Whitechurch Asset Views
Award Winning Wealth Managers

Whitechurch Securities Ltd
WEALTH MANAGERS

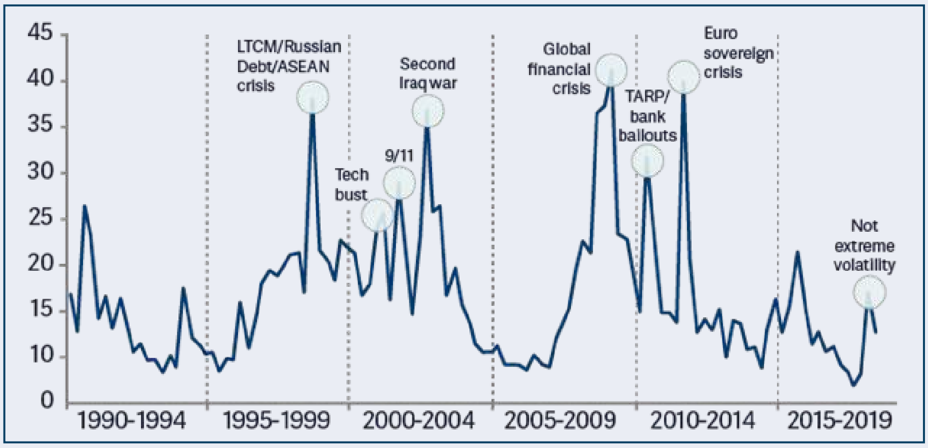
Monthly Round Up - July 2018

Strategic Overview
It's Oh So Quiet...

Below are the key factors that have influenced investment markets in recent weeks, followed by our current position. On the following pages we provide a more detailed review of the markets and touch on how we are positioning our portfolios.

- Markets rose early in June only to fall back towards the end of the month as Central bankers took the limelight from politicians and investors moved into more of a risk-off mode.
- The Federal Reserve spooked investors with fears that a more aggressive US interest rate policy could provide a headwind going forward.
- The ongoing trade war tensions also dragged on investor sentiment with the Asia Pacific and Emerging Markets proving to be most exposed, and lagging developed markets.
- The overall effect was the MSCI World index finished broadly flat (+0.3%) with a small weakening of the pound marginally enhancing returns for UK investors with overseas exposure, with the sterling index return showing +0.7%.
- Whilst markets lacked direction during the month, volatility remains subdued. Although global equities are showing more elevated levels than we saw in 2017; the VIX finished the month at only 15 having reached 18 during the month. In historical terms the low level of volatility is illustrated in the chart below, from Artemis. Going forward it is realistic to expect volatility to be more in line with longer-term levels.
- Currency continues to influence market returns although currency movements also proved more muted over the month. Strong US data and rising interest rates saw an extension of the rally in the dollar and a weakening of the pound enhanced returns for UK investors with overseas exposure.
- Away from stockmarkets, the oil price remained around the highest levels we have seen for four years. The increase in the price of the black stuff is contributing to renewed concerns of inflationary pressures.
- Political uncertainty continues to support demand for 'safe haven' bonds; although this has been tempered by inflationary concerns and bond markets have showed little direction.
- Commercial property has continued to be a good diversifier and our exposure once again produced a steady gain in June.

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.

- Geopolitical headlines will continue to play a significant role in unsettling investors over the summer, with the ongoing concerns of the effects of a trade war and Brexit likely to dominate.

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

The UK stockmarket fell back marginally over the month. Global trade tensions intensified on increased protectionist rhetoric from US against China and this weighed on UK exporters. Mid cap stocks were the best performers over the month, closely followed by large cap whilst the small cap stocks after starting strongly, fell back.

From a sector perspective aerospace and defence was the strongest performer over the month pushed up by strong share performance from Rolls Royce. Food and drug retailers were pushed up by another strong month from Ocado. Surprisingly, general retailers remained in positive territory held up by a strong performance from JD Sports (no doubt helped by a surge in sales of England replica shirts).

In terms of economic data, figures proved more positive than recent readings. Consumer activity, in particular, bounced back strongly in the second quarter. Inflation as measured by the Consumer Price Index (CPI) remained at 2.4% in June despite rising fuel costs.

An interest rate rise in the next three months is now looking more likely as business confidence surveys of the indicator of the economic health of the manufacturing sector, the Purchasing Managers' Index (PMI), have also picked up.

Despite a modest fall over the month it has been pleasing to see a positive quarter for UK shares given that we recently moved towards a more positive stance on UK equities. Although we are mindful of political risk (and we expect to see the noise increase over Brexit over the coming weeks) our belief is that UK shares are deeply unloved and undervalued by investors, thus representing a contrarian opportunity; as 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 another month where positive economic and corporate news-flow emanating from US helped support global markets. However, US news-flow over rising interest rates and renewed threats from Trump over a trade war did cause concern.

The overall effect was a broadly neutral month for US stockmarkets, although they remained at the top of the leader board for major overseas markets. The S&P 500 was up 0.6% and the small cap focused Russell 2000 increased by 0.7%. Returns for UK investors were enhanced by a rally in the dollar translating the S&P and Russell returns to 1.3% and 1.4% respectively.

