Whitechurch Asset Views
Award Winning Wealth Managers

Whitechurch Securities Ltd
WEALTH MANAGERS

Monthly Round Up - October 2018

Strategic Overview
Turning Japanese

Below are the key factors that have influenced investment markets in recent weeks, followed by our current position.

Japanese stockmarkets were the strongest performers in September.
Investors were turning Japanese in September, with this market rallying strongly and the Nikkei benchmark reaching its highest level since 1991. With Asia and Emerging Markets remaining out of favour, the re-election of Prime Minister Abe and a weakening yen acted as a catalyst for global investors to increase Japanese exposure and the market rallied 5%.

Best and worst fund performance
Looking at fund performance in September, the Japanese market rally meant the IA Japan was the best performing sector, returning 2.4% (a weakening yen was the reason for the sector lagging the market returns). But Japanese markets were the only equity fund sectors to make money. At the other end of the spectrum it was IA European Smaller Companies sector that was hit hardest (-2.7%) and IA North American Smaller Companies (-1.7%) saw a sell off following a strong summer.

Mixed sentiment across the globe
Away from Japan there was little momentum. Other developed markets showed little progress and Asia and Emerging Markets continued to suffer outflows with geopolitical issues and trade war concerns weighing on investor sentiment. The MSCI World Index increased by 0.7%.

Stockmarket volatility in September measured by the VIX index was very subdued. The VIX finished the month at below 12 and was below 15 all month. There was more turbulence in Asia and Emerging Markets with volatility particularly high in India.

UK blue chips show signs of recovery
The UK stockmarket had a more positive month, although it was primarily driven by miners and oil stocks due to the rising oil price and increased Chinese economic activity. Blue chip overseas earners continued to be favoured over more domestically focused mid & small cap stocks as concerns of a no deal Brexit rumbled on.

Currency diversification dragged on performance
Although holding a basket of currencies has been positive for UK investors this year, September provided a reminder of the risks of holding overseas investments when sterling strengthens. Although the movements muted, the overall currency effect saw the 0.7% return from the MSCI World Index over the month diluted to a gain of 0.2% for UK investors. Whilst we extol the virtues of holding well-diversified international exposure, given the political uncertainty that threatens the domestic economy, a softer Brexit outcome could see a meaningful rally in the pound that would hit UK investors overseas holdings.

A tricky month for bond investors
Defensive government bonds and investment grade bonds saw a sell-off in September. Strong US economic data over the month saw investors grow increasingly concerned over higher global interest rates. Emerging Market Bonds bucked the trend, and saw a modest recovery over the month and the buoyant US economy meant that High Yield bonds were favoured. High yield bonds are one of the few fixed income areas to have generated positive returns this year.

The best of the rest
Commercial Property had a steady month and is proving a good bedrock within our cautious and balanced portfolios. 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.

Looking ahead
Going forward we still believe that interest rate policies at home and overseas will be key drivers of asset prices. 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 outside of the United States.

As a result of low interest rates our strategic view remains focused on the belief that there is value to be had in several areas of global stockmarkets, compared to the miserly return that is provided by holding money in cash, with a number of areas offering long-term growth prospects and more attractive income.

Risks posed by political uncertainty will be managed through diversification (not second guessing unpredictable events). We believe that 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 long-term perspective.

Our investment focus remains upon generating attractive risk adjusted returns (the amount of return we can generate based upon the level of risk being taken) on a rolling three-year period. It is on these measures that Whitechurch has earned a wide number of industry awards in recent years.

On the following pages we provide a more detailed review of the markets and touch on how we are positioning our portfolios.

UK Equities

UK stockmarkets were mixed over the month. Blue chip stocks were favoured but medium and smaller company benchmarks were in negative territory.

Mining and Oils were the standout performers over the month as the oil price rose whilst there was evidence that China was stimulating the economy helping miners. Banks were sluggish over the month whilst stocks focused towards the domestic economy were mixed.

In terms of economic data, figures remained reasonably positive, with the economy rebounding from weakness early in the year. Average wage rises came in at just below 3% whilst sales growth indicated that consumer confidence is reasonably strong. Rising oil prices contributed to inflation hitting 2.7%, the highest level for six months.

Brexit concerns are naturally at the forefront of UK investors' minds. Like many investors, we learnt lessons from the Brexit referendum of the risks of positioning a portfolio based on probability only to see an unexpected result materialise! Our positioning will be more balanced going forward given the huge uncertainty surrounding the Brexit negotiations.

Despite the political uncertainty creating negative sentiment we remain sanguine on our view of UK equities. Although we expect to see the noise increase over Brexit in the coming months our belief is that UK shares with high overseas earnings benefit from a weaker pound and those with more of a domestic focus are deeply unloved and undervalued by investors, thus representing a contrarian opportunity. Furthermore, we expect a lower for longer rate environment to continue which is supportive for dividend producing shares and with the UK stockmarket yielding close to 4% this is a very attractive feature.

