Whitechurch Asset Views
Award Winning Wealth Managers

Whitechurch Securities Ltd
WEALTH MANAGERS

Monthly Round Up - July 2017

Strategic Overview

Movin' On Up

For UK investors all eyes were on the General Election in June, but despite the surprise result, markets took it in their stride. Of more interest to us, than the ongoing domestic political noise, has been the move of Central Banks over the month towards tightening monetary policy. In the US, the Federal Reserve raised interest rates for the third time since December. Whilst towards the end of June, Mark Carney signalled that UK interest rate rises were under consideration and Mario Draghi hinted Quantitative Easing stimulus may start to be withdrawn in Europe. However, Central Bankers have learnt their lesson in managing expectations, and although this saw a small sell-off in bonds and global shares, volatility has remained at low levels.

The year so far

Halfway through the year and it has been a good six months for investors, with most areas making a positive return and investors prepared to take on risk, in an uncertain political and economic backdrop being rewarded.

In terms of unit trust sectors, China / Greater China has been the best place to be invested with the sector returning 17.5%. We have taken some profits on our Chinese exposure following the strong period of performance. More broadly Asian and Emerging Markets benchmarks have returned double-digit returns, ahead of Developed Markets. Europe has been the pick of the latter, and European smaller companies have particularly benefited from the improving economic environment and increased political stability on the Continent, with the sector returning 16.2%.

Currency movements have not provided the tailwind for UK investors with overseas funds that they did in 2016. Volatility of currency has reduced and sterling weakness has subsided. The pound has strengthened versus the dollar and the yen, whilst the euro has been robust and enhanced returns in Europe for sterling investors.

In the UK it has been a better environment for active managers. The return of 5.5% from the UK stockmarket has been exceeded by the average UK Growth and UK Equity income fund with these sectors returning 7.3% and 6.8% respectively. UK smaller companies funds have performed exceptionally well with the sector returning 14.3%. From a style perspective, following a brief rally at the end of 2016 for Value, it has been Growth stocks that have returned to favour so far this year.

Across other asset classes, returns from gold and Government bonds have been negligible, with the sell-off at the end of the six month period wiping out the returns of UK gilt funds. Corporate bond funds have been a better place to hold fixed interest exposure with credit risk rewarded. The IA Corporate and IA High Yield sectors were up by 2.9% and 3.9%. Akin to their equity markets, Emerging Market bonds have been a good place to be with the IA sector up by 4%, benefiting from a weakening dollar and strengthening economies.

After a turbulent period, following the referendum, calm has been restored to the UK commercial property sector where direct bricks and mortar funds have generated income-driven, steady returns.

Looking ahead

We are approaching the summer doldrums where corporate, political and economic news-flow starts to slow. Although we are not advocates of market timing to guess short-term market trends, investors worried about the current market level as an entry point could consider drip-feeding monies into the market. But even with some equity indices reaching all-time highs, we believe that across global stockmarkets there are areas offering enticing long-term growth prospects and 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 fell back over the month due to a combination of the unexpected UK election outcome and weakness in commodity markets in the first half of June. Then, towards the end of the month, the Bank of England unnerved investors with talk that UK interest rates may begin to rise sooner than expected.

Large, medium and smaller company benchmark indices all fell back between 2% and 2.5%. Although blue chip multinational stocks held up well during the election uncertainty, benefiting from a weakening pound, this reversed in the latter part of June with Utilities and Tobacco stocks being key underperformers as bond yields rose. Whilst, the political noise has been dominating headlines, our views on UK equities are little different to before the UK election result was known. If anything, the change in the political backdrop may result in a softer, more business friendly Brexit, whilst we could see a modest increase in fiscal stimulus to appease voters alienated by flat-lining pay in the Public sector.

Despite the political uncertainty, the UK economy continues to grow at a steady pace, growing by an annualised 2% during the first quarter. Although the PMI business confidence surveys have shown signs of slowing, Manufacturing, Consumer and Services surveys are all well above the 50 benchmark which indicate solid expansion. Unemployment is also close to a forty year low. However, despite these indicators, UK domestically focused stocks are being shunned. This was highlighted by Neil Woodford who released a paper extolling the contrarian opportunities that exist in UK cyclical stocks.

