ALBERT E SHARP

INVESTMENT MANAGEMENT & STOCKBROKING

MARKET COMMENTARY

February 2018

Buying Opportunity

Over the last few months, it has felt like Groundhog Day writing this opening part of the monthly commentary. There are only so many ways to say that stockmarkets are at new highs, the dollar is weaker, the oil price is stronger and bonds are under pressure. Sooner or later the narrative had to change and at the time of going to press (Wednesday 7th February) we have seen a small bounce following the largest points fall in the Dow Jones' 130 year history. US government bonds are off sharply, pushing yields up, suggesting US rates may move higher sooner. What has suddenly happened?

The central issue relates to inflation expectations and how the Federal Reserve responds. Having suffered one of the most damaging economic slumps in history, the global economy is now growing and synchronised for the first time in ten years. Unemployment is falling, demand is growing and production is rising and as a result the US output gap has now been closed. This topic is frequently referred to by politicians and frequently misunderstood. It is the difference between gross domestic product (GDP) that is *actually* being achieved relative to what could *potentially* be achieved. It is the slack in the economy and caused by many factors including joblessness, lack of investment opportunities, or high costs of finance.

Governments would want to see a number close to zero because it implies high levels of employment and a prudent allocation of resources – an economy that is neither too hot nor too cold. However, if the number turns positive (tellingly called the inflationary gap) Chart 1 below very clearly demonstrates what tends to happen – inflation spikes up. This is a sign of an economy that is over-heating and what has tended to happen is that the Fed has then panicked, raised interest rates too fast, choked off demand too quickly and caused a recession. This is why we agree with the line of thought that it is not old age that kills a bull market, it is central bankers.

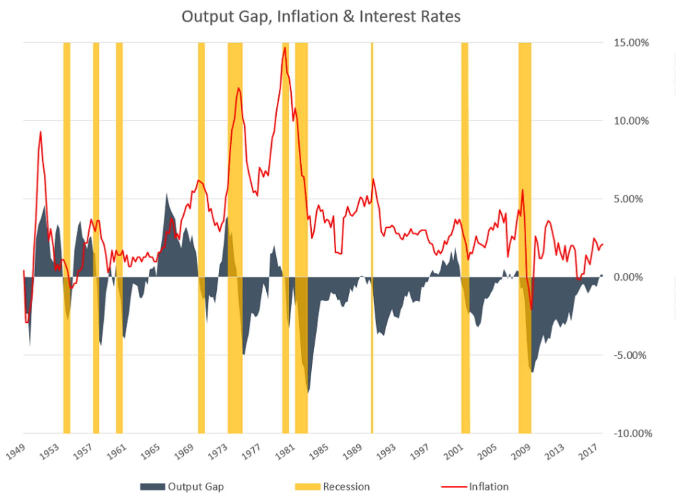

CHART 1 - *Source: Bloomberg ®, Albert E Sharp*

This seems to be the explanation for the shakeout over the last few days. Decent job figures last week from the US provided further confirmation that the economy is getting stronger and it seems to be no coincidence that this has all happened at a time when a new Fed Chairman has just been sworn into office. The consensus had seemed to be that Jay Powell would continue in exactly the same vein as outgoing Janet Yellen, playing a careful game, sticking to the script and averse to cranking up rates. Or maybe a view was forming that he would use this opportunity to go on the front foot and make his mark early? Get the market to adjust to his line of thought from the outset – it might be unsettling at first but further down the line, it would in fact make his job easier. This thesis is appealing, but it overlooks the fact that there is no clear evidence of materially higher inflation anytime soon.

The IMF's recent economic outlook shows its forecasts for consumer price levels in Table 1 below and they are rising. Yes, they have been bumped up since October, but they are still extremely low by historic standards.

	Estimate		Projections		Difference from October 2017 WEO Projections	
	2016	2017	2018	2019	2018	2019
Consumer Prices (% growth)						
Advanced Economies	0.8	1.7	1.9	2.1	0.2	0.1
Emerging Market and Developing Economies	4.3	4.1	4.5	4.3	0.1	0.2

Table 1 - *Source: IMF*

This is the main reason, for now at least, why we remain of the view that equities have further to run. Inflation, though rising, is still very low by historic standards. Interest rates in the US will probably go up at least three times in 2018, but even then will still only be around 2% this time next year. The ECB will likely reign back its expansionary quantitative easing program, but don't expect this to noticeably impact borrowing costs. The Bank of England look set to raise base rates, but the chances of going above 1% even by the middle of next year seem slim. For a real and long-lasting rout in equity prices we need concrete evidence of serious inflationary pressures that prompts a global acceleration in rate hikes. We simply are not there yet and it could be years away.

