Whitechurch Asset Views
Award Winning Wealth Managers

Whitechurch Securities Ltd
WEALTH MANAGERS

Monthly Round Up - March 2018

Strategic Overview
Down But Not Out

February started where January left off – providing investors with a timely reminder that global markets fall quicker than they rise. Strong US employment numbers and evidence of wage growth fuelled investor concerns over inflation and the prospect of a more aggressive US interest rate cycle. This led to a sharp sell-off in equity markets in the first half of the month, with all global stockmarkets being sold off indiscriminately.

The spike in volatility was pronounced. After surging to a high of 50.3 at the beginning of the month (the VIX's highest reading since mid-2015), the "fear index" ended the month below its historic trend level of 20, as investor risk aversion came and went. This was reflected in risk assets which following some of the heaviest falls for the past two years early in the month recovered much of the ground from mid-month onwards. However, volatility may have come and gone for the meantime but the cause of investor concerns remains unresolved and it is reasonable to expect that 2018 is not going to be a repeat of the smooth rising markets witnessed last year.

As inflationary concerns became more heightened and investors focused on the threat of more aggressive US interest rate hikes, bond markets suffered a sell-off in tandem with equities early in February. The yield of 10-year US Treasury bonds nearly hit 3% - the highest level since 2014 - and the sell-off resonated across global bond markets. Despite UK gilts losing around 2% at the beginning of the month, they recovered the lost ground later in the month to finish flat.

Currency continues to influence market returns and, as we have mentioned, has become a key focus for us when assessing global markets. Whilst sterling strength in January hampered UK investor returns, it was the opposite in February. Sterling weakness versus other major currencies, particularly the dollar and the yen, saw local currency losses significantly pared back in these stockmarkets for UK investors.

Indeed, in the case of Japan, sterling weakness against the yen is likely to have translated into some possible gains for UK investors over the month. Movement between the pound and the euro was less significant, with sterling weakness translating into around 1% uplift for UK investors over the month.

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. Furthermore, this week President Trump threw another curveball into the situation with his recent announcement regarding imposing tariffs. Such 'protectionism' could impact global trade if implemented. In the meantime, it further weighs on investment sentiment and could prove another catalyst for more market jitters.

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. 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 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

As per other equity markets, UK stockmarkets declined sharply at the start of February, falling nearly 6% at one point on the back of investor concerns over inflation and US interest rates. There was some recovery towards month end, and although the market finished over 3% lower it held up better than other major Developed Markets. However, whilst a mixed set of trading updates and poor news flow around Brexit and a transition deal further hampered the UK markets, it was the UK mid-caps that held up better than UK large cap overseas earners.

There were several high-profile profit disappointments within UK markets over the month. Tobacco was the key underperformer over the period with British American Tobacco missing market expectations and Imperial Brands first half results were flat year-on-year. Oil companies also struggled despite good results from Shell and BP, as the market remained focused on declines in the oil price.

Overall, whilst it cannot be argued that the UK economy is booming, it is proving resolute despite the ubiquitous Brexit headlines forecasting doom and gloom. Data is showing evidence of wage growth, whilst Purchasing Manager Indices (PMIs) remain robust. With CPI persistently remaining around 3%, early in the month, Mark Carney, the Bank of England Governor indicated that UK interest rate rises could come sooner and by a 'somewhat greater extent' than they thought. The consensus view is that the next rate rise could come in May.

From a market perspective, 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

It was speculation over US inflation and the path of US interest rates that spooked investors and triggered the sell-off in global stockmarkets. As a result, the S&P 500 was at the vanguard of the market declines and ended the month down by 3.8%, the worst of the Developed Markets over February. But once again, as we have often mentioned, currency movements saw the S&P 500 showing marginal losses for UK investors as the dollar strengthened against the pound.

It's all eyes on the US at present, whether it is the new Federal Reserve (Fed) chairman, Jerome Powell, or President Trump and his new trade tariff proposals. US inflation remains static and despite recent evidence of wage growth, Powell has tried to quell this in his recent speech… yet indicated that there may be 4 rate hikes this year!

Corporate America continues to go from strength to strength. 90% of the S&P 500 have announced their quarterly results, with 74% reporting earnings surprises and 78% reporting positive sales surprises (source: Factset). However, these strong earnings are more than represented in the price.

In terms of valuations, the forward 12-month P/E ratio for the S&P 500 is 16.9. This P/E ratio is above the 5-year average (16.0) and above the 10-year average (14.3) (source: Factset). The US is an expensive market – the Shiller PE for the S&P 500 is over 33x, the second highest reading in its history.

We remain underweight the US vs standard global benchmarks. Equity 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

In local currency terms, European equities held up relatively well in the face of negative investor sentiment, with only UK equities proving more resilient within Developed Markets. FTSE Europe ex UK fell by 3.4% in local currency terms (although Germany's Industrial and Manufacturing dominated DAX fell by 4.7%) but a strengthening euro against the pound pared losses for UK investors cushioning falls by a margin of around 1%.

In light of the market volatility, European economic news wasn't great, although not concerning. Eurozone inflation fell back to 1.2% (although this was expected), whilst the jobless rate remained unchanged. The big concerns for the European Central Bank (ECB) though is the strength of the euro combined with weak inflation, especially as QE is destined to run out in September this year.

It remains more positive on the corporate front. Earnings for 2017 showed double digit growth, matching forecasts for the first time since the global financial crisis. These forecasts remain robust for 2018 and the fact that, up until last year, there had been no earnings growth in Europe for several years bodes well for a continued recovery in corporate profits. In P/E terms, Europe is no longer cheap but currently trades at just under 15x, which is marginally higher than the 10-year average. However, Europe remains marginally cheaper than other global markets on a relative basis.

