Whitechurch Asset Views

Award Winning Wealth Managers

Whitechurch Securities Ltd WEALTH MANAGERS

Monthly Round Up - August 2018

Strategic Overview

Walking On Sunshine

Below are the key factors that have influenced investment markets in recent weeks, followed by our current position.

A positive month for stockmarket investors.

Having seen signs of investor nervousness in June, last month saw investors regain their appetite for risk, and it proved to be a sunny climate (matching the weather) for most global stockmarkets. The overall result was a rise of 3.1% for the MSCI World Index.

Looking at fund performance in July, IA Europe Ex UK was the best performing sector, returning 3.7%. Global equity income (+3.7%) and IA North America (+3.0%) were also amongst the strongest sectors. The only two stockmarket sectors to show a negative return were IA China and Greater China (-1.9%) and IA Japanese Smaller Companies (-0.7%).

Low volatility despite ongoing uncertainty

Despite political upheaval at home and abroad, continuing to dominate headlines and causing an uncertain backdrop, investors were in a relaxed mood and stockmarket volatility in July was very subdued.

UK stockmarkets subdued

Following a strong recovery in the second quarter and improving global investor sentiment the returns from the UK stockmarket were tempered, over the month, by Brexit worries. The Chequers Brexit Plan split the Cabinet and an increased prospect of a No-Deal Brexit has returned to the forefront of investor concerns. As a result, sterling fell over the month, which benefited blue chip exporters but UK smaller companies underperformed.

European stockmarkets show recovery

In terms of overseas exposure, having underperformed for much of 2018, European stockmarkets were at the forefront of performance in July. Improvements in economic news-flow and corporate earnings boosted investor sentiment on the continent. Investor sentiment was also boosted by agreements regarding tariffs between the EU and the US Government, reducing the chance of a fully blown trade war.

Currency diversification boosts performance

Currency continued to influence market returns and a weakening of the pound versus other currencies (particularly the dollar) enhanced returns for UK investors with overseas exposure. The 3.1% return from the MSCI World Index over the month translated into a gain of 3.8% for UK investors. We continue to extol the virtues of holding well-diversified international exposure given the political uncertainty that threatens the domestic economy.

Mixed returns from bond markets

Away from stockmarkets, there was a mixed performance from bond markets. Improving investor sentiment over the strength of the global economy boosted demand for higher risk areas of bond markets but more interest rate sensitive, defensive areas of bond markets struggled over concerns of rising interest rates. The IA Gilts sector was one of the few areas to lose money (-0.7%).

The best of the rest

Commercial Property had another month of providing solid gains. The asset class is again displaying the two attributes we seek – attractive yields compared to Government bonds; and a lack of correlation with equity and bond markets.

Looking ahead

The recent political turbulence is just background noise in our view and does not alter our investment outlook. We remain more focused on central bankers and believe that interest rate policies will be key drivers of asset prices. Despite tightening of monetary policies at home and overseas in recent weeks our view remains that any interest rate increases are likely to be cursory, due to a lack of sustained inflationary pressure and fragile economic growth.

As a result our strategic view remains focused on the belief that there is value to be had in several areas of global stockmarkets compared to the miserly return that is provided by holding money in cash, with a number of areas offering long-term growth prospects and more attractive income.

We believe that a well-diversified portfolio can continue to provide cash beating opportunities in a number of areas for those prepared to ignore short-term noise, focus on valuations and take a longer-term perspective.

Our investment focus remains on generating attractive risk adjusted returns (the amount of return we can generate based on the level of risk being taken) on a rolling three-year period. It is on these measures that Whitechurch has earned a wide range of industry awards in recent years.

On the following pages we provide a more detailed review of the markets and touch on how we are positioning our portfolios.

UK Equities

UK stockmarkets rose marginally over the month but underperformed against wider global markets. With concerns over Brexit coming back to the fore it was a weakening of sterling that was the key catalyst. This helped drive overseas earners but led to concerns over companies focused towards the domestic economy. Large cap stocks were the best performers over the month whilst the benchmark for medium sized companies posted a small gain and small cap stocks showed a negative return.

From a sector perspective, the tobacco sector performed strongly pulled higher by better than expected results from British American Tobacco. A large rally in AstraZeneca in July helped propel pharmaceuticals close to the top of the sector leader board. However, it was a bit of a turbulent month for utilities. The sector was hit particularly hard by concerns of an increasing likelihood of a general election and a potential Labour government hitting the sector. Food producers also suffered particularly due to the weak performance of Associated British Foods.

In terms of economic data, figures were mixed with consumer activity having bounced back in the second quarter, it is likely to be pulled back by recent hot weather. Wage inflation remains steady at 2.6% although a removal of the 1% cap by the Government and record high levels of employment will provide upward pressure.

But economic activity was strong enough to allow the Bank of England to increase interest rates by 0.25% to 0.75% at the beginning of August. This had been widely expected and saw little reaction from stockmarket investors although Governor Carney's reiteration of a sustained lower for longer environment saw the pound fall.