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Going back to Chart 1, it is very tempting to think that the next recession must be imminent. (We haven't gone into detail, but recessions are, unsurprisingly, generally not good for share prices.) As soon as the output gap gets back up to zero or beyond, the writing is on the wall – get out! So we have tested to see if this is true, assuming a strategy of buying the S&P-500 Index the moment the gap turns positive and selling out the moment it turns negative.

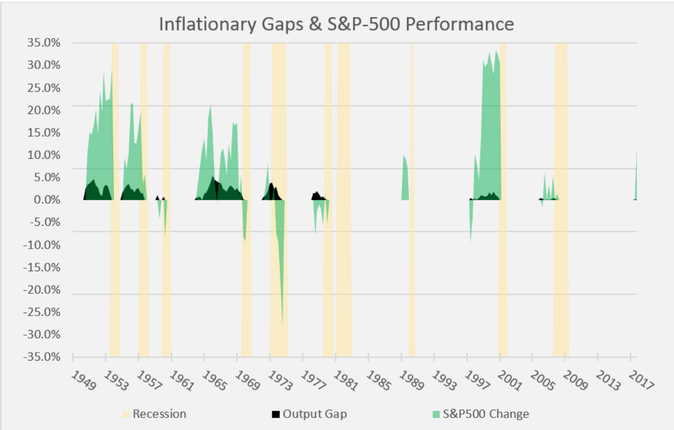

CHART 2: *Source: Bloomberg®, Albert E Sharp*

The graph shows that there were some nasty periods and the 25% sell-off in 1974 rather leaps off the page. However, the combined green area in the 'mountains' clearly outweighs the area in the 'stalagtites'. A strategy of being out of the market during inflationary gap periods would clearly not have paid off.

For bond prices, we remain of the view that the outlook is at best mixed. Government bonds in most of the developed world have yields that are artificially suppressed due to quantitative easing. Put another way government bond prices have been propped up by government action but this is now beginning to unwind. In the US, the 10 year treasury note has seen its yield jump from 2% in September to almost 2.8% last week. Due to the inverse nature of bond yields and prices this was caused by bond prices falling almost 4% since mid-December. This may not sound like a lot relative to equities given what has been occurring of late, but in the bond world it is huge. So we stick to our position that we have held for several years now. Avoid gilts and government bonds and seek out absolute return funds as a replacement in portfolios. That said there will be opportunities but we suggest leaving this to the specialists. We like vehicles with global remits and the ability to dip in and out of the whole range of credit ratings and it helps if we can see that strategies are in place to hedge away risk. The **Artemis Strategic Bond** fund, **Jupiter Strategic Bond** fund and **Legg Mason Brandywine Income Optimiser** tick all these boxes and have excellent track records.

To conclude, we believe that the recent jitters are understandable but misplaced. The incident was a natural side effect of a conventional bull market that we expect to last a good while longer. Dare we say it, but we are actually relieved to see some of the pressure released, some of the froth blown off and a degree of reality return. Buying shares is risky and some market participants were seemingly forgetting this fact.

To call the bottom right now is guesswork, but our sense is that as the Trump tax cut filters through, equities will go on to hit new highs during the course of the year. In last month's commentary (click here to view) we put forward our outlook for the main asset classes and nothing has changed. We still like technology, emerging markets and US small cap in particular and now a lower entry point has presented itself. Some investment trust discounts have widened out, which on the face of it look attractive, but it has been difficult to deal in some names due to a lack of liquidity. In short, we regard the sell-off as a buying opportunity.

