Whitechurch Asset Views
Award Winning Wealth Managers

Whitechurch Securities Ltd
WEALTH MANAGERS

Monthly Round Up - November 2018

Strategic Overview

Free Fallin'

Investors had a rude awakening in October after a prolonged period of relative calm. Markets went into freefall with a sharp sell-off in global equity markets, resulting in the worst month of performance since May 2012. No single event precipitated the fall but the catalyst appears to have been investors becoming increasingly concerned over rising interest rates in the United States and slowing global growth due to the escalating conflict over US trade.

Best & worst fund performance
Whilst the sell-off was largely indiscriminate, IA China and Greater China suffered the heaviest falls (-11.0%) as investors became increasingly concerned over a broader slowdown in China, partly due to the increase in trade tensions with the US. Closer to home, IA UK Smaller companies (-10%) also had a torrid time as Brexit concerns added to the negative sentiment. The best place to hide from the turbulence was IA UK Index Linked Gilts which rallied by 3.2%. IA UK Gilt and IA UK Direct property sectors also posted positive returns.

Volatility spikes across the globe
Stockmarket volatility saw a significant increase in October. The "Fear gauge" VIX index started the month at below 12 and spiked at 25 during the sharp sell-off in the middle before finishing the month at around 21. All Developed Markets fell, Asia and Emerging Markets fell and the MSCI World Index fell by 6.8%

UK blue chips prove relatively resilient
Whilst the UK markets fell back in what was a universal sell off, the UK stockmarket fall of just over 5% meant it was the most resilient of the leading global markets. Defensive blue chip stocks were favoured, but the small cap area of the market was the hardest hit in the UK followed by the Mid 250 stocks, as investors shunned areas of the market more sensitive to the health of the UK economy, as concerns of a no deal Brexit rumbled on.

Currency diversification dragged on performance
Holding a basket of currencies proved positive for UK investors during a risk-off environment in October. As investors sought safe havens during the market turbulence, the yen and dollar were favoured and the Brexit blighted pound fell in value. The overall currency effect helped mitigate losses for UK investors with overseas assets and saw the 6.8% fall in the MSCI World Index over the month translate into a fall of 5.4% in sterling.

A month of two halves for bond investors
Interest rate sensitive Government bonds and investment grade bonds saw a sell-off early in the month as investors grew increasingly concerned over higher global interest rates. But as fear gripped investment markets, investors sought safe havens and lower risk bonds rallied and Gilts finished the month in positive territory. The months movements highlighted how monetary policy tightening across the globe provides a difficult conundrum for bond investors.

The best of the rest
Commercial property proved a resilient alternative to equity and bonds and is proving a good bedrock within our cautious and balanced portfolios. 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. It is during times of turbulence that absolute return funds should come into their own and it was pleasing to see our selective exposure generate a positive return.

Looking Ahead
We do not try to second guess short-term market movements, although less demanding valuations following the market falls do provide more opportunities for those who can invest without being fixated on short-term market fluctuations.

However, we are cognisant not to be over-confident. We cannot be certain that a combination of rising rates and a trade war will not see a fundamental slowdown in the global economy. Therefore, it is prudent to have a well-diversified portfolio across different regions and asset classes combined with 'insurance' positions to cover different scenarios.

Our view remains that any interest rate increases are likely to be cursory going forward, due to a lack of sustained inflationary pressure and fragile economic growth outside of the United States. As a result of low interest rates, our strategic view remains focused on the belief that there is value to be had in several areas of global stockmarkets and other assets, compared to the miserly return that is provided by holding money in cash.

Risks posed by short-term uncertainty will be managed through diversification (not second guessing unpredictable events and sentiment). We believe that a well-diversified portfolio can provide cash beating opportunities in a number of areas for those prepared to ignore short-term noise, focus on valuations and take a long-term perspective.

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 fell back across the board. Blue chip stocks were relatively resilient but medium and smaller company benchmarks were hit harder.

A correction at this time of year is not unusual as October marks the point when companies have to own up if they are not going to meet their full year projections and we have seen several instances of this across the UK market.

Defensive sectors were the only real winners over a very tough month with Fixed Line Telecoms, Utilities and Food producers being the only positive sectors. The decline in global markets caused a rush to safe havens whilst sterling weakness helped global players but domestic areas underperformed

In terms of economic data, figures remained reasonably positive, average wage rises and employment figures remain supportive, although Brexit uncertainty is weighing on business confidence.

