Whitechurch Asset Views
Award Winning Wealth Managers

Whitechurch Securities Ltd
WEALTH MANAGERS

Monthly Round Up - April 2017

Strategic Overview

The Times They Are A Changin'…

It was a strange month for global stockmarkets, as March proved not too dissimilar to February in its outcome. With the exception of the US and Japan, which generally moved sideways, most equity markets moved higher. However, this was also echoed by government bond markets, with yields narrowing as investor ebullience over the Trump-driven reflation trade began to waver.

There were several notable events in March, not least the historic moment of the UK triggering Article 50 and embarking on a lengthy divorce from the European Union (EU). As Brexit has been dominating headlines since the momentous vote last June, it felt like blessed relief now it has been formally started. With sterling already weakened considerably and with the outlook for the UK economy looking relatively robust, UK smaller companies enjoyed a strong month relatively, although all areas of the UK stockmarket moved higher.

Article 50 did little to dampen the enthusiasm for European equities over the month; and these were the pick of regional stockmarkets. The Dutch elections threw up no unwelcome surprises and the impetus of a Le Pen victory started to diminish in the eyes of investors. With corporate profits also looking healthier, a supportive Central Bank and signs of economic growth, the prospects for Europe appear on the up.

It is the US that is generally dictating the fortunes of global stockmarkets and the global economy. The US Federal Reserve (the Fed) announced that it would be raising rates by 0.25% in mid-March and that there were likely to be two further rate hikes this year, depending on the data. The Fed has been telegraphing its intentions to the markets for some time and so there was little impact. However, US equities did struggle over the month. Much of this was due to concerns that Trump may struggle to get his pro-growth policies through after being defeated by Congress on his proposed healthcare reform.

With the exception of Japan, whose equity markets have gone no where this year (in local currency terms), Asian and Emerging Market stockmarkets had a good month (and quarter) even though the Trump reflation trade showed signs of faltering. We still favour Japan over the US in terms of fundamentals and we retain an overweight to Asian and Emerging Markets for higher risk portfolios, given that the long-term dynamics for these markets remain favourable.

March was pretty much an extension of February for bond markets. Government bond yields narrowed by the end of the month despite a rise in US interest rates and higher headline inflation numbers. However, a stalling in oil and commodity prices combined with doubts over the reflationary trade saw investors move back to lower risk assets. The recent move does reinforce our belief that although we see little value in the asset class it is too early to have a high conviction that the inflationary environment is here to stay just yet or that this is the end of the 30 year bull market in bonds.

Looking ahead, unpredictable politically driven events will continue to dominate headlines, not least the latest geo-political tensions over Syria, the French elections and incessant rumblings over Brexit. However, our view remains that such events cannot be accounted for and are not influential in our investment strategy, or a reason to not invest. We have seen that hiding in cash in 2016 as protection from last year's shock events would have seen investors miss out on double digit returns across most global equity and bond markets. Indeed, even with some equity indices reaching all-time highs, we believe that the year ahead can provide many opportunities 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

The headline news came at the end of March as the UK finally triggered Article 50 and officially started the long, drawn out process of leaving the EU. As this date had been announced for some time, it had little effect on UK markets, which continued to gain ground over the month. However, the continued resilience of the UK economy and the current stability in sterling (despite triggering Article 50) saw investors re-appraise UK smaller companies, which outperformed both mid and large caps over the month.

The market trends over March were not too dissimilar from the previous month, with investors becoming less convinced of the sustainability of the Trump-driven reflation trade. As such, income paying stocks and defensive sectors, such as household goods and tobacco, outperformed for another month whereas the banks, oils and miners were sluggish.

Looking ahead, although we expect to see inflation ticking further upwards (Bank of England expects inflation to exceed 3% this year), a low growth environment and ongoing uncertainty regarding the shape of Brexit will mean UK interest rates are likely to remain at emergency 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. However, we also believe that stock-picking in medium and smaller companies that have been out of favour will prove rewarding. Hence, we favour for a contrarian value focused approach.

US Equities

It was a flat month for the S&P 500 as signs that the 'Trump Bump' which had been lifting markets turned to the 'Trump Dump', as some have called it. Even though the President has managed to get some policy through – namely on reversing some of Obama's climate change regulations – he has been stymied by Congress on repealing Obamacare. As such, Health Care stocks endured a setback in March compared to other growth sectors (IT, Utilities etc.).

