Market Commentary

Quarterly update July 2018

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Economic & Market Overview

- Global trade tensions intensified as the US and China imposed 'tit for tat' tariffs, with threats of more to follow.
- Political risk spiked in Europe, and Italy and Spain in particular, threatening to disrupt European markets before resolving relatively benignly, at least for now.
- Inflation in the US continued to rise gradually, as did the oil price, which reached as high as $80 a barrel.
- The US dollar resumed its upward trajectory as US economic data impressed relative to Europe and the UK, representing an increasing headwind for Asian and Emerging Market assets.

Despite the ratcheting up of trade tensions, with US President Donald Trump continuing his policy of putting 'America First' and European politics seemingly deteriorating, global equity markets recovered some of their poise following the market sell-off in February, as company earnings results exceeded expectations.

President Trump's trade war rhetoric stepped up over the second quarter, with $50 billion of tariffs being placed on Chinese imports into the US in June in addition to the global tariffs that had been placed previously on steel and aluminium imports. When China retaliated in kind by imposing tariffs of up to 25% on US imports, including pork and wine, Trump threatened a further $200bn worth of tariffs on Chinese goods. China was not the only country on the receiving end of threats from the US, with the European Union, Canada, and Mexico, amongst others, all being considered trade "foes". All have promised to respond with equivalent tariffs targeting goods produced in states from which Trump draws his electoral support, hoping to hit him where it hurts ahead of the US mid-term elections in November.

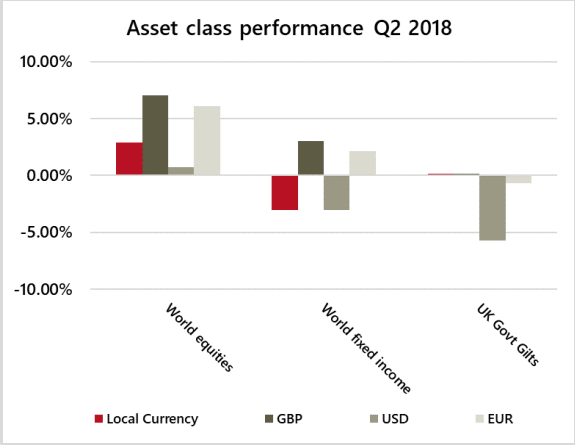
In Europe, politics was threatening to disrupt growth again, with uneasy parallels to the 2011 Eurozone crisis. Amongst uncertainties and drama ahead of the eventual formation of a coalition between the populist Five Star Movement and the right-wing League, Italian government bonds sold off sharply, with the 10-year yield spiking 2.5% above equivalent German Bund yields. This drama coincided with the calling of a vote of 'no confidence' in Spanish Prime Minister Mariano Rajoy by Pedro Sanchez, leader of the opposition Spanish Socialist Workers' Party (PSOE). This opportunistic move by a minority party ended in success as Rajoy was ousted and the PSOE teamed up with separatist parties from the Basque and Catalan regions to take power. Underlying all of these events, concern about immigration has become an increasingly important political flash point, causing significant problems too for German Chancellor Angela Merkel despite a sharp fall in the number of migrants.

Inflation continued to rise steadily in the US, having run at less than 2% for several years. The increase coincided with a significant recovery in the oil price which, at times, touched $80 a barrel as any hope that increased production by shale oil companies may prevent a rise to such a level proved unfounded as infrastructure constraints led to supply bottlenecks. However, despite unemployment having dropped as low as 3.8%, the increase in inflation has not reached a level that is causing concern for the US Federal Reserve, and interest rates have continued to rise in a steady but gradual manner, avoiding the sense of panic in markets witnessed in Q1.

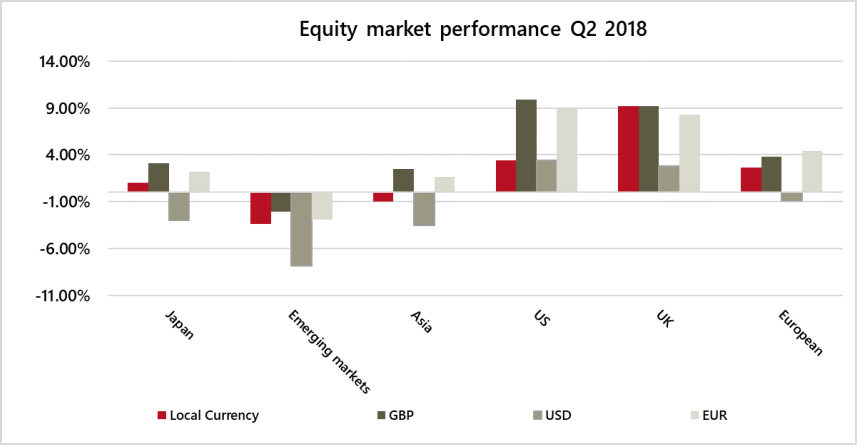
The US dollar resumed its upwards trajectory as the US economy increasingly stood out from the rest of the world, with data published in Q2 for Europe and the UK indicating a slowdown in Q1. As the quarter progressed, leading economic indicators increasingly pointed towards a recovery in growth following the soft patch in Q1, supporting the argument that the weaker data was the result of a very harsh winter and, therefore, temporary. However, many cautioned against this assumption, suggesting that the improved picture may simply be businesses pulling orders through early to beat the introduction of trade tariffs in a very interconnected global economy. Whatever the truth, steadily rising US interest rates, a strengthening US dollar and an escalation in Trump's trade wars, with China at the centre, took its toll on Emerging Markets which, unlike most regions, extended losses from Q1.

