# INVESTMENT MANAGEMENT SERVICE BULLETIN

Q3 2017

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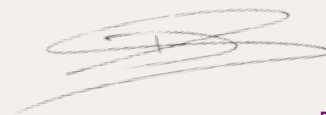
# 01
# FOREWORD

The second quarter of the year saw global equities post their seventh consecutive quarter of positive returns in Sterling terms. It was however the smallest positive return within this sequence. Although market sentiment was bolstered by growing corporate earnings in both the US and Europe along with a broad base of positive economic indicators, questions about the 'stretched' nature of equity valuations continue to be posed. In fixed income markets mixed messages from the Bank of England's Monetary Policy Committee members caused gilt yields to rise meaning that capital values fell.

In the UK, the Prime Minister's calling of a snap general election backfired leaving a minority Conservative government in place. Consequently Sterling strengthened as the prospects for a 'hard Brexit' appeared to decline. The previous weakness of Sterling had contributed to a rise in UK inflation with the latest core CPI figure being 2.6%, a level which is now higher than that of wage increases (2.1%). This difference may put pressure on the UK consumer particularly as we have already seen a fall in personal savings rates and an increase in the use of credit card debt.

In the US, the third interest rate hike of the current cycle materialised as expected and caused little market reaction. By contrast the Bank of England's Monetary Policy Committee's decision to maintain ultra-low interest rates was expected, but some surprise arose from the narrowness of the vote in favour. Although it did not raise rates, the Bank has asked lenders to increase the amounts of capital they retain to support stability, a move which may tighten credit availability. From a political perspective, another new French President has vowed to reform the French economy, while President Trump's legislative agenda has not kept pace with the most optimistic timelines, and despite a much weakened position in government there are no signs that the UK Conservative party will pull back on fiscal austerity.

Within our portfolios we maintain our slight overweight position to equities as we continue to feel that dividends available from shares will remain attractive to investors in a low interest rate environment. We are however very cautiously positioned in UK equities due to continued uncertainty surrounding Brexit and pressures on household budgets. We remain underweight gilts albeit we do not expect rate rises in the UK in the short term, and have added exposure to the infrastructure sector.



DAVID BAKER

Chief Investment Officer
Mazars Wealth Management

# 02

# IS THE CYCLE OVER YET?

We find ourselves in the eighth year of the post-2008 crisis economic recovery and equity markets are robust, as the macroeconomic background is improving. This is already the third longest economic expansion cycle since WWII, the first two being the decade following 1991 and the nine years following 1961. Year to date global equity markets have returned 10.7%, with emerging market stocks gaining 18.4%, US stocks rising 9.3%, European equities adding 8.7% and UK shares lagging, but still positive, at 4.7%. Some valuations are 'rich', especially in the US market, where the Federal Reserve has made further steps towards interest rate normalisation, hiking rates for the fourth time since 2015. However in other regions, such as Europe, valuations are closer to historical averages, in no way suggesting the bout of 'irrational exuberance' usually concomitant with the end of the cycle.

The question on many investors' minds is "as we are already eight years into the cycle, is the proverbial end nigh?" The most common term for this fear is 'acrophobia', a fear of extremities, which we considered in the previous quarter's bulletin. What we have to ask ourselves is whether this fear is rational. After all, an already elongated cycle and above average valuations, along with a sometimes toxic political climate, certainly do not help investor confidence. While we cannot predict how long the rally will last, we believe that it is well supported by a confluence of positive factors.

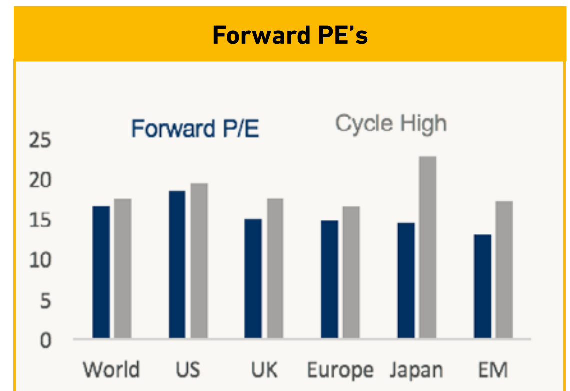



Chart Source: Bloomberg

# 02

# IS THE CYCLE OVER YET?

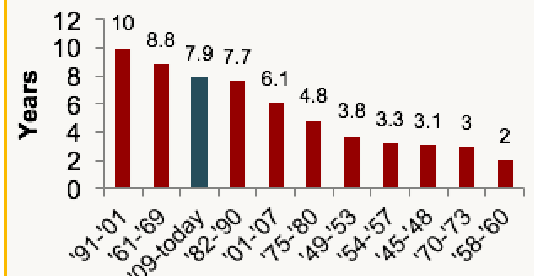
## (continued)

### 1. Cycle length: advanced but mind the history

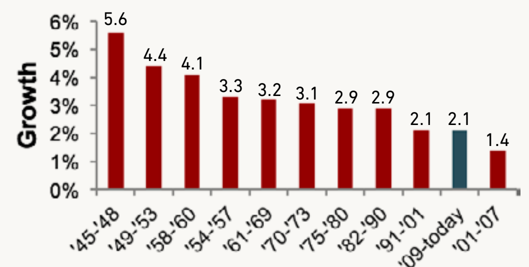
There's an old joke amongst economists about the statistician who drowned in three feet of water, *on average.* Conventional economists usually adhere to the theory of a five-six year business cycle. Hyman Minsky identified such occurrences in which a period of stability encourages risk taking, which leads to a period of instability, which causes more conservative and risk-averse (de-leveraging) behaviour, until stability is restored, renewing the cycle. In the US, the world's leading capitalist economy, the average cycle since 1949 has lasted around 5.5 years, so it is natural that investors may feel fatigued after eight long years.

However if we study the cycles more closely, it is apparent that in the 1950s they tended to last for three-four years, yielding above 4% growth. Conversely, the more recent cycles have tended to last much longer, six-ten years, with average growth closer to 2%. Why cycle dynamics have changed is the subject of much debate, mostly pointing towards the way central banks and regulatory authorities intervene. However, the fact is that fundamental change has occurred. Therefore the length of the cycle may be a warning sign of maturing asset prices, but it does not in and by itself precipitate its end.

**US expansion cycles duration**




**US expansion cycles growth**




**US expansion cycles**

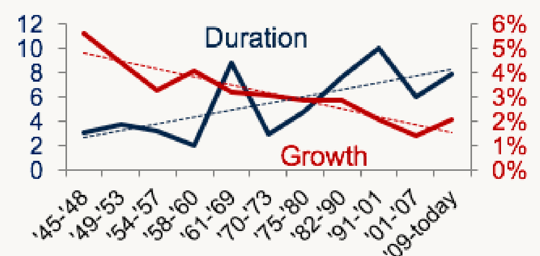



Chart source: NBER, Bloomberg, Mazars Calculations

# 02

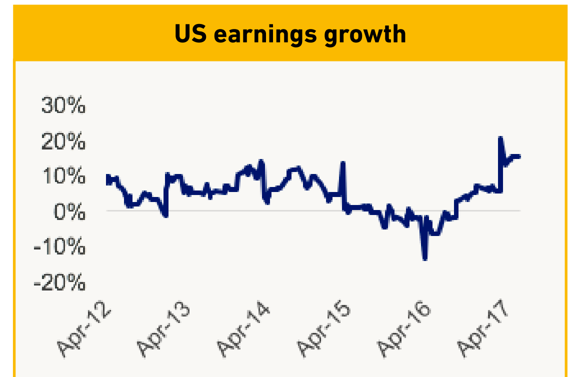
# IS THE CYCLE OVER YET?
(continued)

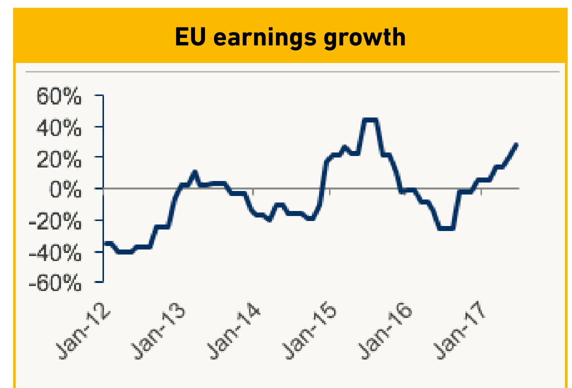
## 2. Earnings growth supporting valuations

The magic number in the investment world is 15. The valuation of a company is deemed fair when the Price / Expected Earnings ratio does not surpass 15-16 times. In the US the ratio is currently 18.5x, while it is closer to 15x in the UK and Europe, 13x in emerging markets and 14x in Japan. The number is used freely and has little importance when valuing banks or technology companies, for example. At the time of writing Amazon, one of the world's biggest companies, was trading at $1000 per share, more than 170x current earnings and 75x expected earnings for this year, meaning that the company needs to significantly grow its future earnings in order to justify the current valuation. If analysts were to use 15x as the benchmark and valued Amazon at 75x this year's expected earnings, the company would need to generate five times this year's expected earnings (75/15) indeterminately for its current price to be a deemed 'fair '.

