



Weekly Digest

Week ending **18 December 2016**

Interest, Inflation and Other Ghosts of Christmas Past

When Charles Dickens first published his seasonal favourite 'A Christmas Carol' in December 1843 interest rates in the UK were 4%. Regular readers and market watchers will no doubt have observed how long term interest rates have moved higher in recent months but we're still some way from what the Cratchit family had to contend with financially, although most would agree we're better off in many other ways. This trend higher in longer rates started to emerge in the UK in the wake of sterling's summer devaluation. On the other side of the pond in the US, where we've witnessed similar it was really only after Donald Trump won the US election, that rates really started to power higher. Although there are different drivers behind these moves and central bank policies in the UK and US are on a differing course for now, it is market expectations for future inflation which ultimately drive these longer term rates and shape the longer end of the yield curve.

In the UK, sterling still remains some 10% below its pre Brexit level on a trade weighted basis despite a near term bounce from near multi-decade lows. The resultant increase in the price of imported goods and components is the primary reason for the sharp increase in inflation, with expectations that have been priced into index linked bonds. The 10 year UK 'breakeven' – which provides an estimate of the market implied rate of RPI inflation for the next 10 years – is now back at around 3%. With the yield on the nominal gilt of equivalent maturity at around 1.4% today that still makes for a nasty negative real expected return. The US offers better real bond returns today and while they remain some way off longer term levels, they are at least positive. This repricing of inflation risk is the reason behind the 'Marmite war' in October (when Tesco and Unilever had a very public spat about pricing). It was also behind the increasingly prevalent phenomenon known as 'shrinkflation'. The Toblerone bar is literally not what it used to be and Maltesers really are the lighter way to enjoy chocolate. Will I find 11 crackers in the box next year?

Last week saw the publication of the latest inflation numbers for the UK, with the data coming in slightly higher than the consensus expectations. Year on year, prices have been steadily increasing through 2017 from a near zero rate at the start of the year. That trend looks likely to continue and the Bank of England is predicting it rise to 2.75% in 2018 before falling back to 2% (caveat their limited predictive

success in the past). Indeed, the cost of input prices for UK manufacturers was nearly 13% higher in November than a year ago. Manufacturers cannot absorb those costs ad infinitum and consumers will ultimately feel this in their wallets or on their toast as we have seen. A recent report showed that the average turkey dinner this Christmas will have risen 14% this year to £10.71 per head (up from around 9 pence in 1843). Crackers are up a whopping 41% apparently. I'll take the 11 then!

Why this obsession with prices? Simply put, the key to preserving and growing wealth over time is the ability to generate positive real returns that (at a minimum) maintain purchasing power, and over the long term enhance it. Achieving this outcome requires investing in a pool of assets that balances the opportunity for growth and income with diversification and protection. Not only do you want to meet or exceed your goal, but you want the most comfortable journey. So if you don't want to find 11 crackers in the box next year or face buying an ever shrinking Christmas tree then you'll need to think about beating inflation over the longer term. Then you'll have a real present worth talking about.

The Marketplace

- Fed raises US interest rate
- US-China tension impacts markets
- UK inflation reaches two year high in November
- Euro area inflation in line with expectations
- Emerging markets fall back amid dollar strength

Market Focus

US

- In its monthly meeting on Wednesday, the Federal Open Markets Committee (FOMC) unanimously decided to raise the federal funds rate by 25 basis points to a target range of 0.5-0.75%.
- The Federal Reserve (Fed) last raised rates in December 2015, while this is only the second increase since the Global Financial Crisis in 2008. However the FOMC members' median forecast for next year predicted three rate rises of 25 basis points – which would leave the range at 1.5-1.75% as of the end of 2017.
- Markets had largely priced in the rise before its occurrence, and thus took the event in their stride. US equities were flat for the week. The move was reflected more in currencies, as the dollar index rose 0.7% on the day and 1.3% over the week.
- Diplomatic events arguably had a more stark effect on markets, after news of China seizing a US underwater research drone in the South China Sea, accompanied by an irate tweet from President elect Donald Trump accusing China of stealing, increased tensions between the two superpowers. The day following the news the dollar index fell up to 1.5% intraday.

Europe & UK

- Figures for UK inflation from the Office for National Statistics (ONS) showed consumer prices rising 1.2% year-on-year in November. The number is the largest annual rise since October 2014. Prices rose in all categories except food, with transport costs increasing the most amid the continued recovery in oil prices (which rose 1.6% last week).
- Meanwhile similar figures for the Eurozone reported consumer inflation at +0.6% year-on-year in November, in line with expectations. Of the twenty nine Eurozone countries, only six - Bulgaria, Cyprus, Ireland, Greece, Romania and Slovenia - reported falling year-on-year prices.

