Investment Insight

Friday, 5 January 2018

Growing pain: *As interest rates have fallen considerably in recent years, investors have sought out those shares that were likely to benefit from low rates. This successful strategy has been supported by loose monetary policy and low inflation. However, in times of rising rates these stocks tend not to fare so well.*

With underlying economic conditions improving over the course of 2017, it is possible that in 2018 European equity investors may move towards a more "value" based strategy. These and other themes for the year ahead are discussed by Paul Casson of Artemis in this week's ***Inside Track****.*

Energised: *New Year, open mind, new ideas! We suggest you first read the Inside Track and in particular the "Energy" section, then this week's* ***Pic of the Week*** *should make more sense. We hope!*

Quoted...

"Life is like a ten-speed bike. Most of us have gears we never use." - Charles M. Schulz

The Inside Track

Paul Casson, manager of the Artemis Pan-European Absolute Return Fund shares his thoughts on the year ahead and how he sees the European Equity sector faring.

In 2017, the economic fundamentals globally began to change. Growth in every region of the global economy picked up. There were sufficient signs of inflation in the eurozone for the ECB to contemplate tapering its asset purchases. Interest rates are rising globally if not (yet) in Europe, with more to come. In many cases, however, investors seemed to spend much of 2017 rooted in the deflationary worries of the past rather than in present-day economic reality: there were long periods in which highly priced stocks with slower (if less cyclically sensitive) growth in earnings outperformed lowly priced stocks showing faster growth.

Inflation...

Inflation is rising again. In the past, it was explained away as being 'just' because of higher oil prices (reflation deniers love words like 'just' and 'but' as if real-world facts should be excluded because it suits their story). A variety of factors are contributing to rising inflation. Faster economic growth tends to reflect higher demand, allowing companies to put their prices up. Workers notice this and expect pay rises. Germany's IG Metall union, for example, is demanding a 6% wage increase from VW in 2018. Metalworkers' salaries won't increase by that much, of course – but even half of that would be well above the ECB's 2% inflation target. My money is on an outcome closer to 4%. Workers whose pay packets grow tend to consume more, feeding demand and potentially leading to more inflation.

Growth versus value...

If I were to rank the risks facing equity markets today, it would not be Brexit, Trump, or North Korea at the top of my list. Instead, it would be the (very) expensive growth stocks that every investor owns already and which need low interest rates to sustain their valuations. It makes no sense to assume that the investment strategies that worked as interest rates were falling will keep working as they go up. If that were the case, we would need to assume that the same strategies will keep working in perpetuity. History suggests otherwise: nothing in equity markets works forever.

Today, the relationship between growth and value may not be quite back at the most extreme levels of 2016 – but it is not far off. It is not just a question of relative valuation: it tends to be cheap cyclical stocks that are driving the majority of the earnings growth in Europe: banks; construction companies; consumer discretionary stocks; industrials; energy. We think these areas will be worth having exposure to in 2018, particularly since many of the stocks in question are still cheap after years of lagging the market. It doesn't hurt that the operational leverage in these companies works in shareholders' favour during a cyclical upturn.

Energy...

One of the cheapest – most under-owned – sectors in the European market is energy. That could change. Energy is an unloved sector among investors, as shown by the wide gap that has opened up between movements in the oil price and performance of shares in oil-related companies. We suspect this gap will be closed by share prices rising to catch up with the oil price as more companies report good news. Concerns surrounding the Opec meeting in November proved unfounded: cuts to production were agreed until the end of 2018. To us, this looks more than enough to underpin the oil price. Supply is already lagging demand and inventories are being reduced, a trend we expect to last while global economic growth stays strong.

Pic of the Week

Is this an opportunity? Read the "Energy..." section of The Inside Track to find out!

Market View

	Last 7 days (€)	Last 12 mths (€)	YTD (€)	5Y Ann. (€)
Global equities	+0.4%	+8.5%	+0.8%	+12.6%
US equities	+0.0%	+7.0%	+0.4%	+16.0%
European equities	+0.7%	+10.2%	+0.9%	+9.2%
EM equities	+2.8%	+20.8%	+2.4%	+5.2%
Irish equities	+0.6%	+8.4%	+0.5%	+15.2%
Commodities	+0.5%	-1.6%	+0.2%	-7.6%
Hedge funds	+0.3%	+3.3%	+0.1%	-0.3%

Currencies	Current	YTD Δ
EUR:USD	1.2067	+0.6%
EUR:GBP	0.8904	+0.2%
EUR:CNY	7.8329	+0.4%
GBP:USD	1.3552	+0.3%
Bitcoin	14,650	+1.1%

Week ahead: Key events

08/01 UK House Price Index & Eurozone Retail Sales
09/01 UK Retail Sales
09/01 Eurozone Unemployment & US Retail Sales
10/01 US Mortgage Applications & UK GDP
11/01 Eurozone Industrial Production & US Employment
12/01 US Inventory & Sales Data

Commodities	*Current*	*YTD Δ*
Gold	1,323.39	+1.6%
Copper	7,180.50	+0.3%
Oil	67.91	+2.0%
Wheat	434.25	+1.8%

Central Bank rates	*Current*
Eurozone	0.00%
USA	1.25%
UK	0.25%

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