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, with a more hawkish tone being taken by the Bank of England, bond proxy stocks may come under increasing pressure over the coming months and it will be important to be selective. 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 UK stockmarket.

US Equities

Returns within US markets were mixed for UK investors over the month of June, whilst the S&P rose marginally by 0.6% (in local currency terms), this return was wiped out for sterling investors by a weakening of the dollar. However, small and mid-cap US indices recovered sharply, with the Russell 2000 increasing by 3.4%.

It was the technology sector that hit the headlines in June as the Nasdaq 100 fell by nearly 3% over the month. After being the darlings of the stockmarket for most of this year, the FAANG (Facebook, Apple, Amazon, Netflix and Google) stocks have come under pressure as investors start to question their stretched valuations. Whilst these stocks do look expensive it would be wrong to draw comparisons with the 'dotcom bubble', when companies with no profits and "blue sky" earning projections dominated. Today the IT sector is dominated by mature, profit making businesses.

As widely predicted, the Federal Reserve announced a further 0.25% rate rise mid-month, bringing the base rate up to 1.25%. Although, well priced in by markets, the view is that they will raise rates one more time this year. However, US inflation undershot expectations, with the CPI showing a Year on Year increase of 1.9%, the smallest increase since last November, which may curtail further rate rises.

On the corporate front, estimated earnings growth for the S&P 500 for Q2 was lower than expected, with ten sectors showing lower growth rates today due to downward revisions over the quarter, led by the Energy sector. Valuations remain elevated with the forward P/E ratio for the S&P 500 at 17.4x. This is above both the 5 year (15.3x) and the 10 year (14.0x) averages (source: Factset).

We remain underweight US equities as valuations, rising interest rates, a strong dollar and scepticism over the effect of Trump's reforms make us cautious on the market. Our underweight has been a positive contributor so far this year with an unwinding of the very strong dollar being instrumental, whilst our favour for European and Emerging Markets equities versus US has worked year-to-date.

European Equities

Following a strong period of performance Europe had a poor month in June with the FTSE Europe ex UK Index falling by 2.1%. However, some of this loss was mitigated for sterling investors as the euro strengthened against the pound.

European markets spent most of June gradually trending upwards, but towards the end of the month Mario Draghi sent shockwaves when he said that "deflationary forces had been replaced by inflationary forces". Investors focused on these overtones and assumed he was signalling a more urgent need to normalise monetary policy. As a result, the euro and bond yields shot up which led to equities falling quite sharply. Not all sectors suffered. Financials (especially Banks) responded favourably to Draghi's comments.

It is important to remember that the withdrawal of stimulus is in response to the Eurozone showing clear signs of economic recovery. Unemployment continues to fall and consumer confidence reached the highest since 2001 in June. Businesses are also upbeat and on the earnings front, the much anticipated profits recovery is materialising. European earnings are growing for the first time in six years.

Although, Draghi's comments put the brakes on markets in June, Europe has been the best of the Developed Market regions year to date and the average European fund was up by 12.9% during the first half of the year. It remains a favoured region for us and with more political stability and an improving economic backdrop, there is scope for further earnings growth to help markets extend the recent rally.

Japanese Equities

June was a good month for Japanese equities, which were the pick of the Developed Markets overall. The Topix rose by 3% over the month (in local currency terms), although this was tempered for UK investors as the yen weakened against the pound.

Overall, Japanese equities have enjoyed a relatively encouraging first-half of the year. Economic growth is looking consistent, 1% for last year and 1.5% and 1% forecast respectively for 2017 and next year. Whilst other Central Banks are talking about withdrawing monetary stimulus, the Bank of Japan is on a divergent policy path and is committed to maintaining an expansionary stance. This should maintain the yen's weakness, which would further support the export-led Japanese economy.

As mentioned in previous months, Japanese equity valuations are no longer cheap, although not stretched either compared to other Developed Markets. However, current dividend policy reform, the ability to return cash to shareholders and scope to improve return on equity make the Japanese equities a relatively attractive investment case to diversify global equity exposure.

