Market Commentary

Quarterly update October 2018

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Economic & Market Overview

- Global trade tensions escalated as the United States imposed further tariffs on $250bn worth of Chinese imports.
- The US equity market was the stand-out performer as the economy continued to improve with Q2 GDP growth recorded at an annualised rate of 4.2%, the fastest since late 2014.
- In Europe, forward-looking activity indicators pointed towards economic expansion, albeit at a slower pace than at the start of the year.
- Emerging Markets faced pressure from the re-emergence of dollar strength mid-way through the quarter, with the Argentine peso, South African rand and Turkish lira among the worst performing EM currencies.

Despite the imposition of tariffs on $250bn worth of Chinese goods by the United States (US) and threats of yet further escalation of the global trade war, equities made further gains over the third quarter. However, the picture was mixed at a regional level, with the US equity market the stand-out performer as the economy continued to motor ahead, with few signs of either the trade war or inflation threatening to stall its progress. Outside of the US, developed economies in the main had a decent quarter, with both Japan and Europe being rewarded for sidestepping the threat of US tariffs on car imports into the US, at least for the moment. However, it was a mirror image for Emerging Markets (EMs), where a slowing Chinese economy faced the implementation of trade tariffs on $250bn worth of goods bound for the US. The pressure on EMs was further exacerbated by the re-emergence of dollar strength mid-way through the quarter, leading to a painful sell-off. The UK stock market was a notable outlier amongst developed markets but for all the wrong reasons. Performance over the quarter resembled EMs, as the global make-up of the UK stock market hurt companies with EM exposure whilst increased fears of a 'no deal' Brexit weighed on domestic-focused companies.

The US Federal Reserve raised interest rates by a further quarter of a per cent to 2.25%, as second quarter GDP growth was recorded at an annualised rate of 4.2%, the fastest since late 2014, and US consumer confidence surged to an 18 year high in August. The main US equity market set twin records, as both an all-time high was reached and the current bull run became the longest in history. By contrast, US government bonds sold off, with the yield on the 10-year Treasury rising to 3.06% by quarter end.

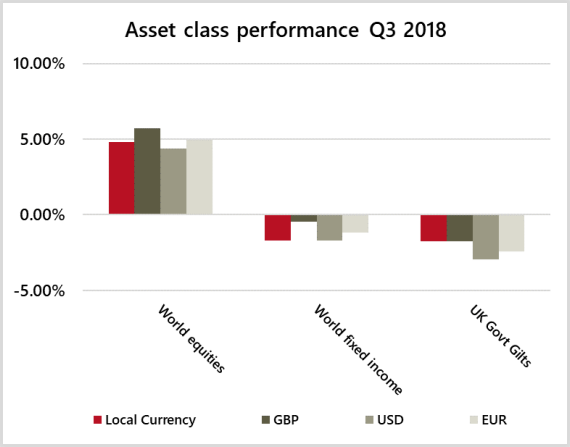
The Japanese equity market was the second best performing of the major markets over the quarter, supported by yen weakness as exporting companies profited from the translation of overseas sales back into higher earnings. The market also benefitted from greater clarity over the medium-term outlook following the re-election of Prime Minister Abe as leader of his party, the LDP (Liberal Democratic Party). Towards the end of the quarter, Japan and the US agreed to begin negotiating a trade agreement on goods, with the stock market reacting positively.

Similarly, a meeting between President Trump and President Junker of the European Commission helped to calm fears over tariffs being applied to European car exports. It was agreed that the US and the EU would work towards a zero-tariff regime for non-auto industrial goods, whilst longer term talks would take place in respect of cars. Forward-looking activity indicators pointed towards economic expansion, albeit at a more subdued pace than at the start of the year. However, in the view of the European Central Bank (ECB), this was still insufficient to warrant a change in monetary policy and they reiterated that interest rates would remain on hold "at least through the summer of 2019".

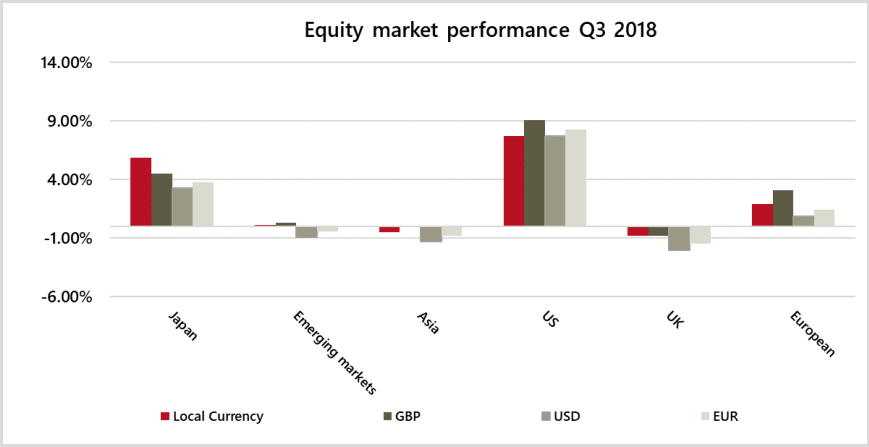
China was the primary cause for underperformance in EMs as it contended with further US trade tariffs being applied alongside a slowing economy. Not wishing to be bullied by the US, the Chinese Government increasingly shifted towards fiscal stimulus and credit easing over the period to support the economy. Midway through the quarter, renewed strength in the US dollar led to the Argentinian peso, South African rand and Turkish lira all coming under pressure. Turkey was the worst performing country in the group but restored some sort of confidence towards quarter end following a higher than expected 675 basis points hike in interest rates to an eye-watering 24% in an attempt to address the risk of rising inflation and capital flight. It was not all bad news in EMs, with Mexico rallying following general elections and an agreement with the US on the re-negotiations of the North American Free Trade Area (NAFTA) whilst Russia outperformed, benefitting from the rise in the crude oil price.

