



# Weekly Digest

Week ending **06 November 2016**

## A temporary phenomenon

As well as death and taxes another near certainty for residents of this green and pleasant land is that the prices they pay for goods and services in the future will be higher than those today. Indeed, since 1948 there are only two brief periods when UK prices have fallen year on year, as measured by the retail price index series (RPI); most recently in 2009 as the economy emerged from the depths of the financial crisis, and a short double dip in 1959 and 1960, the formation year of one of the UK's best loved musical exports, The Beatles. Paul McCartney might well be able to afford the £278,000 needed last year to buy the average home near where he grew up in Allerton, Liverpool, but those with more mainstream career choices may struggle.

Inflation targeting has been core to monetary policy in the UK for several decades now with the Bank of England (BoE) having responsibility for setting interest rates to meet the inflation target set by the Chancellor, currently a 2% target on the consumer price index (CPI). It wasn't so long ago that each month we would read that the Governor of the BoE would have to write to the Chancellor explaining why inflation was exceeding its target and what they proposed to do about it. Today he writes letters explaining the shortfall. The truth is though that many of the factors affecting prices today (the aforementioned taxes aside) are beyond the control of the BoE and are set by the global supply and demand dynamics. Mark Carney and his team have little influence over commodity prices. Strip out the energy component from UK CPI, which fell 9% year on year in 2015, and prices still rose.

Last week the BoE published its November inflation report and on the same day voted unanimously to leave unchanged all the policy levers they are employing. Following the 'Brexit' vote economic activity has arguably surprised to the upside. Coupled with the precipitous fall in sterling, which after steadying in Q3 suffered a further decline in October, the Monetary Policy Committee (MPC) acknowledged that inflation is likely to overshoot its target; certainly market implied measures of future inflation have shot up markedly in recent months. As the MPC must balance inflation risks with real economic activity, the committee judged it 'appropriate to accommodate a period of above-target inflation', albeit they judge 'indicators of medium-term inflation expectations... to be broadly consistent with the 2% target'.

So what does all this mean for investors today? Well in the 'here and now' of global monetary policy regimes deflation remains public enemy number one and the continued quantitative easing programs in Japan, Europe and the UK are testament to efforts to douse that threat. But inflation is not a problem of the present, but of the future, and with forward inflation expectations on the rise globally, today may be the time to buy your straw hat. To protect wealth from inflationary erosion a portfolio should ideally be comprised of assets that preserve purchasing power for the long term. Combining real assets such as property and infrastructure with growth assets such as equities it is possible to create a portfolio to capture and compound these marginal price increases over time, not only preserving capital in real terms but also growing it, a shortfall of traditional index linked gilts.

Compounding the dilemma for UK investors is the impact of weaker sterling on their portfolio. In the short term this has provided currency translation gains on foreign investments, and those assets may also gain from the forward discounting of their future non sterling profits. In the medium term however, we can probably expect a not insignificant rise in inflation as the cost of imported goods and services rise in sterling terms. The BoE has been at pains in the past to state that above target inflation would be temporary and they forewarn the same today. That may be true, but even if inflation averaged its 2% target for the next 20 years purchasing power would be depleted a third. Focusing on the 'temporary' overshoot is misleading to investors as it is the permanent 2% which makes the real dent in capital.

Our portfolio managers subscribe to the philosophy that compounding real returns over time is the most effective solution to preserving and growing long term purchasing power, and their investment framework allows them to construct robust portfolios to help their clients achieve their long term financial goals. With interest rate markets suggesting savers will earn little more than 1% five years from now, but with future inflation priced at over 3%, many investors in 'lower risk' investment solutions may find themselves at risk of losing money in real terms. That won't be temporary and their returns won't be phenomenal. If that were to occur and you live in Allerton, you may find yourself needing 'Help!' and feeling anything but fine.

## The Marketplace

- Investors hedge risk ahead of US election
- US employment data reinforces hike expectations
- UK High Court rules Parliament must vote to trigger Brexit
- Europe Q3 GDP growth at +0.3%
- Oil falls on rising inventories and falling faith in OPEC

## Market Focus

### US

- Global equity markets retreated by 1.8% last week, as investors looked to reduce risk in their portfolios ahead of Tuesday's US election. The S&P 500 index fell by 1.9% over the week, and has now fallen for nine consecutive sessions: the first time since November 1980 and resulting in a cumulative loss of 3.1%.
- Investors will hope to see this streak end today as the FBI announced its new investigation into Democratic, and more market friendly, candidate Hilary Clinton's email account yielded no signs of criminality. Polling averages currently show Clinton with a slim 2.3 point lead.
- Meanwhile the US economy added 161,000 jobs in October, whilst the unemployment rate fell 0.1% to 4.9% and average hourly earnings rose 0.4% month-on-month to take the year-on-year rate to 2.8%. The data helped justify the implied probability of a Fed rate hike next month, which stands at 76%.

### UK

- On Thursday the UK High Court ruled that Parliament must vote on invoking Article 50 before Theresa May's government can formally begin to negotiate exit conditions, which had been scheduled to commence in March 2017. The government appealed the decision, but the likely consequence is that the triggering of Article 50 will be delayed.