Nevertheless for the S&P 500, which is currently dominated by technology companies such as Amazon, analysts get fearful over 15-16x P/E, i.e. the historical index average. First and foremost, the dominance of technology companies helps explain some of the higher valuations based on traditional metrics in the US. As they often have high growth rates, analysts can underestimate future earnings. Then there is the matter of profitability. In the US earnings grew 15% for the year to Q2, up from –15% in April of 2016 and a few years of 0% to 10% growth. EU companies also improved their profitability, growing earnings by 25%, up from -20% in the same quarter last year. UK companies also saw a rapid increase in profitability, but in the case of firms with large overseas operations, profitability is skewed higher by the weaker Sterling.

We feel that current valuations are not overly demanding on aggregate and that the acceleration in earnings supports them.



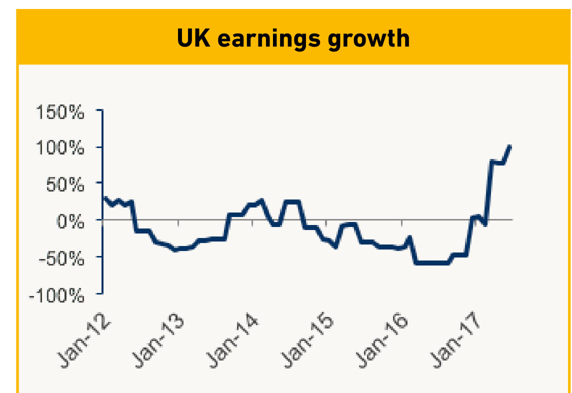




Chart Source: Bloomberg

# 02

# IS THE CYCLE OVER YET?

## (continued)

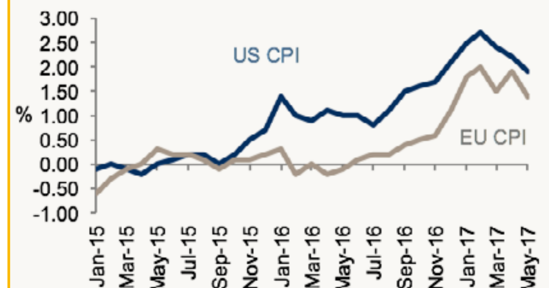
### 3. Improving macroeconomic backdrop

Overall the global macroeconomic backdrop has been improving since mid-2016. Growth rates for the US and Europe accelerated on the back of stronger manufacturing, a robust service sector and increasing consumer confidence. In Europe particularly, we have also seen a significant improvement in credit conditions, which has allowed Spain to grow by 3% on average and reduce unemployment levels. Key trade and productivity indicators have improved and inflation has edged down after oil fell from a $54 high in February to near $46 at the time of writing, allowing producers to maintain their prices. Meanwhile important emerging markets, such as China and India, have maintained their growth rates and are willing to go forward with substantial reform to face the challenges of the 21st century.

The Chinese have taken steps to curb debt levels and shadow banking, while planning for the 'Belt and Road' initiative, a massive infrastructure plan to improve trade, spanning across the whole Eurasian continent. In India, the PM has taken steps to decrease corruption and increase government control over the tax base with an all-encompassing demonetisation, a general sales tax (an equivalent of VAT) and the institution of a national ID system. There are of course pockets of weakness, especially in the UK and some European periphery countries. The former has seen growth and consumption slow down post-referendum, a trend which could accelerate. The latter includes countries such as Italy, which is barely growing at 1%, and Greece, where capital controls and unemployment continue to hamper economic growth. In Q2 2017 we did see some more mixed figures which are considered further below.

**US consumer sentiment**

**Inflation down**




**Global PMIs**

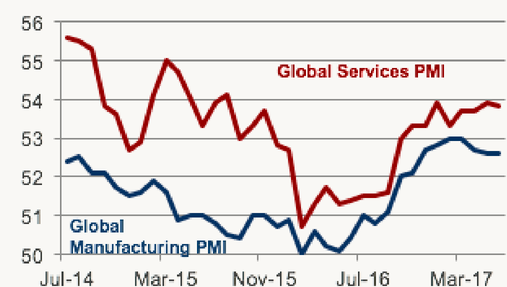



Chart Source: Bloomberg

# 02

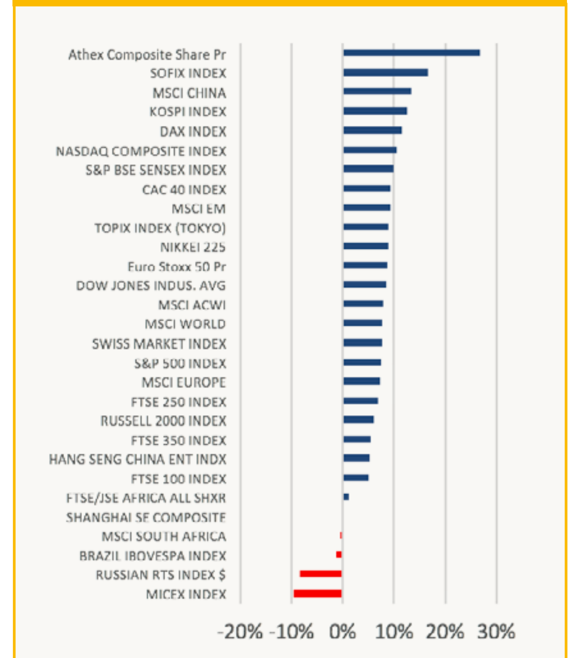
# IS THE CYCLE OVER YET?

## (continued)

### 4. Equity momentum

Global equity momentum has picked up in 2017. After three years of little growth for equities (MSCI World returned 3% in 2014, lost 3% in 2015 and gained 5% in 2016, mostly during the later months) global equities have gained 10.7%. The rise has been very broad-based with almost all regions contributing positively. Meanwhile volatility is near all-time lows. Global markets have not experienced a major 5%+ correction since February 2016. More importantly, retrenchments are usually short-lived and lack depth. Especially in the US, which tends to lead global equities, we have noticed that stocks tend to rebound very quickly following a 2%-3% drop. This momentum could be attributed to several factors including: central banks encouraging risk taking, with a lot of liquidity chasing few opportunities as equity supply has decreased; the rise of algorithmic trading; equity underwriting has been falling in the last two years and share buybacks have been taking stocks out of circulation; so long as systemic risks remain in check and borrowing costs are low, the so-called 'fast money', i.e. hedge funds and high frequency traders, can pursue fast-trading strategies which may provide support in case of market retrenchments; finally an increased supply of confidence towards the new US President's economic agenda.

**Global indices over 200 day M.A,**




### 5. Central bank 'Put'

For three decades the heads of the world's largest (some say the world's *de facto*) central bank, the US Federal Reserve, have assured markets that they would take equity prices into account when considering liquidity conditions. This stance effectively subsidises risk taking, allowing markets to leverage the liquidity offered and augment returns for risk assets. Central banks may now be reducing liquidity levels and the retraction of the Fed's balance sheet (in essence a reverse QE) is a medium-tern concern. However, as long as investors trust that they will be bailed out by central bankers when needed and as long as the economy is functioning well, we believe that we will remain in a secular bull market, one where equities will gain over the longer term and from one cycle to another. While the 'Put' holds, that longer term view may well remain unaffected by various central bank activities of gradually retracting liquidity.

