August 2016

Market Bulletin

The Orchard Practice

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growing together

This month's market update comes from Jupiter Asset Management, managers of the Omnis Emerging Markets Equity Fund and Omnis European Equity Fund.

- An unusually quiet August
- UK and US interest rate policies diverging
- Political events are likely to be a factor in the fourth quarter

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August has a reputation for being a month when markets suffer bouts of the collywobbles leading to significant volatility. Last year was a case in point when they reeled from the news that China was devaluing its currency by 4%. However, August 2016 has proved just the opposite, a paragon of tranquillity and calm! So much so that most major equity markets have traded with their lowest level of fluctuation for many years.

On the economic front, the Bank of England (the Bank) revealed its policy response to the Brexit referendum vote and to mitigate against the possibility of any resulting economic recession (note our emphasis on "possibility"). As widely anticipated, the Base Rate was halved from 0.5% to 0.25%; the Bank announced a new round of quantitative easing (QE) to the tune of £70bn under which it will not only buy UK government bonds (gilts) but also, and this is different from previous QE programmes, will include the purchase of UK investment grade corporate bonds. That is to say it will lend directly to big credit-worthy UK companies raising finance through the bond markets. These measures had been well trailed, nevertheless there are many who fundamentally disagree with the need for them and worry about the long-term ramifications. In the 7 years since the deepest point of the global financial crisis the UK has been operating on the same emergency Base Rate of 0.5% as was applied when high street banks were going bust, and despite decent economic recovery since. The Bank has therefore left itself precious little head-room in which to use interest rate policy as an effective tool to stimulate growth in weaker times, while still keeping interest rates above zero (as it has indicated it will). In this predicament, having failed to follow its own guidance as to when it would increase interest rates, the Bank has only itself to blame.
The net effect of these measures, predictably, was immediately to push bond prices up and their yields (i.e. returns) down. The 2 Year gilt flirted briefly with a near zero percent yield and the 10 Year gilt yields 0.63% at the time of writing; this time a year ago it was 1.98% . The pressure on hard-pressed savers earning a miserable rate of interest is self-evident (if they're lucky enough to receive any at all!). But it extends also to funds, particularly in the pension and insurance sectors in which the appetite for ready cash to meet immediate liabilities is voracious; managers have to search elsewhere for sources of regular cash income at what are deemed reasonable cost and risk (e.g. dividends from companies' shares, property rental income etc.). Still, others might look on enviously and remind us that elsewhere 36% of all global debt trades on a negative yield (i.e. the bond-holder/lender is paying for the privilege of owning those bonds rather than being rewarded as traditional theory would suggest should happen).

Meanwhile, at a monetary policy symposium for global central bankers held at Jackson Hole, Wyoming, US Federal Reserve (US Fed) Chair Janet Yellen reiterated her belief that US economic data, particularly employment and wages, is sufficiently strong to support a rise in interest rates before the end of the year. Wearily, we've been here before but her monetary policy committee remains split both with regards to timing and need. The money markets rate the chance of a single quarter point interest rate rise before the year end at 36% it happening in September, 38% in November and 45% in December; even they aren't overwhelmingly convinced. The next policy meetings of the US Fed and the Bank of Japan (BoJ) coincide on the 21st September; there is a very outside possibility of the Fed raising interest rates (36% chance, as above) while the BoJ cuts (27% chance) which, were it to happen, would be likely to be felt most keenly on the foreign exchanges.

Outlook

Aside from economics, politics will be a factor behind markets' behaviour for the remainder of the year. The US election is in November; while Mrs Clinton leads the polls, it would be rash to discount a Donald Trump victory at this stage. In Europe, on a date yet to be determined but likely to be October or November, Italy has a referendum on domestic constitutional reform. Matteo Renzi, the Prime Minister, has staked his premiership on the outcome, effectively turning it into a confidence vote. Should he resign the ensuing vacuum could be filled by opponents of economic austerity who also tend to be strongly anti-EU, not a prospect the elites of Brussels and Strasbourg relish in the light of Brexit. In the UK, after the summer Parliamentary recess, Teresa May's new government will be setting its Brexit agenda before the anticipated invocation of Article 50 giving formal notice to quit the EU. Much to keep us occupied!

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