Despite Brexit and a tightening of interest rates to concern investors it was a positive month for blue chip UK shares. The month once again highlighted the different forces at work in the UK stockmarket, where a weakening pound acts as a tailwind to global multi-nationals that gain the majority of their earnings overseas.

We remain sanguine in our view of UK equities. Although we are mindful of political risk (and we expect to see the noise increase over Brexit over the coming weeks) our belief is that UK shares with high overseas earnings benefit from a weaker pound and those with more of a domestic focus are deeply unloved and undervalued by investors, thus representing a contrarian opportunity. Furthermore, we expect a lower for longer rate environment to continue which is supportive for dividend producing shares and with the UK stockmarket yielding close to 4% this is a very attractive feature.

US Equities

Once again positive economic and corporate news-flow emanating from the US helped support global markets and investors shook off concerns over rising interest rates and threats from Trump over a trade war.

The overall effect was a positive month for US stockmarkets. The S&P 500 was up 3.7% whilst the small cap focused Russell 2000 increased by 1.7%. Returns for UK investors were enhanced by a rally in the dollar translating the S&P and Russell returns to 4.4% and 2.4% respectively.

In terms of economic data, releases over the month continued to point towards continued strong growth. The US economy grew by 4.2% in the second quarter. Retail sales showed their strongest growth since 2012 and inflation rose to 2.9% (although high fuel prices were largely responsible). Following the positive data readings, the markets are pricing in that there will be two further hikes this year.
From a corporate point of view, according to JP Morgan almost 90% of companies beat expectations of earnings during the second quarter as the corporate tax cuts continue to boost short-term profits. The industrials sector performed strongly during July with strong earnings and reduced concerns of an escalation in the trade war. However, there were disappointments in some of the big technology names following an exceptional period of performance.

Fundamentally, although having an underweight position the US stockmarket has been a bit of a drag on performance year to date, our favour for US smaller companies has been a major positive. On valuation terms our preference for other markets versus the US remains intact, but Trump's tax reform bill could see one final push for the US market bull run. However, we are seeing a number of fund managers starting to question the sustainability of the US economic strength. On this basis the strong run of corporate earnings could begin to falter and high valuations, rising interest rates, and the political uncertainty over Trump are key reasons that make us cautious about the wider US market.

European Equities

European stockmarkets have been in the doldrums for much of 2018 but July saw a much more positive backdrop. The benchmark index rallied by 4.1% in local currency terms and a strengthening euro against the pound saw the index rally by 5.1% in sterling.

In terms of economic news, European business confidence showed an upturn and there was a modest increase in inflation. Positive talks between the EU and US administrations went a long way to resolving the threat of tariffs on trade which was a major boost to investors. PMI surveys continued to provide some optimism that the recent weakness is not leading to a sustained downturn.

Whilst other central bankers have been tightening monetary policy the European Central Bank proved to be more supportive and confirmed that interest rates will remain unchanged until the autumn of 2019 at the earliest.

On a corporate level, second quarter earnings were strong and all sectors showed positive returns. Healthcare, financials, telecoms and energy outperformed, whilst consumer staples - technology and real estate - lagged.

European markets have lagged wider developed markets year to date and our recent reduction in European exposure has been prudent. The strong recovery of 2017 has been losing momentum this year. We have been trimming our overweight exposure to bring monies back home to the out-of-favour UK stockmarket. However, we continue to believe that Europe looks more attractive than the US on valuation measures and with more stimulatory monetary policies likely to remain in place for some time.

Japanese Equities

It was a steady month for the Japanese stockmarket and the benchmark Topix index increased by 1.3%. However, a falling yen acted as a drag this month for UK investors and reduced the index return to 0.9% in sterling terms. Year to date Japan has under performed global markets but the strength of the yen has generated positive returns for UK investors.

In terms of economic news, figures over the month continued to show subdued economic growth and inflation. Export growth is beginning to show an upturn from the weakening of the yen versus the dollar over the past quarter. At the end of July the central bank outlined that it will be maintaining QE policies although it will be more flexible in its approach. The overall effect was that global cyclical areas of the market saw some improvement (having been significant under-performers this year).

Investing in Japan is unexciting at present but despite recent under performance holding yen has been supportive for UK investors during times of risk aversion. The economy is growing at a steady pace and the Bank of Japan is likely to continue quantitative and qualitative monetary easing. This should provide a supportive backdrop. Valuations 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. However, corporate earnings within Japan remain volatile as the value of the yen fluctuates.

Asia Pacific & Emerging Market Equities

July proved to be an improved month for Asian and Emerging Market indices although they continued to lag developed markets. The MSCI Emerging Markets and FTSE Asian Pacific Ex UK Indices were up by 1.7% and 1.4% respectively.

However, there was a significant disparity between different areas. Having had a torrid year to date Brazilian stockmarkets showed a strong recovery and the benchmark index returned over 7% during July. High energy prices has seen an upturn in corporate profitability and sentiment was boosted by lower interest rates.

India rallied strongly, benefiting from a fall in the oil price, a reduction in tax and a defeat of a motion of no confidence against the Modi Government.