**US 100d average daily dispersion**

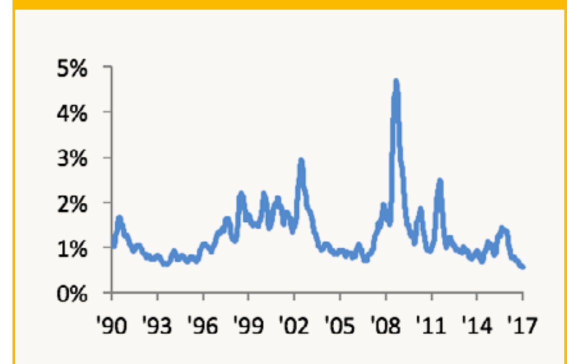



Chart Source: Bloomberg

# 02

# IS THE CYCLE OVER YET?

## (continued)

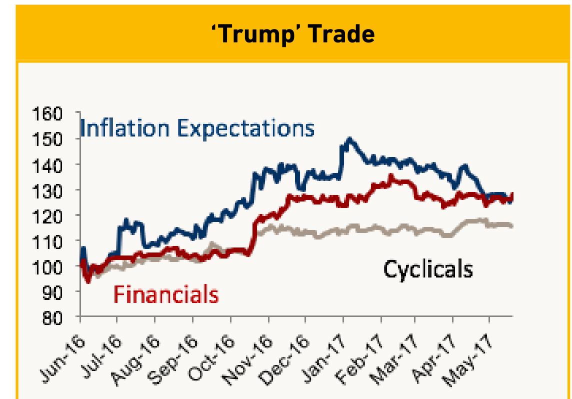
### 6. US: anticipation of stimulus, reform and CAPEX

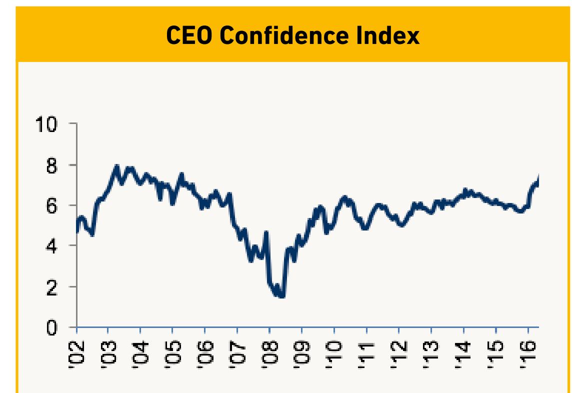
President Trump's election in the US had a surprising effect. Far from the systemic risk predicted, Mr. Trump's elevation to the highest echelons of office, in conjuncture with the Republican dominance in the Senate, have allowed for the breaking of gridlock in Washington, as the GOP now controls both chambers of Congress and the White House. This development has been touted as a catalyst to go forward with a range of issues which could stimulate the US, and subsequently the global economy.

**Obamacare:** The repeal of the Affordable Care Act has been at the top of the Republican legislative agenda for most of the decade. After a couple of false starts, the resolution passed the House only to be stopped at the Senate door, where it became apparent that the proposal needs to be debated and scored before it is approved. To be fair, healthcare reform is a titanic undertaking. Successfully tackled within the year, it could boost market confidence that other projects, like tax reform or infrastructure spending, will also be implemented.

**Infrastructure spending:** Mr. Trump's promise of $1tr in infrastructure spending, also featuring $26bn for the great Mexican Wall, has hit a roadblock as Democrats remain sceptical and Republicans deeply divided and questioning the numbers.

**Tax reform and investment incentive:** The Treasury secretary presented the broad framework for his tax plan last month: a) the seven tax brackets will be revised to three, with rates of 10%, 25% and 35%; b) companies are going to be offered a 10% tax on repatriation of overseas cash; and c) corporate taxes are to be cut from 35% to 15%. The plan is ambitious and would pose the biggest tax reform since 1986, but lawmakers are unconvinced that the effect on public finances will not damage the economy. Tax reform could also bring a 50% bonus depreciation for companies, i.e. allow them to depreciate fixed assets faster. It allows businesses to take an immediate first year deduction of 50% on the purchase of eligible business property. This, in theory, should incentivise companies to accelerate investment in fixed assets. It is also notable that these developments might come at a juncture when US CEO confidence is at its highest level since 2007, which could finally drive profits more towards investments rather than high dividends and buybacks.



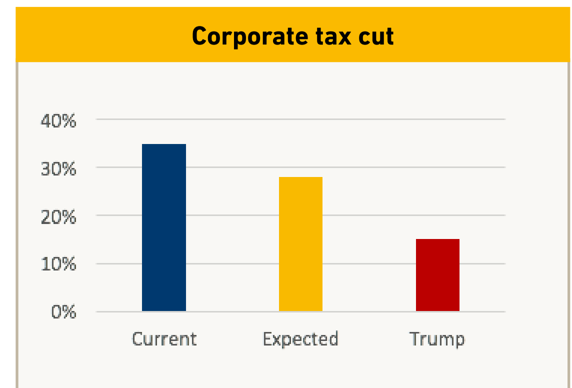




Chart Source: Bloomberg

# 02

# IS THE CYCLE OVER YET?

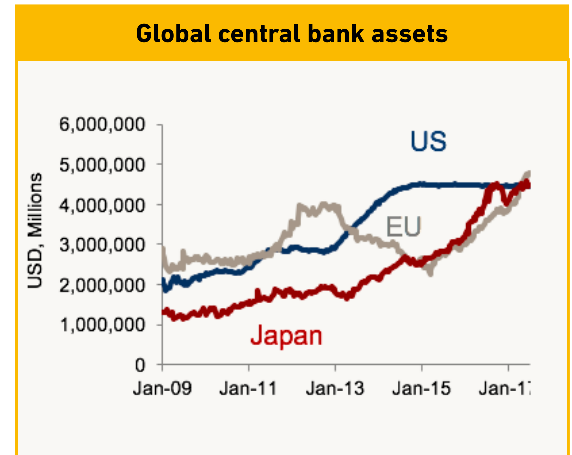
## (continued)

### Risks

There are plenty of reasons that support the continuation of the current cycle. However there are also a litany of negative catalysts which could upend the cycle. First and foremost are the signs that the world is transforming. We stand at the cusp of a great technological revolution, by some accounts tantamount to a new industrial revolution. Apart from the standard five year cycle, economic theory also looks at a 50-60 year cycle, also known as a 'Kondratiev wave'. Russian economist Nikolai Kondratiev first identified these cycles which supposedly affect all sectors of an economy and are driven by big (i.e. not marginal) technological advancements that influence all of society. For our age, this could be the advent of robotics and AI which are already disrupting many industries, from car makers to banks. Anatole Kaletsky identified the post-2008 period as a new era for western capitalism which he dubbed 'Capitalism 4.0'. Kaletsky posited that the western capitalist system must reinvent itself or witness the rise of China as the next economic paradigm. Although central banks have prevented the consequences of non-adjustment materialising so far, as central bank liquidity is slowly withdrawn, the global economic and financial system will be tested. Coupled together these theories suggest that we may find ourselves at a precipice of momentous change. However, we have no way of knowing if the theories hold or how long the transition will take. The old saying that 'markets can stay liquid longer than you can stay solvent' serves as a warning for asset allocators who might want to short the market.

