Whitechurch Asset Views
Award Winning Wealth Managers

Whitechurch Securities Ltd
WEALTH MANAGERS

Monthly Round Up - September 2017

Strategic Overview

Two Tribes

August witnessed escalating tensions between the US and North Korea over the latter's nuclear tests, culminating at the end of the month in a missile being fired over mainland Japan before landing in the Pacific. However, despite these events combined with the devastation caused by Hurricane Harvey, bond and equity markets generally rose. In addition, sanguine inflation numbers across the globe saw investors focus again on a low growth and low inflation outlook during the month. This proved particularly beneficial for Government bonds and perceived higher quality equity sectors.

However, there was some performance dispersion within equity markets. The UK was the pick of the Developed Markets, whilst the S&P 500 finished the month marginally up. Europe and Japan were largely flat, both finishing the month marginally down (in local currency terms). Asian and Emerging Market equities (particularly the latter over the month) continued with their strong performance year-to-date.

Risk aversion returned in August, albeit fleetingly. After months of very low volatility within equity markets, we did see the 'fear' index, the VIX, spike by nearly 40% (from a low of 11 to 16) during mid-month as investors became concerned about the stand-off between the US and North Korea. This was the first time that the VIX closed above 16 since the day of last year's US election. However, by the end of the month it was once again around the 11 level.

For UK investors August proved to be a bit of Brexit-vote deja-vu. UK large / mega cap dollar earners led the markets higher whilst UK investors within overseas markets saw returns boosted as sterling weakened against all other major currencies over the month. This meant that whilst leading European and Japanese bourses were marginally down for the month, returns were boosted by around 3% for UK investors as the pound weakened. We do not make big currency calls and we are not starting now but it does feel like the full extent of a bad Brexit is being priced into sterling at the moment.

It's not only sterling that is weakening, so is the global reserve currency – the US dollar. This has continued to benefit Asian and Emerging Markets. There are many positives for these markets at the moment. As well as the US dollar remaining relatively weak, the lack of inflation is putting a lid on any potential interest rate rises, Chinese growth remains robust and commodity prices have had a bounce back. Although, there appears to be a good level of momentum in the near-term, continued muscle flexing (or worse) by North Korea has the potential to reverse investment flows to these regions.

With the rare recent spike in equity volatility during the month, lower risk bonds returned to favour. In addition, global inflation numbers only reinforced for investors that the 'goldilocks' environment of steady growth accompanied by a lack of inflationary pressure reduces the pressure for rising interest rates. However, the strong performance of bond markets continues to raise concerns over valuations. We continue to see more opportunities in corporate than Government bond markets, but the yield differential between corporate and Government bonds is now lower than it has been since the Global Financial Crisis – so it remains to be selective and diversified.

As mentioned last month, we have moved back into UK commercial property. Now that it appears the FCA is not taking any punitive measures on open-ended funds, we feel far more comfortable in moving back into the asset class. The yields offered by the asset class appear attractive relative to bonds, whilst the UK economy has proven resilient and overseas buyers continue to support demand. As a result we have added a modest weighting to cautious and balanced mandates.

During August the posturing from the US and North Korea was a short-term reminder to investors that after months of complacency, volatility can return to risk assets and quickly. However, with cash continuing to provide a negative real return, a well-diversified portfolio can provide many opportunities to exceed miserly cash returns for those prepared to ignore short-term noise, focus on valuations and take a longer-term perspective.

On the following pages we discuss our approach across global stockmarkets and other asset classes, as we look to extend our award winning performance in 2017.

UK Equities

August proved a mixed month for UK equities. Rising commodities and sterling weakness saw UK large cap oil and mining companies perform strongly over the month, whilst concerns over North Korea saw investors move towards the defensive consumer staples stalwarts such as Unilever and Diageo. However, there was bad news for some high profile investors as Provident Financial, WPP and Dixon Carphone - all announced major profits warnings.

Elsewhere in UK markets, mid caps were marginally up whilst smaller companies generally lost money. This was largely due to investors selling these on the back of risk aversion and the perception that these areas of the market are more correlated to the domestic economy, which remains dogged by Brexit uncertainty.

Talking of which, the next round of Brexit negotiations took place over August. Despite a lot of posturing and lingering uncertainty over process, the UK economy is largely reacting benignly. Unemployment has fallen to 4.4%, the lowest level since 1975 whilst manufacturing surveys still remain strong. However, sterling weakness continues to translate into increased input prices for UK domestically focused businesses.

Despite elevated market levels, with equities providing considerably higher yields than cash and bonds, we believe dividend stocks remain enticing and should provide the core to stockmarket exposure. We think any UK interest rate rises over the next year will be marginal and dividend stocks should remain supported. To complement core equity income positions we believe that stock-picking in medium and smaller companies, that have been indiscriminately shunned due to investor concerns over the UK economy, can provide recovery opportunities. As such we favour funds with a contrarian, value focused approach to beat the wider UK stockmarket.