Brexit concerns are naturally at the forefront of UK investors' minds. Like many investors, we learnt lessons from the Brexit referendum of the risks of positioning a portfolio based on probability only to see an unexpected result materialise! Our positioning will be more balanced going forward given the huge uncertainty surrounding the Brexit negotiations.

Despite the political uncertainty creating negative sentiment we do see opportunities in UK equities. Although we expect to see the noise increase about Brexit around the coming months 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

Following the best quarterly performance since 2013, October was the worst month since May 2012 for US stockmarkets. Concerns over rising interest rates, an escalating trade war with China and mixed corporate news from the big technology companies contributed to a sharp sell-off (although there was a modest recovery towards the end of the month).

The S&P 500 fell by 6.9% and the small cap focused Russell 2000 was hit even harder and fell back by 10.9% Losses for UK investors were diluted by a favour for the dollar translating the S&P and Russell losses to -5.0.% and -9.0% respectively.

Higher interest rates generally result in tighter financial conditions which leads to slower economic growth and these were the main reasons spooking markets. President Trump did little to calm sentiment by commenting that the number of interest rate rises being implemented mean that the Federal Reserve Governor has "gone crazy"! But despite market turbulence economic data releases over the month were broadly supportive.

In terms of corporate earnings, whilst quarterly results were broadly positive, there was some less positive forward guidance which further spooked markets (eg Amazon). From a sector perspective, energy stocks were hit hard as the oil price fell back and technology stocks also underperformed. Defensive areas such as consumer staples proved most resilient (producing positive returns).

Fundamentally, although a relatively cautious view of the US stockmarket has been a drag on performance year to date, our favour for US smaller companies has been a major positive (although not in October). On valuation terms, our preference for other developed markets versus the US remains intact, although Trumps' growth stimulus policies could see one final leg of the US bull market. 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 remain cautious on the wider US market.

European Equities

European stockmarket benchmarks also had a difficult month in October. The benchmark index fell by -5.6% in local currency terms and modest weakening of the euro against the pound translated this to –6.1% in sterling. Telecoms was the only area to provide a positive return, whilst energy, materials and technology shares suffered the most in the sell-off.

In addition to the concerns over a trade war and US rates, European political uncertainty over Brexit, Germany and Italy further dragged on investor sentiment. Italy failed to agree a budget that the EU found acceptable and in Germany Angela Merkel announced she will not seek re-election as CDU party leader (although she will remain Chancellor until 2021.

In economic news there were mixed signals. PMI surveys indicated that business confidence has continued to fall, but inflation has picked up (from 2.1% to 2.2% over the month). Whilst increasing fuel prices are a key driver, wage growth was also a contributor and employment data was positive.

European markets have lagged other developed markets year to date and our reduction in European exposure has been prudent. The strong recovery of 2017 has been losing momentum this year, we have been trimming 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 has more stimulatory monetary policies likely to remain in place for some time.

Japanese Equities

Japanese stockmarkets were the worst of the major developed markets during the sell-off and the benchmark Topix index fell by 9.4%. Although a stronger yen vs the pound diluted the losses to an index fall of 7.0% in sterling terms.

There was no significant economic news-flow to drive markets, although the Tankan business confidence survey showed sentiment hit by extreme weather (flooding, earthquake and typhoon) hitting economic activity during the summer.

The backdrop for investing in Japan has appeared unexciting this year but politics is stable, 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 will remain volatile as the value of the yen fluctuates and there is no doubt the market is highly sensitive towards global economic activity, but the yen does help reduce the cyclicality for unhedged exposure.

Asia Pacific & Emerging Market Equities

Emerging Markets were unable to avoid the global slide in October with all but one region posting steep declines during the month. The MSCI Emerging Markets and MSCI Asia Pacific Ex Japan Indices fell by 7.8% and 9.9% respectively. However, there was a significant divergence.

Brazil was the only market to buck the trend as a change in the political regime brought the far-right candidate Bolsonaro to power which led to the Bovespa index returning close to 21% during the month in sterling terms.

Asia and Emerging Markets more broadly suffered a torrid time. The slowdown in China that has hampered Emerging Markets this year continued to have its effects in October and those economies that are most reliant on external funding are finding the tightening in US monetary policy challenging.

