Monthly Round Up - May 2017

Strategic Overview

Should I Stay Or Should I Go?

Investment sentiment continued to be dominated by political noise over the past month, with the French Presidential Election and Theresa May's calling of a snap UK General Election taking over the front-page headlines from Trump and Brexit. The overall effect of the news-flow proved positive for global stockmarkets and the MSCI World index increased by 1.1% in local currency terms.

Following a prolonged period when US politics has been centre stage, all eyes have been on the French election in recent weeks. Investors breathed a sigh of relief following Macron's victory in the first round of voting and this was ratified when he became President on the 7th of May, receiving two thirds of the vote in the run-off against Marine Le Pen.

However, just when we thought that politics may take a back seat over the summer, Theresa May called a snap General Election for the 8th of June. UK focused areas of the stockmarket rallied on the news with the belief being that a greater majority for the Conservative party may help a more stable negotiation backdrop for Brexit.

The effect on currency movements was highlighted over the month as there was a recovery in sterling, particularly against the weakening dollar. The pound strengthened by over 3% against the dollar and the yen, and 1% against the euro. The effect being negative for UK investors with overseas equity exposure, as the gain of the MSCI World Index translated into a loss of nearly 2% in sterling terms.

Sell In May and Go Away?

It is the time of year for this old adage to be trotted out again and for clients to ask - Should I Stay or Should I Go? Our default position is that we don't believe that looking at a calendar provides a good way to formulate investment strategy. The chart across details the performance of the UK stockmarket during the period of 1st May to St Leger Day over the past ten years and it shows that whilst investors may have avoided periods of volatility they would also have missed out on periods of material gains.

St Leger Day	Return from 1st May
10/09/2016	+9.9%
12/09/2015	-9.2%
13/09/2014	+1.3%
14/09/2013	+4.7%
15/09/2012	+4.0%
10/09/2011	-12.9%
11/09/2010	+0.6%
12/09/2009	+20.8%
13/09/2008	-9.6%
15/09/2007	-1.8%

2016 certainly reaffirmed that such short-term market timing is a thankless task. For many it may have seemed to be the perfect year to sell your UK share portfolio in May and hold monies in cash until the fallout from the referendum settled down. However, had you sold on the 1st May of and reinvested after St Leger day you would have missed out on a remarkable return of just under 10%.

This year, we are sure that the historically high market levels may concern people, given the continued global economic and political uncertainty. However, as cash and bond yields remain at historically low levels the potential return from equities continue to look attractive in our view. Valuations on many measures do not look stretched and maintaining equity weightings seems a sensible strategy for long-term investors. However, whilst UK markets are currently 'making hay while the sun shines', it is important to not become complacent. 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 across different markets and asset classes.

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

Size mattered this month in UK equities with a significant disparity between the blue chip FTSE 100 benchmark, which lost over 1%, and benchmarks for medium and smaller companies, which both posted growth in excess of 3%.

There were a number of contributing factors. A drag on the major oil and mining stocks as commodity prices retreated was instrumental in the fall in the FTSE 100. Then when the surprise announcement came on 18th April that Theresa May was calling the General Election this was warmly welcomed by investors in medium and smaller UK stocks that are focused on the domestic economy. These stocks rallied strongly following the announcement and the strengthening of sterling boosted such companies but acted as a drag on large exporting areas of the stockmarket.

This has extended the reversal we have seen so far in 2017 of last year's dominance of blue chip shares. This has certainly resulted in a welcome relief for many UK active managers, with the large company focused index tracker funds well below average within the UK Growth and Equity Income sectors.

In terms of economic data the Purchasing Managers Index (PMI) confidence survey rose to a four month high and employment growth is also accelerating after a slowdown in Q1. However, data is suggesting that consumer facing sectors continue to struggle and that consumer price inflation (CPI) may have further to rise from the current 2.3%.

Looking ahead, although we expect to see inflation ticking further upwards, 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 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

The S&P 500 returned a steady 1.0% but a weakening dollar translated the return to a fall of -2.4% for sterling investors. The fall in currency was undoubtedly the key factor affecting US holdings and whilst improving sentiment in the pound is partly responsible, Trump complaining about the negative effects of a strong dollar could signal a policy shift towards weakening the greenback.

US economic releases were mixed. The pace of US economic growth was slower than expected during the first quarter, with an annualised growth rate just 0.7%, compared to consensus expectations of 1.1%. Inflation also came in weaker than expected with prices dropping for the first time since Feb. The consumer-price index decreased 0.3% with year on year CPI at 2.4% (below forecast of 2.6%). Given the muted growth and inflation it was no surprise that the Federal Reserve left interest rates on hold during the monthly meeting. There is now a 70% chance of a rate increase in June priced into markets.

Trump's plans for tax reform received a muted response with very little detail. His plan to cut US corporate tax rates from 35% to 15% was estimated to cost over $5 trillion – with team Trump claiming that stronger economic growth will pay for this. On a more positive note, survey data has been positive and the Non-Manufacturing PMI business confidence index hit the highest levels since August 2005. Earnings figures have also been looking more promising than top line economic growth.

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 worked in our benefit over the month.

European Equities

European markets were the pick of developed Markets with the FTSE Europe Ex UK index returning 2.8% in local currency although this reduced to 0.95% for sterling investors as the euro weakened versus a recovering pound.