US Equities

The S&P 500 ended August marginally up (+0.2% on local currency terms), with tensions between the US and North Korea and the devastating damage of Hurricane Harvey weighing on investor sentiment. Despite a relatively weak US dollar, the pound was even weaker and so UK investors investing in US equities received a currency boost of around 2% over the month.

The belief in Trump's pro-growth policies continues to wane as it is becoming clear how difficult it is to get policy through with an unwilling Congress. However, the US economy continues to evidence solid growth and second quarter GDP growth was revised upwards to 3% (from 2.6%) whilst growth for H2 is expected to remain around 2%. In addition, unemployment fell to 4.3%, but with US inflation coming in below consensus at 1.7%, the odds of a rate hike in December widened.

Nearly all S&P 500 companies have reported earnings for Q2; with 73% reporting earnings surprises and 70% reporting positive sales surprises. As a result, year-on-year earnings growth rate for Q2 has come in at 10.3%, the second highest growth for the index since Q4 2011. However, US equities remain expensive relative to other markets and to history.

The forward 12-month P/E ratio for the S&P 500 is 17.5, which is well above both the 5-year average (15.5) and 10-year average (14.1) - Source: FactSet, as at 04/09/17.

With a UK investor base, our underweight in US assets has been a positive contributor so far this year with an unwinding of the very strong dollar being instrumental. Valuations, rising interest rates, a strong dollar and the level of Trump euphoria have been the key reasons that have made us cautious on the wider US market. The dollar strength is now beginning to unwind and markets are pricing in more of a steady growth and minimal rate rise environment. However, high valuations and continued low volatility suggesting complacency continue to make us nervous.

European Equities

Even though August was a positive month for the economic outlook in Europe, this was not reflected in its equity markets which traded sideways. Once again though, UK investors in these markets received a currency boost due to the euro strengthening against sterling and this will have translated into broad market returns of c.3%.

As mentioned, the economic outlook for the Eurozone continues to improve. Q2 GDP growth came in at 2.2%, the highest since 2011, whilst purchasing manager indices (PMIs) continue to remain strong. Inflation remains well below the European Central Bank (ECB) 2% target but it is increasing and the latest core inflation figures came in at 1.3%. All of this momentum has seen the euro strengthen against the US dollar. However, the numbers have led the ECB to become concerned that recovery is not translating into higher prices, whilst a strong euro could drag on inflation. This has seen the ECB continue to maintain its monetary stimulus and to remain supportive in the near term.

From a valuations perspective it is hard to argue that European markets are cheap. However, in Europe there is scope for further earnings growth and after a decade of no earnings upgrades at a market level, we have seen double digit earnings growth year-on-year. Versus traditional benchmarks we have an overweight towards European equities versus US. With an improving economic backdrop and strong earnings growth, not least accommodative monetary policy and a more stable political backdrop, we believe that Europe can be an attractive theme in Whitechurch portfolios for the second half of 2017. However, if strength of the euro continues this may prove a challenge for European exporters.

Japanese Equities

August proved to be a flat month for Japanese equities, with the Topix falling by 0.1% in local currency terms. As per other overseas markets, UK investors will have seen returns bolstered by around 2.5% as sterling weakened against the yen.

In terms of economic news-flow, August was generally a good month. Second quarter GDP growth of 4% (annualised) was significantly higher than the anticipated 2.5%. The higher figure was attributed to higher private consumption and public demand. However, on the flip side to this, wage growth fell and CPI remains stubbornly low at 0.4%.

On the market front we still favour exposure to Japanese equities. Valuations are not stretched and appear relatively attractive compared with other Developed Markets. Given the potential for dividend policy reform, the ability to return cash to shareholders, and scope to improve return on equity, there is evidence of corporate reforms beginning to take hold. This provides a more enticing driver to Japanese stockmarkets than the strength or weakness of the domestic economy.

Asia Pacific & Emerging Market Equities

August was another strong month across Asia Pacific and Emerging Markets equity benchmarks, extending an exceptional period of performance year to date, and both significantly outperforming Developed Markets. This is perhaps surprising given the increasing geo-political tensions emanating from North Korea's aggressive military posturing that threatens to escalate. However, it is the continued positive economic news from China and weakness in the dollar that are proving to be the key drivers for investor demand in these markets.

Russia was the best performing of the major Emerging Markets in August. Stabilising oil prices due to the Saudi-Russian pact, the Russian economy emerging from recession and a cut in interest rates has seen Russia return to favour among higher risk investors. It was a disappointing month regarding the relative performance of India versus China. Having taken profits on our China exposure in June the market has continued to rally on strong economic data. GDP Growth for Q2 came in higher than anticipated at 6.9% and although it is expected to slow in the second half of the year, it is expected that official figures will show that the economy will grow by 6.5% in 2017.

