Q4 2017: Quarterly report

January 2018

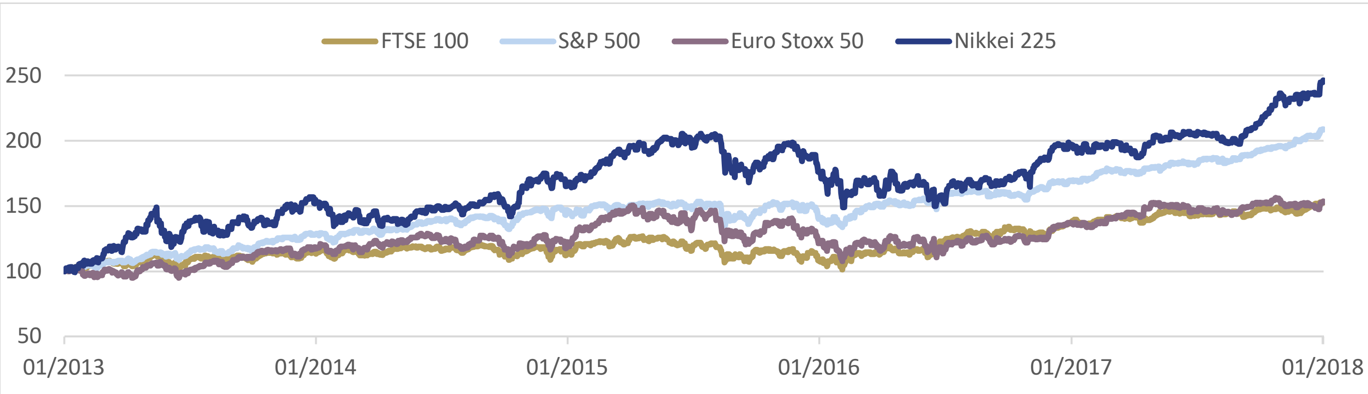
Macro summary

Equity markets across the world ended the quarter at or close to all-time highs. This came as earnings and economic data remained firm and in spite of interest rate rises in the UK and US. Regardless of the high levels of markets, we enter the New Year expecting much the same as last year.

The Bank of England (BoE) raised rates for the first time in 10 years but is only expected to make one further move per year over the next two years. Economic data and company earnings have remained positive for the most part but inflation is stubbornly below target across most global economies. The exception is the UK where the post Brexit vote devaluation has pushed inflation higher. Brexit aside, many technological changes, together with more global supply chains and ageing populations in developed markets are likely to constrain inflation for some time to come. On the other side, low unemployment may put some upward pressure on wages. The oil price has also recovered from its lows as production cuts by the Organisation of the Petroleum Exporting Countries (OPEC) continue to hold. Inflation expectations priced into the index-linked bond market have been low and may move higher but we do not see inflation being a problem over the longer term. Interest rates have risen in the US but in a controlled fashion without the major bond market collapse that some commentators had predicted. The next stage is the gradual shrinking of the Federal Reserve's balance sheet, which will go on for a long time to come. It came as a relief to markets that Trump's nominee to replace Janet Yellen as Chairman of the Federal Reserve was seen as a continuity candidate.

Brexit negotiations have moved to phase two with the current tone seeming more like the so-called 'soft Brexit'. Many within Mrs. May’s party are not going to be happy with continuing to follow EU rules. It remains hard to see the shape of a final deal and negotiations are likely to go to the last possible minute before a deal is struck. The swings in expectations are most likely to be felt in foreign exchange markets. A 'hard Brexit' could lead to a weaker UK economy and a lower pound but this would be positive for the FTSE 100 index where most of the earnings come from overseas. In 2017, the pound rallied against the US dollar but the strength of global economies and earnings growth outweighed the drag of a positive currency (Fig. 1).

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



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

On the European election front, Mrs. Merkel lost ground and has been struggling to form a coalition. In Japan, Prime Minister Abe called an election and fared much better. Following this, the Japanese equity market performed strongly and we can look forward to more progress on the reform programme in the year to come. In the New Year, we will have an election in Italy where the anti-EU Five Star Movement has been a threat to the older establishment.