The US Federal Reserve (Fed) announced a further 0.25% rate rise mid-month, bringing the base rate up to 1%. Although, well priced in by markets, the response was unexpected with the S&P 500 giving up its monthly gain post Fed meeting, whilst 10yr Treasury yields fell to around 2.3%. On the corporate front, Q1 earnings growth for the S&P 500 is 8.9%, the highest (year-on-year) since Q4 2013. However, this is lower than estimated with ten of the eleven sectors having lower growth rates today (compared to end of 2016) due to downward revisions to estimates (source: Factset).

Given the strength of the US economy, the inflationary outlook and the forthcoming Trump administration, it made sense to increase our exposure to domestically focused, cyclical areas by investing in US Smaller Companies. However, in terms of overall exposure to US stockmarket we remain relatively cautious. Expensive valuations, rising interest rates, a strong dollar and an unpredictable President make us cautious on the wider US market.

European Equities

Forget Brexit, forget elections, European equities were the pick of global markets over the month, seemingly undeterred by the background political noise. The broad index was up by 4.5%, meaning Europe has been the best performing Developed Market equity region year-to-date.

With Eurozone headline inflation near to target, the reflation outlook persists in Europe – for the moment. There are several indicators that are pointing to potential outperformance for the region. The ECB still remains supportive, although ultra-loose monetary policy is coming to an end. Economic growth is gradually recovering, inflation numbers have increased… But, most importantly, after years of stagnation there are signs that earnings growth is coming back. With the majority of companies reporting for Q4 2016, the upward trend in earnings has continued and European earnings are in double digit territory year-on-year - exceeding that of the US (source: Aviva).

In terms of politics, thankfully the Dutch Elections didn't throw up any surprises but the election cycle in Europe is far from over with France up next. However, we prefer to focus on valuations rather than political noise. From a valuations perspective it is hard to argue that in aggregate European markets are cheap. However, valuations are at a substantial discount to the US. In addition, profit margins are below historic levels, and to those in the US market, and forward P/Es look undemanding. There is significant disparity in valuations between quality global leaders and domestic cyclicals, where European recovery would be amplified into robust earnings growth as margins expand. The yield of 3.2% also looks compelling given the bond yield alternative.

Japanese Equities

Japanese equities were marginally down over the month, with the Topix weakening by -0.6%. In local currency terms, the Topix has gone sideways year-to-date with UK investors in these markets only really benefiting from further sterling weakness against the yen over the last quarter.

In an update from Man GLG Japan CoreAlpha, the management team state that 'this is a hostile environment' and that activity has been modest with no new purchases or complete disposals. The low level of trading reflects a 'market which has offered few significant opportunities since the turn of the year'. Interestingly, this is not the bullish rhetoric we have heard from the team in recent months and we will be looking to get a further update.

However, JOHCM Japan manager, Ruth Nash, provided a more positive outlook having visited the country just recently. She focused on the positive effect the monetary stimulus is having on the Japanese economy. Now that 10 year Government bond yields are higher than nominal GDP growth, this is encouraging firms and individuals to invest – a key factor in the structural reform process.

Japan remains an enigma, and any effects from structural change are going to take some time. 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.

Asia Pacific & Emerging Markets Equities

In the main, Asia Pacific and Emerging Markets finished the quarter with strong returns. Most of the incumbent markets in these regions provided positive returns in March (with the exception of Brazil and Russia), generally faring better than their Developed Market counterparts, Europe being the exception.

India and China continue to perform well with both regions delivering double digit returns to investors for Q1 2017. On the flip side to this, Russian markets were marginally down over the month culminating in double digit losses for the quarter (in local currency terms). The relation between Trump and Putin appears to be cooling rapidly and recent geo-political events in Syria mean that sanctions are unlikely to be lifted anytime soon.

The biggest short-term risks facing these markets emanate from the US with the strength of the US dollar, the US rate cycle, 10-year US Treasury yields and protectionist policies all potential headwinds in the short-term. Furthermore the current renewed optimism over China should not let investors become complacent over the longer-term risks of instability in the largest emerging market.

However, the past year has seen a trend towards a more stable economic environment in Asia and Emerging Markets. Given that commodity prices and Chinese growth are much more stable than a year ago we think the fundamentals in these markets remain attractive. Structural reforms, better corporate governance, greater consumerism and not least, relative valuations, still make these markets attractive.

Our position of overweight in these markets versus underweight US has been positive year to date. If Trump delivers on strong fiscal stimulus, and revives the domestic US economy, this could lead to a reversal in performance but this may be offset somewhat by stronger global growth that could be positive for these regions. Our exposure does provide a diversifier away from Trump stimulation, which investors have become less confident about.

