Whitechurch Asset Views
Award Winning Wealth Managers

Whitechurch Securities Ltd
WEALTH MANAGERS

Monthly Round Up - January 2018

Strategic Overview

Everyone's a Winner

Global stockmarkets finished the year strongly with most leading indices in positive territory over December. They have started 2018 where they finished last year, with many breaking through record levels boosted by strong economic data and robust corporate earnings.

Having been the laggard for much of the year, the UK stockmarket showed strong outperformance in December returning 4.8% compared to the MSCI World index which increased by 1.1% (local currency terms). Markets were buoyed by constructive Brexit negotiations and strong performance from the oil and mining sectors. Yet the UK stockmarket remains one of the most unloved amongst global asset allocators going into 2018. As contrarians, we are thinking that the overly negative scenario might be priced in and we are seeing opportunities across several areas.

Overseas, the US stockmarket posted a first-time record of rising every month in a year – boosted by Trump's tax reforms getting through Congress, which reduces the corporate tax burden for domestic companies. But it was Asia and Emerging Markets that continued to outperform as optimistic growth figures proved to be a key driver of investment flows.

Everyone's a Winner

Looking back over 2017, all asset classes produced positive returns. The best-performing major developed equity market was, surprisingly, Japan. The Topix index returned over 22% (local currency terms) although a weakening yen diluted returns for sterling investors. An improving domestic and global economic backdrop translated into corporate earnings growth, providing market momentum.

The US stockmarket also gained in excess of 20% based on strong economic and corporate data but the gains were halved for sterling investors by a weakening dollar. Although European stockmarkets have underperformed just recently, it has been a good year for UK investors in Europe who benefited from economic and corporate recovery and a strengthening euro.

However, the star performers of 2017 have been Asia and Emerging Markets. Several factors have contributed to their robust performance: a weak dollar, rising commodity prices, and a rebound in corporate earnings, whilst a rally in technology stocks (particularly in China) has been a key driver for several of these markets.

Going into 2018, stockmarket volatility remains at historic lows, suggesting that there is complacency across equity investors compared to other asset classes and currencies. But stockmarket fundamentals are being strongly supported by synchronized global economic growth and strong corporate earnings against a backdrop of low interest rates. Understandably, this is providing optimism that the rally can extend into 2018.

Bond markets also finished the year well culminating in positive returns in 2017. Corporate bonds fared better than gilts and 2018 could be the year where 'safe haven' bond prices come under the spotlight as yields move higher. Central Banks have been telegraphing their intentions to tighten policy throughout 2017, whilst the global economy has strengthened and inflation continues to tick-up. We are wary of interest rate sensitive bonds and so continue to avoid Government debt, skewing our exposure to corporate credit.

We returned to investing in UK commercial property in 2017 and this has proved rewarding. Attractive yields compared to government and corporate bonds, and the prospect of modest rental growth underpin the asset classes attraction over fixed income.

Currencies have had a significant bearing on returns again. The pound stabilised whilst the weakness of the dollar and the yen have been in contrast to euro strength. The currency risk of holding overseas assets is a strong recovery in the pound, but this seems unlikely, and we maintain that having a portfolio with international exposure is prudent in diversifying risk.

A new year does not mean our views have materially changed. With cash savings offering negative real returns the benefits of holding a well-diversified portfolio are clear to see. Even with some equity indices reaching all-time highs there are still prospects for long-term growth and attractive dividends. A well-balanced portfolio provides many opportunities for those prepared to ignore short-term noise, focus on valuations and take a longer-term perspective.

With sustained performance from stockmarkets, it is important to not get complacent. Risk is of utmost importance in our investment approach and it is imperative to not get carried away by rising markets (for example, the best performers in this environment are often those taking the most risk!).

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

UK stockmarket showed exceptional outperformance in December returning 4.8% compared to the MSCI World index which increased by 1.1% (in local currency terms), making it the best performing Developed Market over the month. Investors were buoyed by constructive negotiations over Brexit, whilst UK indices were driven by strong performance from oil and mining sectors as commodity prices rallied.

From an economic perspective, the UK is looking better than sentiment suggests. Data indicates we are seeing marginal wage growth and PMI business indicators still have services, manufacturing and construction activity levels comfortably above long-term trend rates. However, the outlook for the UK economy in 2018 remains mixed, dampened by concerns over high debt levels, more expensive credit and the impact this will have on consumers.