Market Data

Asset class Returns



Equity Market Returns



Source: Lipper

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Sector Review

Fixed Interest: US Treasuries sold off at the start of the quarter amid declining risk aversion and increased inflation expectations in the US. Data released in April revealed Personal Consumption Expenditures (PCE), the US Federal Reserve's (Fed's) favoured measure of inflation, had reached an annual rate of 2%, in line with the Fed's target. The sell-off was short lived, however, as the middle of the quarter saw the return of volatility in markets linked to a resurgence in political risk in Italy. The political uncertainty raised demand for the perceived safety of core government bonds, whilst peripheral European government bonds and high yield corporate bonds came under selling pressure. The biggest move came in Italian government bonds, as short-term Italian debt suffered its worst loss in 4 years after the country's President, Sergio Mattarella, frustrated a bid by the Five Star Movement and League to form a coalition government.

Property: The quarter got off to a weak start in the UK, as transaction volumes disappointed. With transactions of £1.2bn, the April figure failed to reach £2bn for the first time in six years. However, preliminary May and June figures indicated a rebound, suggesting that investment volumes are still stable. In net terms, overseas demand remains robust, with the largest deals for the quarter dominated by Far East investors. However, in contrast, US buyers have reduced exposure now for 3 consecutive quarters. Looking at sector returns, industrials were once again the stand-out performer, as the popularity of e-commerce led to continued demand for distribution space, outstripping supply. As a result, rental growth remained steady.

US equities: The US equity market ended the period in positive territory despite the prospect of escalating trade protectionism. Much of the attention has been focused on the Trump administration that imposed tariffs on $50bn of Chinese imports, with the threat of further tariffs worth $200bn should China retaliate. Notably, US industrials, a sector most affected by trade restrictions, underperformed the wider market, whilst consumer discretionary stocks outperformed as US consumer spending recovered in Q2 following a slow start to the year. As widely expected, the Fed raised their Fed Funds rate by 0.25% and now anticipates two further rate rises this year. This expectation comes from improving growth and rising inflation, as data in June showed that the US unemployment rate hit 3.8% for May, its lowest level since 2000, whilst average weekly earnings growth in May was 2.7% higher year-on-year.

UK equities: UK equity markets generated strong positive returns for the second quarter, supported by sterling's continued weakness against the US dollar. The weaker domestic currency aided companies with significant overseas earnings and was weakened particularly by April's data release for Q1 GDP growth showing growth of just 0.1%. The Bank of England Monetary Policy Committee voted to keep base rates at 0.5%, citing the weaker than expected GDP growth. However, there was good news for the UK consumer, as wage growth outpaced the rate of inflation, the first-time consumers have had a rise in 'real' pay in over a year.

European equities: Political risk dominated European equities, mainly driven by events in Italy and Spain. In Italy, there were concerns over the possibility of another General Election after the Five Star Movement and League initially failed to form a coalition government when their preferred Finance Minister candidate, known for his anti-euro rhetoric, was vetoed by the Italian President. Also, in May, Spain's socialist opposition party filed a motion of 'no confidence' in an attempt to replace Prime Minister Rajoy. At first equities retreated, with Italian financials suffering the most. However, despite the volatility, European markets calmed after an Italian coalition was eventually formed and, with investors seemingly sanguine about the removal of Spanish Prime Minister Rajoy. European equities finished the quarter in positive territory.

Japanese equities: Japanese equities managed to generate positive returns in spite of the rise in global trade tensions, as the export-heavy market benefitted from a weaker Yen versus the US dollar. Though much attention has been focused on tariffs imposed or threatened by the US on Chinese goods, one specific concern amongst investors is the increased potential for the US to apply tariffs on automobiles, a key Japanese export. On a sector basis, defensive companies outperformed, such as food and railways, while more cyclical stocks, such as shipping and industrials, were hurt by softening global macroeconomic data and fears over US protectionism.

Asian equities: Asian equity markets finished the quarter in negative territory, suffering once again from fears of growing global protectionism. On top of trade concerns, China's economic activity has moderated as a result of its deleveraging efforts and, over the quarter, the People's Bank of China cut its reserve ratio by 1.25% in an effort to encourage greater bank lending to support economic growth. Elsewhere, sentiment for Indian equities dampened. Though less dependent on exports for its growth, the economy came under pressure after crude oil prices moved higher, as India is a net importer of oil.

