Whitechurch Asset Views
Award Winning Wealth Managers

Whitechurch Securities Ltd
WEALTH MANAGERS

Monthly Round Up - August 2017

Strategic Overview
Summertime and the livin' is easy

Stocks are jumping and the market is high (to paraphrase Ella Fitzgerald's seasonal classic). After a slight blip in June, July saw investors shake off concerns over the potential for Central Bank tightening and global stockmarkets reverted to a sunny climate of positive returns and low volatility. The UK and most developed overseas markets posted steady gains, whilst Asia and Emerging Markets were the brightest spots, with some exceptional returns.

As markets have risen, a key characteristic this year has been the distinct lack of volatility. This has particularly been the case in the United States and as the US stockmarket hit new heights in July, the VIX index (known as the fear index, measuring the level of fluctuations of US shares) fell to it's lowest ever of 8.8. Given that the summer can traditionally see elevated price fluctuations due to lower trading volumes, it certainly does appear that there is complacency from equity investors compared to other asset classes.

Whilst equity markets have been rising in tandem, currency movements have diverged and this has skewed returns for UK investors. The Euro continues to rally on improving economic data on the Continent and this enhanced returns for UK investors with European exposure. In contrast, over the past month and year to date we have seen the ongoing weakness of the dollar amid increasing scepticism over the implementation of President Trump's pro-growth policies. The stabilisatiion of the pound and weakening greenback has seen a US stockmarket return of 11.2% so far this year translate to just 4.2% in sterling.

Beneficiaries from the weakening dollar have been 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 rise, 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, sabre rattling (or worse) in North Korea has the potential to disrupt appetite for risk.

Closer to home, the UK stockmarket ended the month higher with medium and smaller companies returning to favour, as the domestic economy has proved relatively robust despite the political uncertainty. More cyclical sectors proved stronger last month, with mining stocks at the forefront. However, many more defensive equity income funds were dragged down by negative news-flow within the Tobacco and Pharmaceutical sectors.

Bonds also returned to favour over the last month. Economic releases encouraged investors that the Goldilocks environment of steady growth accompanied by a lack of inflationary pressure would prove supportive for the asset class, reducing pressure for rising interest rates. However, the strong performance of bond markets continues to raise questions 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 is important to be selective!

One area where we have started to see more value is UK commercial property. Having exited the asset class last summer due to concerns over valuations, the effect of the Brexit vote and the effect of investment flows on liquidity, we are now more sanguine. The yields offered by the asset class appear attractive relative to bonds, whilst the UK economy has not fallen off a cliff and overseas buyers continue to support demand. As a result we have added a modest weighting to cautious and balanced mandates.

This recent move back into property is endemic of our view that with cash continuing to provide a negative real return, there are opportunities across asset classes that can provide more attractive long-term growth prospects and more attractive yields. 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

UK stockmarkets recovered from the post-election blues, although it was rising commodity prices that was the major catalyst for higher market levels with oil and particularly mining sectors performing strongly.

In contrast, many defensive equity income funds suffered underperformance with the favoured sectors of Tobacco and Pharmaceuticals losing money due to poor news-flow. Tobacco was hit by news out of America that regulators may force tobacco makers to cut the nicotine in their products to non-addictive levels. The Pharma sector was hard hit by a 15% fall in AZN as trials of its immunotherapy drug, Mystic, failed.

Last month saw a return to favour for medium and smaller companies, with earnings releases and M&A activity proving a positive. These areas tend to be more focused to the UK economy, but opinions are polarised as to whether the cheaper valuations on offer for domestically focused companies compensate for the potential headwinds of high debt and political uncertainty facing the UK economy.

Economic data releases were mixed and provided little in the way of clear signals regarding the health of the economy, although the Bank of England cut its growth forecasts due to inflationary pressures from a weakening pound hitting consumer spending. There was much more activity in terms of corporate news-flow and seasonal reporting for many blue chip multi-national UK stocks was positive, driven by currency effects, with the energy and banking sector faring particularly well.

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, which 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 returned 2% in July and breached 2400 for the first time but a weakening dollar translated the return to 0.5% for sterling investors. Over the past month we have seen the ongoing weakness of the dollar amid increasing scepticism over the implementation of President Trump's pro-growth policies. He continues to come up against opposition from Congress with another failure to pass his healthcare bill.

US Economic releases have suggested that whilst there is little (or no) sign of Trump's promised 4% economic growth emerging, Q2 GDP growth numbers came in at 2.6% which was broadly in line with expectations. At the same time we continue to see inflationary pressures subside. With inflation well below the 2% target the Federal Reserve has little excuse to push ahead with further interest rate rises in the short-term. This is resulting in the "Goldilocks environment" of steady growth and interest rates remaining at low levels, which is supportive for equity and bond investors.

The US earnings season has started strongly. According to JPMorgan, around 60% of companies have reported: Q2 earnings growth has been positive, with year on year earnings-per-share growth at 9% for the S&P 500; investors love-affair with the technology behemoths continued as Amazon, joined Apple, Microsoft and Alphabet (Google) in being valued at more than $0.5 trillion!

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 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 the low volatility suggesting complacency continues to make us nervous.

European Equities

European markets showed a modest positive return with the FTSE Europe Ex UK index returning 0.4% in local currency although this increased to 1.6% for sterling investors as the euro strengthened on improving economic data.

Economic data continues to paint a very positive picture in the Eurozone. The estimate for Q2 GDP of 0.6% would translate into year-on-year growth of 2.1%, which would be the highest reading since 2011 and more significantly, the growth is synchronized across a larger number of member states. Economic news-flow continues to be positive and beat expectations. The Economic Sentiment Indicator reached its highest level in a decade and unemployment fell to 9.1% – the lowest since 2009.

