MARKET COMMENTARY

November 2016

An (understandably) cautious start

The third quarter started on a cautious tone as global investors considered the ramifications of UK voter's decision to leave the European Union. However, central banks were quick to provide a range of stimulus measures signalling support for the year ahead. Notwithstanding the uncertainties surrounding Brexit, other than Sterling, there appeared little evidence of the severely negative repercussions that had been anticipated by many commentators. Domestically focused companies did indeed struggle but larger multinational companies, which benefit from significant oversees earnings, actually benefited from the fall in sterling.

The European Central Bank (ECB) and the Bank of Japan (BoJ) both pursued vast bond-buying programmes in an effort to ignite inflation and economic growth. However concern mounted over the scale of the rally in fixed-income which had driven many government bond yields into negative territory. Since the summer period, higher volatility and a return to autumn trading has reversed some of those trades, as investors worried over the magnitude of potential interest rate hikes and their effect on these bonds that many commentators would consider to be overpriced.

Across the Atlantic, Donald Trump claimed the mantle of the Republican candidate for the White House. His formal acceptance of the nomination marked an astounding outcome that almost none of the political establishment believed was possible. Trump's protectionist policies will almost certainly direct caution in markets as the autumn vote beckons, albeit neither candidate is without their issues.

The world post Brexit

Following the initial Brexit shock, negative sentiment lifted to some extent as political certainty was restored through the swift appointment of Theresa May as Prime Minister. This was followed by a flurry of cabinet appointments. This level of clarity alongside the desire to build a cohesive plan with the Treasury and the Bank of England, provided a platform for stablising markets.

The toughest question to answer is whether Brexit actually matters for markets or the economy, because nobody knows yet. We won't get much in the way of meaningful information as to the performance of the UK economy until later this year and beyond. Anecdotally business investment has been impacted but as to what extent is yet to be fully understood.

Domestically, we have seen government bond yields fall further, some into negative territory. This represents unchartered waters for UK government debt and credit agencies were quick to cut the UK's rating following the referendum outcome. For now, markets will likely battle on, supported by central banks injection of stimulus measures.

Central Banks to the rescue…again

In the wake of the European referendum result, the Bank of England cut interest rates in half to 0.25%, the first move in 7 years. Although economic confidence surveys have weakened since the referendum, most economic statistics, such as employment and consumer spending data have been resilient.

Mark Carney justified cutting interest rates and warned the UK economy still faces a significant slowdown as a result of the referendum vote. He added that the Bank of England remains prepared to cut interest rates further if necessary, creating a positive backdrop for risk assets.

The American dream

In the US, market data has been relatively buoyant with strong employment figures, positive consumer confidence, supported by mortgage rates hitting the lowest levels on record. Such a background reignited the debate around the timing of when the next interest rate rise would occur.

The US Federal Reserve (Fed) kept interest rates on hold in September but gestured that a rise would be likely before the year's end. This news supported equity markets while the US dollar weakened. Investors were also buoyed by the Fed's signal that it would raise rates only twice next year, down from three hikes in previous projections.

The Fed's next meeting is in November, just two days before the presidential election, making an interest rate rise unlikely. That leaves December as the central bank's last opportunity, but markets are only "pricing in" a 60 percent chance of a rise at that meeting. Should it happen, a victory by Trump in the Presidential election is likely create sufficient short term volatility to postpone any rate rise well into the New Year.

Contagion surrounding Europe

The real fear post Brexit was the threat of contagion in the form of a domino effect across the different European countries. There are a number of key elections and referendums over the next 12 months, including Italy and Germany, where more extremist parties are gaining popularity which could challenge political stability across the region.

Economic confidence in the Eurozone has also taken a hit, suggesting that Britain's vote to leave the EU may have started to hit sentiment across the trading bloc. Other contagion has been the impact on European banks, particularly within Italy. Italian banks have struggled to deal with their mounting burden of non-performing loans (NPLs), which now amount to around €360 billion, some 20% of Italian GDP. Despite recent bankruptcy reforms, the legacy legal process for resolving such bad debts remains complicated and time-consuming.

This problem is exacerbated by the system's low level of profitability, especially with interest rates at such historically low levels. While the ECB remains willing to supply cheap liquidity to Italy's banks, the risk of a systemic crisis continues to be suppressed but it does nothing to resolve the underlying issues affecting the Italian and wider European economy.

Heading East

China played a minor role in terms of headline news over the quarter but their transition from a growth model based on construction and heavy industry towards one based on domestic industries remains important for global growth.

A buoyant property market and government spending on infrastructure softened the blow from a slowdown in manufacturing. But China's industrial economy continues to suffer from rampant overcapacity and deflation. China's overall debt level has soared in recent years to about 240 per cent of GDP, driven by a surge in lending. This and their vast shadow banking industry, which has fuelled their credit boom, remains a key risk to global financial stability.

Conclusion

Global growth remains slow but continues to be supported through central banks and their ability to provide stimulus measures. This is likely to continue for some time to come. The US presidential election is fast approaching and recent polls suggest a close race. As the world's largest economy and stock market, future US policy, in whatever form, will have ramifications for the entire global economy.

Anecdotal evidence from a number of surveys suggest that at least some of the current weakness in US business activity and hiring is due to uncertainty about the economic outlook in the face of the upcoming presidential election. Given current weak inflation signals, it would therefore seem sensible to expect the Fed to wait until after the election before adjusting policy. As mentioned earlier in this note, a Trump victory would likely delay those decisions further,

In the UK, Brexit will continue to provide an uncertain backdrop. Higher inflation and the likelihood of slower employment growth are likely to bear down on spending growth and policymakers may face the challenge of controlling higher inflation alongside subdued growth. However, the world continues to move forwards and opportunities will continue to present themselves.

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WEALTH MANAGEMENT MENZIES BRIGHTER THINKING

IA Sector Returns

Sector	3 Month %	6 Month %	1 Year %	3 Years %	5 Years %
Cash & Near Cash					
Money Facts 90 Day Notice Account (£10K)	0.19	0.38	0.76	2.25	4.58
IA Money Market	0.07	0.16	0.21	0.35	1.07
UK Fixed Interest					
IA Sterling Corporate Bond	6.07	9.53	12.22	22.78	42.95
IA Sterling High Yield Bond	4.35	6.66	8.46	12.01	43.63
IA Sterling Strategic Bond	4.28	6.80	8.37	16.25	37.40
IA UK Gilts	4.53	11.32	15.29	31.37	36.95
Commercial Property					
IA Property	3.65	5.50	12.14	30.16	55.95
UK Equities					
IA UK All Companies	10.12	8.80	11.74	20.74	73.91
IA UK Equity Income	9.18	7.92	11.39	24.10	76.22
IA UK Smaller Companies	14.93	6.55	7.79	29.55	98.15
International Equities					
IA Asia Pacific Excluding Japan	13.54	22.26	36.88	34.64	65.53
IA Europe Excluding UK	8.97	10.98	18.40	27.59	85.15
IA European Smaller Companies	12.40	11.86	22.95	42.52	110.76
IA Global	9.30	15.27	26.15	34.23	80.15
IA Global Equity Income	6.93	13.28	24.67	31.98	78.80
IA Global Emerging Markets	12.92	21.80	36.48	20.90	37.40
IA Japan	12.45	21.76	32.97	37.18	72.29
IA North America	8.75	16.03	30.05	54.21	122.15

Important Notes:

- Source: Financial Express Analytics
- Bid to bid pricing
- Total return basis
- Returns shown in local currency (Sterling)
- Time period ends at end of last quarter (30/09/2016)