Ethical Investment

Model commentary

For this period of reporting since August 2017, we expect everyone will be interested in the events that triggered the falls in the market in early February, especially given the media coverage this has attracted. In terms of the period itself, markets tended to be positive leading up to February with the FTSE 100 returning 6.42% from the start of the reporting period to the 12th January 2018. However, the market correction at the beginning of February saw the markets drop by -8.78% before recovering slightly translating to an overall loss over the reporting period of -0.64%. Within the various equity sectors the most notable performance came from Global Emerging Markets, Asia Pacific ex-Japan and North America. Europe ex-UK, which performed well generally during 2017, lagged in the last quarter.

The areas we intend to cover in this update have been gathered from a series of sources which cover why investment markets have performed so strongly in recent years, what caused the recent fall in values, and what the outlook is from here.

According to the data sources the strong performance from equities in recent years has been due to the global economy performing better than expected, together with the higher forecast for economic growth leading to increased confidence that company earnings will rise in the future, boosting share prices.

This current environment of economic strength emerged slowly from a period of intense anxiety in 2009 following the systemic failure of the global banking system. The path to recovery was created through dramatic action from central banks, cutting interest rates and printing trillions of dollars (or their equivalent local currency) to reduce borrowing rates to historical lows. This provided cheap finance and liquidity to the entire global economy and was ultimately successful in restoring economic growth.

At the present time, the International Monetary Fund (IMF) is predicting that all of the economies it represents will experience positive growth in 2018. This picture of synchronised economic growth is a firm signal of confidence and is reinforced by various other economic leading indicators.

These factors combine to provide further upward momentum to stock markets which had already enjoyed a sustained period of growth with historically low levels of volatility. Towards the end of the period some falls were seen, which accelerated during February.

Whilst the recent downturn has been in contrast to the previous period of stable upward returns, corrections of this type are normal, and occur frequently in both upward and downward long-term trends. The timing of a correction is often a surprise but the correction itself is expected.

Corrections often indicate a change in market expectations and understanding, which can be used to identify investment opportunities going forward and also have a useful cleansing effect. On this occasion it has been interesting to note that some assets, which have shown bubble like tendencies, have been hit hard with the obvious example of Bitcoin, which has fallen in value.

According to our sources the cause of the alarm on this occasion is good news. Figures from the US, relating to the labour market, showed healthy levels of employment and wages increasing at a higher rate than previously thought. The prospect of people earning more and finding work easily is a sign of strong economic growth and is usually something to be cheered. On this occasion stock markets greeted the news with pessimism; why?

Within previous reviews we have covered the interest rate cycle, which has been falling since the 1980s, representing a very long cycle length. Furthermore, the improvement in economic conditions suggested that this long-term cycle was changing and we were now entering an upward interest rate cycle, which would change the characteristics of many asset classes.

The recent market downturn is a reflection of investors generally coming to the same conclusion and becoming concerned that interest rates will now rise, as central banks take action to keep inflation at around 2%. The era of cheap money is coming to an end and undoubtedly there are many assets which have seen their valuations fluffed up by this phenomenon and are now looking vulnerable. Where assets sell-off in one sector the effect of market correlations often causes sell-offs in other assets. Some assets go on to recover their value whilst others do not.

Fixed interest investments are sensitive to interest rate rises, as are companies reliant on ongoing capital raising because the increase in interest rates has a detrimental effect on both of these asset values. Within these markets there are some worryingly high valuations, particularly within high yield bonds, long dated bonds and companies with massive valuations, but with negative earnings.

In terms of the broader markets our sources have reasons to expect asset prices to regain their upward momentum and these falls represent a buying opportunity rather than a signal of a prolonged downturn. Whilst central banks are moving into a rate rising cycle we expect this to be a very slow and measured process. Given the significant efforts which have been made to drag the global economy out of the 2009 credit crisis, central banks will be anxious about choking off the economic recovery. Therefore, inflation will be allowed to run over target rather than pursued aggressively, at least in the early years of the rate rising process.

For example, interest rates in the UK are currently 0.5% and, at the most, are expected to rise to 1% by the end of the year even after the latest comments from Mark Carney, the Governor of Bank of England, suggesting that rates would move earlier and higher than previously expected. A future rate of 1% is hardly an economic activity choking prospect and would still be a historically low level, although it would be bad news for interest rate sensitive assets as mentioned previously.

Furthermore, the wage inflation which has caused the recent concern, is actually preferable in the medium and long term to the alternative of stagnant wages. In order to continue an upward economic cycle it is important that wages rise in real terms in order to allow future consumption to rise. If wages do not rise faster than inflation then consumer debt builds to the point that consumption falls dramatically and leads to a recessionary outcome.

The current shakeout of asset prices has been a useful and necessary event. The assets most at risk are those which have benefited from speculative interest, or where the valuation is heavily dependent on a low interest rate environment. Growth stocks have benefitted considerably in the market rises and some of these stocks now look vulnerable.

Tesla is a useful example, and this business requires new capital of hundreds of millions of dollars a year in order to keep trading, as revenues do not come close to meeting operating costs. Whilst a company like this may change the world in the future, the inherent risks to investors are obvious and if capital is more expensive in the future this will add additional costs to the business model pushing the breakeven position even further into the future.

Value orientated stocks have provided reasonable returns but have not generally kept up with their growth counterparts. These companies have mature and predictable business models and whilst their upside potential is more modest, they tend to be driven favourably by economic growth and are not sensitive to the relatively modest interest rate rises which are now expected.

Strategy

In conclusion, whilst it is difficult to predict how long or how low a correction will go, the sentiment suggests there is confidence that global equity markets will continue in an upward cycle. The current market conditions provide an opportunity to increase equity positions with a bias towards companies linked to economic growth, which is expected to remain positive. The rate rising cycle will be gentle, but negative for fixed interest investments, which have a high degree of sensitivity.