Whitechurch Asset Views
Award Winning Wealth Managers

Whitechurch Securities Ltd
WEALTH MANAGERS

Monthly Round Up - June 2017

Strategic Overview
You Can't Always Get What You Want

If you had obeyed the old adage 'sell in May and go away', you would be kicking yourself last month. May proved to be a good month for investors as virtually all asset classes gained in value. Unusually, global equity markets and bond markets both ended the month in positive territory, and even the gold price moved marginally upwards!

Of course, we cannot avoid mentioning the recent UK general election result. Theresa May's gamble backfired as she lost the Conservative Government's majority and we ended up with a hung parliament. Whether she can formulate a minority government has not been verified as of yet but her position of strength on a hard Brexit has been eroded and so a more placatory stance in our Brexit negotiations with Europe could well be on the cards. This could prove a positive, as market sentiment was not entirely comfortable with May's hard Brexit stance of the UK being out of the single market and the customs union.

In Developed Markets overseas we continue to favour European equities over US equities and this strategy has been very fruitful year-to-date. In sterling terms, MSCI Europe ex UK is nearly 10% ahead of MSCI USA (13.4% vs. 3.9% as at end of May). With Emmanuel Macron winning the French Presidential race, much of the political uncertainty that was shadowing the outlook for European stockmarkets dissipated and sentiment has improved.

US markets shrugged of some politically driven concerns mid-month as Trump came under fire over his dismissal of former FBI director. There is a growing disparity in US markets, with much of headline grabbing performance coming from the big tech stocks such as Facebook, Amazon, Apple, Netflix and Google. With the US earnings season coming up, this could be a crucial time for the world's biggest market, which we believe has been expensive for some time.

Asian and Emerging Market equities continue their strong run year-to-date, no doubt buoyed by the relatively weak dollar. Trump's recent trade agreement with China suggests a softening of his pre-election protectionist pledge which will improve sentiment. No matter where you are, politicians are making headlines. Over in Brazil, President Michel Temer was implicated in corruption charges, which saw the Brazilian equity market nosedive. The commodity rally appears to have run out of steam and we are generally avoiding the commodity influenced markets in these regions.

As mentioned, bond markets also improved over the month. The majority of Developed Market bond yields narrowed as inflation numbers in the US and Europe eased and markets returned to the low inflation, low growth outlook that has supported bond markets for several years. The check in the reflationary outlook suggests that this is not the end of the 30 year bull market in the asset class. Our view on bond markets remains largely unchanged in that we favour corporate credit and that bond prices are unlikely to come under severe pressure for the remainder of the year.

With bond yields narrowing and several global equity markets nearing or reaching record highs, financial markets are starting to look fully valued in several areas. However, with cash and bond yields still at historically low levels the potential return from equities continue to look attractive in our view. In selective areas, relative valuations do not look stretched and maintaining equity weightings seems a sensible strategy for long-term investors.

Although we are not advocates of market timing to guess short-term market trends, it is always prudent to take some profit after a period of strong performance. Investors worried about the current market level as an entry point could consider drip feeding monies into the market, whilst we believe that the best way to manage risk is having a well-diversified portfolio.

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

Compared to April, May saw a reversal in fortunes depending on where you were invested in UK stockmarkets. Blue chips were the best place to be with the FTSE 100 benchmark hitting new highs mid-month and delivering 4.9%. Large caps were sought after as the pound weakened over the month. Medium and smaller companies did not perform as well but still gained in value returning 2.2% and 1.8% respectively.

The UK economy continues to remain robust in the face of Brexit, although first quarter GDP growth was revised lower to 0.2%. The triggering of Article 50 and general election have dampened spirits but overall figures suggest the UK economy is actually growing by more than this. The Bank of England's (BoE) Inflation Report featured a 0.1% decrease on its estimates for 2017 GDP growth which now stands at 1.9%. This downwards revision was driven by a larger hit to real incomes from inflation which the BoE expects to peak at just below 3% towards year-end.

During the month there was a move towards defensive 'bond proxy' stocks and away from cyclical sectors such as Financials. As a result, sectors such as Telecoms, Healthcare, Utilities and Consumer Goods were the best performing areas, whilst commodity focused areas for example, industrials and miners, being the key underperformers. According to the Janus Henderson Global Divided Report for the first quarter of 2017, a quarter of UK dividends have fallen by 5.3% to £15.5bn on a headline basis year-on-year. However, dividend growth has increased by 7.1% although this figure has been skewed by BHP Billiton which sharply raised its dividend pay-out in the first quarter.

