Whitechurch Asset Views
Award Winning Wealth Managers

Whitechurch Securities Ltd
WEALTH MANAGERS

Monthly Round Up - February 2018

Strategic Overview

What Goes Up...

Some investors may be shocked that stockmarkets can go down considering the extended bull run we have seen in financial markets over the last couple of years. However, given that, as we write, major benchmark market indices are generally showing a decline of around 5% (in local currency terms) for the month; in context, this is quite a small movement (so far) compared to previous market sell-offs.

What has caused the sudden change in investor sentiment? Risk aversion has been driven by the US. Strong economic and market growth, further buoyed by the recent tax reform bill, has caused investors to focus on inflation and the future path of US interest rates. Initially, the panic that ensued was confined to a sell-off in Government bond markets at the end of January. However, this has now fed through to equities in February.

It remains to be seen whether we will see sustained market volatility. In August 2015 and January 2016, we witnessed far steeper daily declines only for stockmarkets to regain their poise and forge ahead within a month. Whether the current investor nervousness abates as quickly remains to be seen but we would urge investors not to panic.

Looking ahead, US interest rates (and Central Bank policy overall) and currency movements are going to be key in dictating investor returns as we move through 2018. The threat of rising interest rates triggered January's sell-off in Government bond markets as inflationary concerns increased. The yield of 10 year US Treasury bonds hit 2.8% - the highest level since 2014 and the sell-off resonated across global bond markets. UK gilts saw a loss of around 2% in the benchmark index over the month. Bond guru Bill Gross who called the end of the bond bull market at the end of last year does not expect a dramatic sell off.

As we have often mentioned, currency is having far more of an influence on investment returns than we can ever remember. Improving figures for the UK economy and a glimpse of light at the end of the Brexit tunnel helped the pound reach its highest level since before the EU referendum. January alone saw detrimental returns for UK investors in overseas equity markets as the pound materially strengthened against most major currencies. As a result, movements in currency will be forming a bigger part of our investment considerations when investing in equities during the year.

As we move through February, it seems that the recent declines are global stockmarkets taking a bit of a breather, with investors being spooked by inflationary concerns. Although no-one likes to see their portfolio values fall, in the short-term a reality check that markets do not go up in a straight line may prove timely. Stopping irrational exuberance and markets being driven by the FOMO (Fear-Of-Missing-Out) brigade taking on too much risk and ignoring fundamentals and valuations is welcome in our eyes.

We cannot predict which way markets will turn in the coming weeks, but our top down view remains focused on the belief that there is value to be had in equities versus cash and bonds, with a number of areas offering long-term growth prospects and attractive dividends.

We believe, whilst a well-diversified portfolio can continue to provide cash beating opportunities in a number of areas, for those prepared to ignore short-term noise, focus should be on valuations and taking 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 2018.

UK Equities

The UK was the pariah of global equity markets over January being the only market that declined in value in local currency terms. Global investors continue to favour other markets due to the ongoing spectre of Brexit uncertainty, which continues to cast a pall over the economy and UK corporates. Key corporate news over the months was the collapse of Carillion, which had a knock-on effect on other infrastructure and utilities companies.

Despite the naysayers, the UK appears more robust than sentiment suggests. Wage growth data continues to be positive and unemployment levels remain low. Data indicates we are seeing marginal wage growth and industry sentiment surveys continue to remain upbeat. However, with Brexit negotiations ongoing, the outlook for the UK economy in 2018 remains mixed.

From a market perspective, UK equities remain the most unloved and underweight amongst global asset allocators and it appears that the worst-case Brexit and economic scenario is being priced in. Whilst we do believe several areas of UK markets are looking expensive, and several areas remain challenged, we are identifying several valuation opportunities.

With UK equities continuing to provide considerably higher yields than cash, we believe dividend stocks remain enticing and should provide the core to stockmarket exposure. 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 wider UK stockmarket.

US Equities

US equities delivered some strong returns in January with the S&P 500 gaining by 5.7% (local currency terms), only for all these gains to be wiped out by the global sell off in equity markets. Indeed, it is US investor sentiment that started the global risk aversion, as concerns over US inflation and the path of US interest rate policy triggered a sell in bond markets first before spreading to equity markets.

