

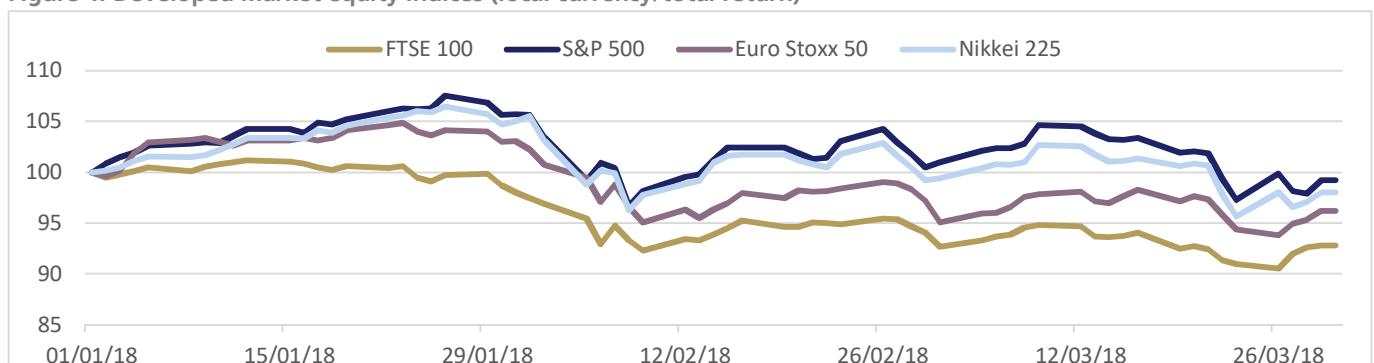


### Macro summary

The year started with a continuation of the positive equity markets of the previous year. This was supported by strong economic data and growing company earnings. In the US, rates were expected to continue to rise but past rate rises had been managed without impacting markets. President Trump's tax reforms looked as if they would give a further boost to the economy. In short, all looked well in the world. Then in late January, markets started to decline. The sell-off was made worse by technical factors around volatility and by computer generated trades. After this initial move down, markets recovered, only to sell off again. In a sense the initial fall came from an excess of good news in the US. It was feared that tight labour markets would lead to higher wages and feed through to inflation. The tax cuts and potential increased spending would add stimulus to an already strong economy. As a result, fears built up that the US Federal Reserve would be raising interest rates faster than had been expected. With the Bank of England (BoE) and the European Central Bank (ECB) also looking to decrease the stimulus measures they had been applying, it looked like there were going to be tighter monetary conditions than had been expected. The company earnings season generally exceeded expectations, helping the markets recover some of the losses, led largely by the US tech stocks. However Trump's announcement of trade tariffs on steel and aluminium sparked fears of a trade war. This was not helped by the removal of some of the more pro-trade members of his Cabinet. Subsequent exemptions for many countries did little to improve the situation as Trump went for further tariffs specifically addressed at China. The threat of reciprocal action from China was detailed after the end of the quarter. Sentiment was dented further by the Facebook scandal and Trump's attacks on the tech sector.

The UK Brexit negotiations, which had moved to phase two at the end of last year, progressed again with agreement on many issues and a timetable for transition. There was an attempt from both sides to present the progress made in a positive light. However many of the most difficult issues, such as the Irish border, remain to be resolved. With some progress made and the BoE looking to raise rates again, the pound strengthened particularly against the US dollar. The strength of sterling weighs on overseas earnings of UK listed companies and the FTSE 100 index fell more than other developed markets (Fig. 1). In Europe, Mrs Merkel finally managed to form a government six months after the German election. In Italy the anti-establishment Five Star movement did well in the election but with no overall majority, forming a government will be as difficult as we expected before the election. In France, President Macron is struggling with the unions to push through his reform agenda. So, politics in Europe is difficult but the European economy has been expanding and unemployment falling which should be positive going forward.

Figure 1: Developed market equity indices (local currency/total return)



Source: London Stock Exchange/Standard & Poor's/ Stoxx/Tokyo Stock Exchange

As we look out into the rest of the year, Trump's protectionist policies and their impact on global trade are the greatest unknown. His advisors have indicated that they are pursuing trade deals and this may all turn out to be a negotiating stance. A global trade war is in no one's interests and the pressure will be on all parties to resolve their differences. We should remember that the economic background and corporate earnings growth remains broadly positive. While interest rates in the US and the UK have been moving up, this is a slow process. The BoE suggested that any changes will be "at a gradual pace and to a limited extent". Trade wars aside, this is a generally constructive background for equity markets. It is always difficult to be positive at times like this but with a price earnings ratio of 13 and dividend yield of 4.3% on the FTSE All-Share index at quarter-end, a lot of bad news appears to be priced in.