Trump had promised much and tweeted more but little was delivered until close to the end of the year. At year-end however, he finally got his tax reform package passed, representing his first major success in Congress. This is largely positive for US companies and may add around 10% to earnings next year. The theory is that tax cuts will trickle down into more investment in the economy, better growth and in the end, higher tax receipts. If this just increases the return to shareholders however, it may prove good for Wall Street but less so for Main Street. US borrowing in the short term is likely to be higher and negotiations over the debt ceiling have just been deferred. Following the Alabama by-election for the Senate, the Republican majority was cut to only one seat, which will mean that progress on his other policies may be hard to come by. Mid-term elections in November are likely to make it even harder to agree new legislation as we get to the end of 2018.

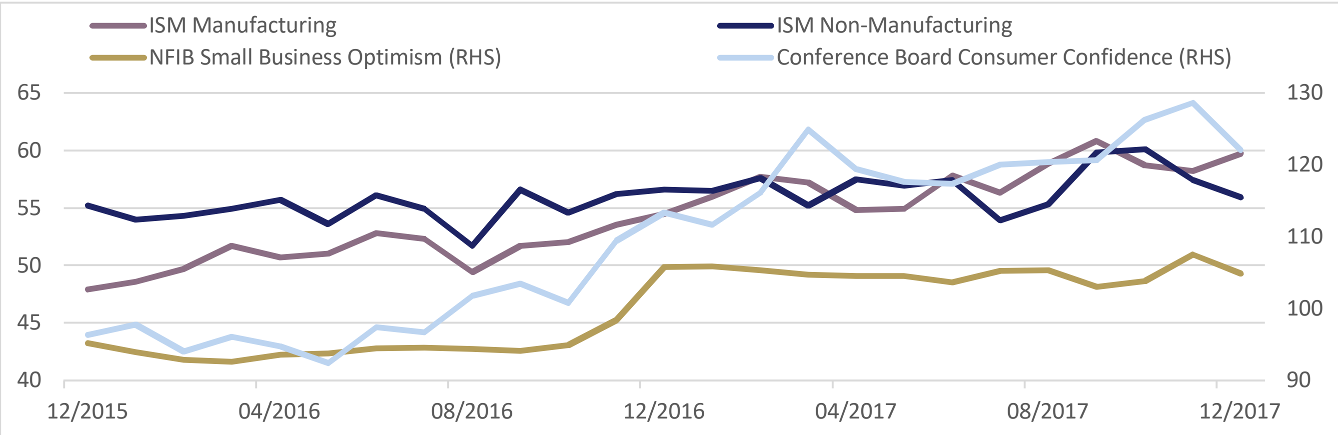
It should be noted that while volatility measures were low last year, at times dispersion within markets has been high. We therefore favour a selective approach to equity markets going forward. We expect conditions to continue to be positive for equities in the year to come but after such a strong run, we would not be surprised to see periodic corrections in the bull market. As with last year, if we are able to look through the political noise and short-term volatility then we expect another positive year for our portfolios.

Fixed Income

If we take a look at the yields offered across the major ten-year bond benchmarks over the quarter, investors could easily assume that central bank activity has been muted. However, this quarter saw two major central banks hike interest rates and the European Central Bank (ECB) announce a reduction in asset purchases starting from 2018, all of which had a minimal effect on bond yields. This demonstrates just how skillful central banks have become at telegraphing the path of monetary policy in order not to stoke market unrest.

The US Federal Reserve (Fed) is the most advanced in reducing its accommodative monetary policy stance. At the end of the last quarter it confirmed that it would start reducing the size of its balance sheet by gradually cutting re-investments of maturing Treasuries and Mortgage-Backed Securities. This wind down takes a slow and steady approach with a long timeframe so it does not adversely affect market liquidity. On the economic data front, a broad array of indicators continued to show broad based strength in the economy (Fig. 2). This gave the Fed increased confidence to raise the benchmark rate by a further quarter of a percentage point in December.