A further significant risk is the process of interest rate normalisation. For close to a decade, global interest rates have been kept at ultra-low levels, accommodating investors and rekindling risk taking. While we have evidence that this risk-taking has somewhat spilled over from Wall Street to Main Street, i.e. from stocks and bonds to real businesses, we must acknowledge the pervasive effect that low rates have had on savers and pensioners. As the western world (China and Japan as well for that matter) grows older in a profound demographic shift, savers and pensioners are becoming an increasingly important demographic. Additionally, as people find it harder to retire frustration grows against a system that doesn't seem to work for them. This anger turns into protest votes, some of which we have already seen: Brexit, the US election and the strong backing for populist parties in recent European elections.Interest rate

**Global central bank assets**




**US ten year bond yield**

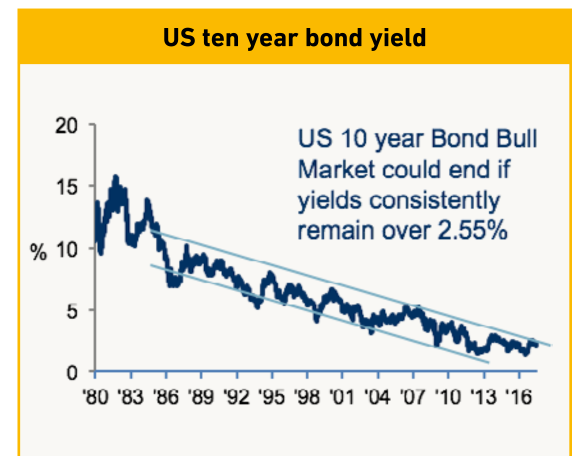



Chart Source: Bloomberg

# 02

# IS THE CYCLE OVER YET?
## (continued)

normalisation should help pension funds to match their liabilities and quell some disappointment against the establishment, but it could also risk derailing the recovery. It is a process which pits some groups against others. The young against the old, the industrial sector versus the financial sector, consumers and investors versus savers. As interest rates normalise, we are also conscious of valuation differentials. So far, companies with high levels of debt have enjoyed a valuation discount versus their peers, as debt is considered a cheaper form of financing than equities. Higher interest rates mean higher interest payments, which should reduce the valuation discounts for stocks of highly leveraged companies.

Italy and European stability are also concerns. The flaws in the architecture of the Euro have never really been addressed and Italy's move to unilaterally bail out some of its banks has created questions about the robustness of the banking union.

The final concern is the high levels of uncertainty and partisanship in US politics. Will the outcome be reform and stimulus, or further gridlock, trade wars and the erosion of American leadership?

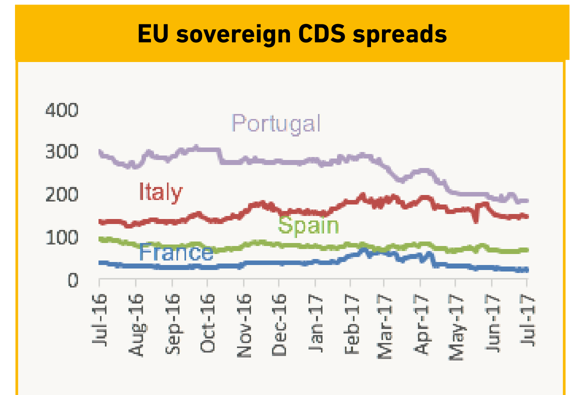



Chart Source: Bloomberg

# 03

# ECONOMIES AND MARKETS

## Global market performance

| Asset Class Country | Q1 2017 | Q4 2016 | Q3 2016 | Q2 2016 | Q1 2016 |
|---|---|---|---|---|---|
| **Equities** | | | | | |
| UK | 4.04% | 1.40% | 4.04% | 3.90% | 7.78% |
| US | 4.40% | -0.60% | 4.40% | 9.07% | 6.24% |
| Europe | 6.78% | 3.22% | 6.78% | 8.61% | 9.08% |
| Japan | 3.62% | 1.89% | 3.78% | 5.03% | 11.48% |
| Emerging Markets | 9.70% | 2.54% | 9.72% | 0.79% | 11.66% |
| **Fixed Income** | | | | | |
| UK Gilts | 1.54% | -1.29% | 1.62% | -3.43% | 2.34% |
| UK Corporates | 1.85% | 0.49% | 1.85% | -2.58% | 5.57% |
| Global Bonds | -0.12% | -1.03% | -0.12% | -1.85% | 3.01% |
| **Other Assets** | | | | | |
| Gold | 6.72% | -4.18% | 6.72% | -7.99% | 1.80% |
| Hedge Funds | 1.08% | -1.48% | 0.47% | 6.27% | 4.08% |

## Indices YTD

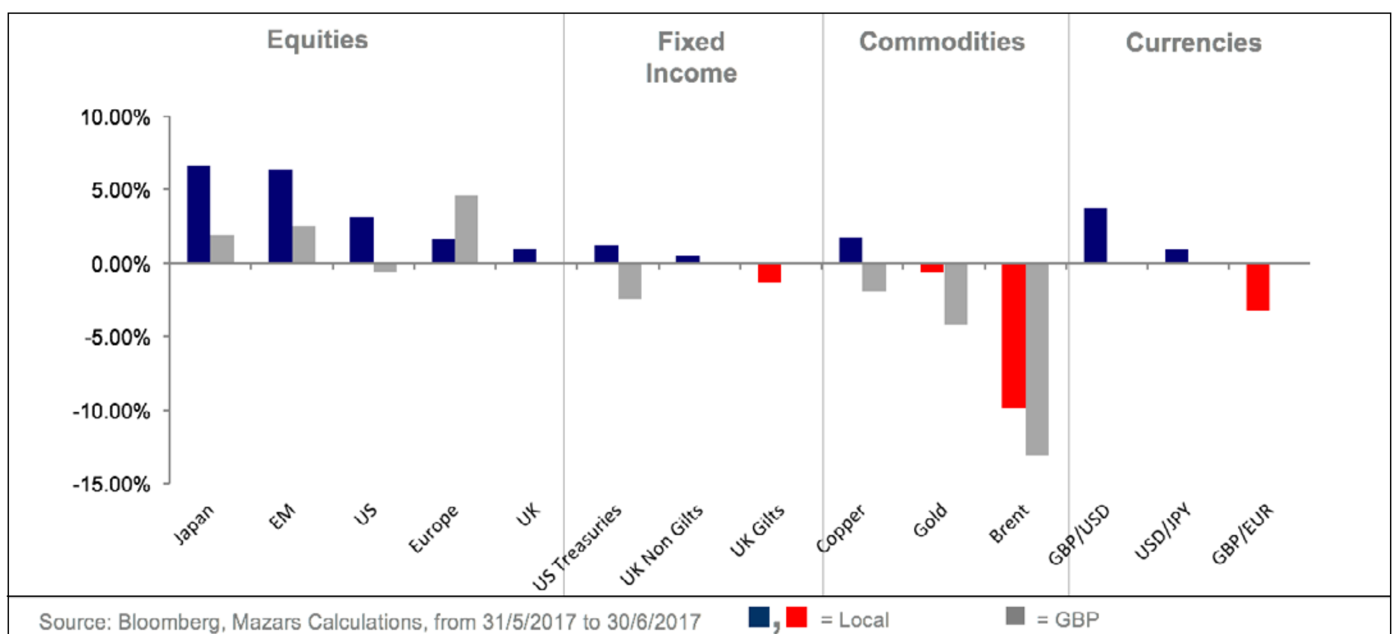



Chart Source: Bloomberg

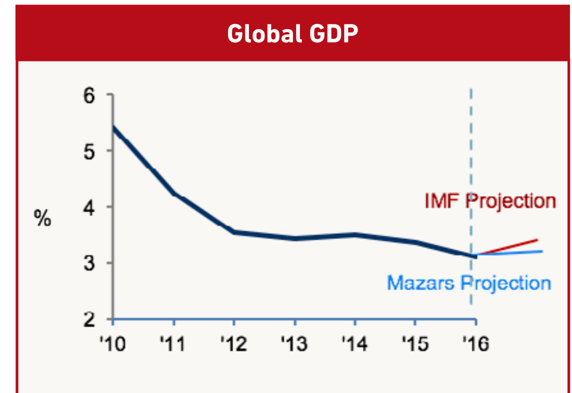
# 03

# ECONOMIES AND MARKETS

## GLOBAL

### Economy

The global economy has picked up pace since last year.
In Q1 positive economic surprises increased significantly, however they decelerated in Q2 as expectations grew accordingly. The IMF calculates that global output will grow at 3.5% in 2017, up from 3.1% in 2016. The manufacturing sector, especially in Europe, continued to lead growth. Worldwide manufacturing production rose for the 56th successive month in June. Both global manufacturing (June PMI 52.6, just under last quarter's 53 average) and the global services sector (June PMI 53.8, slightly above last quarter's 53.5 average) continued to expand at a healthy pace, led by the improved European economy. Inflation pressures abated with oil prices dropping as much as 22% from their February highs. Central banks continue to be accommodative overall, however the tone has slightly changed as central bankers strive to normalise interest rates.
The Fed, already on a tightening path, indicated that it will soon reduce its balance sheet by stopping the reinvestment of maturities of Mortgage Backed Securities and Treasuries. The heads of the ECB and the Bank of England also hinted at removing some accommodation, a move that sparked a sharp bond sell off on the last day of the quarter.




