November 2016

# Market Bulletin

The Orchard Practice

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This month's update comes to you from Columbia Threadneedle, manager of the Omnis UK Bond Fund and Omnis Managed Funds:

In a world where a significant segment of government bond yields continue to hover in or near negative territory, the credit cycle looks to be nearing its end, and the devaluation of sterling is dominating the agenda, we are increasingly mindful of the threats to risk assets that are looming on the horizon.

While we thought that sterling would come under intense pressure as global investors fled the currency, the pound has been devalued to a greater extent than analysts anticipated and we believe it will weaken further to $1.10 next year. The flipside is that both equities and fixed income markets have performed above expectations, largely as a result of ongoing quantitative easing and central bank intervention, both by the Bank of England and the European Central Bank.

But there is a rising fear that the theory of central bank intervention is not matching the reality in so much as ongoing monetary stimulus may be harming markets as much as it is helping them – certainly monetary stimulus is doing little to boost productivity growth. Against that backdrop, if inflation were to pick up and interest rates were to rise, there could be significant implications for risk assets, given how a yield-starved world has been forced to hunt for returns everywhere else.

We have clearly had an extremely reassuring central bank 'comfort blanket' put around what, on the face of it, look to be very expensive risk assets; and this has underpinned valuations and helped us navigate through a challenging macro-economic and geo-political backdrop. As a result, people have become used to explaining away what in absolute and historic terms look to be expensive valuations, by referencing the bond market at all times.

That feels relatively fragile and if you overlay that with an increasing recognition that mo netary policy is doing bad things as well as good things, along with socio-economic tensions globally, then the cry for a fiscal response must be on the increase.

The forthcoming Autumn Statement may raise the prospect for fiscal policies in the UK – where the government has been somewhat critical of the Bank of England's monetary policy – while Europe and Japan arguably need fiscal easing the most.
From a bond market perspective the expectation is that curves would steepen materially if there was a regime shift into fiscal.

So while our central case is that the status quo is maintained and we continue to experience low inflation, low growth, and low interest rates, we are mindful that if growth picks up on the back of increased fiscal stimulus, the interest rate environment is challenged for the same reason and the current valuation of risk assets is contested, we could see a dislocation in markets. This ultimately depends on bond yields rising, how quickly they might do so, and where we ultimately end up, but the worst-case scenario is that risk assets become a turbulent place to be in the next six months.

A significant pick-up in inflation is one factor that could challenge the status quo, so our thoughts have turned to whether the world is being too complacent about inflation. In the UK inflationary pressures linked to a weaker sterling are undoubtedly hitting suppliers and making their way to retailers and we have already seen inflation in September beating analyst expectations. In the US, mild stagflationary pressures are present, with growth stable to slowing and price pressures building from both rising labour costs and

powerful base effects that could see headline CPI inflation doubling to 2% by year-end. This could result in the Fed feeling bold enough to raise rates in December, which would likely increase volatility across risk assets.



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