ALBERT E SHARP

INVESTMENT MANAGEMENT & STOCKBROKING

MARKET COMMENTARY

April 2017

The Return To Normality?

March was another good month for stocks, rounding off a strong quarter in which the World Index closed up a healthy 6.5%. The US is setting the tone and with corporate sales and earnings predicted to have grown by 6-7% in the first three months, it is no surprise that confidence in the region is at a 15-year high. Key economic statistics remain encouraging, with unemployment below 5% and inflation steady at 2.2%. Although further interest hikes throughout the year are expected, bonds have firmed slightly and volatility has been much-reduced. Currencies have also been relatively calm and despite the triggering of Article 50, sterling had its first positive quarter against the dollar for 4 and a half years, despite countless media stories predicting otherwise. Interestingly, gold has rallied almost 9% year to date, suggesting that there are still plenty of nervous investors at large.

Nevertheless, the central narrative for investors right now is that of reflation and the associated 'Trump Trade'. After a lengthy period of low economic growth, subdued inflation (skirting with deflation at times), low interest rates and anaemic corporate profits in the US, economists are now looking at higher inflation, higher corporate earnings and higher interest rates. The general assumption is that under these conditions equities (shares prices) will rise and bond prices fall and recent evidence confirms this. Since the Presidential election on 8th November, the Dow Jones is up 14% and the US 10-20 year government bond index is down 4%. Having barely had chance to get his feet under the table and achieve anything of note (nuclear war aside), the general view is that the rise is purely in anticipation of expansive economic policies and good times to come. Below, we look into this and conclude that it is only part of the story.

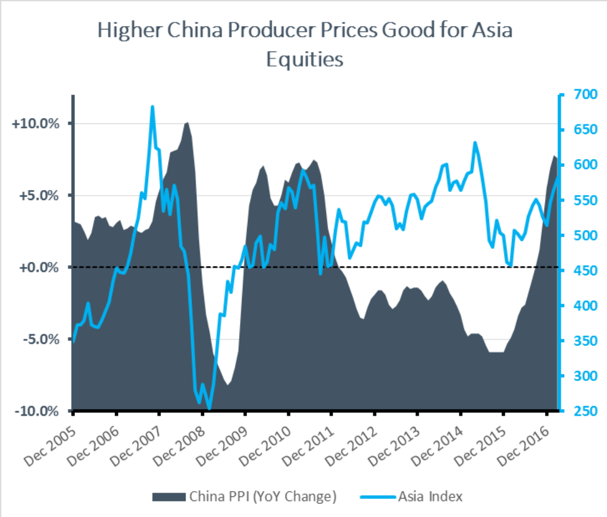
First, it is relevant to see where we are now and where we have come from, because the events of January and early February 2016 are now incredibly important in retrospect. Back then, we saw clear signs of panic as investors fretted over the implications of a lower oil price, deflation, rate hikes, a Chinese hard landing, lacklustre economic growth and the spectre of impending global political change. As a result, and all of a sudden, a consensus seemed to form that the world was stuck, as Larry Summers put it, in a position of secular stagnation. In other words, for various rigid, structural reasons, any form of growth in terms of GDP, corporate earnings, or wages would at very best be negligible and at worst negative. As a result, stock markets which had fallen by over 10% in the first six weeks of the year were set to fall much further.

Our concern was that the US would follow Switzerland, Japan and others into the regime of negative interest rates. This was partly due to the unknown consequences but mostly due to the fact that it was a signal that the US government had lost the willingness and or the ability to use fiscal policy (taxation and government spending) in order to boost economic growth. In response to the unfolding opinions of economists, the media and the signal from the financial markets, the Fed did the only thing it could do and reversed its policy of raising interest rates. As a result, monetary conditions were eased globally, but crucially they did not go negative and the markets (and the Albert E Sharp team) breathed a sigh of relief.

In retrospect, it could be argued that the deciding factor as to why confidence was restored actually stemmed from several key events that were not driven by monetary policy. These included a credit splurge in China, fiscal stimuli in Japan and in the EU and the huge benefits of lower oil prices for the consumer. Finally and fatefully, as the year went on, the promise of Trump-driven tax cuts in the US, combined with higher infrastructure spending offered something more meaty further down the line.

By mid-December, the stock market was mirroring the pattern that was formed in the first six weeks of the year. In a very short space of time, investor focus moved away from concerns over a pessimistic, downward deflationary spiral, towards the hopeful, reflationary return to normality.

However, we do not put this entirely down to Trump, because at the time, very clear and positive evidence from Asia was emerging. So much so that in the first quarter of 2017, the region's equity index was up over 13%, representing the third highest quarterly gain in over 30 years and the simple reason is a return of price inflation. Over the last seven years much of the region has been facing falling commodity prices and labour costs.