### Market Performance

Large cap global equities gained 4% over the quarter, propelled by outperforming indices in Japan and emerging markets. They were trading at an average 16.9x P/E at the end of the quarter, higher than the 15.2x average since 2000. US equities appear to be trading at a premium versus their European, UK and emerging market peers, while Japan is the cheapest market amongst its developed market counterparts. Conversely, global bonds were down 1.9%, with the largest part of the move occurring in the final days of trading.
Oil prices lost 9% while gold lost 0.6% for the quarter.

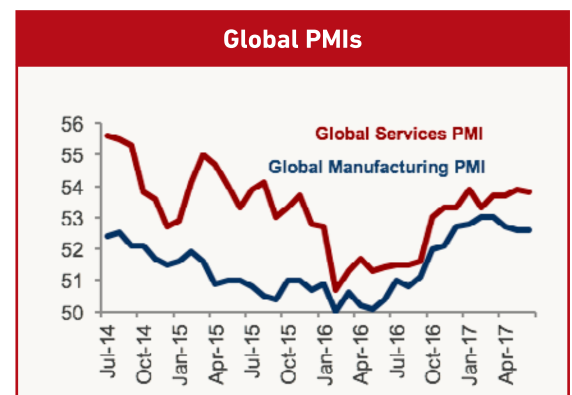



Chart Source: Bloomberg

# 03

# ECONOMIES AND MARKETS

## GLOBAL (continued)

### Outlook

Valuations for global stocks are fair, if not somewhat 'rich'. However, as we explained in the previous chapter, we believe that earnings growth and a robust macroeconomic backdrop support tthis premium. The big question going forward is whether we will see the era of easy money come to an end, thus upending the current economic paradigm. The answer is that it will probably happen at some point during this cycle. However, with core inflation still subdued, whatever tightening we see will be gradual and very well communicated, as per the pace that the Fed has set since the 2013 taper tantrum.

Chinese producer prices

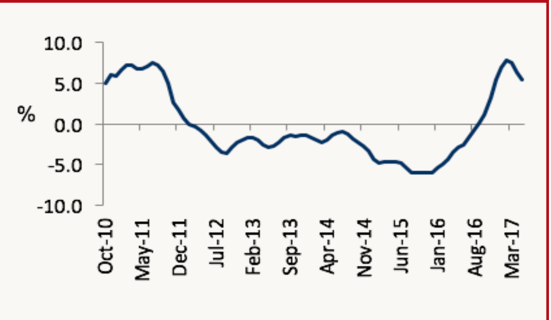



Chart Source: Bloomberg

# 03

# ECONOMIES AND MARKETS

## UK

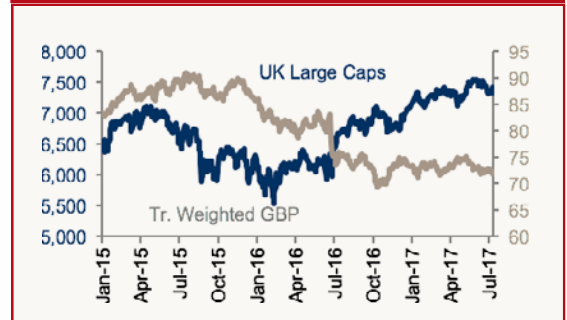
### Economy

The British economy is still resilient post-Brexit, however in the last few months it has shown signs of fatigue, especially in the retail sales sector, which has been supporting growth since the referendum. For the year to March economic output grew by 2%, surpassing post-Brexit expectations. However the signs in Q2 were less encouraging. Retail sales in May decelerated to 0.6% year-on-year, the slowest pace since April 2013. Wages were also subdued, with total earnings growing by just 1.5%, 1.4% below inflation and well below the 3.2% rate in June 2015. The latest industrial production figures suggested a sharp slowdown (PMI 54.3 down from 57) as the nation's industries failed to take advantage of the weaker Pound. This has driven the National Institute of Economic and Social Research to reduce its quarterly GDP estimate to just 0.2% (0.8% annualised). According to the latest surveys, the UK household savings ratio has dropped from 11.5% in March 2010 and 6% before Brexit to 1.7% in March 2017, suggesting that consumers have been dipping into their savings to finance their spending habits. Consumer inflation rose to 2.9%, the highest it's been since 2012, mostly due to the weaker pound, further eroding disposable income. Nevertheless, the Monetary Policy Committee voted narrowly (five-three) to retain ultra-low interest rates, as some members felt that the very low unemployment rate (4.6%) could boost core inflation. Mark Carney surprised markets at the end of Q2, suggesting that he would be willing to support a rate hike if growth and wages pick up, contributing to a bond sell-off.

### Market Performance

UK large caps gained just 1% last quarter, lagging behind other developed markets. IT, Financials and Industrials outperformed while Retail, Energy and Utilities (the latter often considered a bond proxy) were, as expected, the worst sectors. UK stocks were trading at 15.1x earnings, at a discount to global stocks, but still above the 12.7x average since 2006. Gilts lost 1.3% for the quarter but credit gained 0.5%. Sterling gained 3.8% versus the US Dollar, as the latter weakened throughout the quarter, however it lost 3.2% against the Euro.

**Stocks vs GBP**




**GDP growth (NIESR)**

**Forward P/E**

Chart Source: Bloomberg

# 03

# ECONOMIES AND MARKETS

## UK (continued)

### Outlook

The snap election which took place on 8 June complicated the economic backdrop and Brexit negotiations as uncertainty increased given the resultant hung parliament. Inflation continues to creep up but it is almost solely imported, a product of the lower Pound. To gain more clarity, economists are now focusing on the Brexit negotiations. The three key issues to watch for are: a) the ability to agree on the fate of the five million citizens affected by Brexit , a relatively straightforward subject; b) the size of the Brexit bill (anywhere between £40 and £110 billion); and c) when trade negotiations will begin. An increase in certainty is a prerequisite for economic activity to pick up, but it is by no means the only factor. The government is now under severe pressure to reduce austerity, which means that the Bank of England might feel compelled to continue with monetary accommodation. One rate hike, signalling a reversal of the post-referendum emergency liquidity measures, is not out of the question, but we don't yet expect a tightening cycle. So long as Brexit-related uncertainty persists, we do not anticipate a major shift in the current weak economic trends and are thus sceptical about British risk assets.