Emerging Europe also performed positively. The Russian economy is looking in reasonable shape and a positive World Cup and Putin coming out on top in his meeting with Trump has boosted investor sentiment over the Russian stockmarket.

However, trade concerns weighed on Chinese equities as Trump maintained the pressure on Chinese imports into the United States, announcing further tariffs during the month. Korea also suffered from concerns over export levels being hit by US tariffs. The conclusion of this scuffle is hard to predict, but the longer this drags on, the greater the risk that it starts to impact sentiment more broadly.

Despite a clear divergence in the drivers of Asian and Emerging Markets equities, we believe that there are good opportunities to deliver strong performance from these areas. However, it will remain important to be selective when investing in these higher risk markets. As we have seen with concerns of a trade war, the optimism over China can be checked very suddenly and is a timely reminder that we do not become complacent over the longer-term risks of instability in the largest emerging market.

Furthermore, if we see a continuance in the recent rally in the dollar this will prove to be a headwind.

However, overall fundamentals across Asia and Emerging Markets still 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

Bond markets showed mixed signals in July as the positive effect of strong growth boosted higher risk areas such as Emerging Market Debt and High Yield bonds, although inflationary fears and increased investor confidence reduced the demand for 'safe haven' Government bonds.

In the United States, the strong economic data increased expectations that there will be another interest rate rise of 0.25% in August (although Trump decided to put his oar in to tell the Federal Reserve they should not be increasing rates). US treasuries proved fairly resilient and our exposure was boosted by currency. We increased our allocation to US Government bonds over the month, this is now our largest holding in many cautious and balanced mandates. We don't subscribe to the view of J.P. Morgan Chase chief Jamie Dimon who was recently quoted as saying "that people should prepare for U.S. yields of 5 percent"!

For UK bond holders it was all about waiting to see if there would be a rise in interest rates. It was no surprise when they were unanimously raised by 0.25%. Bond markets took this in their stride and gilt yields remained around 1.3%.

Yields in Japanese bonds spiked during the month over concerns of monetary tightening, but this proved premature and they retreated by the end of the month.

Although the overall trend in global bond markets is towards a monetary tightening phase, with interest rates heading up, it is going to be a slow process with central banks telegraphing their intentions to markets along the way. Even though many bond markets are historically overvalued, this approach by the central banks leads us to believe that there will be no collapse in bond prices.

Our exposure to fixed interest is through a basket of complementary and diverse bond funds for cautious and balanced income orientated portfolios. We will continue to avoid UK Government bonds, although we have a material position in US treasuries to provide insurance during risk-off periods. Overall we continue to favour our fixed interest exposure in corporate bonds and less interest rate sensitive areas of bond markets. Exposure ranges from defensive investment grade corporate bond funds and strategic bond exposure right up to financial bonds. We also hold Emerging Market Debt where we believe attractive yields provide adequate reward for risk.

Commercial Property

November was another 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 for the UK.

Given the relatively attractive yields still available from property and its lack of correlation with equity and bond markets, we have increased our exposure into our cautious and balanced strategies. Our preferred funds currently are from F&C, Henderson and Kames and we increased our weightings to these positions during the month.

Alternatives

The increase in volatility that we have seen in 2018 has proved to be a timely test for our alternatives exposure, and the Absolute Return funds held have continued to prove broadly positive over the month.

With increasing interest rates weighing on returns from bond markets and stockmarkets displaying a higher level of volatility our belief remains that a basket of alternative strategies is necessary to provide an added level of diversification.

An upturn in the relative performance of our alternatives funds year to date has been welcome as the use of these funds has been called into question several times during the tandem bull run for equities and bonds. However, we have a preference for equity long/short strategies and we continue to be frustrated by the (lack of) performance from the popular multi-asset strategies.

Although it is important to be selective and have a strong understanding of long/short funds, they are true diversifiers within our portfolios, and offer different opportunities versus traditional 'safe haven' asset classes, which appear expensive.

Commodities

Oil prices fell back over the month with Brent Crude down by 5.7%. A strong rise in oil prices has been a key feature this year and despite the recent fall the oil price has risen by 17% since the beginning of 2018 which will fuel short-term inflation.

The dry weather that we have seen in the UK has been replicated across many regions worldwide and this is having upward pressure on food prices which will also be inflationary in the short-term.

With investors regaining an appetite for risk, Gold fell for the fifth month in a row with the gold price ending down 1.6%. It has now fallen by over 11% since April (not what we call a low risk investment). 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 do not have direct exposure to commodities elsewhere within our portfolios, although mining and energy will feature within UK and overseas equity exposure.

Cash

UK inflation remained at 2.4% in June as measured by the Consumer Price Index (CPI). It is likely to remain at least at these levels with inflationary commodity prices and a renewed weakening of sterling and cash remains unattractive. Despite the recent 0.25% interest rate rise the best instant access Cash ISA deals are still offering around 1.3%. It remains likely that a Cash ISA will provide a negative return in 2018.

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. We are not going to see interest rates reverting to their long-term average for a long time. When asked when this may be in a recent interview Carney stated "hopefully in my lifetime" – he is only 53. 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, August 2018

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