Looking ahead, although we expect to see inflation ticking further upwards, a low growth environment and ongoing uncertainty regarding the shape of Brexit, now we have a hung parliament, which means that 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 has shown a good level of recovery since the start of the year will continue to prove rewarding, with a favour for a contrarian value focused approach.

US Equities

Returns within US markets was mixed over the month of May, whilst the S&P rose by a relatively healthy 1.3% (in local currency terms), small and mid-cap US indices fell back sharply, with the Russell 2000 down by 2.1%.

US economic data released over the month were mixed. The US jobs report at the beginning of the month came in strong (usually an indication of further economic growth) whilst unemployment in the US is now down to 4.4%. Purchasing Manufacturer Indices came in weaker for the month and consumer confidence moved lower during May. Despite core inflation falling from 2.4% to 2.2%, it remains above target and with the unemployment numbers so low, markets are pricing in at 95% of another incremental interest rate rise by the US Federal Reserve in June.

US corporate profits and sales growth are both buoyant at present and this is the main factor in keeping the markets near record highs and equity valuations at elevated levels. At the vanguard of this has been the technology sector, with the FAANG (Facebook, Apple, Amazon, Netflix, Google) stocks in particular continuing to gain favour with investors. Indeed, Amazon joined a select club of leading US companies recently as its share price moved over $1,000.

We remain underweight US equities as valuations, rising interest rates, a strong dollar and the level of Trump euphoria continue to 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 equities versus US has worked to our advantage over the month and year-to-date.

European Equities

European markets made further gains in May, buoyed by Macron's victory in the French Presidential Election. The FTSE Europe Ex UK Index gained 5.4% in sterling terms, although much of this was driven by currency as the pound fell against the euro over the month by 3.5%.

In terms of economic news the Eurozone economy is gaining momentum on a number of measures. The first quarter GDP growth for the Eurozone came in at 0.5%, led by Germany and Spain, whilst business confidence surveys signalled further expansion across the region. In addition, unemployment is gradually falling, whilst retail sales have beaten estimates. However, inflation eased back to 1.4% from 1.9%, which may see the European Central Bank (ECB) hold back from any policy easing.

From a valuations perspective it is hard to argue that in aggregate European markets are cheap. The MSCI Europe Ex UK trades on a P/E of over 21.6x. However, in Europe there is scope for further earnings growth and the outlook for 2017 is positive. Profit margins are significantly below historic levels and those in the US market. Versus traditional benchmarks we have an overweight towards European equities, which has paid off well this year. The average European fund was up by 14.1% at the end of May as investors have warmed to a more positive backdrop for economic news and corporate earnings.

Japanese Equities

May was a positive month for Japanese stockmarkets, which ended the month being the best performing of the Developed Markets. The Topix gained 2.4%, which was enhanced for UK investors in these markets due to sterling weakness against the yen. Data released last month saw the Topix index posting record earnings per share and with profits beating expectations from a number of the index constituents. This was also backed up by record high dividends, evidence that the structural changes are taking hold.

There are also positive signs for Japan's economy. GDP growth for the year came in at 1.6%, supported by private consumption, exports and a rise in capital expenditure. Inflation also increased by 0.4% year-on-year, driven by higher costs of food and transport, whilst the cost of housing continues to fall. Core consumer prices also rose by 0.3%, the fourth monthly increase in a row and hitting its highest level since April 2015.

Japan remains an enigma and the effects from structural change, whilst showing early signs of working, are still going to take some time. Japanese equity 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 Market Equities

May proved to be a strong month for Asian Pacific and Emerging Market equity benchmarks, which outperformed their Developed Market counterparts. This is perhaps surprising given the fallout in Brazil and that investors were in a more cautious mood elsewhere, retreating to traditional less cyclical areas over concerns regarding political uncertainty. However, more caution over the strength of Trumponomics played into the hands of investors in these markets.

Political intrigue hit Brazil mid-month, with released reports implicating President Michel Temer in a cover-up, leading to the Brazilian equity market falling 10%. This means that Temer will find it hard to legitimately enact the game changing reforms he once promised. There seems very little to like in Brazil: the commodity rally has run out of steam, valuations do not look particularly cheap and the indebted economy continues to struggle.