However, with improving economic data comes the prospects of tightening monetary policy and "Draghi watch" will remain at the centre of investor thinking. The next major meeting of the ECB, to review policy, is on 7 September and although growth has exceeded forecasts, inflation remains subdued. The latest monthly figures show headline inflation at just 1.3%. This has reassured investors that the policies will remain accommodative in providing ongoing stimulus.

From a valuations perspective it is hard to argue that in aggregate European markets are cheap. However, in Europe there is scope for further earnings growth and the European earnings season has started stronger than in the US, with year-on-year earnings-per-share growth at 13% for the companies who have reported.

Relative to traditional benchmarks we have an overweight towards European equities versus US. Europe remains more attractive in our view, driven by cheaper valuations, earnings recovery potential, more accommodative monetary policy and a more stable political backdrop (at present!). With an improving economic backdrop and strong earnings growth 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

It was a steady month for the Japanese stockmarket overall. The Topix showed a 0.4% gain behind the MSCI World index, and there were not many headlines to excite investors. Currency was also stable with the yen translating this into an index gain of 0.6% for sterling investors.

Economic data in Japan has been broadly positive, if rather unexciting! Employment releases once again illustrated how tight the labour market is, with unemployment at 2.8% — a 23 year low. Whilst other developed markets are discussing tightening policy it is very much business as usual for the Bank of Japan in providing stimulus. During the month there was no change to policy but they pushed back their forecast for when inflation will hit 2% to 2019, as CPI remained at 0.4%

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, corporate reforms are providing a more enticing driver to Japanese stockmarkets than the strength of the domestic economy.

Asia Pacific & Emerging Market Equities

July proved to be another positive month for Asia Pacific and Emerging Market (EM) equity benchmarks, which outperformed their Developed Market counterparts. The rally was widespread and although China continues to lead gains across Asian / EM indices, India rallied strongly and Commodity sensitive markets recovered.

These markets are remaining well supported and have been boosted this year by the unwinding of the dollar strength and the threat of aggressive rises to US interest rates subsiding. Growth in China has remained robust and this has helped see a recovery in commodity prices in recent weeks. In fact there has been little negative news-flow and this is encouraging investors to take more risk. However, the potential for geopolitical risks have been highlighted in recent days by renewed tensions with North Korea and an increase in risk aversion would cause a correction.

In terms of tactical exposure we recently sold some China exposure, following the exceptional returns over the past year. We added a position in the Indian market which has endured six years of earnings downgrades. But with economic reforms, falling inflation and robust economic growth this could provide catalysts for earnings upgrades.

Overall, our position of favouring these markets versus underweight US has been a distinct boon in 2017 as Trump has failed to deliver the fiscal stimulus and economic revival that took him into the White House… so far anyway. Given how the status quo is benefiting these markets they feel like a good place to be as we move through 2017.

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 economy in the area. But 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

Most areas of bond markets were in positive territory as a lack of inflation across developed economies reassured investors that interest rates are likely to remain grounded for some time.

However, there is no doubt that central bankers in US, Europe and UK would like to tighten monetary policy to provide them with ammunition to support the economies when the next slowdown occurs. It does appear that a key driver of investment markets for the remainder of the year will be a focus on how effectively they can withdraw stimulus.

Despite the wishes of central bankers we maintain that the lower for longer interest rate environment will remain and we 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.

However, 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 could continue to come under pressure from increasing pressures to end austerity. As a result 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

Property continued to recover over the month, with most open-ended direct property funds producing another month of income driven incremental gains, despite the uncertain political backdrop.

Following a number of meetings with UK property managers, in recent weeks, we have returned to investing in the sector. We have been encouraged by a more stable climate that has been boosted by a better than expected domestic economic backdrop and a weak sterling boosting demand from overseas investors. The major UK bricks and mortar commercial property funds have reverted to type and produced six monthly returns of 3-3.5% primarily from income since the start of the year.

Given the relatively attractive yields still available from property, 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 in managing risks and seeking attractive yielding opportunities.

Alternatives

In general, our core basket of multi-asset absolute returns funds provided mixed returns over the month, and we have reduced exposure to this area to make way for commercial property exposure.

With equity and bond markets edging higher and showing low levels of volatility it is proving a difficult environment for such funds to provide competitive returns.

These funds are designed to grind out a return greater than cash. 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 as they provide ballast in cautious and balanced mandates. We continue to see divergent performance within the basket and this is to some extent deliberate in order to achieve diversification. In aggregate, the basket of funds held acts as a defensive diversifier to portfolios.

As equity markets have become more expensive, we have increased exposure to funds that can make money from both short and long positions.

Commodities

It was a positive month for energy and commodities, particularly the former. Oil prices showed their best monthly gain this year with S&P GSCI Brent Crude Spot (USD) price rising by 7.6% over the month and oil trading over the $50 per barrel mark. Much of this was driven by Saudi Arabia and Russia announcing further production cuts.

However, Fidelity produced an interesting opinion piece on oil towards the end of the month, stating that as the oil price rises, shale rigs become profitable which puts downward pressure on prices as supply increases. This lead to Fidelity boldly stating that 'The days of $100 per barrel of oil are over".

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 the conviction to invest directly, and this probably sums the situation up suitably – the precious metal is an enduring enigma!

Cash

UK CPI fell back from 2.9% in May to 2.6% in June, but still remains above the Bank of England (BoE) target rate. With the BoE latest Inflation Report implying inflation above 2% and only potentially one interest rate increase in the foreseeable future, cash is not going to provide real returns in 2017.

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, August 2017

Head Office: The Old Chapel, 14 Fairview Drive, Redland, Bristol, BS6 6PH **Telephone:** 0117 916 6150 **Website:** www.whitechurch.co.uk