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Market View

Since the financial crisis of 2008/2009 the global economy has been growing, but at a level below long term trends. This underperformance was manifested in low growth, very low inflation (sometimes deflation) and thus central banks were happy to set both short term and long term interest rates at close to zero. They did this through the practice of Quantitative Easing, i.e. buying bonds at below the prevailing market level thus forcing yields down. Initially, this practice was fine but each subsequent QE program had progressively less impact on the global economy. We have long argued that growth needs three pillars to support it, low interest rates, bank lending and government spending. The problem until the middle of 2016 was that governments were taking cash out of economies, in order to pay down high levels of borrowing and the banks couldn't lend, because interest rates were too low to make a profit. Frustration with this lack of growth started in Japan, where Central Bank Governor Kuroda, twisted QE to create higher future interest rates but maintain short term rates close to zero. We then had the Brexit referendum shock, realisation dawned that QE had not benefitted the wider population. Jobs had been created but at lower wages, on zero hours or no contracts, the middle classes were no better off than they were in 2008 and were financially solvent only through benefits and artificially low mortgage rates. Apart from the South East they had not seen a boost to property values either. The Brexit vote was a wakeup call to politicians and central bankers that all was not well for the majority of voters, and not just in the UK. This same pattern spectacularly repeated itself in the USA. The Trump victory was even more emphatic than the Brexit vote. The political world and also the economic world have now changed, QE is on its way out, and fiscal stimulus is the new mantra.

Bond Yields

Past performance is not a reliable indicator of future results.

This change has been manifested in a jump in bond yields. Earlier this year the US Treasury 10 Year Yield was 1.3%, since the election the rate has moved up to 2.4%, when the official US interest rate is 0.5%. So the market thinks that US official rates need to go up. The 30 Year rate is at 3.0%, which is consistent with inflation at 2%. So post the Presidential Election and the belief that Trump will spend the US back to growth, the bond markets have priced in a return to "normal" historic growth levels. Market pricing is based on what might be happening in 12 to 24 months' time, not on today. So it is a possibility with a reasonable probability of success, IF Trump delivers. But interest rates are dangerous things; higher interest rates will help savers and the banks, but have an immediate negative impact on homeowners.

Mortgages and the US Housing Market

Any policy change brings benefits but also costs. The fast rise in rates has spurred US homeowners to stop refinancing their mortgages. The US 30 year fixed mortgage rate has jumped from 3.6% to 4.2%. The US Mortgage Bankers Association now estimates that consumers refinancing their existing mortgages in order to either reduce their monthly outgoings or release extra capital will fall by 46% next year, to $484 billion. The fall in refinances will hit an important area of consumer-loan growth for banks. To reduce the possible damage, banks are already offering riskier loans that come with adjustable interest rates or allow borrowers to pull more equity out of their homes. This month's rate increase has eliminated a large share of borrowers for whom refinancing would make financial sense. "Before the election, 70% of all borrowers with a 30-year fixed-rate conforming mortgage stood to incur at least a half a percentage point in savings by refinancing. Now only 35% of borrowers are eligible for such savings," according to FTN Financial. The markets have raised rates before the Trump stimulus has even been announced. This has the potential to squeeze US consumer spending and impact the housing market just at the wrong time.

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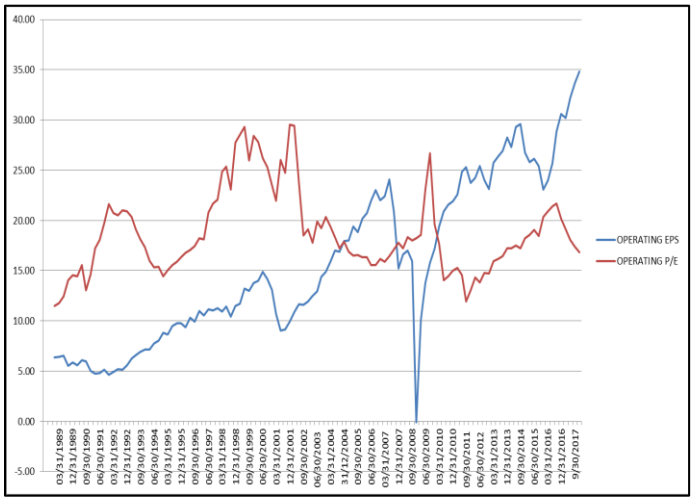
S&P 500 Operating EPS and P/E ratio .....Good News!



This chart displays the quarterly earnings and Price to Earnings ratio for the S&P 500 constituents. It also includes the forward estimates to end December 2017. What can be seen is a return to the growth trend for corporate profits (blue line). This growth then impacts on the valuation metric (red line); the P/E ratio starts to fall and does so rapidly and moves downwards away from "expensive" towards "good value". What is particularly interesting is that these future estimates are based on the underlying companies own guidelines. These were published before the Trump victory and thus take no account of any possible fiscal stimulus or tax cuts. So we can assume with a reasonable degree of confidence that the US markets are back to good value.

Source: Standard & Poor

Italian Referendum

Italian PM Mateo Renzi called a referendum in order to reform the structure of the Italian political process and therefore implement much needed, structural reforms. It backfired, his proposals were rejected. For now, this will mean the appointment of a technocratic government, i.e. not elected, which is peculiar to Italy and often leads to better management of the Italian economy. The big issue for Italy is that their sizeable banking sector has still not written off the debts from the Credit Crunch, there is therefore the risk, that this set of circumstances could have an impact on the stability of the Italian banking system. An Italian banking crisis would drag in the rest of the euro group should it occur, the dreaded contagion. Banca Monte di Paschi needs e5bn and is the first in a long "domino-line" of Italian Banks that need new capital. Ultimately, Italy will have to have a General Election and currently the anti-Europe Five Star Movement is riding high in the opinion polls. Such a move in Italy would place severe pressure of the European Union and the euro. France may move "right" in its Presidential Election, Republican candidate Fillon may be just right wing enough to prevent Le Pen from taking the Elysee Palace? Europe remains the epicenter for political risk at present.

Markets

It's been eight years since the start of the Credit Crunch and we seem to be in sight of the US and thus the global economy finally returning to "normal". The corporate world is seeing profits pick up and market valuations are falling, money is finally flowing out of expensive bonds into equities. For the investing world all would appear to be well. But, as ever, nothing is that easy. Democratic politics can act as a major short term drag on investment returns. In Europe 75% of the population will be voting in one way or another over the next 12 months and given that unemployment levels are still elevated the political risk is very high. Italy is in focus at the moment, especially given the fragility of Italian Banks. If Europe does move towards the right, as long as the euro remains in place, might be no bad thing, as it could lead to the long awaited reform of the EU. A collapse of the euro would, however, have major implications for financial stability. For the markets we know that the natural long term trend is upward, with periodic recessions causing pullbacks. However, we have also seen historically that a political mistake can cause short term distortions to the cycle. Given all of the possible risk events occurring in Europe we do have to be mindful that such an event (creating knock-on economic problems) is always possible. However, we mustn't let the political news flow dominate the fact that we have an improving background for corporate profits, especially with governments starting to spend. This will cause interest rates to move up and the banks can start making money again, so back to "normal". But, risk levels are high. None of this will be easy to achieve, there are also prickly personalities involved, but the multinational companies we invest in can do very well in this environment. True investors will always buy value and wait, regardless of what is going on in the world. The contrarian investor is nearly always the most successful one.

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