Fixed Interest

Bond markets had a mixed month with yields increasing early in the month before falling back during the second half. 10-year gilt yields fell from 1.2% to 1.08%, their lowest level since October. We have also seen the curve flattening with the gap between 2 and 30 year gilts falling to below 1.6%. Of the major bond markets only Japan has a flatter yield curve than the gilt market.

This translated into the FTSE British Govt All Stocks Index showing a modest rise of 0.3% and the IA Gilt sector and the IA Index linked gilts sector rallied by 0.8%. Although the triggering of Article 50 had little effect on bond markets, it does appear that the strong performance of gilts is partly as a hedge against Brexit damaging the UK economy. There has been strong appetite from Central Banks, sovereign wealth funds and pension funds which have driven down yields, despite inflation increasing.

The key event for global bond markets was in the US where the Fed approved a 0.25% rate increase, which had been priced in by markets. At the same time, there are signs that conviction in the 'Trump trade' is waning and that his pro-growth policies will fail to meet expectations. The combined effect was that markets now believe that there will only be two (not three) rate hikes this year. This led to a sharp fall in treasury yields, which in turn led other government bond yields lower for the month.

Managing the bond conundrum is as important as ever as we potentially move into a new economic phase of inflation and gradual growth. However, we do not expect this to be a rapid or a smooth transition. As a result our bond exposure consists of a complementary and diverse range of funds for cautious and balanced income orientated portfolios. Exposure ranges from index-linked gilts and investment grade credit, through to strategic bond exposure, short duration high yield and European bank paper.

Commercial Property

Property funds are continuing to see a recovery as we move through 2017. The sustained sell-off that was feared after last year's referendum has not materialised and figures in Q1 suggest the opposite. London commercial property has continued to perform strongly boosted by overseas buyers taking advantage of weak sterling. This was highlighted in March by the Chinese buying the 'Cheesegrater' building for £1.15bn, breaking the record for city property at a price per square foot of £1,885 and on a yield of just 3.4 per cent.

L&G property managers provided a recent update and their outlook is relatively sanguine, with their central case being *"for all property total returns to average around 5% per annum between 2017 and 2021… performance will largely be driven by income; modest rates of rental growth will mainly offset asset depreciation, leaving property values little changed"*.

The yield on UK property is looking attractive but the 12 month total return projections from leading property managers are for a modest loss. However, it is still a contrarian play and 2017 could provide an opportunity to re-build a position in income focused strategies. Whilst we should consider both open ended and closed ended funds, the risk of open-ended funds is that the FCA feel the need to step in and change how they are regulated.

Alternatives

The core positions provided mixed returns in March, with varying successes for the multi-strategy teams as interest rate expectations and yield curve flattening acting detrimentally to some tactical positioning. The majority of the funds we utilise in this area have produced positive returns year-to-date and over the last 12 months. However, in many cases we have been using them as a proxy for not investing directly in gilts and this call has not paid off yet.

With bonds and equity valuations looking expensive in many areas, it seems to be that this is exactly the time when these strategies need to be held, to provide ballast in cautious and balanced mandates. In aggregate the basket of alternative funds adds diversification and acts as a defensive diversifier to portfolios.

Commodities

Commodity markets were weaker over March as the rally in prices was checked. The Brent Crude Oil price fell by 3.9%, whilst base metals came off by just under 1%. With regards to the oil price, OPEC's agreement to cut supply combined with heavy capex cuts is expected to lead to weaker supply growth and provide support to prices. However, North American shale can be profitable if the oil price stays above $50 per barrel and so increased supply here could once again offset this.

Given it was a month where investor sentiment became more risk averse and commodities fell in value, you might expect Gold to have benefited but the precious metal also fell back over the month by 0.4%. This highlights to us how speculative this perceived 'safe haven' can be, although it is looking more useful as a portfolio diversifier in the current environment.

Our exposure to this area remains indirectly through exposure to mining shares, which serves two purposes, commodity exposure for momentum and gold exposure for diversification attributes. The position has worked well and we are coming to see it as a maturing trade, whereby we might take profits.

Cash

UK CPI increased to 2.3% in March from 1.8% the previous month. RPI increased from 2.6% to 3.2%. With CPI and RPI widely expected to pick up further following the substantial drop in sterling, cash remains unattractive. With the best Cash ISA deals showing instant access at 1% (National Savings) there is little doubt that a Cash ISA will provide a negative return in 2017.

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. 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, April 2017

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