What has spooked investors? The Fed has been very open about its interest rate intentions this year but it seems that economic strength and evidence of rising wages has led investors to reappraise their views on inflation and, in turn, focus more intensely on interest rate rises. Share prices may be falling but on the corporate front, US companies continue to march on it seems. 24% of S&P 500 companies have reported with 81% beating sales estimates and 76% beating earnings estimates. This has led to some exuberance from analysts who are projecting earnings growth of 16.3% from the S&P 500 for 2018. Naturally, these projections were made prior to the recent sell-off.

We remain underweight in US equities. Valuations, rising interest rates and potential dollar strength have been the key reasons that made us cautious on the wider US market. Dollar strength versus the pound has begun unwinding and markets are pricing in three rate rises in 2018, whilst tax breaks should boost growth. Now that we have seen some falls in share prices, if we see further weakness we could be upping our exposure to the US. However, high valuations historically and relatively mean we will remain materially underweight versus global benchmark indices.

European Equities

European equity market returns were pared back towards the end of January as the onset of investor risk aversion began to take hold in global stockmarkets. However, Europe's bourses did end the month in positive territory. Once again currency played a part for UK investors, albeit detrimentally, as sterling strength against the euro translated into c1% reduction in returns.

Although we have seen further falls in European stockmarkets this month, as investors sell equities across the globe, the economic picture in Europe continues to paint a positive picture. Industry sentiment surveys remain positive and GDP growth has been for 2017 at 2.5%. This is the strongest growth from the region in a decade. At present, the European Central Bank remains accommodative, although QE in Europe has a deadline. This could prove significant as we move nearer to the end of the bond buying programme, which terminates in October this year.

With an improving economic backdrop, an accommodative Central Bank and another year of corporate earnings growth, exposure to Europe remains a favoured position in Whitechurch portfolios. Even after a good 2017 for European corporates, profit margins remain significantly below historic levels (and those in the US market), and there is significant disparity in valuations between quality global leaders and domestic cyclicals where further recovery in Europe would be amplified into robust earnings growth as margins expand. The 3% plus yield from European equities also looks compelling given the bond yield alternative.

Japanese Equities

January was a positive month for Japanese equities despite investors selling out of global equities towards month end. The Topix showed a gain of 1.1% (local currency) but was the worst performing of the Developed Markets. This was compounded further for UK investors in these markets as a strengthening pound meant that any gains from the markets were converted into losses due to currency.

Despite the recent shake out in global stockmarkets, the bull case for Japan remains the same. Whereas other major Developed Market Central Banks are in monetary tightening mode, Japan remains the outlier. The authorities remain committed to fiscal stimulus, with a dovish Bank of Japan (BoJ) committed to continuing quantitative and qualitative easing. Add in the fact that corporate reforms are beginning to take hold, and the backdrop for Japanese asset prices remains highly supportive.

Japanese equity valuations are not stretched and appear relatively attractive compared with other Developed Markets. With an improving economic backdrop fuelled by stimulative policies and scope to improve return on equity for Japanese equities, the region provides a relatively attractive investment case versus other Developed Market equities.

Asia Pacific & Emerging Market Equities

Until the recent shake out in global stockmarkets, Asian and Emerging Markets had started 2018 exceptionally well, with Brazilian, Russian and Chinese benchmarks all producing double digit returns in January. Asian and Emerging Market indices generally outperformed their Developed Market counterparts as continued dollar weakness, positive economic news from China and increasing commodity demand, continued to be the key drivers for these markets. However, a stronger pound diluted returns from these markets for UK investors, a difference of c. 3-4% in most cases.

China was at the vanguard of the outperformance over the month with the technology sector leading the way. Alibaba and Tencent make up 31% of MSCI China alone. Brazil was not far behind with a tailwind of strong commodity prices and positive political news (2018 is an election year). Towards the end of the month the Brazilian market reached its highest level for over 3 years. Russia was also one of the best performing areas as the increasing price of oil boosted economic prospects.

Out of the big four markets, India's stockmarket lagged, and adverse currency movements meant UK investors endured losses over the month. Last year, investors and markets had to absorb reforms (Goods & Services Tax, demonetisation), which stalled markets and with the imposition of new CGT laws at the beginning of February, enthusiasm has been dampened again. However, recent forecasts that India's economy will achieve GDP growth of 6.5% (March financial year end) has been welcomed and the longer-term outlook for the stockmarket remains upbeat.