Figure 2: US economic soft data

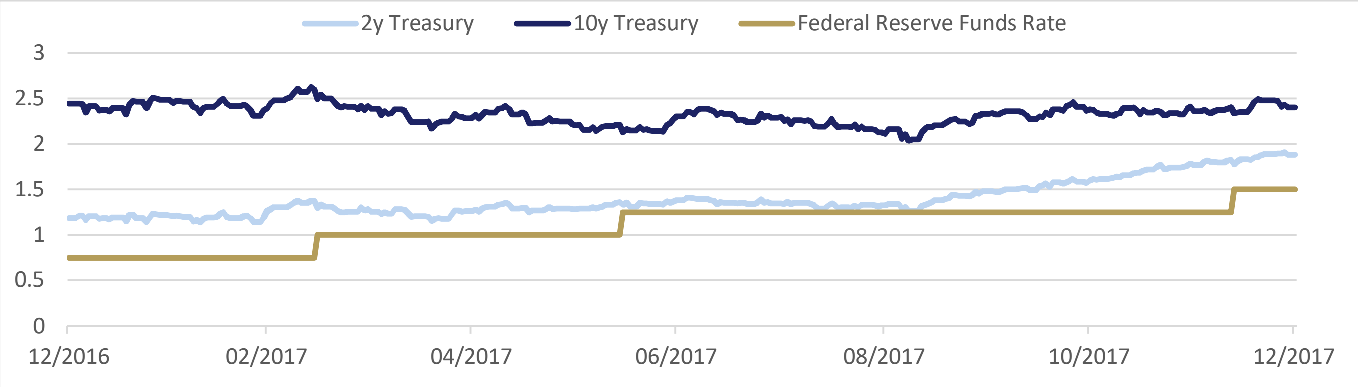


Source: Institute for Supply Management/National Federation of Independent Business/Conference Board

The US central bank is meeting its objectives on maximum employment with the current rate of unemployment below its longer-run normal range and moderate long-term interest rates but has faced challenges meeting its sustainable inflation target, like most of its developed market peers. While outgoing Fed chair Yellen has blamed some transitory factors for not meeting their 2% inflation target, there has been a bit more disagreement on whether one-offs are affecting inflation or whether it is something more persistent. Shorter maturity treasury yields have risen on the back of interest rate increases and expectations of further policy normalisation. Longer maturity treasury yields are unchanged to somewhat lower leading to a flatter yield curve (Fig. 3). It is currently at levels not seen since 2007 which has seen increased commentary on just how late stage this recovery cycle is.

The fate of the Fed chair was decided this quarter. There were fears that Trump would choose someone with more radical policies in mind but ultimately he decided to opt for Jerome Powell who is a Fed insider and is seen by many as the continuity candidate. During his testimony, he hinted that he would roll banking regulation back a little to encourage more lending. This, combined with the US tax reforms, could give the economy a boost that could warrant further interest rate hikes in 2018.

Figure 3: US bond yields against US interest rates



Source: Bloomberg/Federal Reserve

The other central bank that hiked interest rates was the Bank of England. Even though their economic forecasted growth ranges were historically wide, it was difficult for the central bank to ignore the strong employment data and above target inflation. This rate hike only unwinds the emergency rate cut that was undertaken following the decision to leave the European Union (EU). Despite raising the benchmark rate for first time in ten years, the language surrounding this policy tightening was dovish with Brexit clouding the outlook. The negotiations progressed over the quarter with the UK and the EU reaching an agreement on the so-called phase one of the discussions. Commencing divorce talks proved difficult given the contentious issue of the Irish border, particularly given the current coalition government. Considering the challenges of passing the initial hurdle, it is difficult at this stage to see just how the parties will reach a grand compromise, thus increasing the risk of a no-deal scenario.

