Whitechurch Asset Views
Award Winning Wealth Managers

Whitechurch Securities Ltd
WEALTH MANAGERS

Monthly Round Up - March 2017

Strategic Overview

The Only Way Is Up…

February was a month of universal price rises across Developed Market equities, higher risk Emerging Market benchmarks as well as safe havens such as lower risk bond markets and gold – making it difficult to see what was the key themes motivating investors. Surely something has to give?

On one hand for equity markets it appeared to be a case that "a rising tide lifts all boats" whereby positive news-flow across the global economy was driving stockmarkets higher. Global manufacturing Purchasing Managers Indices (PMIs), which provide an indicator of business confidence, continue to improve and global economic growth is now widely predicted to exceed 3% this year.

However, the spectre of political uncertainty has remained prominent enough to tone down the sentiment to "cautiously optimistic" and this saw more defensive equity sectors favoured whilst bond markets saw surprisingly strong demand (despite increasing inflation and likelihood of rising interest rates).

The change in leadership to more defensive sectors was particularly pronounced in the UK stockmarket and this was exploited by defensive stalwarts such as Woodford, Evenlode, Trojan and Rathbones. Overseas equity markets enjoyed a strong rally over February, but it was also quality and defensive sectors leading the way as bond yields across the world fell substantially. The best performing sectors were the defensive areas of Healthcare, Staples, Utilities, IT, which suggests that markets continue to climb a wall of worry rather than being driven by bullish euphoria!

The US stockmarket forged further ahead and was the best performing of the Developed Markets. During the month the Dow Jones index posted twelve consecutive daily gains for the first time in thirty years as Trump's pro-growth policies continue to create a wave of optimism. But with the volatility index at very low levels, we wonder if investors are becoming complacent as to whether the promises can be translated into economic growth. Whilst burgeoning optimism and high valuations does make us cautious on US equities overall, we do believe that smaller companies can be beneficiaries of the focus on domestic growth. But our favour for Developed Market equities is focused towards Japan and Europe.

Following the sell-off that followed Trump's election, Asian and Emerging Markets have returned to favour so far this year and in February, these markets continued to produce positive returns based on expectations of stronger global growth.

Despite economic figures continuing to suggest that we are seeing a reflationary outlook, the surprise in February was that bond markets signalled the opposite. After nearly six months of coming under pressure, government bond markets enjoyed a revival and, in particular, UK gilts saw a strong rally. A cooling off in commodity prices leading to reduced inflationary pressures and concerns over future political uncertainty seemed to be the driving factors. Such moves reinforces our view 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.

This month saw the last UK Spring Budget, which was a bit of a damp squib really. The Budget had little to say of note from an investment perspective, with the only exception being the reduction in the annual dividend allowance from £5,000 to £2,000.

The unpredictable politically driven events will continue to dominate headlines. Our view remains that these continue to be a sideshow and are not influential in our investment strategy or a reason not to invest. We have seen that hiding in cash as protection from last year's shock events would have seen you 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

It was a positive month for UK shares with mid cap and blue chip indices providing robust returns of around 3%, although small company benchmark returns were more modest.

Over the month, there was a return to favour for income stocks and defensive sectors; Tobacco, Pharmaceutical and Household goods outperformed accentuated by the two day approach for Unilever by Kraft Heinz which lifted the whole sector. Aerospace and Defence also performed strongly as Trump stated he would be increasing American Defence spending and increasing their military. At the other end of the spectrum, Oil, Miners and Banks saw a break to their recent strong performance and lagged wider markets.

Domestic economic news was mixed over the month. GDP growth revised upwards to 0.7% for the final quarter of 2016, suggesting a more resilient economy than that feared post Brexit vote. However, survey data saw confidence across PMIs slow unexpectedly, undershooting analyst expectations. Currency markets reacted negatively with sterling slumping. Inflation has continued to climb on the back of a falling exchange rate and producer price inflation is beginning to feed into consumer prices.

Looking ahead, although we expect to see inflation ticking further upwards (Bank of England expects inflation to hit 2% this month), 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, with a favour for a contrarian value focused approach.

US Equities

The US market continued to rally strongly with a 4% increase in the S&P 500, enhanced for UK investors by a strengthening of the dollar. This month's "Trump Watch" saw markets focusing on his comments reinforcing expectations of significant infrastructure investment.