Asia Pacific & Emerging Market Equities

June proved to be another positive month for Asian Pacific and Emerging Market (EM) equity benchmarks, which outperformed their Developed Market counterparts. However, most Asian / EM currencies fell over the month versus sterling, diluting returns for UK investors. There was a divergence in performance with China continuing to lead gains across Asian / EM indices. Commodity sensitive markets continue to suffer as Oil officially dropped through to bear market territory, whilst India is facing short-term turbulence regarding the introduction of tax reforms.

JP Morgan provided a bullish case for EM in a recent commentary. The earnings picture is encouraging, following years of downward revisions. Looking forwards projected analyst estimates of earnings forecast double-digit returns for the asset class. Whilst in US dollar terms, the MSCI Emerging Market Index is still 30% below its 2007 peak.

It has been a strong year to date for Asian and EM equities although there has been a significant divergence in performance. China has been the story in 2017. Fiscal stimulus and a weaker outlook from the Fed has seen liquidity flow back into China. In contrast Russia has been the worst performer, falling heavily in recent weeks and our decision to exit Russia at the beginning of April has proved prudent.

During the month we also decided to take profits on our China exposure, following the exceptional returns over the past year, valuations are looking more expensive and look exposed if economic data begins to soften. In contrast India, has endured 6 years of earnings downgrades, but with economic reforms, falling inflation and expanding GDP. This could provide catalysts for earnings upgrades across India.

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. 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

Bond markets trod water for much of June before falling back at the end of the month over fears that Central Bankers were looking to tighten monetary policies. In the US, the Fed raised interest rates for the third time since December, whilst towards the end of June, both Mark Carney and Mario Draghi signalled that interest rate rises were under consideration and Quantitative Easing stimulus will start to be withdrawn.

It does appear that a key driver of investment markets for the remainder of the year will be a focus on how effectively Central Banks can withdraw stimulus. The ECB held their annual conference in Sintra in Portugal at the end of June, attended by all the heads of major central banks except Janet Yellen. The outcome pointed towards a much more hawkish tone, looking to prepare investment markets for tighter monetary policies.

Despite the change in tone 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.

However, it would be no surprise to see yields drift higher if the move away from monetary to fiscal policies are pursued globally. UK gilts could continue to come under pressure from increasing moves 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, 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.

Fiona Rowley at M&G produced an update on the sector and she saw the election result as positive, *"this new cloud of political uncertainty may have a silver lining. A softer, more business-friendly Brexit is likely to be considered; meanwhile the risk of a second independence referendum in Scotland looks off the agenda following a big swing away from the Scottish National Party."*

In terms of returns she predicted that over the next five years (2017 to 2021), *"UK commercial property will generate total returns of around 5.5% per annum. Of this, 4.9% per annum is forecast to be rental income."*

It has been a stable six months to invest in UK commercial property 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 2.5-3.5% primarily from income generation during the six months.

Given the relatively attractive yields still available from property, we will consider returning to the asset class within our income-focused strategies, although we maintain a "wait and see" approach given the domestic political uncertainty.

Alternatives

In general our core basket of multi-asset absolute returns fund fell back marginally over the month, although proved to be more resilient than the sell-off in Government bonds. So far this year our multi-asset positions have worked as a bond proxy (versus Government bonds) and the aggregate 6-month returns of the core funds has been positive in absolute terms. The recent under performance of fixed interest has helped our justification for the alternatives exposure as a bond proxy and helped relative performance for our portfolios.

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 need to be held to 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.

Commodities

It was another gruelling month for oil, with Brent Crude dipping below $50 per barrel. Oil has now erased much of its 2016 rally as supply continues to weigh on the market, with suggested OPEC supply cuts not enough to address the global supply glut.

However, industrial metals performed well over the month, up 3%, but have been remarkably stable year to date. Gold is beginning to behave in a similar way to bonds, down 2.5% over the month, as bond yields spiked in US / Europe and investors began to worry about the opportunity cost of holding this non-yielding asset.

We have little exposure to commodities, only holding a small amount of gold indirectly through absolute return funds and selective miners through value focused equity strategies.

Cash

UK CPI rose to 2.9% in May, up from 2.7% in April, remaining above the Bank of England (BoE) target rate and rising to its highest level since September 2013. On the same terms, RPI rose to 3.7% up from 3.5%. 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.

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