In terms of economic data, releases over the month continued to point towards strong growth. In response to positive data readings, the Federal Reserve increased interest rates by 0.25%. This had been priced in by markets, but further guidance is that there will be two more hikes this year (the markets had only been pricing in one rise).

From a sector point of view consumer sectors were the strongest performers whilst Energy rallied as the oil price remained above $75 a barrel. Industrials lagged with exporters suffering from concerns over a potential trade war. Takeover activity continues to remain a key driver. The first half of 2018 has seen record levels of M&A deals with over $2.5 trillion reported.

Fundamentally, our underweight position to the US stockmarket has been a bit of a drag on performance, year to date, but our favour for US smaller companies has been a major positive. On valuation terms our preference for other markets versus the US remains intact, but Trump's 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 broadly flat over the month. The benchmark index fell by 0.2% in local currency terms but a marginally strengthening euro against the pound saw the index provide a modest gain of 0.3 %. However, there was a significant disparity by country, with Spain and Italy recovering as their political situations stabilised whilst Germany was the worst developed market (because Auto stocks were hit by the threat of US sanctions).

In terms of economic news and monetary policy, Europe seems to be polarising that of the US. There was a raft of soft economic data – consumer figures were sluggish and although inflation reached 2% this is almost solely due to energy prices and core inflation fell to 1% where it has been for the past year. More encouragingly, PMI surveys did provide some optimism that we are not seeing a sustained downturn.

At the June meeting, the European Central Bank confirmed an end to the bond buying Quantitative Easing (QE) at the end of 2018 but stated that interest rates will remain unchanged for at least another year.

On a corporate level there was a significant disparity in sector performance. Less cyclical areas outperformed, with utilities, healthcare and consumer staples amongst the best performers; whilst financial and consumer stocks were the big underperformers.

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 month of two halves for the Japanese stockmarket. Having rallied strongly in the first half, it gave up all the gains and the Topix fell by -0.8%, compared to a flat return from the MSCI World index. A falling yen acted as a drag for UK investors and the index fell by 1.9% in sterling terms. 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, figures over the month proved broadly positive. Inflation rose to 0.7% above expectations of 0.3% and unemployment unexpectedly fell from 2.5% to 2.2%. This is the lowest level since 1992. Export growth was also better than expected, although retail sales disappointed.

The central Bank of Japan outlined that it will remain supportive, maintaining QE policies and the target for 0% yield on 10 year Japanese Government bonds. This weakened the yen which boosted stockmarket sentiment during the first half of the month. However, the second half of the month was dominated by concerns over the potential for Trump sanctions which hit exporters.

The overall effect was that global cyclical areas of the market finished up underperforming; whilst, in line with most global markets, the energy sector and defensive areas such as healthcare and consumer staples were the best performers.

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 central bank is likely to continue quantitative and qualitative monetary easing and 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

June proved to be a difficult month for Asian and Emerging Market indices with most major indices ending the month in positive territory, in local currency terms. Trade concerns weighed on Asian and Emerging Market equities. The conclusion of this scuffle is hard to predict but the longer this drags on the greater the risk that it will start to impact sentiment more broadly. As expected, China has been hit particularly hard.

In addition to trade concerns, the most vulnerable of the Emerging Markets, with large current account deficits, such as Turkey and Argentina, have come under significant pressure with sharp currency and equity market falls. Further US interest rate rises or dollar strength could put additional pressure on these most vulnerable economies. However, the market has shown some ability to distinguish between the weak and the strong, with Indian equities up over the quarter.

Hence, it was another month where there was a marked divergence amongst the markets. Chinese equities were one of the worst performers due to concerns over the trade war; however, India was marginally positive.

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

Overall fundamentals across Asian 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 showed mixed signals in June as the negative effect of inflationary fears were offset by the political noise and increased the desirability for 'safe haven' investments.

In the United States, despite the strong economic data and an interest rate rise of 0.25%, US treasuries proved resilient; whilst European and Japanese central bankers signalled that they would maintain an accommodative stance.

So 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.

Our exposure ranges from defensive investment grade corporate bond funds and strategic bond exposure right up to financial bonds, and Emerging Market Debt where we believe 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 and 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 proved to be a timely test for our alternatives exposure, and the Absolute Return funds held 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.

Alternatives (Continued)

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. However, we have a preference for equity long/short strategies and we continue to be frustrated by the (lack of) performance from the popular multi-asset strategies.

Although it is important to be selective and have a strong understanding of long/short 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 2.7%. News that OPEC will increase production by less than the pre-meeting market expectations led to a rebound in prices.

Despite it being a broadly risk-off month Gold was volatile over the month, ending up down 3.7%. 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. We do not have direct exposure to commodities elsewhere within our portfolios, although mining and energy will feature within UK and overseas equity exposure.

Cash

UK inflation remained at 2.4% in June as measured by the CPI. Although UK inflation may fall further over the coming months (as stronger sterling reduces the 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, July 2018

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