Whitechurch Asset Views
Award Winning Wealth Managers

Whitechurch Securities Ltd
WEALTH MANAGERS

Monthly Round Up - June 2018

Strategic Overview

Mama Mia, here we go again.....

There have been plenty of geopolitical issues to keep investors on their toes recently but one area that has been remarkably calm has been European politics. But last month that all changed as Italian politics took centre stage in terms of generating headlines. A key concern was the potential appointment of an anti-Euro Finance minister. But this was vetoed by the President and after a period of uncertainty a coalition was formed with a more moderate cabinet, easing investor nervousness.

There was also increased political uncertainty in Spain with a vote of no confidence ousting Prime Minister Rajoy who was subsequently replaced by Socialist Sanchez. Across the pond Trump increased the pressure of a potential trade war further spooking investors.

But although the fallout from the political turbulence in Italy and Spain saw an increase in nervousness and falls in European equities, the political uncertainty did not lead to a widespread sell off in stockmarkets and UK and US shares were both in positive territory over the month.

Currency continues to influence market returns and a weakening of the pound enhanced returns for UK investors with overseas exposure. The political uncertainty did see a favour for perceived safe haven currencies and the dollar and yen performed strongly, whilst weak UK economic data (reducing expectations of a rise in UK interest rates) saw a fall in the pound. Having seen a sustained period of weakness, May was the third month in a row where the dollar has rallied. We continue to extol the virtues of holding well-diversified international exposure given the political uncertainty that threatens the domestic economy.

The lack of reverberation from the political uncertainty was highlighted by the level of the Vix index not reaching anywhere near the levels of volatility seen in February. However, stockmarket volatility has been higher than the exceptionally low levels of volatility seen in 2017. Going forward it is realistic to expect it to be more in line with longer-term levels going forward. Geopolitical headlines will continue to play a significant role in unsettling investors over the summer with the fallout from the latest G7 summit and ongoing concerns of the effects of a trade war.

Away from stockmarkets, the oil price hit $80 a barrel for the first time in four years. The increase in the price of the black stuff is contributing to renewed concerns of inflationary pressures. However, for bond investors political uncertainty was more of a driver than inflationary concerns. As investors sought safe havens there was a rally in the price of core 'defensive' Government bonds, whilst there was a fall in the price and rise in yields of peripheral European Government bonds. Commercial property has continued to be a good diversifier and our exposure produced a steady gain in May.

We remain more focused on central bankers than politicians. We still believe that interest rate policies at home and overseas will be key drivers of asset prices and meetings this month should provide more guidance. Our view is that any interest rate increases are likely to be cursory due to a lack of sustained inflationary pressure and fragile economic growth. This has been reinforced by sluggish UK economic data reducing the likelihood of an imminent UK interest rate rise.

The recent political turbulence is just background noise in our view and does not alter our investment outlook. 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. 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 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 2018.

UK Equities

For the second month in a row the UK stockmarket was one of the strongest global performers. The main UK Indicies hit record highs during the month, although the increasing political concerns took their toll in the latter part of the month, dampening returns.

The market was driven by an extension of the strong rally in resource stocks, fuelled by the rising oil price, whilst a weakening of sterling boosted UK exporting blue chip shares. However, there was also ongoing recovery in oversold UK domestic stocks and mid cap stocks outperformed the wider market.

From a sector perspective Oil and Gas Producers and miners increased sharply. At the other end of the spectrum, Fixed Line Telecommunications and Mobile Telecommunications performed poorly.

In terms of economic data, weaker growth and ongoing uncertainty about the future of the Brexit negotiations kept the Bank of England on hold at its May meeting. Only two members of the Monetary Policy Committee voted for a rate hike, while seven members voted for no change.

The UK showed the rather puzzling combination of very strong employment data and yet relatively weak business sentiment. GDP grew by just 0.1% in the first quarter. It is unclear how much of this weakness is due to unusually cold weather in the first four months of the year. .

It was pleasing to see another positive month for UK shares given that we have recently moved towards a more positive stance on UK equities. Although we are mindful of political risk, our belief is that UK shares are deeply unloved and undervalued by investors, thus representing a contrarian opportunity. It appears that there has been excessive risk aversion and short-termism at play within the UK stockmarket. This is particularly true of domestic facing businesses, which have been hit the hardest and are trading at undemanding valuations. Furthermore, we expect a lower for longer rate environment to continue which is supportive for dividend producing shares.

US Equities

It was positive economic and corporate news-flow emanating from US that helped support global markets and override the concerns over European political uncertainty and the renewed threats from Trump over a trade war.

As a result the US returned to the top of the leader board for major overseas markets. Whilst the S&P 500 was up 2.3% the small cap focused Russell 2000 increased by 6.0%. Returns for UK investors were enhanced by a rally in the dollar translating the S&P and Russell returns to 5.9% and 9.8% respectively.