Emerging Market equities: Emerging Market equities suffered the worst losses for the period. The asset class was negatively impacted again by global trade uncertainty but one of the most significant headwinds was the relative strength of the US dollar, as emerging countries reliant on international funding faced a higher cost of servicing dollar-denominated debt. This pressure was especially evident in the decline of the Turkish Lira, falling 10% in May alone, forcing the central bank to implement an emergency rate rise to stop investors selling the currency. Argentina, Indonesia and the Philippines also raised interest rates to combat currency weakness. Overall, Turkey and South Africa were the weakest equity performers and all sectors in Emerging Markets fell in value, with the exception of media.

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Performance Review

Positive contributors to performance were:

- Fund selection in Global equities.
- Fund selection in US equities.
- Overweight position in Global equities.
- Overweight position in US equities.
- Overweight position in Property.

Negative contributors to performance were:

- Fund selection in UK equities.
- Fund selection in European equities.
- Fund selection in Japanese equities.
- Fund selection in Emerging Market equities.
- Fund selection in Absolute Return.
- Underweight position in UK equities.
- Overweight position in Emerging Market equities.

Across all our models, our overweight position in equities was the biggest contributor to returns, as positive Q2 earnings and supportive economic data overcame concerns about escalating US-China trade tensions.

For our lower risk models, the portfolios delivered strong returns from 0.7% to 2.6% over the quarter. Fundsmith Equity was the stand-out performer, returning 12.3%. An overweight position in Property helped as well, whilst the biggest detractor was fund selection within Absolute Return (AR), with Old Mutual Global Equity Absolute Return falling 2.7% in a quarter during which Absolute Return funds struggled in general.

Our medium risk models also generated strong returns of 2.6% to 3.1% over the period. Our preference for European equities over UK equities detracted from returns. Fund selection was mixed over the quarter. The stand-out performer was Old Mutual North American Equity, which returned 11.8%. However, fund selection in other areas was less strong, with GAM Multistock Euroland Value Equity and Hermes Global Emerging Markets being the worst performers, falling 3.0% and 4.2% respectively.

The higher risk models produced strong returns of 3.8% to 4.1% for the quarter. Our overweight position in Emerging Market (EM) equities was a negative, as the strengthening US dollar increased the borrowing costs of many emerging economies. Fund selection was mixed over the quarter. The worst performers were Hermes Global Emerging Markets and MI Somerset EM Dividend Growth, falling 4.2% and 5.9% respectively, although these losses were offset partially by the other EM fund, PineBridge India Equity, which rose 5.1%.

(Performance figures source: Lipper)

Portfolio changes

Tactical Asset Allocation

No change.

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Outlook

After several years of very strong equity market returns, it has been a difficult H1 for investors. Markets have moved from an overly bullish stance at the beginning of the year, aided by US tax cuts, to concerns over US interest rates, European politics and, increasingly, an escalating global trade war, with President Trump threatening to impose tariffs on ever increasing volumes of imports. Company results, particularly in the US, have continued to exceed expectations and, following a slowdown in Q1, leading indicators are once again pointing to a pick-up in global growth. The outlook for the global economy is further improved by moderate inflation expectations, despite significant falls in unemployment (particularly in the US), with the threat of central banks choking off the recovery remaining low. However, most markets have yet to regain their highs because the interest cycle in the US and an escalation in trade wars have taken centre stage. We view the raising of interest rates by the US Federal Reserve as a normalisation of rates to prevent over heating further into the economic cycle rather than an attempt to cut-off inflation, providing monetary authorities with ammunition for the next downturn. However, with not all investors being as sanguine, it has produced a volatile period for markets as investors adjust to the new environment.

Valuation multiples on equities have been declining, which is normal later in an economic cycle, although this time around the effect has been amplified in the US by tax cuts. However, we expect increased earnings to more than offset this de-rating, allowing markets to rise further, so we have maintained our neutral exposure to equities. Nonetheless, until US interest rates peak, we acknowledge that valuations will continue to be under pressure.

Similarly, whilst the US dollar continues to strengthen it is likely to continue to hamper Emerging Market assets, be that equities, bonds or currencies. However, having reduced our Asian equity exposure in favour of US equities at the beginning of the year, we are reluctant to reduce our exposure further for several reasons: emerging economies will benefit from the gentle upswing in the global economy, valuations are more attractive than Developed Markets and the US dollar will not rise indefinitely.

Having been bearish on fixed interest assets for a number of years, we are increasingly looking at the opportunities within government bonds and the benefit of holding them as a defensive asset, particularly in the US where 10-year Treasury yields may be close to their peak. We remain mindful that, in all probability, yields have further to rise, as investors today are not just concerned with rising interest rates but the withdrawal of the large bond buying programmes by central banks. However, as calling the top or bottom of any market is challenging, closing down our underweight in stages remains an option.

We remain of the view that this economic cycle, already the second longest on record, has the potential to become the longest, as growth and inflation have remained moderate to date and the peak in interest rates is likely to be significantly lower than previous cycles. However, the largest elephant in the room today is a further escalation in President Trump's trade war. Though the global economy can withstand the $50bn worth of tariffs on Chinese imports already implemented, the additional $200bn of trade tariffs threatened could derail the recovery, helping no one. To date, markets have taken the view that the threated escalation is a negotiating tactic by President Trump. However, as more and more tariffs go from threat to reality, investors are becoming increasingly nervous.

Important Information