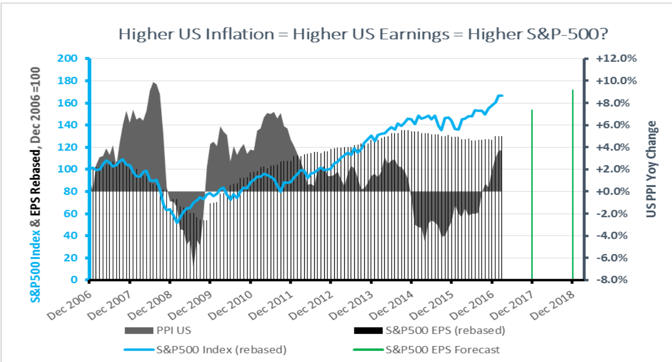


Having steadily become more negative since 2012, Chinese producer prices have moved from -6% p.a. at the end of 2015 to +8% in the last few weeks. This massive 14% swing has filtered through to corporate earnings improvement, wage increases, higher levels of consumer confidence and higher consumer spending. In fact, corporate earnings had grown by barely 1% p.a. in US$ terms since 2011 (i.e. virtually flat for more than five full years) but following this injection of inflation into the system, analysts now have an expected 15% growth rate for 2017, the fastest rate since 2010. None of this is down to Donald Trump.

Click on blue links for more information online

Unsurprisingly, markets are pricing-in that the same will prove to be the case elsewhere and the chart below explains why investors are upbeat about the US. The line of thought is that inflation, as measured by the US Producer Price Index (PPI) impacts earnings per share (EPS) in the US's main index, the S&P500. In order to simplify the message, we have rebased the number so that it represented 100 in December 2006. Therefore the furthest right black column in March 2017 of 130 implies 30% growth over the period. Bearing in mind this took over 11 years to achieve, this is the equivalent of just 2.4% p.a. and in fact it has hardly improved at all since 2012. Given this information and looking back, it becomes clear why the secular stagnation camp has had a strong case to make.

But by the same token, the reflationists point to the future and building on current evidence of embedded rising prices, the green columns show that we are expecting 18% growth during 2017 and another 11.6% in 2018. This doesn't sound like stagnation, quite the reverse in fact. As the light blue line might suggest, the S&P500 is anticipating this to a degree, but the conclusion must be that if moderate positive inflation remains, this is good news for the stock market. The key point is that the forecasts in green are purely based on the momentum of current economic trends and do not take into account any of Trump's potential economic policies.



The debate shows no signs of cooling and the reflationists seem to be have the upper hand at the moment. Support was recently extended by Claudio Borio (a senior official at the Bank for International Settlements) who in a recent speech cast aside Larry Summers' thesis arguing that it simply did not make sense. He suggests that it is central bankers' overreactions of the past in slashing rates that has caused the problems and it is possible to bring them back to 'normal' levels of old without killing off growth. We find the argument persuasive.

The important point is that that the expectations for earnings growth are driven mainly by existing inflationary pressures and *not* potential US tax cuts, this factor just adds to the upside. In truth it remains unclear how much Trump can practically achieve, given the difficulties he has faced with healthcare reform so far and some of the initial investor enthusiasm has waned of late. But any weakness could well prove to be a buying opportunity. Gramsci's musings on the "pessimism of intellect and optimism of will" seem particularly apt here. Donald Trump doesn't seem to face the hindrance of the former and is certainly not short on the latter.

Post Script: Don't Fret Over Nuclear Holocaust

At the time of writing (Tuesday after Easter) media headlines are warning of a military confrontation on the Korean peninsula and potential nuclear war. The financial markets seem surprisingly unruffled but have nevertheless opened lower, following the long weekend. At times such as this, it seems glib to argue that the worst will not happen, given the lack of trust in Trump, let alone the North Korean leadership.

But if anything has been learned from recent skirmishes, it is that the situation is diffused due to the cataclysmic potential consequences. Furthermore, it has been to buy on weakness and this time should prove no different.

