slightly, with CPI +0.6% YoY, slightly above expectations. Consumer confidence, shown by the GfK consumer confidence index, was better than expected, up from extremely low levels previously. However, business indicators suggest that businesses aren’t as confident as consumers. Sterling and bond yields rallied towards the end of the month, as investors tried to determine whether Brexit will actually have a detrimental effect on the economy, whether analysts have been too pessimistic in their outlooks, or whether we are in a “phony war” scenario with the main Brexit impacts still to come.
As yet, we still don’t have a clear indication of when Article 50 will be invoked. The Prime Minister had indicated it wouldn’t be invoked this year however there is pressure, particularly from Europe, for a quick decision to be made. Another suggestion is that Article 50 shouldn’t be triggered at least until after the French and German elections next year, further delaying Britain’s exit from the EU. Labour leadership hopeful, Owen Smith, has indicated that he will call for a second referendum should he win. However, that seems unlikely as he is well behind incumbent Jeremy Corbyn in the polls, and the Labour Party are well behind the Conservatives too. The uncertainty surrounding Brexit continues, even if it does feel that things are a little muted during the quiet summer period. Team GB’s stellar performance at the Rio Olympics helped to boost national morale. It will be interesting to see if that will continue as we approach the autumn and we have a clearer understanding of what “Brexit means Brexit” actually means.
EU

August was a quiet month for Europe too. Equity markets continued their recovery from post-Brexit lows, however they are still underperforming the US and UK, which are close to all-time highs. One of the main concerns is over the banking sector, particularly the Italian banks. Non-Performing loans on Italian banks are huge at about 20% of the GDP of the entire country. Prime Minister Matteo Renzi is in a tough position. He initially indicated that he wanted to use public funds to shore up the Italian banks balance sheets. However, this contravenes EU rules about the public bail outs of indebted banks. He could allow the losses to be borne by the banks current bond holders but this is a risky strategy as a substantial portion of the outstanding bonds are held by small retail investors, i.e. voters. Instead, the Italian government sponsored a private fund, called Atlante 2, to shore up the banks’ balance sheets. The fund had been expected to raise a minimum of €3bn, however it only managed to raise €2.4bn which is enough to look after the short-term issues, but not enough to resolve the problem in the long term.

Italy is the country in the European media spotlight at present. As well as the banking sector issue, Prime Minister Renzi has a referendum approaching (due in November) on constitutional reform. He has effectively made the vote a vote-of-confidence in his leadership, and has vowed to resign should he lose the referendum. However, Five Star Movement, the Italian euro-sceptic party, have been increasing their share of the vote and could be a potential problem for Renzi. The rise of Euro-sceptic parties has been evident across Europe. Marine Le-Pen and the National Front have been increasing their share of the vote in France. The Alternative für Deutschland (AfD) anti-immigration party in Germany is also polling well. In Austria, the re-run of the 2nd round of the Presidential election is scheduled to take place on the 2nd October, with the far right Freedom Party’s candidate, Norbert Hofer, currently in the lead in opinion polls.

Economically, not much has changed in the outlook for the European economy in August. The ECB hinted that further monetary easing may be necessary in September, and the amount of negative yielding debt in Europe has increased. The ECB continued its corporate bond purchase programme but data still shows an economy that isn’t rebounding as much as the authorities would like. German business sentiment (Ifo index) fell as did economic sentiment across the continent. Negotiations between the European Union and the USA on the Transatlantic Trade and Investment Partnership (TTIP) have stalled and is unlikely to be concluded before President Obama leaves office, if it is completed at all. Relations between the EU and USA were put under further strain when the EU imposed a massive €13bn tax bill on Apple because of a reduced tax deal that they had agreed with Ireland. Both Apple and Ireland are appealing against the decision, however the EU claimed that the deal was illegal, as member states cannot give tax benefits to selected companies as it is against EU state aid rules. The European Union is taking on the giants of corporate America and it will be an interesting contest.

US

The markets are back on “Fed watch” where the financial community is fixated on whether the Federal Reserve will raise interest rates, when they will do it and by how much. In August, this all focused on Federal Reserve Chair Janet Yellen’s speech at the annual Jackson Hole conference in Wyoming. There are hawkish noises coming from Fed members. Stanley Fischer, the Federal Reserve vice-chair, suggested there could be two increases this year, one in September and one in December. The recent Fed minutes, however, suggested that there would be no imminent rate rise. At her Jackson Hole speech, Ms Yellen indicated that she was closer to raising rates than previously, by saying that the case for a rate hike had strengthened as inflation and employment
metrics were nearing their targets. US dollar rose in response to these comments. The market is not completely convinced, however, as they have only priced in a 36% chance of an increase in September and a 44% chance of an increase by the end of the year. The market is waiting for the Non-Farm Payroll employment figures due just after month end (2nd September) for a clearer picture of Fed expectations.

Source: Bloomberg
Despite this, markets remain extremely buoyant. All three of the main equity market indices, the Dow Jones Industrial, the S&P 500 and the Nasdaq, hit all-time highs at the same time, the first time that this has happened since the dot-com boom in 1999. Bond yields remain at extremely low levels, with the 10yr Treasury yield remaining around the 1.5-1.6 level for most of the month. Historical volatility in equity markets is at extremely low levels. We will see if market volatility returns in the autumn.