## Fixed Income

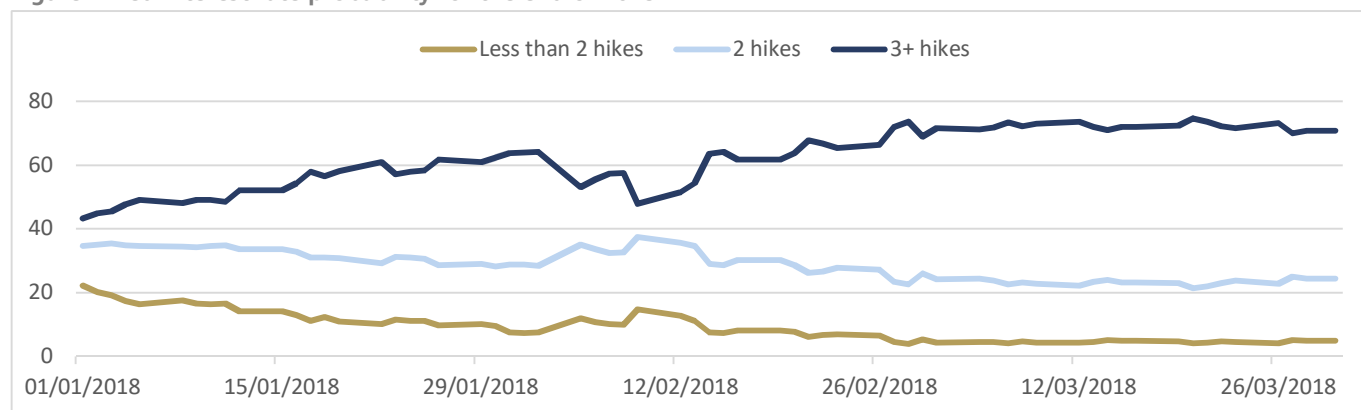
Last year was notable for the limited surprises in rate markets. Interest rate increases were broadly well flagged and therefore had little market impact. Global growth was on an upswing with solid momentum across most of the developed world. This enabled central bankers to "take their foot off the pedal," so to speak. The ECB continued to pare back its asset purchase program and the US Federal Reserve (Fed) announced that it would gradually start to reduce its balance sheet. Domestically, the BoE took back its post-Brexit emergency rate cut as the labour market continued to improve.

The tax reforms that Trump passed towards the end of the quarter marked a shift in this dynamic. The US economy at that time was already running near full capacity by an array of economic indicators. Introducing fiscal stimulus at this stage in a developed market economy is generally unheard of. While it can clearly boost growth in the interim, given that companies are incentivised to bring expenditure forward, these unfunded tax breaks raise the annual deficit to levels that would be considered dangerous for emerging market economies. The additional borrowing required to fund this will see US Treasury issuance rise substantially at a time when the Fed is stepping back from buying these assets. These pro-growth measures have also been factored into economic growth and inflation expectations by the Fed. This led several members to comment that additional tightening may be required in order to prevent the economy from overheating. The combination of looser fiscal and tighter monetary policy has pushed conventional US Treasury yields significantly higher with rising inflation expectations.

It was no surprise that the Fed raised interest rates at their March meeting by another quarter percent to the 1.50-1.75% range, given the broadly supportive economic conditions. However, their expectations of the path of future rate hikes showed a more aggressive policy tightening stance in the coming years (Fig. 2). This was the first meeting under the new Chairman, Jerome Powell, who was previously seen as the continuity candidate. However, the more hawkish tone from Fed members have given markets some pause for thought. On the other hand, the recent volatility driven by President Trump's erratic trade policy has brought into question whether the Fed will be able to proceed as planned should the situation escalate further. US treasuries are now caught between these two market forces, which in all likelihood means more volatility in bond markets going forward.