Confidence in the US is extremely high amongst consumers and corporates. The survey of consumer confidence rose to 114.8 in February from 111.6 in January, with consumers at the most confident over economic prospects for 15 years. Business confidence has been boosted by the recent reporting season seeing the majority of companies beating earnings estimates. However, these figures are skewed by the recovery in energy and financials rather than broad based profit growth.

It is now widely expected that the Federal Reserve (Fed) will make the next hike in interest rates sooner rather than later. A strong labour market, increasing inflationary pressures (CPI reached 2.3% in January) and Trumps' fiscal stimulus plans leading to higher growth potential has seen the probability of an increase on 15 March become largely priced in. Interestingly, on that same day is the US Debt Ceiling Deadline ($20trn debt), at which point the US Treasury has only $200bn of cash left if the ceiling is not raised!

Given the strength of the US economy, the inflationary outlook and Trump's administration, it has made sense to increase our exposure to domestically focused, cyclical areas of the market by investing in US Smaller Companies. However, overall we remain relatively cautious. Our underweight has been detrimental during the Trump rally. But valuations, rising interest rates, a strong dollar and the level of Trump euphoria continue to make us cautious on the wider US market.

European Equities

European markets posted steady gains in February although a weakening euro diluted returns for UK investors. In line with other global markets there was a marked outperformance of defensive versus cyclical sectors; a reverse of recent momentum.

There are clear signs that the Eurozone economic outlook is improving as leading indicators continue to provide positive surprises. PMI surveys have illustrated the highest level of confidence since 2011 and a move towards a reflationary environment was highlighted by consumer prices rising sharply to 1.8% year on year. The European Central Bank (ECB) made no changes to monetary policy during the month. However, improved economic data and inflation numbers means it is likely that they will start talking about an orderly winding down of QE providing there are no upcoming political shocks.

In terms of politics, risk-off sentiment crept back into Europe over the month. Le Pen in France and VPP in Netherlands are both gaining traction. The Dutch election is on 15 March and even if the far right VPP do poll the most votes a coalition will likely be formed with the VPP excluded.

We prefer to focus on valuations rather than politic 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 significantly below historic levels and those in the US market and the forward P/E multiple looks 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

It was a fairly quiet month for the Japanese stockmarket overall and the Topix showed a 0.9% gain. However, a renewed strengthening in the yen translated this into roughly over gains of 2% in sterling terms for UK investors.

Economic data continued to be lukewarm. Inflation rose to 0.4%, though deflationary concerns remain. GDP growth remains weak at 1% annualised for the final quarter of 2016, whilst Japanese investors are also still struggling to work out whether Trump is a positive or negative for Japan. Early signs are that Japan is not being targeted aggressively by Trumps' protectionist policies. Indeed, during the month, Prime Minister Shinzo Abe and Trump seemed to spend a very cordial weekend together (once Abe had recovered from Trump's over-zealous handshake).

Despite some policy disappointments last year, the backdrop for Japanese markets appears supportive for 2017. Although economic activity remains sluggish the Bank of Japan stated that they will continue 'quantitative and qualitative monetary easing aiming to achieve the price stability target of 2%, as long as it is necessary.' Furthermore, Japan does not have the political uncertainty that is spooking investors in UK, US and Europe. 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 continued their good start to 2017, with most of the incumbent markets in these regions providing positive returns, although in February benchmarks lagged their Developed Markets counterparts. Out of the major markets, only Russia fell in value. Following an exceptional recovery in 2016 this market has lost a bit of momentum year to date.

In contrast China and India have rallied strongly. India was the best performer of these regional markets in February. Q4 GDP growth came in at 7%, making it the fastest growing of the major global economies. This was welcomed by investors concerned over a short-term drag from Modi withdrawing banknotes last November. At the same time inflation has fallen to 3.2% (the lowest since CPI was introduced in 2012). Chinese markets also continued to perform strongly over the month and their return to favour has been a key feature year to date too, as investors see scope for the country's economic recovery to strengthen.