Of course, the media will be completely focused on the US Presidential election which is rapidly approaching. Hillary Clinton still has a substantial lead in the polls, however everything can change following the live Presidential debates, with the first one due on the 26th of September. Both candidates have come under severe media scrutiny. Donald Trump has been in the media glare for a long time. In August, he was again focusing on the immigration issue. Commentators thought that he might have started to tone down his anti-immigration rhetoric, but then at the end of the month he went to Mexico to have a meeting with President Enrique Peña Nieto. His Arizona speech immediately after that meeting suggested that he was still as hard-line on immigration as ever, calling for all illegal immigrants to be deported and re-iterating his idea for a wall to be built along the US-Mexican border, with Mexico picking up the cost. Hillary Clinton, on the other hand, has come under increased scrutiny over her health, while the issue of her use of private emails on state business when she was Secretary of State still remains unresolved. In August, the Clinton Foundation came under the spotlight with suggestions that she traded access to herself and others in government in exchange for payments to the Foundation. This is vehemently denied however increasing question marks over her integrity may still impact Hillary’s campaign.

Asia Pacific & Emerging Markets

In August, it was the same old story for Japan. Currency strength continued, with the Yen breaching the 100 level against the US dollar for the first time since 2013. This had the usual effect on the exporter focused stock market which fell with Yen strength and ended the month flat. This has been a major theme over the year as the strengthening currency has prevented the equity market from participating in the rally seen in US stocks. Yen price action is also taking its toll on the economy, with the preliminary Q2 GDP reading showing no growth QoQ mainly due to a drag on exports. Inflation figures were also disappointing, with Consumer Prices falling, and Core Consumer Prices (i.e. ex Food) falling for the 5th month in a row. Therefore, the Japanese economy is still struggling from low growth and a deflationary environment. There were a few bright spots, for example Industrial Production +2.3% MoM, beating expectations however the markets will be watching the Bank of Japan for any signs of increasing monetary stimulus in the forthcoming months.
China, on the other hand, looks to have stabilised its growth, with GDP growth remaining at 6.7% YoY, pretty much in line with expectations. Manufacturing, Industrial Production and Retail Sales figures all came in almost exactly in line with indications and expectations. The Renminbi gradual weakening continued after a rally into the July month end. The currency finished August at 6.6793 to the US dollar, close to lows for the month. The major news that came out of China in August was the announcement that the HK Connect programme is to be extended to Shenzhen. This programme allows mainland investors to invest in certain HK stocks, and for HK based investors to access the mainland China equity market. Previously, this had only been a connection between HK and Shanghai, however the extension to Shenzhen means that the programme will cover about 70% of the mainland market capitalisation. For mainland investors, traders now have access to 417 listed stocks in HK, as it is extended to small cap stocks. Exchange Traded Funds are due to be included in the programme in 2017. The Connect programme is a step in the right direction for the opening up for the Chinese stock market however take-up of the initial connect programme between HK and Shanghai was disappointing so the authorities will be hoping that the extension to Shenzhen will have a better response.

Emerging Markets have had a good couple of months as investors look for additional yield. Brazil’s equity market had a strong couple of months, now that they are beginning to put the impeachment of President Rousseff behind them. The successful staging of the Olympic games, despite a lot of empty seats in the venues, seemed to help buoy the Brazilian markets. India, Korea, Taiwan have all had a strong couple of months, as the main index, the MSCI Emerging Markets Index, is up over 12% YTD and is at the highest for over 12 months.
Elsewhere in Emerging Markets, the oil price is still having a major impact. The oil price had a volatile month, after falling into the end of July, it rallied strongly in August as there was increasing talk of OPEC production cuts and a drop in stockpiles in the US. However, an increase in Saudi exports and a realisation that the mooted production cuts were just talk, pushed the price down towards the end of the month. The lower oil price has had a substantial impact on a lot of the oil producers in Emerging Markets. Nigeria, Africa’s largest economy, is under severe stress, as inflation has reached an 11 year high and it has now officially entered a recession. South Africa’s stock market has also underperformed the rest of the Emerging Market space over the last couple of months, and its currency, the South African Rand, is coming under increasing pressure following news that its finance minister, Pravin Gordhan, is being investigated by the police over allegations that a “rogue” unit at South Africa’s tax revenue service spied on government officials when it was under Mr Gordhan’s control. Any corruption investigation would have a detrimental effect on investor confidence and therefore recovery in the country.
Another country that is struggling with the commodities downturn in recent years is Mongolia. The Mongolian economy is extremely mining dependent and has had a tough time recently. The currency, the Mongolian Tugrik, has lost 17% against the US dollar since June, and has halved since 2008. In an attempt to protect the currency, Mongolia hiked its interest rates from 4.5% to 15%. While this has helped to stabilise the currency in the short term, the country has a long road to strengthen its economy and move away from being commodity dependent. One good piece of news in the Emerging Market space came from Colombia, where the country came to an agreement with the guerrilla group Farc to end the civil war that has been raging in the country since 1964. This should help to stabilise the country, allowing the economy to grow, which is in stark contrast to the economic and societal problems currently being felt in neighbouring Venezuela.