Ethical Investment

Market Commentary: Key Points for Last Period

This reporting period has continued to provide positive returns for equity investors. UK Gilts have fallen slightly although this has not, so far, impacted on corporate bonds, which rose during the period.

Generally robust company earnings in the second quarter underpinned recent optimism in the short term. However, from a macro-economic perspective the two key factors which primarily influenced global markets have been future inflation expectations and the possibility of future interest rate increases in the US and other major markets. Whilst the Federal Reserve and its chairperson, Janet Yellen, appear keen to push interest rates higher, market commentators have repeatedly highlighted the case for keeping rates lower for longer and focus on any weak data as a reason to postpone or cancel possible rate rises.

At the Federal Reserve meeting on 14th June 2017, interest rates were increased from 1% to 1.25% and the associated commentary indicated a slow but steady continued upward direction. The so called 'dot plot', which shows the various Fed committee member estimates of future interest rates, has not changed and continues to estimate rates rising to 2% during 2018 and hitting the 'long run' target of 3% in 2019.

Whilst the increase in interest rates was widely expected by markets there was a surprise element. Janet Yellen outlined a future plan to begin the process of reversing quantitative easing. This essentially means pulling some of the vast quantities of printed money used to support bond markets back out again. The numbers discussed were very low with an initial figure of $6bn per month rising to $36bn, but based only on maturing bonds. The process was described by one member as watching paint dry to underline how gentle it would be, however the change in direction from easing to tightening is significant.

The first increase in US interest rates occurred in late 2015 and there have now been four rate increases since this time. The UK has not followed this trend, as the most recent change in interest rates was downwards in June 2016 to 0.25%, as an emergency measure following the Brexit referendum result. The uncertainty of Brexit is likely to keep rates on hold for now, but nevertheless this is expected to be the bottom of the cycle and the next move will be upwards whenever that might be.

On the face of it, the seemingly loud voices pushing for continued low interest rates have a pretty thin argument. In total, more than $14trn has been printed by major central banks following the credit crisis to reduce the cost of borrowing. This has been effective in stimulating global growth and employment which has continually risen to the point where levels are now at or near historic highs. Therefore, it appears to be 'job done' for the central banks and time to normalise the position to avoid an overshoot in inflation.

That may all be true, say the voices against interest rate rises, but where is the inflation? Without evidence of rising core inflation and wage inflation there is no need to increase interest rates and, in fact, to do so would risk the current recovery and cause a recession. The amount of consumer debt has risen due to low interest rates and this would become unaffordable if rates rise, forcing a downturn in consumer spending.

For those tuned to short term data, the reality is that bond markets have already become more volatile with lower returns, which is a reversal of the longer-term trend. The case for bonds having peaked already is strong in our view. The two key factors are firstly; bond yields are too low to provide any return in any case and secondly; inflation may be about to increase. On-going global growth coupled with high employment is more likely, than not, to be inflationary. The fact that inflation has not appeared yet is not a good reason to suppose it will not occur when economic growth is robust and the position of full employment is fast approaching.

Rising debt levels may be a concern, however the low cost of debt reduces this risk considerably. Rising employment and low interest charges suggest that defaults will not be a problem in the short term. In fact, interest rates are so low that affordability remains strong even if rates move up a little. The risk is on the side of investors who have lent too cheaply, making returns which may become uneconomical.

In conclusion, we expect that inflationary pressures will rise gradually and interest rates will increase very slowly. The fiscal tightening will be slow enough to be absorbed by on-going economic growth and increasing company earnings whilst fixed interest markets will face lower or negative returns, with elevated volatility, as a consequence of inflation rising ahead of current expectations.

It is important to be alert for a shock fall in bond markets. If inflation suddenly spiked upwards, this would cause a fall in most asset classes and cash would be attractive in these circumstances.