Economic and Investing Review 2018

by Peter Brown

Peter Brown does an economic review looking at our domestic economy and how the Irish economy is doing.

We started 2018 with a number of economic and geopolitical themes. Trump being the most influential. For followers of the markets this was strange as throughout the Obama era, it was the Federal Reserve that influenced markets and not the president. All that has changed so whether you like Trump or loath Trump, you cannot ignore him.

The global economy is still focused on recovering from the 2008 crash and it is the US economy that is leading the world out of recession. They have full employment and growth and that has led to a tightening in monetary policy, i.e. higher interest rates. They have gone from an era of Quantitative Easing to Quantitative Tightening, interest rates have risen from 0.5% to 2.5% and the benchmark stock index, S&P500 is up 350% since March 2009.

In contrast, Europe and the rest of the world are languishing. Germany is doing well but in contrast Italy is in deep trouble, 1% growth in a decade, 40% youth unemployment and €2 trillion of debt. This compels the European Central Bank to maintain loose monetary policies, printing money will only end this December and interest rates are firmly at zero and set to stay there well into 2019.

The existence of interest rates in the US versus Europe the UK and Japan results in a strong dollar. That is problematic for emerging market economies as they service debt in dollars and as their currency depreciates, loan repayments become more onerous. So, it has been a bad year for the likes of Turkey, South Africa, Brazil, Argentina etc.

The nine-year recovery has been pretty defined with the US doing very well and Europe and the rest of the world lagging. That has led to a lot of investment flows into US stocks. The US market is now twice as expensive as Europe and European stocks has not been as cheap compared to their US counterparts in 30 years!

The great economic question of 2018 is whether the longest stock market rally in history is at an end? This matters as most investors in Europe have 50% plus exposure to US markets whether that is an investment or in a pension. Most off the shelf investment products sold in Ireland follow the MSCI world index slavishly and that template invests heavily in the US S&P500. From 2009 it has been the best market for returns but now it means stock exposure to the most overvalued market in history and currency exposure to a very over valued dollar. Time to re-balance your portfolio.

The hiccups in the market; the 10% fall in February and the adjustment in October are caused when money managers decide to take profits and sit their clients in cash for a period. As US bond rates break the 3% barrier this becomes more attractive, especially if the client has benefited from a big chunk of the 335% rally. As a consequence and as a result of their now being a safe investment alternative, we may have seen the top in the US stock market for quite a while.

Of course, the market does not just focus on interest rates and currencies. Geo-political and other stories can dominate. This year we have had; North Korea, Turkey, Brexit, Italy, Iran, Saudi Arabia and of course the Trump trade wars. Yet none of these single issues have caused much market turmoil. I get asked about this in the media all the time. The fact is the market does not believe that any of these stories will deteriorate into a major event and cause a market set back. The market has been wrong before so a couple of these are worth analysis.

The trade wars may be just Trump bullying for political gain. That is his style and what his followers like. He is the bully in the school yard and we see that with his dealing with North Korea and Iran. China accepts the sanctions, to a point, because they have little choice, they have benefited from free trade with the US for decades, a bit of pay back is acceptable as long as it doesn't get out of hand. Mexico and Canada get this message too.

Trump has "instincts" "exports are good, imports are bad," "Whatever is good for me must be bad for you, and vice versa," but he has no long-term strategy. The way to handle Trump is to sign up to a deal where he gets some kudos and hope he will move on and leave you alone.

Brexit is a kick the can situation and the market knows that.

Greece was handled that way and amazingly Greek bonds are now trading at 4.5% down from a staggering 20% at the last bailout. We are still lending them money they will never repay and their debt now stands at €250 billion. Once you get a story out of the headlights the markets get bored and moves on. Only stories that have a definitive impact affect prices and Brexit does not fall into that category, yet! Too much political posturing, no detailed outcomes and washy deadlines leave the market with no option but to ignore for now.

We cannot do an economic review without mentioning our domestic economy. What a turnaround! It is likely we will post 5% plus growth this year and the outlook for 2019 is just as good. Yes, we have major social problems in housing and health. Housing is a supply and demand issue and can only be solved by building more and higher. That will take three years and any tinkering around the edges is just political point scoring. Frankly some of the proposals are ludicrous.

Health is an issue of inefficiency, it always has been. The budget is big enough but the government will not tackle administration over-staffing or bad management. Whenever you run a business without management accountability this is what you get. We want the health service we desire not the health service we can afford. That is a fundamental flaw but one, no politician will tackle.

Outside these issues the Irish economy is booming. We have an exposure to a Brexit decision from left field but I do not believe that will happen. We have divergence with rural versus urban recovery but I believe in time the high level of domestic growth will lift all boats to some degree. The economy is growing so fast we are struggling to keep up and that is the political and infrastructural challenge.

Lastly, I want to mention MIFID 2. Whether you are advising your clients or it is your personal investments or pension the new legislation introduced in January compels all investment and life companies to declare the true cost of investment products. The results are shocking! Total commissions and fees range from 2% to 6% with little logic as to why.

If you risk assess a client via the ESMA scale they score between 1 and 7. A score of 1 means the client is totally risk adverse and moneys stay on deposit. 7 is very high risk with 100% invested in the stock market. Depending on the clients risk profile the adviser is obliged to sell a product matching that score.

A risk profile of 3 has an investment target of 2-5% per annum. Given the fees that are being charged and tax at circa 41% or 33% the reality is the client has no chance of making any money.

There are billions under management in risk categories 1-3! If you have a client or are yourself in that space, you need to consider whether you have any possibility of making a return or are simply destined to lose money regardless.

Some companies are charging between 2 and 4% to manage their client's monies in cash!

You would think very few investors are accepting that but hundreds of millions are invested in these products when a better alternative is a simple deposit account.

We are in a low interest rate environment for a protracted period of time so we need to be aware of the futility of some investment strategies alongside the challenge of achieving returns.

In summary the US market and the dollar have probably little upside left. Europe and emerging markets are far better value. I do not see a market meltdown just a higher level of volatility. Returns are still out there but we need to invest in assets that offer value.

If you require clarity or more detail on any of the points raised above I would be delighted to hear from you.

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