In terms of economic data although Q1 economic growth was marginally revised down to 2.3%, there was a raft of positive indicators. Unemployment fell to 3.9%, the lowest level since 2000 and consumer confidence and PMI surveys showed positive readings.

Monetary policy will continue to be a key driver for US equities. It is widely expected that the Federal Reserve will announce an increase of 0.25% to interest rates in June but markets were reassured by more dovish rhetoric and a lack of wage inflation.

Corporate earnings saw an exceptional first quarter fuelled by the corporate tax cuts. The consensus is that 2018 will see earnings growth of 20% (with 10% projected for 2019). From a sector point of view Energy rallied strongly as oil hit $80 a barrel and healthcare benefited from talk of less stringent regulation of profits.

Fundamentally, our underweight to the US stockmarket has been a bit of a drag on performance year to date, although our favour for smaller companies has been positive. On valuation terms our favour for other markets versus the US remains intact, but Trumps' tax reform bill could see one final push for the US bull market run. However, we are seeing a number of fund managers starting to question the sustainability of the US economic strength. On this basis the strong run of corporate earnings could begin to falter and high valuations, rising interest rates, and the political uncertainty over Trump are key reasons that make us cautious on the wider US market.

European Equities

European equity market returns were hit by the fallout from the Italian elections and lost money over the month due to negative investor sentiment. The FTSE Europe ex UK fell by 1.6% in local currency terms but a strengthening euro against the pound saw losses for UK investors pared to 0.8%.

It was the recurring theme of European political turbulence that spooked investors during the second half of the month. Concerns over the potential appointment in Italy of an anti-Euro Finance minister alarmed investors but by the end of the month the situation had been calmed with the formation of a less Euro-sceptic Government. Spain also saw an increase in political uncertainty with a vote of no confidence against Prime Minister Rajoy who was subsequently replaced by Socialist Sanchez.

Away from the political noise economic news-flow has been mixed. Although economic growth for the first half was subdued at 0.4% this was in line with expectations and data over the month was broadly positive. Unemployment has continued to fall and this resulted in ongoing strong consumer confidence.

European Equities (Continued)

The big concerns for the ECB and European exporters is the strength of the euro combined with weak inflation. Although QE is destined to run its course by the end of this year, it seems unlikely that the ECB will be looking to raise interest rates any time soon.

On a corporate level, earnings figures were broadly positive. There was a broad disparity in sector performance, less cyclical growth areas outperformed with healthcare and technology amongst the best performers. Financial stocks were the big underperformers as political uncertainty weighed on the banking sector.

European markets have lagged wider developed markets year to date and our recent reduction in European exposure has been prudent. Although Europe remains more attractive than the US on valuation measures there are signs that the strong recovery of 2017 could be losing momentum. We have been trimming our overweight exposure to bring monies back home to the out of favour UK stockmarket. However, we continue to believe that Europe looks more attractive than the US on valuation measures and with more stimulatory monetary policies.

Japanese Equities

It was a negative month for the Japanese stockmarket. The Topix fell by -1.8%, compared to a flat return from the MSCI World index. But the yen exposure proved positive with its negative correlation to risk resulting in the Topix translating this into an index rise of 2.4% for sterling investors. Year to date Japan has underperformed global markets but the strength of the yen has generated positive returns for UK investors.

In terms of economic news it has been fairly sluggish. Inflation remains subdued with a 0.7% increase in May. The political backdrop appeared more stable with pressure reducing on Abe. Whilst the Central bank outlined that it will remain supportive maintaining QE policies.

Corporate earnings for the year to end of March showed earnings growth of 22% in line with expectations, although cyclical areas struggled more. There are signs that earnings momentum is improving.

Investing in Japan is unexciting at present but despite recent underperformance holding yen has been supportive for UK investors during times of risk aversion. The economy is growing at a steady pace and the Bank of Japan are likely to continue 'quantitative and qualitative monetary easing', this should provide a supportive backdrop. Valuations 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. However, corporate earnings within Japan remain volatile as the value of the yen fluctuates.

Asia Pacific & Emerging Market Equities

Increased talks of trade wars were the key concern for investors in these regions although Asian and Emerging Market benchmarks proved relatively resilient and only showed modest losses. FTSE Asia Ex Japan Index fell by 0.6% and MSCI Emerging Markets index fell by 2.2%. Currency provided a boost for UK investors with the sterling index returns translating to +2.5% and -0.4% respectively.

It was another month where there was a marked divergence amongst Asian and Emerging Markets. Chinese equities were in positive territory over the month despite concerns over the trade war. India also was marginally positive with strong economic growth of 7.7% annualised reported for the first quarter of 2018.