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), whilst 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

As per other Developed Markets, Japanese equities were not insulated from investor risk aversion and the Topix fell by 3.7% (in local currency terms). However, it was positive for UK investors as the yen's 'safe haven' status saw the currency appreciate against the pound. This resulted in positive gains of 1.7% for the Topix over the month when converted into sterling.

Haruhiko Kuroda was reappointed as Bank of Japan (BoJ) governor over the month, the first person to win a second term since 1961. This signals a further 5 years of monetary stimulus, underscoring Abe's commitment to escaping deflation. And given the recent inflation number, you can see why Japan is committing to loose policy going forwards. Consumer prices rose by 1.4% year-on-year in January (following on from a 1% gain the previous month) and beating estimates. This is the highest inflation rate since March 2015, and is quite a turnaround from Japan's record inflation low of -2.5% in October of 2009.

With Kuroda's reappointment, and Prime Minister Abe's commitment to reforms, Japanese equities still look well placed. Japanese equity valuations are not cheap – but throw in the dividend policy reform, the ability to return cash to shareholders, scope to improve return on equity and a supportive Central Bank and this continues to make Japanese equities a relatively attractive investment case vs. other Developed Market equities.

Asia Pacific & Emerging Market Equities

The rally in Asian and Emerging Markets equities ran out of steam in February, generally mirroring the falls in Developed Markets equities over the month. Only Brazil's stockmarket ended the month in positive territory. However, sterling weakness over the month was a boon for UK investors in these markets and losses were reduced, with currency fluctuations even translating into gains for UK investors with Russian equity exposure.

China was at the vanguard of the underperformance over the month despite official economic growth figures coming in higher than expected at 6.8% year-on-year. In relative terms, India fared well against other markets in these regions but still fell in value over the month. Manufacturing and services activity numbers were weaker over the month, although these are anticipated to be modest and transitory in nature.

Of the other big two markets within these sectors, Brazil and Russia both delivered positive returns for UK investors boosted by sterling weakness. Indeed, in the case of Brazil, its stockmarket was in positive territory both in local currency and sterling terms, mainly driven by renewed optimism over the country's economic outlook. Finally, Russia held up relatively well and whilst valuations appear compelling, the threat of further sanctions from the US could see this market remain under pressure.

Despite recent risk aversion 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. As we have seen recently, renewed 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. 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 endured a mini taper tantrum at the start of February before recovering toward the latter half of the month. The sell-off emanated from the US where strong job numbers spooked investors further over the increasing risk of wage inflation and therefore further interest rate hikes. This was enough to push up the US 10-year treasury yield to 2.95% by the middle of the month (the highest level for four years).

The turbulence resonated across global markets and UK gilts were at the forefront of the sell-off, falling 2% in the first half of the month before recovering all their ground and finishing flat for the month. An undertaking for further purchases of gilts by the Bank of England (reinvesting proceeds of maturing gilts) has provided some short-term technical support.

It wasn't a good month relatively for corporate credit. Fears over inflation and interest rates saw longer duration and more interest rate sensitive areas of corporate bonds suffer. The IA Sterling Corporate bond was the worst performing sector falling by 1.2%, whilst the High Yield sector also fell by 0.9% over the month. The best performing area of fixed interest during February was Emerging Market Debt (EMD), which produced positive returns for UK investors, where sterling weakness boosted returns.

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 monetary policy tightening mode in Developed Markets. However, with a yield at 3% we concede that US treasuries would provide value in an interest rate climate that we believe will remain lower for longer. To add diversification 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

Despite the sell-off in equity and bond markets during February, UK commercial property funds remained solid during the month, providing marginal, income driven gains. However, one of our core positions, Janus Henderson UK Property moved its price during the month due to slower asset flows, and this translated into a fall of just under 4%.

However, it has been a strong six months since we returned to investing in UK commercial property. The major UK commercial property funds have reverted to type and produced steady returns between 2.5% to 5%, mainly 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 falls in risk assets and the increase in volatility was a timely test for our alternatives exposure, and they didn't disappoint, with some of our holdings delivering positive returns over the month. Our remaining exposures to alternatives all held up relatively well against other risk assets, only losing marginal value over the month.

With stronger economic growth across the globe, and more hawkish rhetoric from Central Banks, the past month showed signs that interest rate sensitive assets are under pressure. This enforces our belief that a basket of alternative strategies can deliver against gilts. This is reassuring as our alternatives bucket has been called into question several times. We continue to see these funds as diversifiers within our portfolios, and offer better opportunities versus traditional 'safe haven' asset classes going forwards.

Commodities

After a weak start to the month, oil prices regained some momentum over the month on the back of stronger demand growth and the continuation of OPEC's lower production agreement. Following a short but sharp period of cold weather, waning gas supplies has proved supportive to the upside in the respective commodity price. This is likely to be short lived and something that has most likely run its course.

Gold did not provide a refuge from volatile investment markets and lost around 2% during the month. A slightly more hawkish view from the Fed following strong payroll numbers took away any upside gains year-to-date. The precious metal remains a speculative trade in our book, as higher interest rates will weigh on this non-yielding asset. However, as we have seen, it does enjoy short spells of support when risk asset volatility comes to the fore.

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 remained constant at 3% in February, whilst RPI decreased from 4.1% to 4%. Although both CPI and RPI are widely expected to fall over the coming months due to falling food and commodity prices, cash remains unattractive. With the best Cash ISA rates at around 1.5% (instant access), it remains highly likely that cash will provide a negative real 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, March 2018

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