**Wage growth and savings**

**Wages and inflation**

**UK housing**

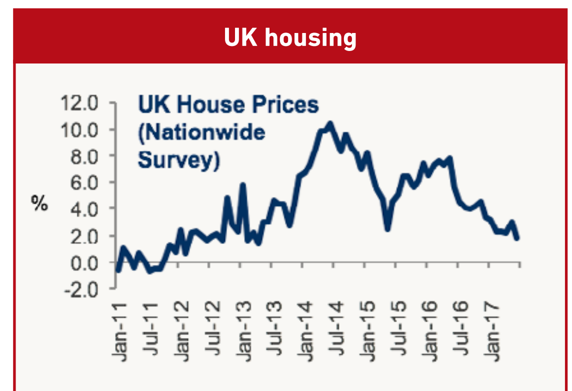



Chart Source: Bloomberg

# 03

# ECONOMIES AND MARKETS

## US

### Economy

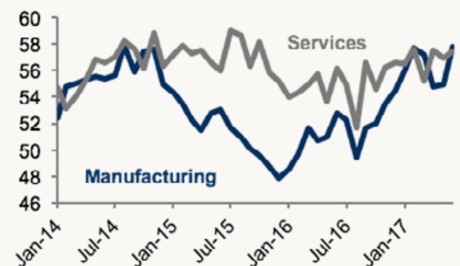
The signs for the US economy were more mixed in Q2, but still supportive of moderate output growth. GDP grew by 1.4% annualised in Q1 (2.1% year-on-year), on the back of a stronger manufacturing and service sector, with growth accelerating for the third straight quarter. The so called 'Trump Trade', i.e. higher inflation expectations, benefiting cyclicals and financials, has significantly waned since February, as markets have lost some confidence in the President's ability to fully implement his agenda. Economic surprises were significantly reduced and house building decelerated in Q2, mostly due to supply issues. Auto sales decelerated and overall retail sales were flat in May. However some softer indicators were positive. Consumer confidence and small business sentiment remained near their highest levels in a decade. Manufacturing and Service PMIs (57.8 and 57.4 respectively) remained in solid expansion territory, suggesting higher expansion rates for Q2 GDP. Unemployment levels remained low (4.4%), and wage growth was steady at 2.5%. Headline inflation came off from 2.7% in February to 1.9% in May. However, acting on evidence of moderate and broad-based growth, the Fed proceeded with its second rate hike this year (with the markets pricing in a third one by December) and revealed plans to slowly reduce its $4.5tr balance sheet.

### Market Performance

US large caps gained 3.1% for the quarter and are up 9.6% year-to-date, led by Healthcare, Industrials and Financials. Stocks are trading at 18.6x earnings, above the 16.1x average since 2000. Hawkish comments from central banks drove long yields up, but overall for the quarter the yield for the ten-year Treasury Bond fell from 2.39% to 2.30%. Lower inflation expectations, a more dovish than expected Fed and the return of China as a net buyer of US Treasuries pushed the yield as far down as 2.14%. The US Dollar lost 7% versus the Euro, 3.8% versus the Pound and gained only 0.9% versus Japanese Yen.

**GDP vs stocks**

**PMIs (ISM)**




**Forward P/E**

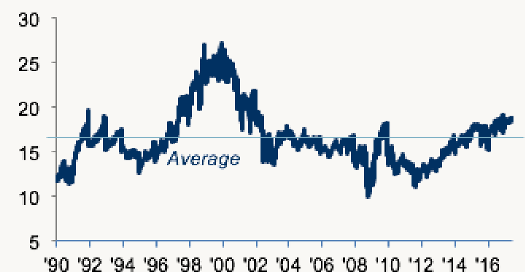



Chart Source: Bloomberg

# 03

# ECONOMIES AND MARKETS

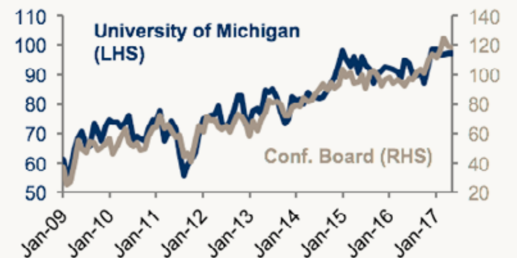
## US (continued)

### Outlook

The outlook for the US economy is overall positive despite some retail weakness in Q2. Forward-looking indicators are optimistic, while some legislative initiatives coming through (such as tax cuts and deregulation) should act as catalysts for further growth. The Fed has not strayed from its highly communicative path, ensuring that the markets are comfortable with any move, such as balance sheet reduction, well in advance of the actual event. The extent to which legislation will go through, unlocking further growth, could determine asset prices in the near future. Uncertainty over reforms, in conjuncture with high valuations, could create pockets of weakness. However, as long as the 'Fed Put' holds, retrenchments are more likely to be viewed as buying opportunities, part and parcel of a bull market still very much alive, rather than lead to cycle-killing sell-offs. We are still positive on US risk assets due to the robust economy and the US Dollar's allure, especially after its recent weakness.

**'Trump Trade' faded out**

**Consumer confidence**




**Retail sales**

Chart Source: Bloomberg

# 03

# ECONOMIES AND MARKETS

## EU

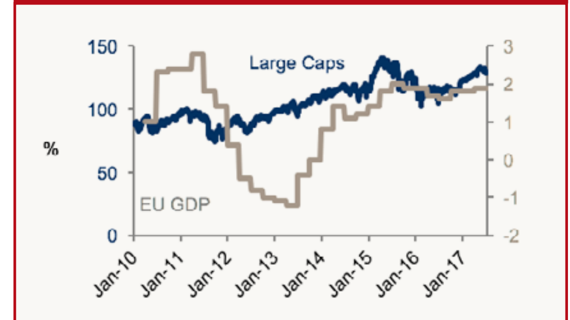
### Economy

The EU economy is firing on all cylinders on the back of strong industrial production and the highest levels of consumer confidence in almost a decade. Geopolitical risk in the region receded, pushing sovereign and bank CDS downwards after Emmanuel Macron won the French presidency. Meanwhile the Italian government took the initiative, with the implicit tolerance of the European Commission, to back the bail-out of two of its most troubled lenders, Banca Intesa San Paolo and Monte Dei Paschi Di Siena, without bailing-in minor bond-holders. Corporate earnings grew by 25% in Q2 after a 1.9% GDP rise in Q1. Growth was fairly broad-based. Germany saw solid growth of 1.7% while Spain grew by 3%. France grew by 1.1% and Italy by 1.2%. Aggregate CPI fell sharply from 2% in February to 1.3% in June and unemployment also moderated in countries like Italy and Spain, while Germany remained at near full-employment levels. Manufacturing PMI rose to 57.4 in June despite the stronger Euro reaching the highest level in three years, while services PMI retreated from a high of 56.4 in April to 55.4 in June. Good economic conditions allowed ECB President Mario Draghi to hint that some stimulus might be withdrawn, contributing to the bond sell-off in the final days of the quarter.

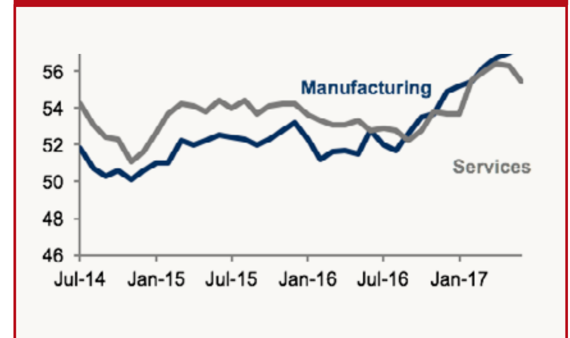
### Market

EU stocks gained 1.7% for the quarter. Although they were ahead of the pack for the majority of the three month period to July, they retrenched by about 2.4% in the last few trading days. They are now trading at 15.9x forward earnings, still above their 12.2x average since 2005. Financials, Industrials and Healthcare, which benefited from some major drug approvals, were the best performers, while Energy, Materials and Autos were the industries that suffered most. Yields on the ten-year Bund rose from 0.33% to 0.46%. The Euro gained ground versus both the US Dollar and Sterling.