Investor sentiment was significantly boosted by the result of the first French Presidential vote (that led to Macron becoming President in the run-off). JP Morgan believe the result will be significant in a reduction in risk and lead to increasing acceptance to allocate to Europe. They state that "We may well look back at April 2017 as the turning point for European equities in terms of their performance relative to the rest of the world".

In terms of economic news the Eurozone economy showed growth of 0.5% during Q1 2017 in line with market expectations. Inflation increased, with CPI expected to increase by 1.9% year-on-year, in April 2017 whilst unemployment figures remained at an eight year low. The European Central Bank (ECB) made no changes to monetary policy during the month.

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 20.7x. However, there is scope for further earnings growth in Europe. Profit margins are significantly below historic levels than those in the US market. Versus traditional benchmarks we have an overweight towards European equities. We do not believe that this position is consensus but European equities have been the pick of Developed Markets, year to date, with investors seemingly undeterred by the background political noise. The average European fund was up by 8.3% until the end of April as investors warmed to a more positive backdrop for economic news and corporate earnings.

Japanese Equities

It was a more positive month for the Japanese stockmarket overall. The Topix showed a 1.3% gain ahead of the MSCI World index, although there were not many headlines to excite investors. However, a renewed strengthening in the pound versus the yen translated this into an index loss of -2.1% for sterling investors.

In terms of economic activity Schroders predict that Japanese growth will be 1.6% in 2017 with inflation at 1.1% supported by looser fiscal policy and a weaker yen. Such a backdrop would provide a 'goldilocks' backdrop for investors. However, inflation remains muted with CPI in Japan at 0.2% in March compared to a 0.3% in February and the lowest rate since last October. The Bank of Japan left interest rates unchanged at -0.1 percent at its April 2017 meeting, as widely expected. The Bank raised their economic growth forecast to 1.6% for 2017 from an earlier projection of 1.5%.

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 local currency terms, there was an uplift of around 2% for the core Asian and Emerging Market indices, faring well against the majority of Developed Market counterparts. However, the strength of the pound affected returns for UK investors in Asian and Emerging Markets and the indices ended April in negative territory in sterling terms.

Generally, there has been little in the way of newsflow / updates on these markets over the month (quarter even) as all eyes have been focused on European elections, anything US and / or a war with North Korea. However, with the energy and commodity rally going backwards combined with the geo-political headlines, some of the markets focused on these areas (e.g. Russia and Brazil) have come under a bit of pressure recently. Given the uncertainty surrounding the Russian market we decided to take profits on our exposure in April.

Asian and Emerging Markets are still cheap relatively but looking more expensive than a year ago. In particular China, with the MSCI China Index, is trading nearly 25% higher than it was in April last year. Investors currently sanguine over China should not underestimate the potential instability its economy could bring to global markets. If China causes another correction, there is no hiding place in global equity markets.

As long as commodity prices and Chinese growth provide 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

April provided another reminder that it is too early to call the end of the bull market for global bonds with most areas of the fixed interest universe providing a positive return for investors. Reduced growth and inflation figures in the US and the political uncertainty caused by the French election led to overseas investors continuing to buy the asset class for safe haven attributes.

The one exception was conventional gilts where improving economic data and improving investor confidence following the calling of a UK General Election saw muted demand and a broadly flat return. The IA Gilt sector fell back 0.2%, but inflation linked gilts rallied and the IA Index Linked Gilts sector increased by 1.2%.

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 exposures 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. Open-ended funds from Kames and Threadneedle have both posted positive returns over 12 months which is impressive given the domestic economic uncertainty.

However, the yield on UK property is looking attractive but the 12 month total return projections from leading property managers are for a modest loss. The fact that investment trusts now trade on marked premiums are an indicator that it is not a contrarian play and the opportunity to exploit the post-Brexit recovery has passed.

The yields available 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 in the FCA feeling the need to step in and change how they are regulated.

Alternatives

Our core multi asset absolute return funds all performed well over the month, posting positive returns. Invesco Perpetual has been a consistent performer within our Absolute Return basket, a recent meeting with the management team has reinforced our conviction that this is one of the better mandates in the multi-asset absolute return space. Premier Defensive continues to perform well in the very low risk areas, delivering another 0.5% over the month.

It is pleasing to see our core global macro funds performing well over the month. However, the positive performance of fixed interest versus alternatives exposure year to date has overshadowed these funds. But 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 balanced and cautious mandates. In aggregate the basket of alternative funds adds diversification and acts as a defensive diversifier to portfolios.

Commodities

It was a poor month for energy and commodities. Brent crude spot price fell by -3.2% over the month and oil is now trading well below $50 per barrel. The production cuts from OPEC are not having the desired effect and US supply is currently more than making up the slack. In addition, the expectations are that OPEC will not be cutting production further, hence the weakness in price due to oversupply.

It was a similar story for industrial metals over the month (-3.1%). Both iron ore and copper have had material falls and the Bloomberg Commodity Index is now down 8% from its recent high water mark, which has virtually cancelled out the gains of last year. The commodity rally running out of steam made us decide to sell out of BlackRock World Mining over the month.

With the dollar weakening and risk aversion creeping up, gold enjoyed a relatively strong month with the spot price moving up by 1.4%.

Cash

UK CPI held steady at 2.3% in March, this was in line with expectations as RPI fell to 3.1%.The best Cash ISA deals show instant access at 1% (National Savings) and there is little doubt that a cash ISA will provide a negative real return in 2017, eroded by inflation.

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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