Market Data

Asset class Returns



Equity Market Returns



Source: Lipper

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Sector Review

Fixed Interest: Developed market government bonds sold off over the quarter as markets worried about rising US interest rates. However, this was not the case at the beginning of the period when investors sought the safe haven status of government bonds prompted by Emerging Market (EM) instability and global trade tensions. EM debt experienced a tumultuous quarter, with the pain felt most extremely in Turkey and Argentina, whose central banks were forced to raise interest rates in order to halt severe declines in their respective currencies. In Europe, volatility returned to Italian government bonds, which sold off sharply as investors contemplated a potential downgrade to sub-investment grade. The sell-off was sparked by concerns about the budget proposed by the Italian Government and prompted an equivalent rally in German bunds. However, as markets calmed, government bonds sold off, giving back gains made in the middle of the quarter. Whilst performance was mixed across sectors, corporate bonds gave positive returns for the period, with High Yield bonds outperforming Investment Grade globally.

Property: The quarter got off to a strong start in the UK as transaction volume reached £7.5bn in June alone. This was followed by a slowdown of volume in July to £3.3bn before activity re-accelerated for August, reaching £4.7bn. Overseas capital continued to dominate, making up almost two thirds of all investment in August, up 42% from July. There remains continued strong overseas demand for central London prime office assets, with foreign investors accounting for over 70% of office investments year to date. Likewise, the industrial sector, which historically has performed well this year, remained robust. Despite concerns amongst businesses over Brexit uncertainty and exchange rate volatility, rental growth continued for the sector as a whole.

US equities: The US outperformed other major regions significantly, with the third quarter representing the strongest quarter for the US equity market since 2013. Trade tensions with China were ultimately outweighed by strong economic growth and earnings data, with GDP growth confirmed at 4.2% for the previous quarter and employment data better than expected. September wages grew at their fastest rate since 2009 while non-farm payrolls showed job additions of over 185,000 on a three-month average, with the upbeat data allowing the Federal Reserve to raise interest rates by 0.25% to 2.25%. Within US equities, healthcare sectors were boosted by strong earnings, though materials companies struggled with potentially weaker demand associated with the US/China trade war.

UK equities: UK equities fell marginally over the quarter in spite of a brief market rally towards quarter end on renewed sterling weakness, which aided companies with significant overseas earnings, and rising Brent crude oil prices which supported UK energy stocks. Brexit uncertainty was reflected by a volatile sterling. The currency reached a 2018 low of $1.27 in August before rallying to above $1.32 by mid-September. However, the currency declined late in the quarter to finish broadly flat over the period when the UK Government's Brexit plan was rejected by the EU. Economic data released in September showed a higher than expected increase in UK inflation whilst UK retail sales impressed too as the good summer weather provided a boost to consumer spending.

European equities: Italian political risk dominated European headlines once again, this time on concerns of a clash between Italy's populist government and the EU over the former's fiscal spending plans. The prospect of the Italian coalition government breaching the EU's budget deficit limit weighed on market sentiment. Ultimately the government proposed a deficit of 2.4%, within the EU's maximum allowed deficit level of 3% but above the lower level allowed for a country with Italy's existing level of debt (and this before any challenge to the economic assumptions used to calculate the budget that may come from the EU). Eurozone banks were particularly hurt by this political uncertainty, as well as by contagion fears over their exposure to EMs, notably to the Turkish lira, which struggled over the quarter. Despite these headwinds, European equities managed to finish the third quarter in positive territory, with industrial stocks amongst the leading sectors.

Japanese equities: Japanese equities ended the quarter with solid gains, in spite of continued global trade tensions. A weaker yen relative to the US dollar certainly helped, with the Japanese stock market containing a high proportion of export-led companies. However, the strong performance was also down to solid company profits and a rebound in economic growth from a relatively weaker first quarter. Furthermore, sentiment in Japanese automobile makers improved after the US administration agreed to defer any decision on auto tariffs until after current trade negotiations between the two countries are complete.