**GDP vs stocks**




**PMIs**




**Forward P/E**

Chart Source: Bloomberg

# 03

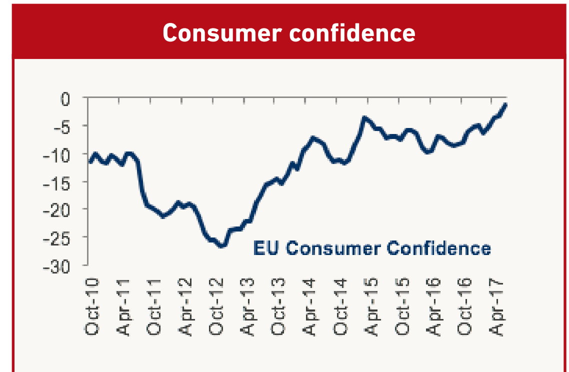
# ECONOMIES AND MARKETS

## EU (continued)

### Outlook

Uncertainty over the future of Europe was quelled, at least in this quarter, by Emmanuel Macron's emphatic win in the French election. After gaining a significant parliamentary majority, Mr. Macron has a wide mandate to reform the French economy and is considered by many the new face of a more united Europe. Despite the sweeping political optimism, the growth in corporate earnings, the attractive valuations and the robust manufacturing and service sectors, some concerns linger. Italy's unilateral decision to help its banks, while positive in the short term, could undermine investor trust in the already fragile and incomplete European Banking Union. The Italian economy is weak and an election, slated for 2018, could produce an anti-EU government for the world's third largest debtor. Greece is still also a concern, as the economy remains mired in depression for the 7th consecutive year. However investors believe that, by and large, European markets are insulated from Greek risks. We are mostly positive on Europe on comparative earnings growth and overall subdued political worries.

**Consumer confidence**




**Industrial production**

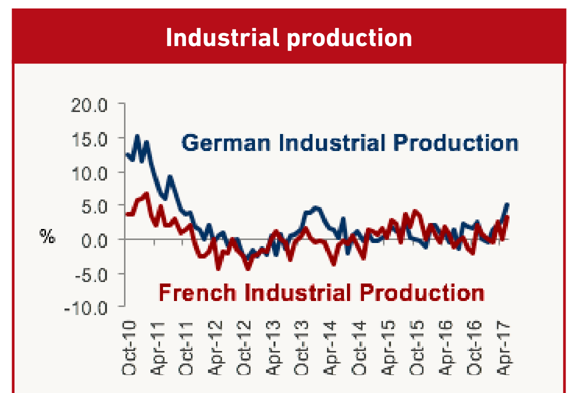



Chart Source: Bloomberg

# 03

# ECONOMIES AND MARKETS

## EMERGING MARKETS AND JAPAN

### Economy

Japanese GDP grew by 1.3% in Q1, slightly down from the previous quarter. However the Tankan survey as well as trade imports, a proxy for GDP, indicated the probability of a much stronger Q2. Industrial production grew by 6.8% for the year to May on the back of a weaker Yen, the highest rate in more than three years. On the other hand, retail sales slowed from 3.5% to 2% in May, but the more forward-looking indicator, the services PMI, suggested a pickup in consumption, reaching its highest level (53.3) since June 2015. Consumer prices remained subdued at 0.4%, prompting the Bank of Japan to continue with its easy money policy. The Chinese economy grew by 6.9% year-on-year, while producer prices dropped, suggesting reduced inflation pressures for developed market producers. The government is continuing its efforts to clamp down on shadow banking and reduce overall debt levels before they become a systemic risk. In India, GDP growth slowed down sharply from 7% to 6%, as demonetisation finally took its toll on economic activity.

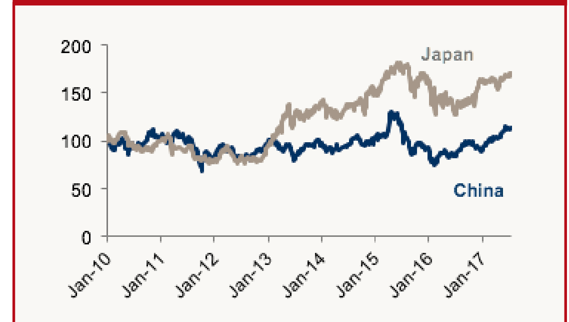
### Markets

Emerging market stocks rose 6.3% for the quarter and Japanese stocks rose 6.8% as investors sought to take advantage of attractive valuations. Emerging market large caps are now trading at 12.9x earnings, while Japanese Topix stocks trade at 14.3x. In Japan, growth was led by Telecoms and IT, while for emerging markets the best performing sectors were Consumer Discretionary and IT.

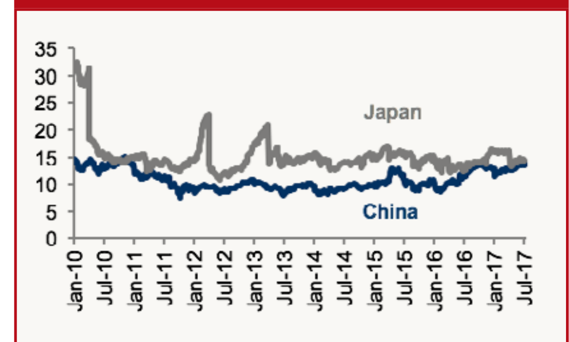
### Outlook

The Japanese economy looks attractive, fuelled by the weakest Yen in more than a year. Still, we have yet to see convincing evidence of inflation or an indication that Abe's recent reforms have finally unlocked the market forces needed to drag the economy out of a 25-year slow growth environment. In China the economy appears to be doing well. However some indicators, such as a stagnated manufacturing PMI for the last two years, are not entirely consistent with 6.9% growth. We, like the rest of the market, do however trust the government's willingness and ability to curb debt before it becomes a significant drag on growth.

**Japanese and chinese stocks**




**Forward PEs**




**Japan Tankan Survey**

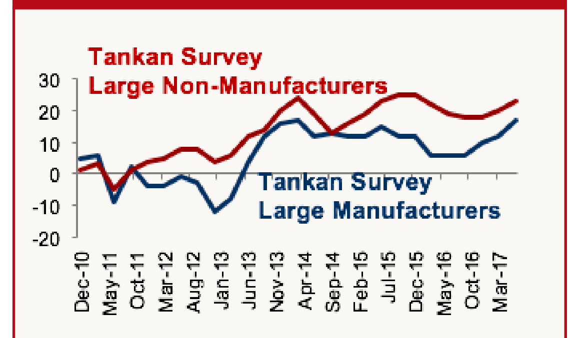
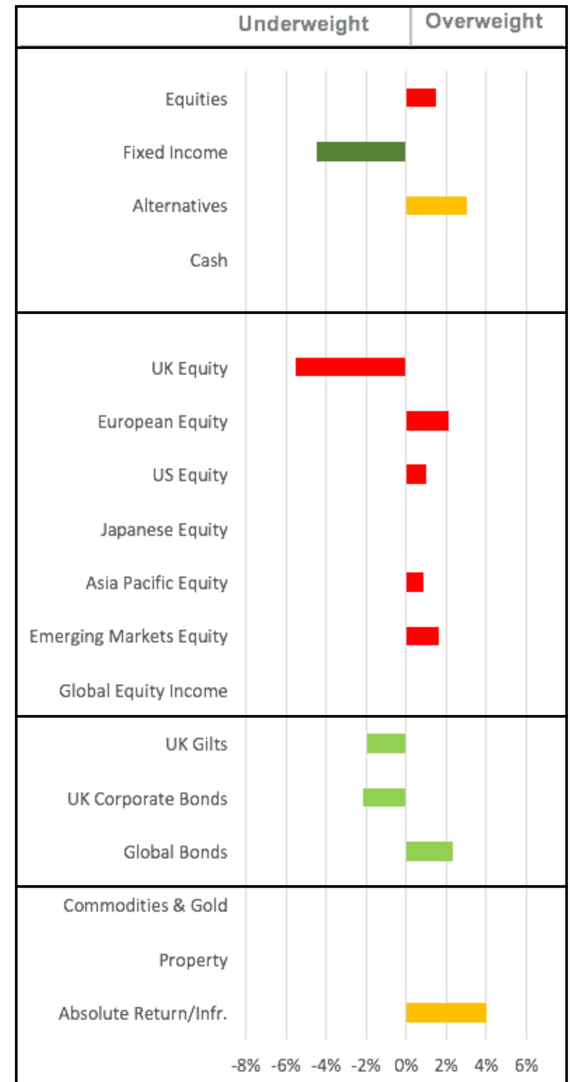



Chart Source: Bloomberg

# 04

# ASSET ALLOCATION

Despite evidence of economic resilience we remain cautious on the UK due to uncertainty regarding monetary and fiscal policy in the wake of Brexit. Aside from an underweight UK position, we have no strong geographic preferences. In January 2017 the Investment Committee added slightly to our equity exposure, simultaneously reducing our weight in bonds, in order to adjust to an environment with a higher risk tolerance. At the latest June Investment Committee we maintained our overweight in equities and made no asset allocation changes, as the momentum for stocks and corporate earnings remains positive. We moved some holdings from absolute return into infrastructure. We still favour large-caps and high dividend stocks. In the bond space we maintain an exposure in longer and shorter dated Gilts, adopting a more 'barbell' approach for the fixed income part of our portfolios. We are monitoring signs of a shift in market preferences between 'Growth' and 'Value' stocks.