In mainland Europe, things are looking up despite the regional dispute in the Spanish state of Catalonia. After the Spanish Federal Government misjudged the illegal local elections and clamped down too heavily, the fallout was significant but the tone has since been a bit more conciliatory. Growth has firmed up in the Euro Area and the unemployment rate has fallen below levels last seen in early 2009. The recovery has been broad based with manufacturing soft data reaching multi-year highs pushing GDP to 2.6% year over year at the end of the third quarter. Whilst growth and employment are at levels that would warrant policy tightening, inflation remains stubbornly low. Core inflation continues to hover around 1% which is still problematic for the ECB as their inflation target is close to the 2% level. In light of this, the ECB decided this quarter to extend asset purchases until October 2018 at a reduced pace of €30bn. On top of these additional purchases are the reinvestments of maturing bonds that the ECB currently holds. The defined path of monetary policy, combined with a fairly dovish message, continues to support European Government debt despite negative interest rates.

Credit continues to be well supported as negative interest rates, in tandem with ongoing central bank purchases, is pushing further investment in the space. Fundamentals are broadly supportive as global growth has firmed and commodity prices have been stable. These factors have reduced the compensation this asset class offers above the equivalent government debt, taking the spread close to the levels last seen during pre-crisis lows. The Republican tax deal reduces the tax breaks offered on companies that use a lot of debt so this may reduce supply in the coming year. However, at these levels of compensation, there is less of a safety net as investors have priced in most of the good news without accounting for some of the risks. We saw some event risk rear its head in the junk telecommunication sector over the quarter, which spawned a modest repricing of the asset class. Therefore, considering the current level of pricing, we see scope for increased volatility in corporate debt over the coming year as central banks look to gradually withdraw from the market at which point company fundamentals start to matter more.

Equities

UK Equities

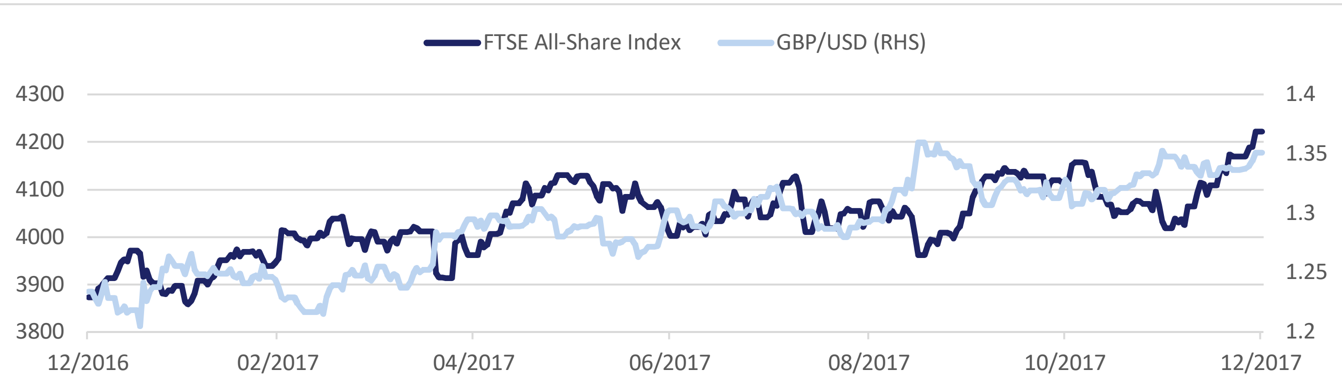
The last year will be remembered as a challenging, but rewarding year for UK equity investors. The FTSE All Share index was up 13.1% in total return terms and the FTSE 100 index of leading stocks hit a new all-time high. The index may not have outperformed other leading international indices such as the S&P 500 (which was up by 21.8% having delivered an unprecedented positive return in every month) but UK equities did manage to outperform UK corporate bonds and gilts. One of the reasons that all equity markets are doing well is that the global economy is experiencing a strong synchronised upswing. The pulse of economic activity can be gauged through a variety of different means, but Purchasing Manager surveys are widely followed and therefore it is worth noting that Markit's global manufacturing PMI (Purchasing Manager's Index) rose to a near seven-year high in December.