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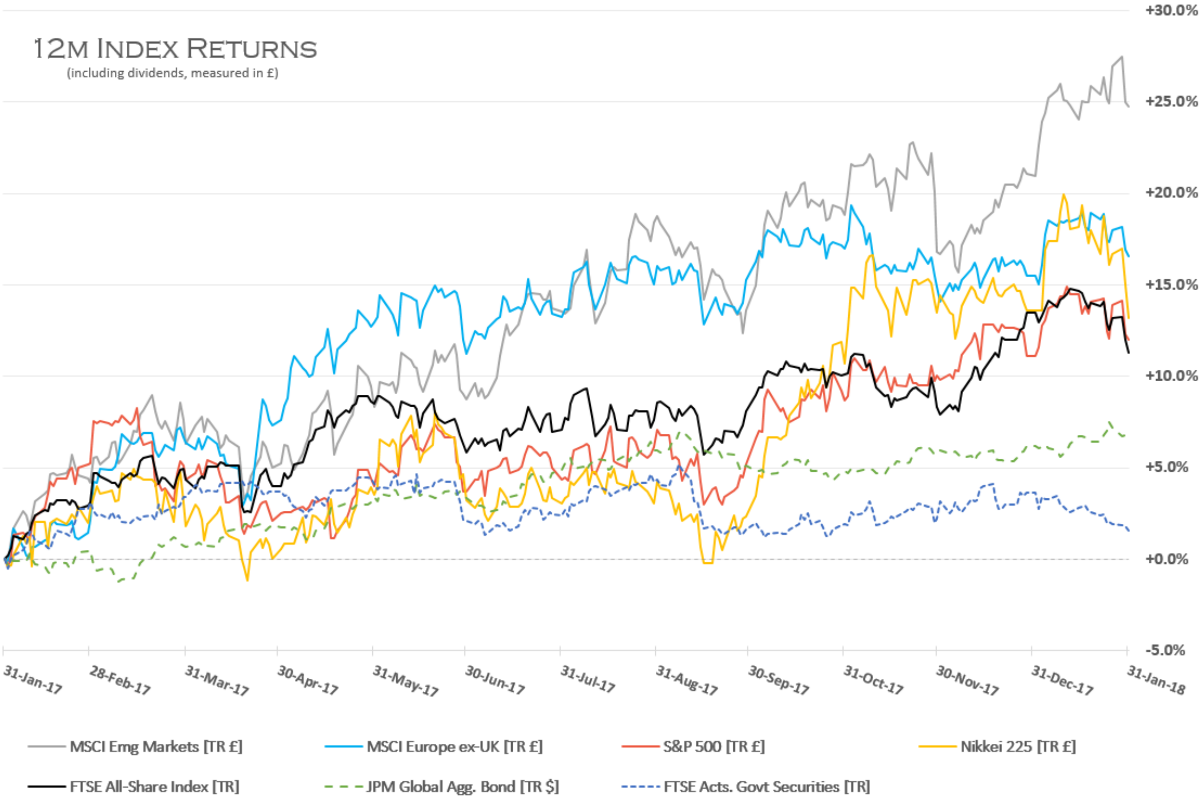
Index Returns

Index	Region/Asset Class	31 Jan 2018	1 Month Change	1 Year Change	2 Year Change
UK 100	UK	7,533.6	-2.0%	+6.1%	+23.8%
UK Mid Cap	UK	561.6	-1.9%	+8.3%	+17.4%
UK Small Cap	UK	5,897.8	-0.2%	+13.3%	+35.1%
Dow Jones Ind Avg	USA	26,149.4	+5.8%	+31.6%	+58.8%
S&P 500 Index	USA	2,823.8	+5.6%	+23.9%	+45.5%
NASDAQ Comp.	USA	7,411.5	+7.4%	+32.0%	+60.6%
Nikkei 225	Japan	23,098.3	+1.5%	+21.3%	+31.9%
Euro Stoxx 50	Europe	3,609.3	+3.0%	+11.7%	+18.5%
CAC 40 Index	France	5,481.9	+3.2%	+15.4%	+24.1%
DAX Index	Germany	13,189.5	+2.1%	+14.3%	+34.6%
Milan Index	Italy	23,507.1	+7.6%	+26.4%	+26.0%
MSCI Emg Mkts (£)	Emg Mkts	593.4	+3.1%	+24.8%	+76.4%
IBOVESPA Index	Brazil	84,912.7	+11.1%	+31.3%	+110.1%
MICEX Index	Russia	2,290.0	+8.5%	+3.3%	+28.3%
S&P BSE SENSEX	India	35,965.0	+5.6%	+30.0%	+44.6%
Shanghai SE Comp.	China	3,480.8	+5.3%	+10.2%	+27.1%
Hang Seng	Hong Kong	32,887.3	+9.9%	+40.8%	+67.1%
UK All Property	UK Property	7,216.8	+1.0%	+7.8%	+10.1%
UK Conv Gilts	UK Gilts	3,517.4	-2.0%	+1.6%	+6.0%
UK Index linked Gilts	UK IL Gilts	4,779.1	-2.6%	-0.5%	+18.2%
JPM Glob Agg. Bond ($)	Global Bonds	574.1	+0.7%	+7.0%	+8.9%
iBoxx Non-Gilt	UK Corp Bonds	337.5	-0.9%	+4.4%	+12.9%
WTI Crude ($/barrel)	Oil	64.7	+7.1%	+22.6%	+92.5%
LMEX	Base Metals	3,432.5	+0.4%	+20.2%	+58.3%
Gold Spot ($/oz)	Commodities	1,345.15	+3.2%	+11.1%	+20.3%
S&P Agri & Livestock	Agriculture	758.99	+0.7%	-7.5%	-10.0%
£1 = US$	Currencies	1.42	+5.0%	+12.8%	-0.4%
£1 = €	Currencies	1.14	+1.5%	-1.9%	-13.1%
£1 = Yen	Currencies	154.96	+1.8%	+9.2%	-10.2%



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