Asset Allocation based on the Mazars Balanced Portfolio, as of 1 July 2017

Chart Source: Mazars

05

# APPENDIX I – ECONOMIC AND MARKET REFERENCES

| | Latest GDP | GDP Projected for 2017 | Industrial Product. | Inflation | Core Inflation | Headline Inflation Exp. 2017 | Unemployment | CA Balance (%GDP) | CA Balance Change YoY | Budget Balance (%GDP) | Interest Rates (10y bond) | Currency YoY | Stock Index YoY |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| US | 2.1 | 2.1 | 2.2 | 1.9 | 1.4 | 2.7 | 4.4 | -2.4 | 0.1 | -3.1 | 2.36 | 0.68% | 18% |
| China | 6.9 | 6.6 | 6.5 | 1.5 | 2.2 | 2.4 | 4 | 1.5 | -0.9 | -3.4 | 3.59 | -1.09% | 33% |
| Japan | 1 | 1.2 | 6.8 | 0.4 | 0 | 1 | 3.1 | 3.8 | 0.3 | -5.7 | 0.1 | -9.17% | -4% |
| UK | 2 | 2 | -0.2 | 2.9 | 2.6 | 2.5 | 4.6 | -3.9 | 0.8 | -2.9 | 1.28 | -3.67% | 18% |
| Canada | 3.3 | 1.9 | 4.9 | 1.3 | 1.3 | 2 | 6.5 | -3.1 | 0.4 | -0.1 | 1.86 | -0.03% | 11% |
| Euro Area | 1.9 | 1.7 | 1.4 | 1.3 | 1.1 | 1.7 | 9.3 | 3.5 | -0.1 | -1.5 | 0.55 | 4.64% | 24% |
| France | 1.1 | 1.4 | 3.4 | 0.8 | 0.5 | 1.4 | 9.6 | -1.1 | -0.5 | -3.4 | 0.92 | 4.64% | 25% |
| Germany | 1.7 | 1.6 | 4.8 | 1.5 | 1.1 | 2 | 3.9 | 8.6 | -0.4 | 0.8 | 0.56 | 4.64% | 27% |
| Italy | 1.2 | 0.8 | 2.8 | 1.2 | 0.9 | 1.3 | 11.3 | 2.7 | 0.5 | -2.4 | 2.33 | 4.64% | 31% |
| Spain | 3 | 2.6 | 3.4 | 1.6 | 1.1 | 2.4 | 17.7 | 1.9 | 0.2 | -4.5 | 1.69 | 4.64% | 33% |
| India | 6.1 | 7.2 | 3.1 | 2.2 | 4.1 | 4.8 | 8.4 | -0.7 | 0.1 | -9.8 | 6.49 | 5.78% | 16% |
| Brazil | -0.4 | 0.2 | 4 | 3 | 4.5 | 4.4 | 8.2 | -1 | 0.8 | -9.7 | 10.51 | -1.87% | 22% |
| Russia | 0.5 | 3 | 5.6 | 4.4 | 3.5 | 4.5 | 5.2 | 2.4 | -0.7 | -3.9 | 4.31 | 8.39% | 5% |
| Taiwan | 2.6 | 1.7 | 0.8 | 1 | 1 | 1.4 | 3.8 | 12.7 | -1.6 | -0.3 | 1.1 | 0.00% | 25% |
| S. Korea | 2.9 | 2.7 | -1.5 | 1.9 | 1.4 | 1.8 | 3.6 | 6.4 | -1.4 | 0.5 | 2.28 | 0.00% | 24% |
| S. Africa | 1 | 0.4 | -0.8 | 5.4 | 4.8 | 3.8 | 27.7 | -9.5 | | -4.1 | 8.9 | 12.58% | -1% |
| Turkey | 3.4 | 2.5 | 3.5 | 10.9 | 7.5 | 10.1 | 11.7 | -3.9 | -0.5 | 0 | 10.82 | -20.00% | 35% |
| Greece | 0.1 | 2.2 | 5.4 | 1 | 0.8 | 1.3 | 21.7 | -1.1 | -1.3 | 0.7 | 5.38 | 4.64% | 54% |

Table Source: Bloomberg

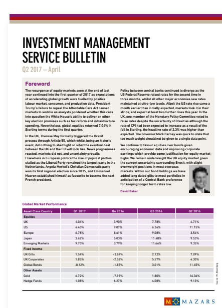
# 06

# APPENDIX II – OUR BLOGS FOR THE LAST 6 MONTHS

| Blog | Date | Author |
|---|---|---|
| Euro rallies on fundamentals | 23/01/2017 | Daleep Singh Shahi |
| How will the Supreme Court's decision impact the form of Brexit? | 24/01/2017 | James Rowlinson |
| 5 key investment questions for 2017 | 27/01/2017 | George Lagarias |
| Do Androids dream of stock prices? | 02/02/2017 | George Lagarias |
| Chinese growth: slipping off the radar? | 06/02/2017 | Carly Said-Moorhouse |
| Are US equities overpriced? | 07/02/2017 | Daleep Singh Shahi |
| Disrupting global trade (and my lunch!) | 10/02/2017 | George Lagarias |
| Will we see serious US tax reform? | 13/02/2017 | David Baker |
| Will an 'America first' policy create market imbalances? | 20/02/2017 | George Lagarias |
| Is Germany a currency manipulator? | 02/03/2017 | James Rowlinson |
| Is European political volatility an investment opportunity? | 03/03/2017 | Daleep Singh Shahi |
| Chasing the sun: the new fed exit strategy | 13/03/2017 | George Lagarias |
| Is Japanese inflation here to stay? | 15/03/2017 | Carly Said-Moorhouse |
| How to read an election poll and assess market impact: by the world's most boring investment writer | 17/03/2017 | George Lagarias |
| Has the sentiment train run out of steam? | 20/03/2017 | Daleep Singh Shahi |
| Politics aside, is the cycle over yet? | 31/03/2017 | George Lagarias |
| Are we seeing a normalisation of yield curves? | 10/04/2017 | James Rowlinson |
| Do economists really get it that wrong? | 24/04/2017 | George Lagarias |
| Why haven't we seen 'Taper Tantrum II'? | 03/05/2017 | Carly Said-Moorhouse |
| India's top five trajectory unaffected by demonetisation | 09/05/2017 | Carly Said-Moorhouse |
| Is the UK due a house price correction? | 06/05/2017 | George Lagarias |
| Does strong US employment signal the end of populism? | 22/05/2017 | James Rowlinson |
| Geopolitical update | 24/05/2017 | George Lagarias |
| Will we see a more hawkish or dovish Fed? | 06/06/2017 | Daleep Singh Shahi |
| 2017 election result: what does it mean for our investment portfolios? | 12/06/2017 | George Lagarias |
| Oil on a slippery slope? | 20/06/2017 | James Rowlinson |
| UK temperatures soar as inflation runs hot | 22/06/2017 | Daleep Singh Shahi |
| Italian Political Risk: Postponed to 2018? | 05/07/2017 | Carly Said-Moorhouse |
| The answer to Brexit? Better weather | 06/07/2017 | George Lagarias |
| Why are markets up? Three words: The Fed Put | 13/07/2017 | George Lagarias |

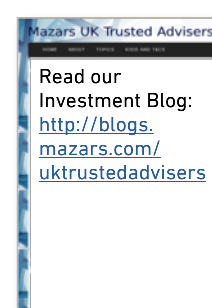
# MORE READING...

Mazars weekly window



Investment bulletin

Quarterly newsletter



Investment blog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