US Equities

September saw more muted returns for the US stockmarket but it still finished in positive territory, resulting in the best quarterly performance since 2013. Positive US economic and corporate news has been the key investment theme driving stockmarkets over the summer of 2018. US investors continued to shake off concerns over rising interest rates, and the escalating trade war, and remain focused on the strong domestic economic data.

The S&P 500 was up 0.5% but the small cap focused Russell 2000 fell back by 2.4% as there were signs of profit taking. Returns for UK investors were diluted by a modest recovery in the value of the pound.

There were continued strong economic data releases but the strong economic growth saw the Federal Reserve increase US interest rates from 2% to 2.25%. The Federal Reserve has also signalled that there will be one further rate rise this year and three further rises in 2019.

Because he is so divisive, it is hard to take / get an objective view of Trump's policies. The forthcoming Mid-term elections will provide a useful bell-weather on how he is being viewed by the electorate. However, with US growth remaining very strong, it is reasonable to expect a showing for Trump based on the Clinton quote "It's the economy stupid".

Fundamentally, although a relatively cautious view of the US stockmarket has been a drag on performance year to date, our favour for US smaller companies has been a major positive. On valuation terms our preference for other developed markets versus the US remains intact, but Trump's growth stimulus policies could see one final leg of the US bull market. 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 remain cautious on the wider US market.

European Equities

European stockmarket benchmarks showed little change in September. The benchmark index fell by -0.1% in local currency terms and modest weakening of the euro against the pound translated this to -0.5% in sterling. Although stockmarket momentum was broadly positive for much of the month, trade wars and concerns over the Italian budget held markets back.

In economic news there has been a significant weakening in manufacturing exports and consumer confidence has also continued to fall (particularly in France). At the same time inflation has picked up (from 2% to 2.1% over the month). Whilst increasing fuel prices are a key driver, wage growth was also a contributor and ECB Governor Draghi sounded a warning over this, which pushed up bond yields.

On a corporate level, it was a reversal of the August performance with value areas such as Financials, Real Estate and Energy outperforming whilst Consumer Staples and IT underperformed.

European markets have lagged wider developed markets year to date and our reduction in European exposure has been prudent. The strong recovery of 2017 has been losing momentum this year. 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 likely to remain in place for some time.

Japanese Equities

September was a very strong month for the Japanese stockmarkets and the benchmark Topix index increased by 5.5%. Although a weaker yen versus the pound diluted the returns to an index gain of 2.7% in sterling terms.

The renewed impetus to invest in Japan, seems to have been driven by a TINA syndrome. (There Is No Alternative). US equities were less sought after and Asia and Emerging Markets remain out of favour. According to a Nikkei report international investors committed close to $13 billion to Japanese equities in the third week in September (the highest level for four years).
The re-election of Shinzo Abe for a third term also provided a catalyst for more positive sentiment over Japanese equities. A weakening yen (it hit the lowest level versus the dollar for 11 months) boosted demand for exporters whilst a summit at the end of the month saw Japan and US agree to start negotiating on trade agreements.

There was no significant economic news-flow, although the job market remains very tight with the highest jobs to applicant ratio since the 1970's.

With less political tension to unnerve investors than other regions, valuations are also making the Japanese market appear relatively attractive compared with other Developed Markets.

Asia Pacific & Emerging Market Equities

September proved another difficult month for Asia and Emerging Market indices which continued to lag Developed Markets. The MSCI Emerging Markets and MSCI Asia Pacific Ex Japan Indices fell by 1.2% and 1.4% respectively. However, there was a significant divergence.

The commodity rich Russia and Brazil recovered some of their recent losses but all other main Emerging Market bourses were in negative territory,

The slowdown in China that has hampered Emerging Market performance over the quarter continued to have its effects in September and those economies that are most reliant on external funding are finding the tightening in US monetary policy challenging.

With the exception of a few oil rich economies the higher oil prices are not helpful for markets that are large oil importers, particularly those whose currencies have fallen sharply, further increasing the cost of imports in local currency terms. The tightening in interest rates that some economies have been forced into, to defend their currencies and control inflation, will prove a drag on growth.

Of most note, was the heavy fall in the Indian stockmarket and the rupee in September. It has been a wretched few weeks for India as it has suffered from the headwinds of rising oil prices, a strong dollar, weakening growth and political uncertainty. UK investors in India funds will have seen falls in excess of 10% over the past month.

Valuations have been driven down by the sell off and given that there is scope for earnings recovery across many Asia and Emerging Markets they are beginning to look relatively attractive. But, with such negative momentum, if feels like catching a falling knife at present.