In contrast news-flow from South America was generally poor. The worst performing of the major emerging markets over the month was once again the Brazil Bovespa which was down 9.8% in local currency terms. Ongoing political uncertainty and poor economic figures are seeing investors shun this market at present. Argentina is also struggling as the peso continues to fall and with interest rates increasing, the country held talks throughout the month with the IMF for a bailout.

Elsewhere, Turkey is facing similar issues with the lira being in a similar state and continuing to fall, but with no response from the government in terms of interest rate rises and limited reserves to support it.

Despite significant divergence in Asian and Emerging Markets equities, we believe that there are good opportunities to deliver strong performance from these areas. However, it will remain important to be selective when investing in these higher risk markets. As we have seen with concerns of a trade war, the optimism over China can be checked very suddenly and is a timely reminder that we do not become complacent over the longer-term risks of instability in the largest emerging market.

Furthermore, if we see a continuance in the recent rally in the dollar this will prove to be a headwind.

However, overall fundamentals across Asia and Emerging Markets still 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

Bond markets were mixed in May as the negative effect of inflationary fears was offset by the political noise increasing the desirability for 'safe haven' investments.

This resulted in a rally for UK Gilts, US Treasuries and German Bunds, whilst the benchmark for UK Government bonds rallied by 1.8%. But while US, UK and German government yields were falling, Italian yields rose sharply in the month due to the political risks. The spread between Italian and German 10-year government bonds widened above 2% for the first time for a year.

The political turbulence resulted in a "risk-off" month across the globe as investor confidence fell. As a result it was a more difficult month for higher risk areas of bond markets. The IA High Yield Bond and the Emerging Market Bond sectors were the worst performing bond sectors falling by 0.6% and 0.7% respectively.

In the United States, despite the strong economic data, the comments from the Federal Reserve reassured bond markets that interest rate increases will be measured. Whilst there is a 0.25% increase priced in for June, the expectations are that we may see a pause afterwards. Indeed some commentators such as bond guru Bill Gross believe that this will be the final increase of 2018.

Whilst we have moved towards a monetary tightening phase, with interest rates heading up, it is going to be a slow process with Central Banks telegraphing their intentions to markets along the way. Even though many bond markets are historically overvalued, this approach by the Central Banks leads us to believe that there will be no collapse in bond prices.

Our exposure to fixed interest is through a basket of complementary and diverse bond funds for cautious and balanced income orientated portfolios. We will continue to avoid UK Government bonds, although the recently added US treasuries provide insurance during risk-off periods. Overall we continue to favour our fixed interest exposure in corporate bonds and less interest rate sensitive areas of bond markets. Exposure ranges from defensive investment grade corporate bond funds, to strategic bond exposure, right up to financial bonds, and Emerging Market Debt where we believe that attractive yields provide adequate reward for risk.

Commercial Property

UK commercial property funds once again remained solid, providing marginal, income driven gains.

It has been rewarding for investors since we returned to investing in UK commercial property last summer. The major UK commercial property funds have reverted to type and produced steady returns from income generation but also some capital growth. We have recently increased our exposure to property as the asset class is again displaying the two attributes we seek – attractive yields compared to Government bonds; and a lack of correlation with equity and bond markets.

Alternatives

The increase in volatility that we have seen in 2018 has proven to be a timely test for our alternatives exposure, and the Absolute Return funds have continued to prove broadly positive over the month.

With increasing interest rates weighing on returns from bond markets and stockmarkets displaying a higher level of volatility our belief remains that a basket of alternative strategies are necessary to provide an added level of diversification.

An upturn in the relative performance of our alternatives funds year to date has been welcome as the use of these funds has been called into question several times during the tandem bull-run for equities and bonds. Although it is important to be selective and have a strong understanding of such funds, they are true diversifiers within our portfolios, and offer different opportunities versus traditional 'safe haven' asset classes, which appear expensive.

Commodities

Oil prices continued to rise over the month with Brent Crude up 4.6% ending the month on a spot of $77, having breached $80 earlier in the month for the first time in four years. There is some debate over what direction OPEC will take at their next meeting in June which is likely to see volatility in the oil price. Saudi Arabia and Russia are favouring easing supply curbs whilst Iran and Kuwait are not.

Despite it being a broadly 'risk off' month Gold was volatile over the month ending down 1.4%. However, there is still a preference for investors to own physical gold over the equities of gold mining companies and the gap between the two is now at its widest level since last September. 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. Elsewhere we do not have direct exposure to commodities within our portfolios, although mining and energy will feature within UK and overseas equity exposure.

Cash

UK inflation fell from 2.5% to 2.4% in May as measured by the Consumer Price Index (CPI). Although UK inflation is expected to fall further over the coming months (as stronger sterling reduces price of imports), cash remains unattractive. With the best instant access Cash ISA deals offering around 1.3% it remains likely that a Cash ISA will provide a negative return in 2018.

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 2018

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