The Eurozone economic trend improved throughout last year which was aided by subsiding political risk. With a more stable growth outlook and declining unemployment, the ECB has indicated a greater degree of confidence to step away from asset purchases later this year. At their last meeting in March, they voted unanimously to remove the language indicating that bond purchases could increase by size or duration. The political environment has not seemed to unnerve European investors despite the recent Italian election handing more support to the populist parties who are currently in

**Figure 2: Fed interest rate probability for the end of 2018**



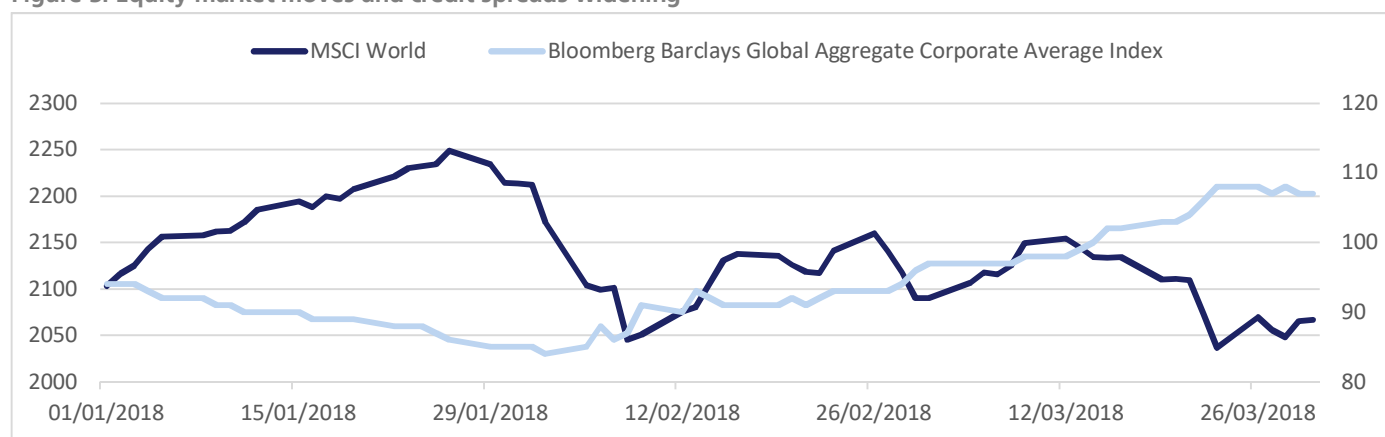
Source: Chicago Board of Trade/Bloomberg

negotiations to form the next government. The limited volatility in peripheral sovereign bond markets highlights the change in investor comfort with Eurozone assets. Although the ECB has grown in confidence, it still remains some way away from meeting its close to 2% inflation target as core inflation has remained around 1%, with the euro strength exerting some downward price pressure.

Even though there was a lack of clarity at the start of the quarter on Brexit, the BoE stepped up its hawkish rhetoric in January as the tight labour market increased their confidence that wage pressures would continue to increase. This led the futures market to price in a rate hike at their May meeting. This quarter saw a lot of contentious comments come out from both sides during the Brexit negotiations, especially surrounding the Irish border. However negotiators managed to work past the rhetoric and saw the need for a transitional agreement. This will run until the end of 2020, which the UK government hope will give businesses some much needed clarity. Whilst labour market conditions are firm, the rest of the economy continues to run at a somewhat sluggish pace. This affirms the gradual and limited approach for future rate hikes that the BoE has guided to the market.

Corporate debt has, in the past year, been generally well insulated from market volatility given the ongoing asset purchases by the ECB and expectations of low default rates. The ECB reduced the overall asset purchases from the start of this year to €30bn from €60bn. Looking at the composition of these purchases, it is clear that they have favoured to reduce sovereign bond purchases while keeping the absolute level of corporate bond purchases. Credit markets were not immune from the bouts of volatility that affected risk assets. Spreads have widened across the board but this has generally been a gradual widening than large shocks (Fig. 3). With low default rates outside the retail sector, the overall health of the credit markets remains pretty favourable for now. However, the continuing rise in US labor rates may put pressure on interest cover ratios and refinancing rates over the coming months, contributing to a slightly less constructive tone in corporate bond markets.

**Figure 3: Equity market moves and credit spreads widening**



Source: MSCI/Bloomberg Barclays

## Equities

### UK Equities

Since the start of 2018, and in local currency terms, the UK has been one of the worst performing developed equity markets. There are three main reasons for the selloff seen since the start of the year.

The first is the upwards move in the pound against the dollar. This has weighed on the earnings potential of the market (a reflection of the fact that over 70% of FTSE 100 earnings are generated outside of the UK), and the dividend outlook for large dividend payers like Shell and HSBC that actually report in dollars.