Despite recent sentiment leading to some profit taking from these markets, we believe that 2018 can deliver strong performance from Asian and Emerging Market equities. However, it will remain important to be selective when investing in these higher risk markets. The current renewed optimism over China should not lead investors to become complacent over the longer-term risks of instability in the largest emerging market. However, 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

A volatile month saw January end badly for several areas of bond markets, except for Developed Market higher yielding areas. It was US sentiment that instigated the sell-off. After a strong start for equity markets, investor concerns over potential inflationary pressures leading to more aggressive Quantitative Tightening (QT) from Central Banks, caused jitters in rate sensitive assets. In terms of IA sector performance, Gilts (both conventional and index linked) were hit hardest, down by c. 2%, with investment grade bonds posting marginal losses. High Yield held up well despite risk aversion coming to the fore generally ending the month marginally ahead.

Given the turn in sentiment, within Developed Markets 10-year Government bond yields widened (2.7% on US Treasuries looks relatively attractive in our view). But some Emerging Market Debt (EMD) yields narrowed, largely due to a further weakening dollar. Worries about inflation, interest rates, QT etc. meant that longer duration, interest rate sensitive areas fared the worse.

During the month we received an update from Ariel Bezalel, manager of Jupiter Strategic Bond, which has been a core position within our portfolios for nearly a decade. Bezalel's outlook is quite bearish and to paraphrase his view: major Central Banks carried out $2trn of QE in 2017, and this year there will be none. In other words, a significant level of support has been removed from bond (and equity) prices. Considering recent events, his concerns are spot on.

With interest rate sensitive yields under pressure, we will continue to avoid Government bonds and skew our exposure to corporate bonds and less interest rate sensitive areas of bond markets given the QT mode in Developed Markets. On a medium-term outlook we have allocated some monies to EMD. Given that this can be a volatile asset class, we have only introduced it within higher risk, income focused portfolios.

Commercial Property

It was business as usual for bricks and mortar funds over January, providing investors with another month of incremental, income driven returns. Commercial property returns are loosely correlated to UK economic strength and despite Brexit uncertainty producing a cloudy outlook, they do not react as per equity and bond markets when investor sentiment becomes risk adverse.

We met with the managers of Janus Henderson UK Property and Kames Property Income during January and they were largely reading from the same piece of paper: the outlook for property remains all about the income, and the management and security of that income. Given the relatively attractive yields still available from property and its lack of correlation with equity and bond markets, our exposure here has been beneficial during the recent falls in risk asset markets.

Alternatives

It was a mixed month for our alternatives exposure in absolute terms. However, one of the reasons we allocate to these funds is an alternative to gilts, which our basket of funds outperformed in aggregate.

Another reason for holding these funds is to increase diversification and reduce portfolio volatility. Within the recent period of low volatility and rising markets, these funds have found it challenging. Now we have seen risk assets under pressure and volatility spiking, this is exactly the environment where these types of funds will earn their corn and help defend capital. As a result, we continue to see these funds as useful diversifiers within our portfolios, and offer better opportunities versus traditional 'safe haven' asset classes going forwards.

Commodities

The oil price edged higher over the month aided by a weaker dollar with Brent Crude finishing the month around the $70 per barrel mark, close to the highest price for three years. The oil price has seen a marked turnaround and more than doubled since it fell below $30 two years ago, having been supported by strong demand coupled with supply restrictions imposed by Russia and OPEC. However, recent market turbulence has seen the oil price pare back.

The gold price rallied 2.3% in January, making a third consecutive monthly gain. This was attributable to the culmination of further dollar weakness and risk aversion towards the end of the month. Unsurprisingly, the turbulent start to February has seen the precious metal price rise accordingly. However, our longer-term view is that gold will struggle to compete with yield-bearing assets when borrowing costs rise, which means gold loses its lustre in our view whilst monetary policy tightening continues.

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.

Cash

UK CPI fell back slightly as the figures for December came in at 3% (down from 3.1%). However, RPI rose to 4.1% (from 3.9%). Best cash ISA rates are around 1.1% (instant access), so cash continues to offer negative real returns.

Whilst cash will have protected you from market falls in the immediate term. our view remains that cash is going to continue to be 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.

Whitechurch Investment Team, February 2018

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