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 also 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

The S&P 500 was up by 1.1% over the month in local currency terms to complete an exceptional 2017 return of 21.1% (although this translated to a return of 10.6% in sterling terms due to the weakening dollar). A number of records were broken including it being the first time that the US market has risen every month. In terms of sectors it has very much been large Tech stocks that have been at the forefront of the rally with the Tech sector returning almost 40%. But gains have been broad based with consumer discretionary, financials, materials, industrials and healthcare all returning in excess of 20%. (source: JP Morgan).

The year finished strongly for the US boosted by Trump's first major reform, with Congress passing the tax bill, reducing the corporate tax rates from 35% to 21% for domestic US companies and providing other tax breaks. Over the month, best performing sectors were Telecoms (boosted by a repeal of an Obama law that all internet services are treated evenly), Energy (as oil went through $65 a barrel) and Consumer Stocks. However, Utilities were hit hard as these are not expected to benefit from the recent tax reforms.

As expected the Fed increased rates on the improving economic outlook (Q3 figure of 3.2% is strongest since 2015 and 2018 forecast has been upgraded). Despite the lack of inflation at present, consensus forecasts are for a further three rises in 2018. According to the Fed forecasts, they see unemployment falling to 4.1% for 2017 and 3.9% for 2018. Inflation is predicted to be 1.5% in 2017 and 1.9% forecast for this year.

Despite the strong US market our underweight has been a positive contributor in 2017 with the average US fund returning 10.5% in sterling terms compared to over 17% for Europe and Japan and around 25% returns from the average Asian and Emerging Market funds. Valuations, rising interest rates, a strong dollar and the level of Trump euphoria have been the key reasons that made us cautious on the wider US market. The dollar strength is now unwinding and markets are pricing in three rate rises in 2018, whilst tax breaks should boost growth. However, high valuations and the low volatility suggesting complacency, continue to make us nervous.

European Equities

European equity market returns fell back marginally in December, although returns were marginally positive for UK investors as the Euro continued its strong run. It has been a solid year for European stockmarkets with the benchmark showing the best return since 2013 (MSCI Europe +13.6% translated to 15.8% in sterling).

Economic data continues to paint an upbeat picture in the Eurozone. Economic surveys continue to be positive and beat expectations, whilst European consumer confidence is at the highest level for a decade. Inflation in Europe remains subdued with the latest reading showing Eurozone CPI falling to 1.4% which means that Central Bank policy is likely to remain accommodative. Although the European Central Bank (ECB) is moving into a tightening monetary phase, it is still behind the UK and US, having extended the bond buying programme out to September 2018.

For over a year we have been extolling the potential for European equities based on the prospect of the improving economic translating to greater for earnings growth across the region and the Q3 earnings picture was positive, increasing by 10% year on year. From a valuation perspective, it is hard to argue that European markets are cheap but there is scope for further earnings growth. Profit margins are significantly below historic levels and those in the US market, whilst 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 3% yield from European equities also looks compelling, given the bond yield alternative.

Japanese Equities

December was a solid month for the Japanese stockmarket overall. The Topix showed a 1.6% gain ahead of the MSCI World index, although yen weakness marginally detracted, translating this into an index gain of 1% for sterling investors. In 2017 Japan was the best performing of the major Developed Markets returning 22.2% (although this was diluted to 15.6% for sterling investors).

The market gained momentum as the year progressed, as an improved domestic and global backdrop translated into improved corporate earnings. In Q3 corporate earnings rose by an impressive 16% year-on-year. In addition, the Japanese economy grew by 2.5% year-on-year, significantly above the initial estimate of 1.4%. Inflation is also showing signs of a welcome increase although it remains low at 0.9% The political backdrop looks stable with the re-election of Shinzo Abe as Prime Minister. He buoyed investor sentiment, in Q4 , by promising the electorate that he would maintain fiscal stimulus. This resulted in a strong bounce in the market and strong net flows from foreign investors. Whilst the Central bank is also likely to remain supportive as it strives to get inflation to 2% (it is thought that the Bank of Japan Governor, Haruhiko Kuroda, will take on a second term in April).