The second reason is politics and more specifically, widespread concerns that infighting within the Tory party could usher in a vote of no confidence, a new General Election and a Labour Victory. The UK stock market has fared reasonably well under previous Labour governments but investors are wary of Mr Corbyn's nationalisation and tax promises. Nationalisation (and other additional forms of Government spending) is feared because it could lead to a sharp upwards move in gilt yields. This would undermine current equity valuations because the present value of future earnings from

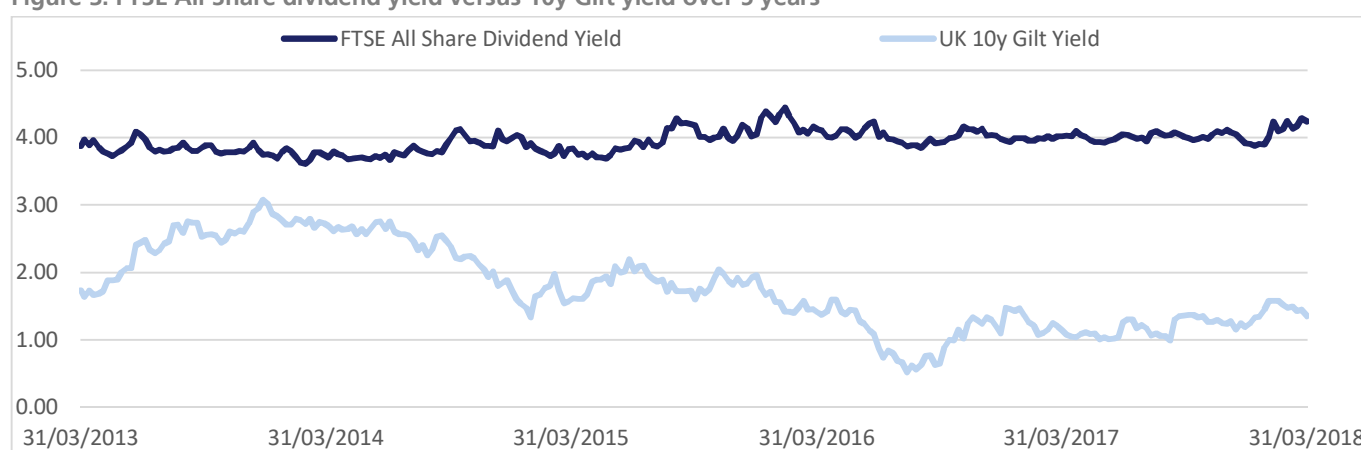
equities would be reduced if a higher discount rate were applied. Higher taxes are a separate concern because they could lead to an exodus of talent and lower profits. These political fears have faded somewhat of late, as Conservatives have started to fare better in opinion polls.

The third reason for the selloff seen since the start of the year is a concern that the UK market contains very few global companies with better than average growth prospects, and almost no Amazon and Netflix style success stories that are capable of shaping our tomorrows. This last point has been an ongoing source of concern but there are other positive factors that are starting to come into play.

For example, there is a recognition that the domestic UK economy has held up well. The BoE concluded recently - on the basis of interviews conducted with at least 700 businesses between late December and February - that UK manufacturers are planning to step up investment. Good growth in exports has tightened capacity, but the pickup in investment intentions also reflect improved profit margins. The UK consumer remains the biggest influence on the economy, of course, and despite suggestions to the contrary, the outlook has begun to improve. Employment in the UK is currently at a record high of 32.2m while unemployment, at 4.3%, is at its lowest rate since 1975. The BoE is keeping a careful eye of the outlook for inflation, and it is already outlining some increases in interest rates. With the latest wage data showing growth in regular pay of 2.6%, the spending power of the average UK consumer should continue to fuel consumption – the traditional motor of the UK economy.

More importantly perhaps, we are also aware that the selloff in the market is beginning to attract bargain hunters. The fall in the FTSE All Share index since the start of the year means that the UK market has de-rated sharply. The dividend yield now sits close to a 20-year high and the gap between the dividend yield and the yield on the UK's benchmark Government bond is near levels only seen during periods of significant stress.

**Figure 3: FTSE All Share dividend yield versus 10y Gilt yield over 5 years**



Source: London Stock Exchange/Factset/Bloomberg

There is a heavy 'cyclical' element to UK dividends, which is no surprise given that Royal Dutch Shell in its own right accounts for more than 11% of the index. However, currently there is an interesting disconnect between falling share prices and dividends which have held up well. The longer-term potential of the UK stock market may not be as good as that of other leading markets, but the recent selloff does appear to have presented investors with a good buying opportunity.