There is a widespread belief that the current economic expansion can last longer than previous expansions. The other main belief is inflation is unlikely to bubble up as furiously as it did in the past. As investors who have to assess potential rewards against potential risks, consideration does have to be given to the possibility that this "Goldilocks" view of growth becomes "too hot" rather than "too cold" over the course of 2018. Core inflation has begun to pick up in the UK. It is expected to moderate but we remain alert to the risk of inflationary pressures as economic slack diminishes further. UK equity valuations may not be particularly expensive when set against the price to earnings multiples that prevail in other leading markets, but all equity valuations are under-pinned by low bond yields. The prospects for further progress in the FTSE All-Share could easily be stymied if the bond markets adjust to a previously unimagined pickup in inflation.

We will be keeping a close eye on the oil price and associated geopolitical risk. This is mainly because the oil price is a key influence on the profitability of heavyweight UK stocks like Shell and BP, but also because commodity price rises could ripple through to renewed inflationary pressures. Our other major pre-occupation this year will be the pound and its movements against major currencies such as the US dollar and the euro. This is because around 70% of revenues for the FTSE 100 are derived from international markets. The ratio falls to 50% for the FTSE 250 index, but it should be clear that for the UK market as a whole the pound is a key influence on reported earnings (Fig. 4).

The pound appreciated modestly against the US dollar over the final few months of 2017 as investors warmed to the possibility of a 'soft Brexit'. The risk is that an associated re-assessment of the UK's future prospects could take the pound higher still. This would please those looking to travel abroad next year but it would weigh on the share prices of some of our long-term favourites! With this in mind, we are taking a fresh look at some domestic-related assets to determine whether previous (and generally quite negative) assumptions about the trajectory of the UK economy have resulted in attractive valuation opportunities.

Figure 4: Sterling versus FTSE All-Share



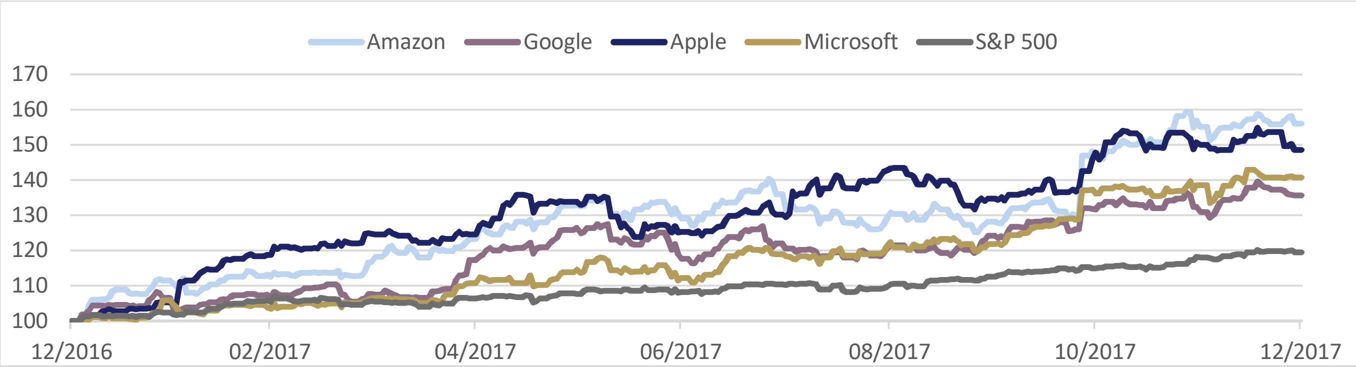
Source: London Stock Exchange/Bloomberg

The pound aside, we are also appreciative that UK economic data may end up being stronger than expected. Wage growth has edged higher and some commentators expect it to move towards 3% during 2018. With a tight labour market, news of falling immigration could place increased upward pressure on wages and thus support UK consumer stocks.

International Equities

It was a case of deja-vu during the quarter as the rise in international markets continued apace with next to none left behind. Performance of the S&P 500 in the US was driven by the tech sector and new economy consumer titans like Amazon, Google, Apple and Microsoft. All the evidence points to accelerating growth in online usage and consumption driving more and more incremental dollars to the largest company (or companies) in each sector (Fig. 5).