- On the same day, the Bank of England's Monetary Policy Committee kept the base interest rate unchanged at 0.25% in its monthly meeting, and adopted a more neutral tone. The members stated that "monetary policy can respond in either direction to changes to the economic outlook".
- These developments benefitted sterling which rose 2.7% over the week against the US dollar, to reach USD 1.25. But UK equities suffered, losing 4.3% in sterling terms.

### Europe

- The provisional reading for Eurozone economic growth in the third quarter of this year painted a picture of resilience after the UK's Brexit vote and amid various country specific political risks. Real GDP rose by 0.3%, matching the growth rate of the second quarter and leaving the year-on-year rate unchanged at 1.6%.
- The euro appreciated 1.4% against the dollar last week to USD 1.11. But continental European equities couldn't avoid the general sell-off, falling 3.8% in euro terms over the week.

### Commodities

- General scepticism over the ability of the Organization of Petroleum Exporting Countries (OPEC) to organise production cuts, coupled with the largest reserves increase on record in the US last week, caused Brent crude oil to suffer its worst trading week in eleven months, falling 8.3% to USD 45.58 per barrel.

Alex Harvey (CFA) & Oliver Bickley

Asset Class/Region	Currency	Currency returns			
		Week ending 04 November 2016	Month to date	YTD 2016	12 months
<b>Developed Market Equities</b>					
United States	USD	-1.9%	-1.9%	3.3%	0.7%
United Kingdom	GBP	-4.3%	-3.7%	11.1%	8.4%
Continental Europe	EUR	-3.8%	-3.2%	-6.8%	-9.3%
Japan	JPY	-3.3%	-3.3%	-11.1%	-10.6%
Asia Pacific (ex Japan)	USD	-1.6%	-1.7%	8.6%	4.3%
Australia	AUD	-1.8%	-2.4%	1.5%	3.5%
Global	USD	-1.8%	-1.8%	1.7%	-1.1%
<b>Emerging Market Equities</b>					
Emerging Europe	USD	-3.5%	-3.8%	11.7%	-3.7%
Emerging Asia	USD	-2.0%	-1.8%	9.3%	2.5%
Emerging Latin America	USD	-5.2%	-5.7%	37.1%	21.8%
BRICs	USD	-3.1%	-3.1%	14.1%	5.9%
MENA countries	USD	-1.8%	-2.1%	-3.0%	-6.3%
South Africa	USD	-1.5%	-4.0%	16.7%	-3.3%
India	USD	-2.3%	-2.2%	6.6%	4.4%
Global emerging markets	USD	-2.6%	-2.7%	13.1%	3.8%
<b>Bonds</b>					
US Treasuries	USD	0.4%	0.3%	4.4%	4.3%
US Treasuries (inflation protected)	USD	0.2%	0.0%	7.1%	6.5%
US Corporate (investment grade)	USD	0.1%	0.1%	8.4%	7.7%
US High Yield	USD	-1.1%	-0.8%	14.6%	8.9%
UK Gilts	GBP	1.2%	1.0%	11.2%	11.9%
UK Corporate (investment grade)	GBP	0.9%	0.7%	10.5%	11.7%
Euro Government Bonds	EUR	0.0%	0.0%	4.1%	4.1%
Euro Corporate (investment grade)	EUR	0.1%	0.0%	5.2%	5.1%
Euro High Yield	EUR	-0.4%	-0.4%	7.6%	5.6%
Japanese Government	JPY	0.2%	0.2%	5.3%	6.2%
Australian Government	AUD	0.4%	0.1%	5.0%	4.9%
Global Government Bonds	USD	1.6%	1.3%	8.3%	8.4%
Global Bonds	USD	1.2%	1.0%	7.3%	7.2%
Global Convertible Bonds	USD	-0.2%	-0.3%	1.2%	-0.7%
Emerging Market Bonds	USD	-0.5%	-0.4%	13.0%	10.5%

Asset Class/Region	Currency	Currency returns			
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<b>Property</b>					
US Property Securities	USD	-2.0%	-3.6%	0.6%	0.9%
Australian Property Securities	AUD	1.0%	-0.5%	1.3%	0.6%
Asia Property Securities	USD	0.0%	-0.4%	7.9%	6.9%
Global Property Securities	USD	-0.9%	-2.0%	3.3%	2.7%
<b>Currencies</b>					
Euro	USD	1.4%	1.5%	2.6%	2.5%
UK Pound Sterling	USD	2.7%	2.2%	-15.1%	-18.6%
Japanese Yen	USD	1.6%	1.7%	16.6%	17.9%
Australian Dollar	USD	1.0%	0.9%	5.3%	7.4%
South African Rand	USD	1.7%	-0.9%	13.9%	2.7%
Swiss Franc	USD	2.0%	2.1%	3.5%	2.6%
Chinese Yuan	USD	0.2%	0.1%	-3.9%	-6.3%
<b>Commodities &amp; Alternatives</b>					
Commodities	USD	-3.5%	-2.1%	6.1%	-5.6%
Agricultural Commodities	USD	-1.1%	-0.8%	2.2%	-1.3%
Oil	USD	-8.3%	-5.6%	22.3%	-6.2%
Gold	USD	2.3%	2.1%	22.9%	17.8%
Hedge funds	USD	-1.0%	-0.9%	-0.3%	-2.3%

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