MARKET UPDATE – SUMMER 2017

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Financial markets have become unsettled by the escalating war of words between US President Donald Trump and the North Korean leader Kim Jong-un. It is possible, but seemingly unlikely that the rhetoric leads to an armed conflict because of the sheer mismatch in military capabilities between the two countries.

Trump's unorthodox tactics to diplomatically lure Russia and China into the frame appear to be working, and hopefully North Korea will be persuaded by its neighbours to back down. This is the base case outcome, but in the event of a military tug-of-war, the skirmish will probably be short-lived. Geopolitical situations like this tend to cast a fleeting shadow over markets before investors return to the longer-term fundamentals, which remain bullish for global equities and bearish for developed market government bonds.

Equity markets have declined in the last few trading sessions, but are still very close to the record highs set earlier in the summer. Safe haven assets such as government bonds, gold and the Swiss Franc have risen in value. This type of price action is a good example of what can happen during the low volume, holiday season when opportunistic day traders rather than fund managers can dictate market direction for short periods of time. It is important to remember that nothing has materially changed to negatively impact equity market valuations, or make government bond yields appear any more appealing.

The second quarter earnings season has been extremely positive and more than 73% of S&P 500 companies reported numbers in excess of analyst's expectations.

The IMF also reaffirmed its forecast for global growth at 3.5% in 2017, rising to 3.6% in 2018. The outlook for risk assets remains upbeat and the recent sell-off is little more than a healthy, long overdue correction in the bull market that started over eight years ago. The recent flight-to-quality into government bonds, especially UK Gilts, has driven real yields further into negative territory, which make equities even better value on both a dividend and risk adjusted basis.

The legacy of the great recession that gripped the world in 2008 has been consigned to the history books and the government sponsored quantitative easing programmes have largely run their course. The normalisation of interest rate policy in the US, UK, Europe and Japan will be a massive hurdle to overcome if the global recovery is to remain intact. Central Bank balance sheets have become bloated with trillions of US Dollars' worth of government and high-grade securities. The gradual unwinding of these bond purchases will result in markedly higher yields, unless it coincides with a significant decline in government and corporate borrowing requirements. Inflation is also on the rise, especially in the UK, which makes current bond valuations highly unappealing.

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The stand-off between the US and North Korea will run its course over the next few weeks and will ultimately have little impact on global markets

Equities are set to trend higher and bond prices will fall given the positive trajectory of global growth and the return of inflation. Nothing tangible has occurred during the summer, other than the fact that UK markets have become even more unattractive on a relative basis. The Conservative Party scored an own goal by losing its majority in the House of Commons and is still unable to articulate its Brexit strategy. To make matters even worse, the Bank of England has failed in its primary monetary objective to promote price stability. Sterling remains undervalued and is more likely to appreciate when the inevitability of a softer Brexit is realised and interest rates start to climb.

There is no need to panic with the minor correction in equities, but there is every reason to be concerned about the level of the bond market.

Alan Greenspan, the former chairman of the US Federal Reserve recently said:

"By any measure, real long-term interest rates are much too low and therefore unsustainable. We are experiencing a bubble, not in stock prices but in bond prices. This is not discounted in the marketplace."

The bursting of the bond bubble is the primary threat facing financial markets today. In the coming months, portfolio diversification within and between asset classes will be vital, especially when accompanied by a short duration bias across all bond holdings.

Investors will need to remain patient during this period of transition and rely on a disciplined approach to risk management.

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