In contrast, Indian economic growth has been disappointing with GDP growth at an annualised 5.7% for Q2 2017. This is well below consensus expectations of 6.6%, with lower consumer spending and exports acting as headwinds. It is the slowest growth the economy has shown since the beginning of 2014. The Sensex was the worst performing market and fell back by 2.4%. However, over the long-term we still favour the earnings growth potential that the Indian equity market has to offer.

Going forward it will remain important to be selective and the current renewed optimism over China should not let investors become complacent over the longer-term risks of instability in the largest emerging market. Overall fundamentals across Asia and Emerging Markets look attractive with structural reforms, better corporate governance, greater consumerism and, not least, relative valuations providing good opportunities for investors seeking long-term growth.

Fixed Interest

With inflation numbers remaining relatively stable across Developed Markets, August saw investors looking ahead to a return of the relatively low growth, low, stable inflation scenario that has supported bond markets so well in recent years. Throw in some risk aversion caused by fervent and persistent sabre rattling by North Korea plus the devastation in the US caused by Hurricane Harvey, then it doesn't surprise that Government bonds were sought after over the month and yields generally narrowed across the board in Developed Markets.

Despite the wishes of Central Bankers we maintain that the lower for longer interest rate environment remains and do not see a material increase in bond yields any time soon. The US is pricing in one further rate rise in 2017 and monetary tightening in other major developed economies will be very measured with bond market expectations being carefully managed by Central Bankers.

It would be no surprise to see yields drift higher, if the move away from monetary to fiscal policies is pursued globally and UK gilts continue to come under pressure from increasing calls to end austerity. As a such, we will continue to avoid Government bonds and skew our exposure to less interest rate sensitive areas of bond markets.

We have a basket of complementary and diverse bond funds for the cautious and balanced income orientated portfolios. Exposure ranges from index-linked gilts, through to investment grade credit and strategic bond exposure, right up to short duration high yield and European bank paper.

Commercial Property

It was a solid and steady month for open-ended commercial property funds, with the 'bricks and mortars' funds all delivering another month of income driven, incremental gains despite the ongoing uncertain political backdrop.

Following a number of meetings with UK property managers' in recent months we have returned to investing in the sector. Commercial property has moved on from last year's liquidity issues and we have an improving outlook for the asset class. Now that it appears the FCA is not taking any punitive measures on open-ended funds, we feel far more comfortable in moving back into the asset class.

Given the relatively attractive yields still available from property and its lack of correlation with equity and bond markets, we have added funds from F&C, Henderson and Kames into our cautious and balanced strategies. We have been impressed with how these managers handled the "stress test" of last summer in managing their funds and liquidity issues and we believe the funds are well positioned to manage risks and seek attractive yielding opportunities.

Alternatives

In general, our core basket of multi-asset absolute return funds provided positive returns over the month and the recent changes we have made to this component of our portfolios has been positive so far.

However, with equity and bond markets continuing to trade at elevated levels and with low volatility it is proving a difficult environment for such funds to compete at present. With bonds and equity valuations looking expensive in many areas, it seems to be that this is exactly the time when these strategies cannot be ignored, to provide ballast in cautious and balanced mandates. In aggregate our basket of funds acts as a defensive diversifier to portfolios.

Commodities

The oil price was broadly flat over the month, with Brent Crude finishing the month marginally higher and remaining above the $50 per barrel mark. Hurricane Harvey has had little impact as only 15% of US oil production now comes from the Mexican Gulf and may have a negative effect as the Hurricane has taken refining capacity offline in Texas, reducing short-term demand.

Industrial metals rallied strongly, gaining by 8.6% fuelled by strong Chinese growth and a weak dollar. Many are hitting multi-year peak prices. The gold price also rose by 3.9% over the month. The precious metal benefits from a weak dollar and increased risk aversion; both of which occurred in August due to heightening concerns over North Korea's nuclear tests.

We do not have direct exposure to commodities within our portfolios, although mining and energy will feature within UK and overseas equity exposure. We only hold gold indirectly through a small amount in alternative strategies. Gold is a diversifier, but we find it hard to value and its lack of yield provides a headwind as interest rates rise. We don't have conviction amongst the team for us to invest directly, and this probably sums the situation up suitably – the precious metal is an enduring enigma!

Cash

UK CPI remained unchanged as figures for July came in at 2.6%. However, RPI rose marginally to 3.6%. The Office for National Statistics also suggested that the impact of the Brexit vote was washing through as input prices rose by 6%, but down from 10% in June. With utility prices on the increase and energy prices reported to rise in the wake of Hurricane Harvey, transitory inflationary pressures remain.

For investors taking a medium-long term view we continue to believe that there are more attractive opportunities across other asset classes to beat cash. Therefore, cash is only held at present for tactical reasons or within lower risk strategies to enable us to counterpoint this with higher risk assets..

Whitechurch Investment Team, September 2017

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