## International Equities

The quarter saw the first pause in equity markets for some time. Whilst the MSCI World index was down nearly 2% in dollars and closed near its low for the period, this belies the fact that earlier in the year the index was up as much as 7%. In the US, the S&P 500 fell 1% for its first fall in ten quarters dating back to Q3 2015. The previous move upwards was fuelled by an excellent reporting season, whereby S&P 500 sales rose 6% and earnings per share 11% in 2017, with growth accelerating through the course of the year in the US.

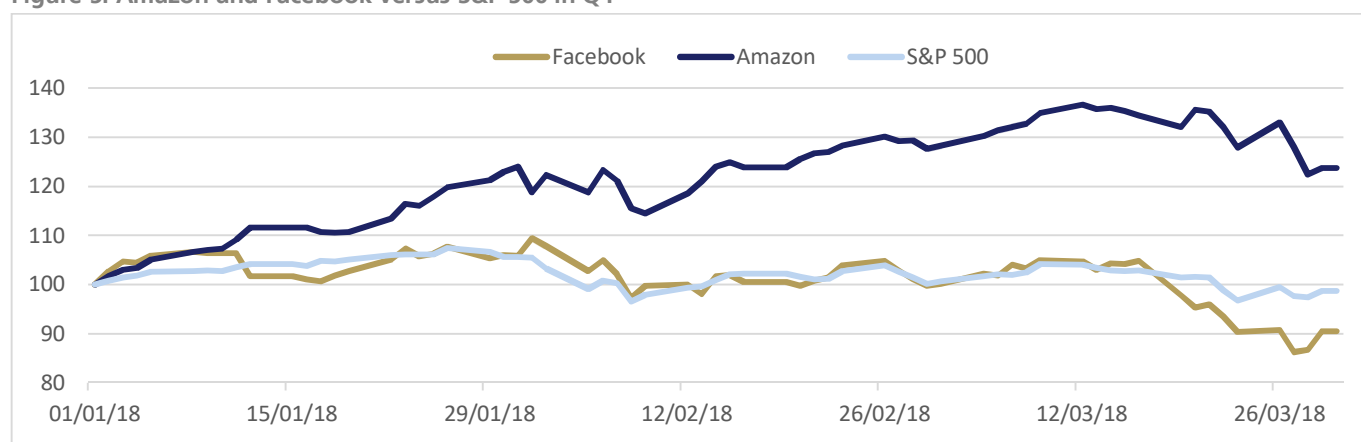
This was quickly forgotten, however, as President Trump followed through on one of his campaign pledges and erected tariffs on US steel and aluminium imports. While markets collectively breathed a sigh of relief as their breadth was lessened with carve outs for partners in Canada and Europe, this didn't last long. Trump subsequently initiated a wide

range of tariffs on Chinese imports and referred the country to the World Trade Organisation for intellectual property theft. China then targeted US food imports, but the net result was a swooning in equity markets on the realisation that a trade war looks to be a threat for the first time in a long while.

By contrast, the technology-heavy US Nasdaq index rose 3% during the quarter, though not without a similar drawdown and with a much more mixed intra-sector performance than has been seen for some time. Alphabet (the parent company of Google) was down a little, Apple was flat and Facebook fell 9%. The latter made headlines all over the world as it became clear it had allowed a significant breach of users' data to happen. To worsen matters, management did not appear to have either taken it especially seriously at the time, or notified the authorities. As Facebook's unique selling point to advertisers is the precision and impact of advertising on its platform given quite how much it knows about users, investors rightly worried what the furore might do for the goose and its golden egg.

The US consumer discretionary sector rose 3% in Q4 2017 but this was really all about Amazon, which rose an astonishing 24% in just one quarter, adding over \$100bn to its market capitalisation. At the time of writing, though, the stock has given back half of these gains as President Trump daily admonishes the company for not paying taxes, allegedly fleecing the United States Postal Service in its delivery contract and causing the demise of the all-American shopping mall.

**Figure 5: Amazon and Facebook versus S&P 500 in Q1**



Source: Standard & Poor's/Bloomberg

The staples sector offered no respite either as US and global tobacco stocks were hit by the regulator suggesting tighter regulation of nicotine. Investors also worried over both the impact of Amazon on branded food and household products and whether the margin improvement from cutting costs to the bone through 'zero-based budgeting' has run its course.