The biggest short-term risks facing these markets emanate from the US with the strength of the dollar, the US rate cycle, 10-year 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 these regions. Given that commodity prices and Chinese growth appear much more stable than twelve months ago we think fundamentals are more attractive despite Trump. Structural reforms, better corporate governance, greater consumerism and not least, relative valuations, still make these markets attractive.

Our overweight position of these markets versus underweight US can be a headwind (and key risk in 2017 as it was in 2016). If Trump delivers on strong fiscal stimulus, and revives the domestic US economy, this could lead to underperformance, but this would be offset somewhat by stronger, long-term global growth that would be positive for Asia and Emerging Markets. Our exposure here does provide a diversifier away from Trump stimulation, which appears a crowded trade.

Fixed Interest

After nearly six months of coming under pressure, government bond markets enjoyed a revival in February, as Developed Market bond yields narrowed. It was a mixed month for different areas of bonds markets, with interest rate sensitive areas performing well and higher yields proving popular too. Overall it was investment grade corporate bonds and Emerging Market debt which were the best performing areas of bond markets over the month.

During the month we held updates with TwentyFour and Invesco Perpetual and both of their market outlooks are very similar. Both believe that there will be two more 0.25% rate increases by the Fed (June and November?), which is priced into markets. Invesco believe that UK rates will not rise until the start of 2019 and at the end of 2019 for Europe.

We believe that the lower for longer interest rate environment remains, whilst the telegraphed US rate rises have been priced in already. Over the month, bond markets trod the familiar ground that we have seen for a number of years and we have to wonder if markets are losing faith in the reflation outlook, or at least the pace of it.

Having increased exposure to the asset class following the sale of property funds last year, we have constructed a basket of complementary and diverse bond funds for our portfolios. Managing the 'bond conundrum' going forwards is crucial and we are looking to be as diversified as we can. As a result, our exposure to the asset class ranges from index-linked gilts, through to investment grade credit and from strategic bond exposure right up to short duration high yield and European bank paper.

Commercial Property

Now that trading suspensions have been lifted, redemptions have been reversed and the UK economic outlook has been upgraded; commercial property has reverted to type with all of the open-ended funds producing marginal positive returns over the month.

During the month the FCA released its discussion paper on 'illiquid assets and open ended investment funds', which will be open until 8 May. The general view so far is that nothing will fundamentally change – further details can be found in our Property Research Note, (available on request).

The yield on UK property remains attractive, particularly versus government bonds and this is what attracted us back into the asset class in Q4 2009. With the UK economic outlook improving in the immediate term, the outlook for property is also becoming more sanguine. Given the changing dynamics, we may look to reduce our bond exposure and add to the property once again for the usual reasons: its income stream and diversification attributes.

Alternatives

All of the core multi-asset absolute return positons we hold produced positive returns over the month. In a month when government bonds and gold did well, it is unsurprising to see Newton Real Return leading the pack. Our alternatives exposure is used, in part, as a proxy for not investing directly in UK gilts. This strategy is holding up well at present, having outperformed UK gilts year-to-date.

We use these funds to reduce cyclicality and spread risk in portfolios. However, when investing in these funds it is important to be selective and understand the wide ranging differences in risk and reward profile that these funds can offer. With the outlook for fixed interest markets coming under pressure, having selective exposure to alternatives could prove a prudent call going into 2017.

Commodities

There was a small increase in the oil price over the month, with Brent Crude finishing the month around the $56 per barrel mark – the highest level for the past year. However, whilst OPEC agreeing to cut supply has supported prices this has been somewhat offset by increased supply from North American shale, where many oil producers become profitable with the price above $50.

Industrial metal prices rallied during the month. However, gold rallied strongest for the second month in a row and has been the best performing 'asset class' year to date, despite the fact that equities have been universally performing strongly in tandem.

Our exposure to this area remains indirectly through exposure to mining shares which serve two purposes, commodity exposure for momentum and gold exposure for diversification attributes. The position has worked well, although much of this can be attributed to its exposure to UK listed miners, which have benefited from weaker sterling and the recovery in commodity prices.

Cash

UK CPI increased to 1.8% in January, up from 1.6% in December, hitting its highest level since June 2014 (RPI increased from 2.2% to 2.5%). At present, the best Cash ISA and deposit accounts are offering less than inflation and so holding cash on account is losing savers money in real terms.

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, March 2017

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