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Smart[im]: Weekly Market Review

05 January 2018
Smart Investment Management

The week to date as at 12 p.m. Friday (GMT).

Markets and key events

New Year optimism

Optimism has continued into the new year that synchronised global growth can continue through 2018, with the greatest risk to markets most commonly cited as the re-emergence of inflation. All three of the main US stock exchanges have claimed record highs in the first few days of 2018, with the Dow Jones Industrial index rising 1.4%, Standard & Poor's 500 index up 1.9%, and the technology focused Nasdaq index up 2.5%. The Japanese Topix index, having opened for its first day of trading on Thursday, leapt 2.6% on the day, trading at a 26-year high, and now up 3.5% over just two days. The EuroStoxx 50 is up 2.9% as data continues to point to a resurgent Eurozone economy. Asia and emerging markets have also started off with a strong start, benefitting from dollar weakness and resurgent commodity prices. The MSCI Asia Pacific ex Japan index rose 2.3%, whilst the MSCI Latin America index rose 4.6%. Even the UK's FTSE 100 hit a record, rising 0.5% over the week, currently trading at 7,726, benefitting from a rally in commodity related stocks.

Leading indicators exceed expectations

A plethora of leading indicators have exceeded expectations in the first few days of the year, with the US manufacturing Purchasing Managers Index (PMI) hitting 55.1 (any figure above 50 representing expansion), its highest level in almost three years. The Chinese Caixin survey of manufacturing rose to 51.5, beating forecasts. Eurozone manufacturing PMI surged to a record 60.6. Institute of Supply Management's US manufacturing index rose to a 13-year high of 59.7, beating expectations. Yet despite this, the US dollar has continued to weaken. Attention has now turned to the latest US non-farm payroll employment figure due out later today, with an expectation of 190,000 new jobs created in December. Any signs of an acceleration in wage growth inflation are of particular interest, as this would lend weight to expectations of further US interest rate rises and add pressure to US company margins.

Commodity prices continue to rise

Commodity prices have continued to rise, with Brent crude having risen as high as $68.27, in part due to concerns over the Iranian oil supply given civilian unrest seen in recent weeks. In truth though, much of the increase in the oil price is more likely due to a combination of surging demand and supply constraints imposed by OPEC (Organisation of the Petroleum Exporting Countries). Oil consumption has expanded by almost 5m barrels a day over the last two years, versus annual growth of well below 1m barrels a day when the oil price was above $100 a barrel. How the production of US shale oil responds to higher oil prices will likely have a significant impact on the direction of the oil price over the rest of the year.

It is not just oil prices that have got off to a good start. Base metals including iron ore, copper and zinc have all risen, with the latter having touched its highest level in 10-years amid concerns over a supply shortage. Gold, having retreated to July levels mid-December, has also since gone on a tear rising 6% from its December lows to now trading at $1,318 an ounce.

Changes to the portfolios

There have been no changes to the portfolios.

Issues under discussion

Inflation

The synchronised global growth that began in mid-2016 continues. As most economic cycles are ended by central bank action, investors are trying to judge whether inflationary pressures make a comeback, resulting in interest rate rises to match. With unemployment falling in most developed economies, and already being at historically low levels in the US and the UK, the conditions look ripe at least for wage inflation. Yet so far it hasn't materialised in any meaningful way. There are many theories as to why this might be, including the impact of technology, the number of self-employed and part time workers who would prefer to be in full time employment amongst them, but as yet, no conclusion has been reached. The corporate and personal tax cuts recently passed by US Congress could reasonably be expected to stoke inflation, but not if corporates choose to use this money for mergers and acquisitions, or share buybacks, rather than increasing investment. This would be a case of Wall Street benefitting rather than Main Street.

Central bank withdrawal of QE

The other more obvious risk to markets is the withdrawal of quantitative easing (QE) by central banks. The US Federal Reserve has begun to reduce the amount it reinvests from bonds maturing in its portfolio, initially by $10bn a month, but this will gradually rise to $50bn a month during this year. At the same time, the European Central Bank has halved the size of its monthly QE programme from €60bn to €30bn. Although the ECB's policy remains expansionary, the reduction in the bond buying programme is likely to have an impact on markets. Perhaps the other central bank that investors do not pay quite so much attention to is the Bank of Japan. Currently they are holding 10-year government bond yields (JGB's) at close to zero. Not only is this distorting their own bond market, but global markets too as Japanese investors seek yield from other sources, thereby keeping bond yields artificially low across the globe. If this changes at any point, it has the potential to disrupt markets globally.

Despite valuations not being cheap, we do not see any immediate reasons to be bearish on markets, but we also remain cautious, recognising that the consensus view on markets is almost universally held. Historically, the risks that bring markets down are those often overlooked prior to the event.