The MSCI World Europe followed the US down in falling 3% with no Amazon in the credits column and plenty of exporters to the US likely to get caught in the crossfire of a US-China trade war. The German Dax index fell 4% as luxury cars appeared an easy target and the Topix index in Japan was broadly flat. The only large move by a major emerging market was in Brazil where the Bovespa index rose 10% as the country managed to avoid the sort of negative headlines seen throughout 2017.

## Alternative Investments

### Hedge Funds/Targeted Absolute Return

Targeted Absolute Return funds performed relatively well compared to equity markets in the first quarter of 2018, with many offering some downside protection once volatility resurfaced in February and March. We were not invested in inverse volatility products like VelocityShares Daily Inverse VIX Short-term fund which lost 90% of its value during the few days in early February when volatility spiked up. The increase in volatility itself resulted from the markets assuming that the pace of interest rate rises by the Federal Reserve will be higher than market expectations. As volatility remained low for the last two years, income-seeking investors piled into these products. We shied away from these strategies because we simply did not believe such low levels of volatility could persist and therefore our clients were not impacted when the inevitable happened.

The best performing strategies during the quarter were generally the "Equity Long / Short and Equity Market Neutral" strategies. When their stock selection worked well, both benefited from positions on the long and short side of their books. Interestingly, as markets pulled back we did not see the style/sector rotation experienced in the last few years, suggesting that some of the excess of liquidity that has distorted markets through the quantitative easing years may have started to ebb. Another strategy we continue to support is "Event Driven" which has benefitted from increased corporate activity. Political uncertainty is always a risk factor in this strategy, as we saw recently when the US administration intervened in one of the largest mergers between Qualcomm and Broadcom. Consequently, we continue to favour an active approach executed by a very experienced management team. Pleasingly, the new increased volatility / rising interest rate environment is offering opportunity for fundamental macro managers who have had lacklustre performance during the years of forward guidance and low volatility, with most having a good quarter. Conversely, systematic trend following funds were slightly down across the quarter, typically making money in January but then selling off in February as trends reversed sharply. The weakest absolute return strategy this quarter was, understandably, the multi-asset absolute return funds. The fall in equity markets, coupled with flat bonds' performance and increased correlation between bonds and equities presented a challenging environment for these funds.

Looking ahead, we have not changed our preferences within the absolute return sector, favouring "Equity Long/Short" and "Event Driven" strategies that can come to their own in an environment of increased volatility. From a portfolio construction standpoint, the diversification offered by these strategies is valuable when traditional asset classes (bonds and equities) become challenged by the dual headwinds of high valuations and changing technicals. In this environment, we may not need a lot of disappointment to re-rate further. Therefore, we believe that the search for diversified sources of return within portfolios might be more pertinent than for some time.

## **Property/Infrastructure**

As bond yields moved higher over the quarter, the discount rate used in pricing of real estate assets rose and therefore we saw weakness in returns. Of particular note was infrastructure, which having seen strong returns of over 15% annualised over the last 5 years (to December 2017), reversed strongly in January on the back of rate rise expectations. Although listed real estate was down during the quarter, it was marginally better than the fall in infrastructure.

Property will continue to have headwinds in the coming quarter. The falls in value have not yet retrenched sufficiently to create an attractive entry point in our view, although as always with this asset class each sub-set has to be judged on its own unique merits. That said, unlike the pre-2008 period, the sector does not feel over heated in a way that makes us fear a whole scale panic. UK residential property remains challenged, and mortgage approvals trended down during the quarter, reflecting the well-reported stagnation of real incomes. However, the government remains committed to home ownership and addressing the housing shortfall. As most UK mortgages are based upon short-term rates, the rises we see in borrowing costs feed through quickly but despite this, the ongoing supply shortfall means that we feel a pause is more likely than a major market correction.

With one year to go, the UK appears to have achieved a workable transition agreement with the European Union, meaning the fear of a 'no deal' Brexit cliff edge has abated for now. There is better clarity for businesses, which may ease some of the uncertainty that has held back investment since the Brexit vote. The immediate frenzy of foreign buyers of UK commercial real estate attracted by the fall in sterling has subsided and the market has now found a quasi-equilibrium price level. We continue to be cautious, as whilst some discount opportunities might have been created during this period, one needs to be extremely selective.

The biggest risk in the coming quarter for both property and infrastructure is going to be the direction of rates. We believe that market jitters around the future path of normalisation that surfaced in the first quarter of 2018 may well continue for some time yet.

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