Figure 5: Tech stocks versus S&P in 2017



Source: Standard & Poor's/Bloomberg

Hand-in-hand with their rise was further strength from US financials, banks in particular. Increased capital return to shareholders, an improving US economy and rising interest rates, paired with Trump's tax reform should reduce their long-term tax bills. This remains true even if there is a one off hit to balance sheets from a reduction in deferred tax assets.

In Europe, resource stocks led the way as economic indicators consistently came in stronger over the quarter and oil and commodities prices remained robust. The former came as production cuts held and were extended, the latter came on improving global and Chinese growth prospects. Japan performed well as Abe's latest test at the ballot box was a success and should enable him to (finally) fire 'Arrow 3' of his economic programme and reform labour markets to boost productivity and workplace participation over coming decades.

Earnings in aggregate were once again good, and we continue to see the best opportunities for high quality long-term compounding companies in the US where the rise of the internet has created some of the largest oligopolies since the US railroads.

Alternative Investments

Hedge Funds/Targeted Absolute Return

Targeted Absolute Return strategies had a strong finish during the last quarter and finished the year up around 5% (as measured by the HFRX Global Hedge Fund index). After a difficult 2016, the performance in 2017 has been a welcome relief for this sector. Performance was positive across the spectrum with the largest gains in long/short equity. Equity market neutral was the next best performing strategy helped by stock dispersion at both market and sector level. In addition, there was no major reversion in investment style as in previous years. Event driven strategies continued to do well, however, the performance was impacted by some major event risk during the quarter. An example of this risk includes the judicial review of the AT&T and Time Warner merger which spooked the markets, despite little regulatory risk to the deal at its inception. This review has brought a new political risk to future merger activity. In addition, there have been fewer mega deals or cross-border deals during 2017. A lot of this stemmed from political uncertainty on tax reforms and the rise in populism. After two years of flat performance, systematic trading performed well as trends emerged in major asset classes bar fixed income. Multi-asset and macro posted positive returns but were hindered by high correlation between equities and bonds and the lack of asset class volatility.

In this Goldilocks period, volatility has been stubbornly low. Any unexpected pickup in inflation could trigger a rise in volatility, which would increase the opportunity set for this asset class. In an environment of technological disruption and fair valuation of assets, the opportunity set for active long/short equity funds remains attractive. The recently approved tax reforms in the US, particularly the repatriation of overseas cash and tax incentives for capital expenditure, encourage management to pursue corporate activity to generate growth that in the past has been difficult to come by. Although the last few years have been poor for macro funds, which benefit from asset volatility, we remain constructive on this strategy as monetary policy tightens.

Property/Infrastructure

Both real estate and infrastructure assets continued to deliver positive results in the last quarter and finished the year up. As highlighted in the last report, UK listed infrastructure was the only subsector which remained weak during this period. However, it seems the threat of nationalisation by a future Labour government remains low. The synchronised global growth does provide support for real estate as demand remains buoyant. However, on valuation grounds, they are not as attractive as a few years ago; most of this is due to the outlook on fixed income yields rather than a weakness in rental yields.

Within UK real estate, residential should continue to hold up well, particularly outside London. The government is committed to home ownership and policies are slowly being formulated towards a long-term housing strategy. Supply remains well below demand putting a floor on prices. The UK commercial real estate cycle is at a mature stage and expectations of further capital growth are limited. Income remains attractive, although risks may rise should conditions turn recessionary or political uncertainty increase.

The US real estate market has low vacancies across most sectors and markets, although the sizeable retail sector is coming under increased pressure. In Europe, the recent relative strength in economic growth, coupled with limited new supply, provides support for this asset class. The European Central Bank is still far from policy normalisation and therefore European real estate valuations continue to remain supported.

In summary, valuations are fair at best across the different regions, with the US and UK appearing vulnerable. However, as we continue to see economic growth, investors are likely to remain invested in this sector for income rather than for capital appreciation.

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