Emerging Market valuations have been driven down by the sell off. Given that there is scope for earnings recovery across many Asian and Emerging Markets, they are beginning to look relatively attractive. But, with such negative momentum it feels like catching a falling knife at present.

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. Furthermore, if we see a continuance in the recent rally in the dollar this will prove to be a headwind for many of these markets. However, long-term fundamentals across Asia and Emerging Markets still look attractive with structural reforms, better corporate governance, greater consumerism and cheaper valuations providing good opportunities for investors seeking long-term growth who can accept the high volatility.

Fixed Interest

Fixed interest markets showed a high level of volatility during October, as bond investors struggled to interpret the potential effect of rising interest rates and slowing global growth.

Traditional defensive Government bonds and investment grade bonds saw a sell off early in the month (the IA Gilt sector fell back 2% at one point) as concerns over inflation and rising interest rates increased. But as the level of fear increased, investors flocked to safe haven fixed income assets in the second half of the month. Government and inflation-linked bonds finished strongly to generate a positive monthly return. Perhaps surprisingly, high yield did not endure a sell off over the month despite the falls in equity markets.

There is no doubt we are in a monetary tightening phase. Whilst the market's realisation of this has led to volatility, we believe it is going to be a slow process with central banks telegraphing their intentions to markets along the way.

This approach by the central banks leads us to believe that there will be no collapse in bond prices. Within Government bonds, given the US market is substantially further ahead in its monetary tightening phase, we continue to see contrarian value opportunities within US treasuries. We believe these assets provide greater scope for greater capital protection than UK/EU government bonds whose yields remain well below inflation. US bonds also offer attractive yields, and provide some dollar exposure within our fixed income basket.

The bulk of our exposure is within global mandates – hedged back to sterling. Overall, we have constructed a basket of complementary and diverse bond funds for the cautious and balanced income orientated portfolios. In addition to our US Government bond exposure we continue to favour our fixed interest exposure in corporate bonds and less interest rate sensitive areas of bond markets

Commercial Property

Our holdings in direct UK commercial property funds continued to provide steady positive returns during a volatile month. The IA UK Direct Property sector increased by 0.2%. On a 12 month view, property returns have significantly outperformed fixed income.

Commercial property forms a core source of income within our cautious and balanced portfolios. We have stuck with our favoured three of F&C, Henderson and Kames. 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. It is also pleasing to see modest net inflows returning to our favoured funds.

Alternatives

What we are looking for within alternative assets is the ability to provide a portfolio with greater diversification than simply holding traditional asset classes, whilst generating attractive risk adjusted returns. It was pleasing to see that our equity long / short strategies provided positive returns during the stockmarket sell-off.

We have been reducing exposure to the large multi-asset absolute return mandates, where we have lost conviction. Our favour is shifting towards dedicated long/short specialists and looking at niche sector alternatives. We are also considering genuine long only alternatives that invest in physical assets (such as infrastructure and niche property).

Commodities

Oil officially hit bear market territory at the end of the month, declining more than 20% from its peak. The majority of this move downwards happened during October. The main reason was due to build ups in inventory levels through the month, although fears of an economic slowdown also added to the downside.

Gold provided some protection as investors looked for a hiding place from falling markets. The gold price rallied by 1.8% in October.

With further US interest rate rises expected non-yielding assets such as gold will appear less attractive so this makes us cautious that we are going to see a sustained period of upside for gold. That being said, a watchful eye should be kept on any further signs of distress in markets which could lead to a hunt for safe havens.

We do not have direct exposure to commodities within our portfolios, although mining and energy will feature within UK and overseas equity exposure and gold within absolute return mandates

Cash

UK inflation fell from 2.7% to 2.4% in October as measured by the Consumer Price Index (CPI). With high commodity prices and a weak sterling it is hard to see inflation falling below this level in the near future. Despite the recent 0.25% interest rate rise the best instant access, cash ISA deals are still only offering around 1.3%. It remains likely that a Cash ISA will provide a negative return in 2018.

For investors taking a medium to 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 UK interest rates reverting to their long-term average for a long time. 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.

But it is a different story in the United States. With the current trajectory of interest rate rises bank deposits may yield 3-3.5% in 12 months' time. Higher cash rates could have significant ramifications for financial markets as bank deposits become more appealing – food for thought!

Whitechurch Investment Team, November 2018

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