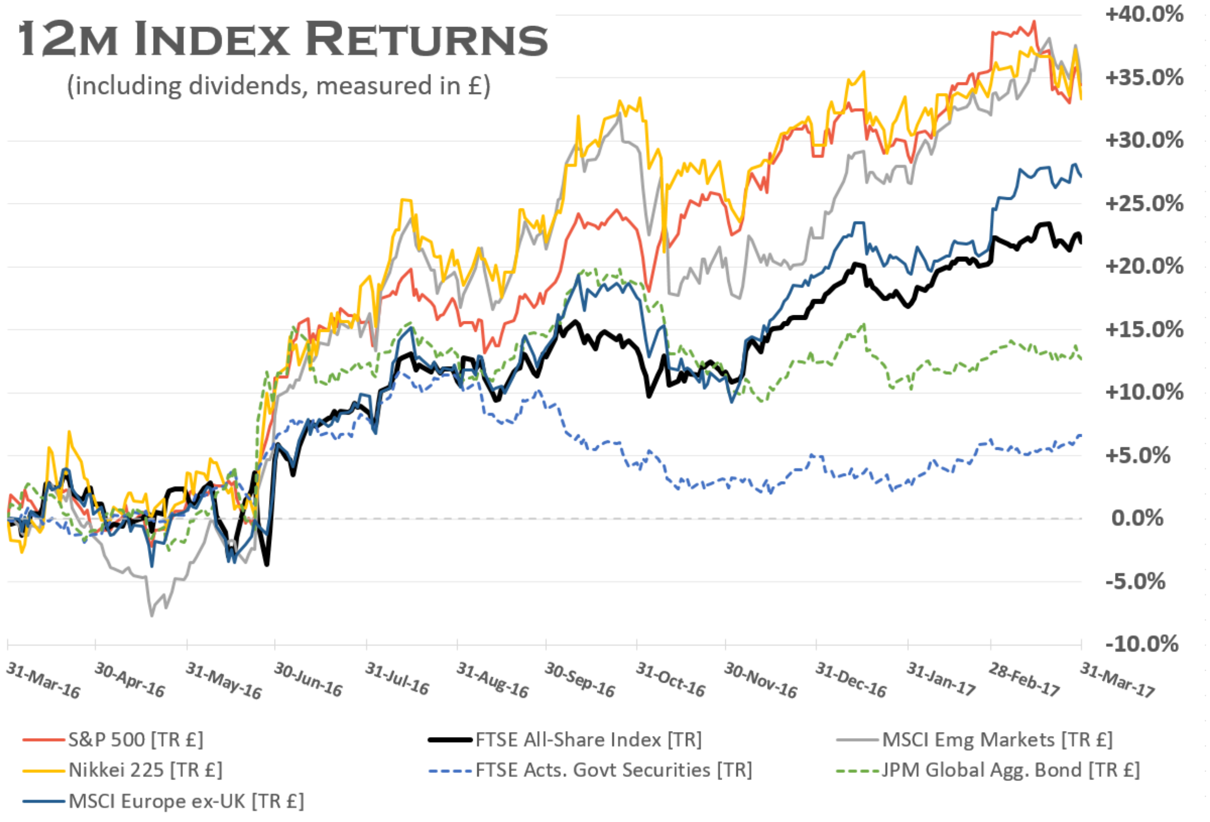
Post Post Script: Don't Fret Over General Election

Today's surprise news that there will be a general election on June 8th should not be taken as bad news for investors. The immediate sell off in the pound was a knee jerk reaction suggesting that the uncertainty beforehand could be damaging. Within minutes, the decline was erased as the markets realised that this would likely only strengthen the government's position and that it would not be a proxy Brexit re-vote. If investors want reasons to be worried then they should look to France right now, not that we expect any nasty conclusion. But at least it puts the 'worries' over the UK vote into perspective.

Click on blue links for more information online

INDEX RETURNS

Index	Region/Asset Class	31-Mar-17	Monthly Change	1 Yr Change	2 Yr Change
UK 100	UK	7,322.92	+0.8%	+18.6%	+8.1%
UK Mid Cap	UK	544.54	+1.7%	+9.1%	+7.1%
UK Small Cap	UK	5,430.46	+2.7%	+19.5%	+18.1%
Dow Jones Ind Avg	USA	20,663.22	-0.7%	+16.8%	+16.2%
S&P 500 Index	USA	2,362.72	-0.0%	+14.7%	+14.3%
NASDAQ Comp.	USA	5,911.74	+1.5%	+21.4%	+20.6%
Nikkei 225	Japan	18,909.26	-1.1%	+12.8%	-1.6%
Euro Stoxx 50	Europe	3,500.93	+5.5%	+16.5%	-5.3%
CAC 40 Index	France	5,122.51	+5.4%	+16.8%	+1.8%
DAX Index	Germany	12,312.87	+4.0%	+23.6%	+2.9%
Milan Index	Italy	20,492.94	+8.4%	+13.1%	-11.5%
MSCI Emg Mkts (£)	Emg Mkts	505.69	+2.0%	+34.7%	+22.4%
IBOVESPA Index	Brazil	64,984.07	-2.5%	+29.8%	+27.0%
MICEX Index	Russia	1,995.90	-2.0%	+6.7%	+22.7%
S&P BSE SENSEX	India	29,620.50	+3.1%	+16.9%	+5.9%
Shanghai SE Comp.	China	3,222.51	-0.6%	+7.3%	-14.0%
Hang Seng	Hong Kong	24,111.59	+1.6%	+16.1%	-3.2%
Conventional Gilts	UK Gilts	3,581.87	+0.3%	+6.6%	+10.1%
JPM Glob Agg. Bond (£)	Global Bonds	814.83	-0.3%	+12.7%	+21.7%
WTI Crude	Oil	50.60	-6.3%	+32.0%	+6.3%
Gold Spot $/Oz	Commodities	1,249.35	+0.1%	+1.3%	+5.5%
£1 = US$	Currencies	1.26	+1.4%	-12.6%	-15.3%
£1 = €	Currencies	1.18	+0.6%	-6.7%	-14.7%
£1 = Yen	Currencies	139.81	+0.1%	-13.5%	-21.5%



Source: Albert E Sharp, Bloomberg®

ALBERT E SHARP
INVESTMENT MANAGEMENT & STOCKBROKING
WWW.ALBERTESHARP.COM
7 Elm Court
Arden Street
Stratford Upon Avon
Warwickshire
CV37 7LN
☎ 01789 404000