Emerging Markets

- Global emerging market equities fell 2.4% last week, hit by a combination of weak currency movements relative to a strong dollar, rising geopolitical tensions between China and the US, and falling commodity prices.
- Over the week, the MSCI EM currencies index and Bloomberg Commodities index fell 0.8% and 0.3% respectively.

Alex Harvey (CFA) & Oliver Bickley

Asset Class/Region	Currency	Currency returns			
		Week ending 16 December 2016	Month to date	YTD 2016	12 months
Developed Market Equities					
United States	USD	0.0%	2.8%	12.1%	10.6%
United Kingdom	GBP	0.8%	3.4%	17.0%	20.5%
Continental Europe	EUR	1.6%	5.7%	1.8%	3.2%
Japan	JPY	1.7%	5.5%	2.3%	2.9%
Asia Pacific (ex Japan)	USD	-2.5%	-1.1%	6.8%	9.3%
Australia	AUD	-0.5%	1.7%	8.9%	15.0%
Global	USD	-0.3%	2.5%	7.7%	7.3%
Emerging Market Equities					
Emerging Europe	USD	1.8%	7.2%	23.1%	22.4%
Emerging Asia	USD	-2.3%	-1.0%	6.5%	7.7%
Emerging Latin America	USD	-4.4%	-3.7%	25.1%	22.4%
BRICs	USD	-3.0%	-2.7%	10.4%	10.7%
MENA countries	USD	0.1%	2.5%	6.8%	9.2%
South Africa	USD	-4.9%	-0.9%	10.8%	12.2%
India	USD	-1.9%	0.0%	1.3%	4.4%
Global emerging markets	USD	-2.4%	-0.7%	10.1%	10.9%
Bonds					
US Treasuries	USD	-0.6%	-1.1%	0.2%	0.2%
US Treasuries (inflation protected)	USD	-1.7%	-2.2%	2.7%	3.4%
US Corporate (investment grade)	USD	-0.3%	-0.7%	4.7%	4.9%
US High Yield	USD	-0.1%	1.2%	16.4%	16.8%
UK Gilts	GBP	-0.2%	-0.6%	7.9%	7.8%
UK Corporate (investment grade)	GBP	0.0%	0.0%	8.5%	8.6%
Euro Government Bonds	EUR	0.5%	0.0%	2.5%	2.7%
Euro Corporate (investment grade)	EUR	0.2%	0.1%	4.2%	4.4%
Euro High Yield	EUR	0.6%	1.5%	8.7%	8.3%
Japanese Government	JPY	0.0%	-0.8%	3.5%	3.9%
Australian Government	AUD	-0.1%	-0.6%	2.2%	2.7%
Global Government Bonds	USD	-1.2%	-2.0%	0.1%	0.3%
Global Bonds	USD	-1.0%	-1.7%	0.5%	0.5%
Global Convertible Bonds	USD	-0.6%	0.1%	-0.4%	-0.2%
Emerging Market Bonds	USD	-0.6%	0.0%	8.2%	8.5%

Asset Class/Region	Currency	Currency returns			
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Property					
US Property Securities	USD	-0.6%	2.7%	5.4%	5.8%
Australian Property Securities	AUD	0.1%	0.9%	3.7%	3.1%
Asia Property Securities	USD	-4.5%	-3.7%	2.2%	3.7%
Global Property Securities	USD	-1.8%	0.4%	2.9%	4.0%
Currencies					
Euro	USD	-1.1%	-1.3%	-3.7%	-4.2%
UK Pound Sterling	USD	-0.6%	-0.1%	-15.2%	-16.7%
Japanese Yen	USD	-2.2%	-2.9%	2.0%	3.6%
Australian Dollar	USD	-1.9%	-1.1%	0.3%	1.0%
South African Rand	USD	-1.7%	0.3%	10.2%	6.5%
Swiss Franc	USD	-0.9%	-0.9%	-2.4%	-3.6%
Chinese Yuan	USD	-0.9%	-1.0%	-6.8%	-7.1%
Commodities & Alternatives					
Commodities	USD	-0.3%	2.1%	12.9%	14.6%
Agricultural Commodities	USD	0.2%	1.0%	2.8%	2.7%
Oil	USD	1.6%	9.4%	48.1%	48.5%
Gold	USD	-2.2%	-3.3%	6.9%	5.8%
Hedge funds	USD	-0.1%	0.8%	2.3%	2.5%

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