Asian equities: Asian equity markets faced a volatile quarter, once again suffering from ongoing trade tensions between the US and China. The US stepped up its tariff implementation, as $34bn worth of tariffs against China took effect in July. This was followed in September by tariffs on an additional $200bn worth of Chinese imports, initially at 10% but planned to rise to 25% in 2019. In response, China imposed its own retaliatory tariffs on $60bn worth of US imports. Meanwhile, Chinese macroeconomic data disappointed, suggesting mixed growth in both industrial production and fixed asset investment. Elsewhere, Indian equities struggled over concerns about a weakening rupee and rising inflation. Given that India is a net importer of oil, the strength in the oil price also harmed sentiment, with the potential of a widening trade deficit.

Emerging Market equities: Continued US dollar strength prompted a volatile quarter for the asset class. Countries more reliant on international funding faced a higher cost of servicing dollar-denominated debt, and the pain was felt particularly in EM currencies, most notably the Argentine peso, Turkish lira and South African rand. Turkish equities were the worst performing market, whilst Mexico was the best emerging equity market after relatively smooth general elections. The new president elect, Lopez Obrador, was expected to bring in populist measures but, to the relief of markets, he promised to continue Mexico's prudent fiscal management. Mexican equites were also buoyed by the successful conclusion of negotiations with the US over a new version of NAFTA (North America Free Trade Agreement).

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Performance Review

Positive contributors to performance were:

- Fund selection in UK equities.
- Fund selection in Japanese equities.
- Fund selection in Asian equities.
- Overweight position in US equities.
- Underweight position in Government Bonds.
- Short-term tactical position in US Treasuries.

Negative contributors to performance were:

- Fund selection in Absolute Return.
- Fund selection in European equities.
- Fund selection in Emerging Market equities.

For our lower risk models, the portfolio delivered returns from 0.5% to 1.8% over the quarter.

The quarter was one in which what we did not own was as important as what we did own, with our underweight position in Government Bonds being the biggest contributor to relative returns. However, whilst our longstanding underweight position protected us from what would have been significant losses, we were able to make a positive return in the asset class though a short-term tactical position that we took in US Treasuries.

By contrast, the biggest detractor to performance was fund selection within Absolute Return (AR), in what was another lacklustre quarter for AR funds overall, the worst being Old Mutual Global Equity Absolute Return which lost 1.1%.

Our medium risk and high-risk model portfolios generated returns from 1.3% to 2.0% for the period.

Our overweight position in US equities was the biggest contributor to returns, with Merian North American Equity (previously named Old Mutual North American Equity) and LF Miton US Opportunities returning 10.0% and 7.9% respectively. Fund selection in Japan also helped, with Man GLG Japan CoreAlpha Equity, which rose by 12.7%. The performance of the Merian and Man GLG funds were aided by switches to their respective hedged unit classes during the quarter, as currency was, once again, an important driver of returns.

Similar to the lower risk models, fund selection within AR detracted from performance. Our European equity holdings disappointed too, although reducing our weighting during the quarter helped to limit losses. The biggest detractor was fund selection within EM equities, with KLS Sloane Robinson Emerging Markets falling 6.4% during the period of ownership.

Portfolio changes

Tactical Asset Allocation

- Reduced underweight position in UK equities.
- Overweight to underweight position in European equities.

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Outlook

The US economy continues to strengthen, unemployment is at record lows and inflation has stirred. Correspondingly, the Federal Reserve (Fed) has embarked on a path of gradual rate rises to prevent the economy from overheating and to normalise interest rates, having held them at emergency levels for an extended period.

However, eight and a half years into this economic recovery, the second longest on record, markets have entered a difficult period, as investors try to second guess the when the cycle will end. The belief that this end may be near comes from an assumption that inflation has to become a problem with unemployment so low. However, it has yet to become problematic and, whilst credit growth remains moderate, there are strong reasons to believe this situation can persist. Therefore, the Fed's sure and steady path of rate increases does not have to end the economic cycle, providing the Fed remains data dependent and does not overreach with its rate rises.

Elsewhere, an unusually cold winter and a concerted effort by President Xi to tackle the explosion in debt has taken its toll in China, with a meaningful slowdown in economic growth. The disparity in growth between the US and the rest of the world has allowed the US dollar to strengthen once more, increasing pressure on those countries that continue to finance current account deficits through US dollar borrowing. In truth, there are far fewer countries in this position today than in the Asian crisis of 1997, but this does not stop indiscriminate selling of all those countries that fall underneath the EM banner. However, the US dollar will not strengthen indefinitely, as either the Fed interest rate cycle will peak or the growth disparity between the US and the rest of the world will contract.

Equity market valuations are not cheap, and the attractiveness of the asset class is increasingly being challenged by the higher rates available on government bonds. That said, whilst not cheap, valuations in much of the world are not expensive either and, provided that companies can keep increasing earnings over and above the cost of capital, there is no reason that equity markets cannot make further progress. However, whilst the Fed is normalising interest rates, for that is how it should be viewed rather than tightening, it will remain a tricky period for markets. We retain a broadly neutral and well diversified position in equities but are increasing our exposure to government bonds on weakness whilst maintaining an underweight position for now.

Important Information