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. Furthermore, if we see a continuance in the recent rally in the dollar this will prove to be a headwind for many of these markets. However, long-term fundamentals across Asia and Emerging Markets still look attractive with structural reforms, better corporate governance, greater consumerism and cheaper valuations provide good opportunities for investors seeking long-term growth who can except the high volatility.

Fixed Interest

Fixed interest markets were mixed during September. Traditional defensive Government bonds and investment grade bonds saw a sell off (The IA Gilt sector fell back 1.4% which is close to a years' yield on a ten year gilt) as concerns over inflation re-emerged. Strong US economic data over the month and more hawkish comments from the Federal Reserve saw investors grow increasingly concerned over US interest rates. Our favoured US government bond position fell back over the month due to interest rate concerns and a weakening dollar.

However, higher risk areas of bond markets bucked the trend. Emerging Market bonds saw a modest recovery over the month. We no longer own direct emerging market debt exposure (due to a loss of conviction / elevated level of risk coming from the asset class). The buoyant US economy meant that High Yield bonds were favoured in America. As a result the IA £ High Yield sector was the best performing area of bond markets and returned +0.3%.

Whilst the bond market's realisation that we are in a monetary tightening phase has led to volatility, we believe it is going to be a slow process with central banks telegraphing their intentions to markets along the way. This approach by the central banks leads us to believe that there will be no collapse in bond prices but returns will be muted.

Within our fixed income basket, the bulk of our exposure is in global mandates – hedged back to sterling. Overall, we have constructed a basket of complementary and diverse bond funds for the cautious and balanced income orientated portfolios. We will continue to avoid UK Government bonds (in favour of US Government bonds). We continue to favour our fixed interest exposure in corporate bonds and less interest rate sensitive areas of bond markets.

Commercial Property

Our holdings in direct UK commercial property funds continued to provide modest positive returns over the month. The IA UK Direct Property sector increased by 0.2%. On a 12 month view, property returns have significantly outperformed fixed income.

During the month, the FCA provided guidance on their consultation on: "proposals to reduce the potential for harm to retail investors in funds that hold illiquid assets, particularly under stressed market conditions". The consultation does not close until January 2019, so nothing is certain yet but it will be key to monitor findings when assessing holding open ended property funds.

Commercial Property forms a core source of income within our cautious and balanced portfolios. We have stuck with our favoured three of F&C, Henderson and Kames. 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. It is also pleasing to see modest net inflows returning to our favoured funds.

Alternatives

What we are looking for within alternative assets is the ability to provide a portfolio with greater diversification than simply holding traditional asset classes, whilst generating attractive risk adjusted returns.

Absolute return mandates have attracted large amounts of money as investors have become increasingly nervous of the potential returns from equity and bond markets. However, there can be little argument that a large number of these mandates have frequently disappointed and the managers have failed to add value in a variety of environments.

We have been reducing exposure to the large multi-asset absolute return mandates, where we have lost conviction. Our favour is shifting towards dedicated long/short specialists and looking at niche sector alternatives. We are also considering genuine long only alternatives that invest in physical assets (such as infrastructure and niche property).

Commodities

Oil enjoyed a strong performance during September which benefited exporting countries. The oil price closed the month up 9%. Issues surrounding Iran and Venezuela all added to the price rise with concerns around sanctions on Iran increasing and the view that Venezuela is becoming a failing state.

The threat of higher oil prices, which many are forecasting (guessing!) will hit the $100 a barrel mark, will hamper those economies that don't have the ability to benefit from domestic production and could be a headwind for global growth.

Gold started the month around $1200 per ounce and traded in a tight range until rates were increased in the US when it dropped to $1182. With further US interest rate rises expected, it is hard to see where the catalyst will be for a sustained period of upside for gold. That being said, a watchful eye should be kept on any further signs of distress in Emerging Markets that could lead to a hunt for safe havens.

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 increased to 2.7% in August as measured by the Consumer Price Index (CPI) helping to vindicate the recent increase in interest rates by the Bank of England. With high commodity prices and a weak sterling it is hard to see inflation falling in the near future. Despite the recent 0.25% interest rate rise the best instant access Cash ISA deals are still offering around 1.3% it remains likely that a Cash ISA will provide a negative return in 2018.

For investors taking a medium to long term view we continue to believe that there are more attractive opportunities across other asset classes to beat cash. We are not going to see UK interest rates reverting to their long-term average for a long time. 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.

But it is a different story in the United States on the current trajectory of interest rate rises, bank deposits may yield 3-3.5% in 12 months' time. Higher cash rates could have significant ramifications for financial markets as bank deposits become more appealing – food for thought!

Whitechurch Investment Team, October 2018

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