DNCA INVESTMENTS

Market comment
September 2016

By Igor de Maack
Fund manager and spokesperson for DNCA fund management team

"In light of concern over political uncertainty from economic players, both households and corporates, governments must step in and take over from central banks".

The summer's seeming peace and the stabilization on the financial markets did not stop investors continuing to move away from the Eurozone and towards emerging markets in record numbers. Fear of a break-up of Europe, and in particular the Eurozone, has been the most common reaction from non-European residents since the Brexit vote. Unless renewed impetus for European construction emerges, this sentiment will persist and jeopardize consumer and domestic business confidence, as these groups are set to hoard their savings and cash rather than spending or investing it. The first bridge to cross is in Italy in November, when voters will have to decide on an institutional change that would put an end to the current bicameral system and sound the death knell for the chronic instability of the Italian political system. This constitutional referendum is to take place at a time when regulators, the state and banks are endeavoring to put together a rescue plan that would rid the banking system of provisions for non-performing loans and shore up banks' capital.

The recovery in the Eurozone has not yet faltered. US growth is admittedly less impressive but still remains robust, as do employment figures. Emerging markets (Brazil and Russia) were buoyed by easing commodities prices. Lastly, China has still not slumped despite a real issue over debt. A zone-by-zone analysis of world growth still paints a mixed picture, but it is less disastrous than had been expected at the start of the year. Terrorist attacks and the refugee crisis did not trigger a massive drop in consumer spending in Europe, except perhaps for the tourist sector in France this summer. The full effects of Brexit are still difficult to assess, particularly as the timeframe for this event changes with each changing statement from UK politicians. Unemployment is down in the Eurozone and is still very low in the USA. Inflation indices are still looking dismally low compared to central banks' targets and past trends. Forecasters are expecting world growth to stay steady at around 3% for 2017.

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US monetary policy is becoming increasingly difficult to sustain and the next rate hike is approaching. The dollar could also strengthen in the medium term. Meanwhile, the ECB will also have to deal with the rate hike dilemma if inflation recovers. The markets are paying very close attention to US employment figures to try to identify indices that would trigger the forthcoming rate hikes. In Europe, questions are emerging as to whether the ECB's quantitative easing program will indeed end in March 2017 as planned due to the relative effectiveness of these moves on private investment. The Fed's difficulties in putting an end to a lenient and highly accommodative monetary policy will act as a lesson for Mario Draghi and his team. The ECB also has to juggle between its role as central banker and custodian of Eurozone integration. Governance of the Eurozone is more complex than the dollar zone, so it important to try not to draw too many parallels between monetary policy in the two areas. However, excessive and long-lasting divergence between monetary policies would knock the international financial markets off-kilter and trigger deadweight effects.

The world economy admittedly stabilized but forthcoming political and electoral events (Italy, USA, followed by France and Germany) are set to affect the markets, which may witness the return to volatility disappeared during the summer. If these obstacles are reasonably overcome, European equities could catch up part of their performance lag. So far, corporates' HI earnings reports have been reassuring. In view of the situation in some emerging markets, investment portfolios could be justified in revisiting these themes with a highly selective approach. Cautious is in order in the USA in view of the potential rate hike and historical levels displayed on the equity markets. Investments in longer-term bonds are becoming high-risk investments in the USA as well as in Europe. As a result of political uncertainties, European equities are still trading at a discount, which is difficult to fully quantify. However, investors adopting a selective approach can still unearth earnings growth, value creation during M&A deals and comfortable dividends on the Eurozone equity markets.

Text completed on September 5, 2016 by Igor de Maack, fund manager and spokesperson for DNCA fund management team.

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