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

Asian and Emerging Markets equities regained momentum in December, finishing the year strongly resulting in these markets being the best performers last year. Several factors contributed to their robust performance. A weak dollar has historically been supportive of the relative performance of these markets and this proved to be the case in 2017. Furthermore, these markets also benefited from a rebound in corporate earnings. A rally in Tech stocks was extremely beneficial, with over 25% of benchmark indices made up of the sector. The general recovery in commodity prices also supported the more commodity-focused stock markets in the second half of the year.

China has been at the forefront of the rally with an exceptional 55% return last year (converted to 40% for sterling investors). This has been driven by the BATs (Baidu, Alibaba and Tencent) with the Chinese Tech sector up 70%. India is a market we favour, and it produced a 30% return over 2017 (26% for sterling investors). With the economy and market having absorbed the short-term 'shocks' of the Goods and Services Tax and demonetisation reforms, we are optimistic on the outlook for Indian equities in 2018.

Going forwards we believe that 2018 can deliver more of the same from Asian and Emerging Market equities if the status quo remains. However, it will remain important to be selective when investing in these higher risk markets. 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

It was generally a positive month across all areas of bond markets although with a varied dispersion in returns depending on where you were invested. Index linked Gilts were the best place, the sector finishing up by 2.6%. High Yield was the worst place to be, with the sector going sideways (+0.1%) over the month. Looking back over the calendar year, all areas of bond markets produced positive returns but with a contrast in fortunes compared to those areas that performed well in December. For example, it was good news for credit with investment grade and high yield corporate bonds (+5.1% and +6.1% respectively) leading the way, but conventional gilts performed poorly with the sector returning just 1.7% over 2017.

December saw the Fed embark on further 'quantitative tightening' (QT) raising rates by 0.25% to 1.5%. As per usual, the Fed has been careful to manage bond market expectations with monetary policy and the recent rate rise had been well priced in already. In keeping with this stance, the Fed has indicated that there will be three rate rises in 2018 depending on economic data. The ECB has also adopted a similar approach and the reduction in its bond buying programme begins this month (although the programme has also been extended until September this year). The ECB upgraded the Eurozone's growth forecasts in its December press conference, citing a "significant reduction" of economic risks, and greater confidence in hitting inflation targets. This is a gentle reminder to markets that the ECB is also in QT mode.

We will continue to avoid Government bonds and skew our exposure towards corporate bonds and less interest rate sensitive areas of bond markets given the QT mode in Developed Markets. We are also seeing a significant conviction that EMD is representing some enticing opportunities for highly regarded 'go-anywhere' managers and we allocate exposure to the asset class within income focused higher risk portfolios.

Commercial Property

December was another solid and steady month for open-ended commercial property funds, with the 'bricks and mortars' funds all delivering another month of income driven, incremental gains. Commercial property returns are loosely correlated to UK economic strength and recent Brexit trade agreements have provided a fillip for the economy and the asset class.

With the relatively attractive yields still available from property and its lack of correlation with equity and bond markets, we have increased our exposure into our cautious and balanced strategies. Our current preferred funds are F&C, Henderson and Kames and we increased our weightings to these positions during the month.

Alternatives

Given the relatively strong performance of government bonds in December, our core basket of absolute return funds underperformed although they still managed to produce positive returns in aggregate. Interestingly, despite these funds being much maligned in recent months, the majority of our holdings here outperformed government bonds over 2017, and with generally lower levels of volatility.

It has been a challenging environment for such funds to provide competitive returns but these funds are designed to grind out a return greater than cash and or inflation. With bonds and equity valuations looking expensive in many areas, it seems that this is exactly the time when these strategies cannot be ignored, providing non-directional ballast in cautious and balanced mandates.

Commodities

It was an exceptional month for energy and commodity prices. Oil prices rose strongly with the S&P GSCI Brent Crude Spot (USD) price gaining by 5.4% over the month, with the oil price seeing out the year at just over $66 per barrel. Given the recovery in the oil price and the forced restructuring by the Oil Majors in recent years, if prices remains around this level or higher then the outlook for those oil stocks with well covered income streams could be attractive.

Gold marginally gained in value over the month, despite the Fed raising interest rates and signalling three more over 2018. However, 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 rose slightly to 3.1% (up from 3% the previous month), beating market expectations. However, RPI fell back to 3.9%, lower than the 4.1% forecast. With the best instant access cash ISA rates offering just over 1%, cash is providing negative real returns and this does not look like reversing any time soon.

Our view remains that cash is going to continue to be eroded by inflation and 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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