India's economy continues to grow apace, despite a short-term slowing in the first quarter in response to the policy to withdraw certain banknotes at the end of last year. China's stockmarkets were the best performers over the month. This was despite Moody's cutting the Chinese credit rating from A1 to Aa3. In response, the authorities stepped in to boost the Renminbi, which hit the highest level versus the dollar for six months. Furthermore, China and the US signed a trade deal, another sign that the aggressive anti-China rhetoric from Trump in his campaign has softened.

Although it appears that they have had an exceptional run, the performance of these regional markets over the past year have only been marginally ahead of broad global stockmarket indices, and still valuations remain attractive relative to Developed Markets. Providing the Chinese economy provides no shocks, we think the fundamentals in Asia and Emerging Markets remain attractive. Structural reforms, better corporate governance, greater consumerism and not least, relative valuations, still make these markets attractive for longer-term investors with a higher risk tolerance.

Fixed Interest

Despite some increase in headline inflation numbers, the reflationary outlook faltered once again over the month as commodity and energy prices continue to stumble. With geo-political headlines receding (for the moment), investors focused once again on the global economy. As a result, May saw investors looking ahead to a return of the low growth, low inflation scenario that has supported bond markets so well in recent years. Government bonds were sought after over the month and yields narrowed across the board in Developed Markets, with the exception of Japan.

Although it was a positive month for all areas of bond markets, higher yielding areas remain sought after and corporate bonds of financial companies and Emerging Market debt were some of the strongest performing areas.

During May, the Bank of England (BoE) released their latest Inflation Report. The BoE suggest that the fall in sterling is likely to keep inflation above 2% for the next three years, and that current market interest rates suggest only one 25bps rate rise over the next three years also. On the one hand, the lower for longer interest rate environment supports gilt prices, whereas inflation well above gilt yields makes them unattractive, particularly with core inflation now at 2.9%, the highest it has been for 5 years. Surely one side has got to give?

Managing the bond conundrum is as important as ever if we do actually move into a new economic phase of inflation and gradual growth. However, as last month has shown, 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 continued to recover over the month, with most open-ended direct property funds producing another month of income driven, incremental gains. The outlook for commercial property remains relatively stable. Henderson held a web-conference mid-month stating the asset class offers:

"very much income focused returns..." and they continue to see "opportunities for growth through managing assets wisely (improving tenants and properties)."

The FCA Illiquid Assets discussion paper closed in May and the regulator held a roundtable with the great and good of the asset management industry to provide feedback and take questions. Generally, the FCA was relatively pleased with how the property funds managed the liquidity issue post Brexit last year. In addition, there was little indication that there would be any fundamental changes to how open-ended funds operate, although the FCA will not be publishing its findings until later this year.

Given this feedback and 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 return funds posted positive returns over the month, which was satisfying in a month when bond markets were well supported by investors. After being one of the first 'retail' investors in the fund, we finally closed our position in Standard Life GARS, after a decade. In recent times the fund has struggled and lagged its peers. Over the years several key members have moved on and set up replica funds with other groups, which we have also supported and which are more ably navigating these current market conditions.

It is pleasing to see our core global macro funds performing well over the month. 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 we hold aids diversification and helps defend capital in our portfolios.

Commodities

There was a small fall in the oil price over the month, with Brent Crude finishing the month marginally above $50 per barrel mark. The key event in the month was the OPEC meeting, which saw OPEC and Russia agree to limit supply and this should support prices going forwards. The volatility in the oil price has fallen significantly over the past year and the price has largely traded within the $45 to $55 range.

Industrial metal prices fell back during the month. However, the gold price marginally rallied over the month despite equity markets also performing strongly in tandem. Our exposure to commodities remains limited having taken profits on our directly held commodities exposure in the previous month. We only hold gold indirectly through a small amount in absolute return funds. However, we are warming to the idea of using the precious metal as a hedge in our higher risk portfolios.

Cash

UK CPI rose to 2.7% in April, up from 2.3% in March, remaining above the BoE target rate and rising to its highest level since September 2013. On the same terms, RPI rose to 3.5% up from 3.1%. With the Bank of England's latest Inflation Report implying inflation above 2% and only potentially one 25bps interest rate increase over the next three years, cash is not going to provide real returns for the foreseeable future.

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, June 2017

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