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Smart Investment Management - strong start to the year...

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Portfolio returns have been strong this year to date, in spite of subdued global growth and equity valuations that can hardly be described as cheap. What has driven these returns to date and what do we think the rest of the year has in store?

	GBP	USD	EUR
iGuard Defensive	2.12%	2.19%	5.10%
iGuard Cautious	3.65%	2.70%	7.26%
iGuard Cautious +	3.97%	2.57%	8.31%
iGuard Balanced	4.52%	2.94%	9.71%
iGuard Balanced +	4.88%	3.02%	11.63%
iGuard Aggressive	5.32%	3.18%	12.75%
iGuard Aggressive +	6.29%	5.50%	14.58%
Smartfund Defensive	1.07%	-	-
Smartfund Cautious	1.36%	-	-
Smartfund Balanced	2.95%	-	-
Smartfund Growth	3.27%	-	-
Smartfund Aggressive Growth	5.51%	-	-

Source: Lipper and Smart[IM]

The primary drivers for strong returns have been a combination of:

- an overweight to European equities which have performed very strongly in euro terms on the back of the announcement of the European Central Bank's (ECB) Quantitative Easing (QE) programme; and
- hedging out currency risk for sterling and US dollar investors.

For euro investors, holding any asset in a currency other than euros has almost certainly led to a gain. The euro has devalued by over 7% year to date versus sterling and 12% versus the US dollar.

European markets respond

In December of last year, Mario Draghi of the ECB finally announced a package of QE aiming to drag the Eurozone away from a potential deflationary spiral as was experienced by Japan in the 1990s and noughties. The magnitude of the plan exceeded expectations, prompting immediate weakness in the euro (which as previously suggested is the main aim of the policy even if the ECB does not explicitly say). For a region where exports of goods and services makes up over 40% of GDP, the benefits of a weakening euro should not be underestimated. QE does not cure all ills in Europe, but for the moment markets are willing to give it the benefit of the doubt, especially as investor expectations for growth had been so low. As a large net importer of energy, the weak oil price has also greatly benefitted Europe. These factors have all contributed to a positive deflationary impact in the near term.

Hedging out currency loss

Although year to date the EuroStoxx 50 index is up 13.6%, the euro has devalued versus sterling and the US dollar.

- In our USD portfolios we hedged our European exposure to the dollar
- In our sterling portfolios we hedged half our exposure to sterling and the other half to dollars.

This has meant the portfolios have retained the positive returns from European equities rather than exchange rates eroding away gains.

Strong start to the year for Japan

Japanese equities have also been strong, returning 8.4% over this period in Yen terms. Following a huge programme of QE from the Bank of Japan, the Yen/US dollar exchange rate has weakened from 80 Yen to the dollar to around 120 Yen. We can debate whether we think the Yen is likely to weaken further from here, but what we can be confident of is that Japanese companies are significantly more competitive at this level. Additionally Japanese companies are under increasing pressure to run efficiently, a discipline which simply did not exist before. As per the exposure to the euro, we have been hedging either half or all of our exposure to the Japanese Yen during this period of currency weakness. We continue to assess at what point we may start to remove these hedges.

US dollar continues to help

Elsewhere equity returns have not been quite so strong, but depending on the investors' base currency, the returns they have achieved may have been very respectable indeed. For example, year to date US equities in dollar terms have barely moved the dial, increasing in value by under 1%. However, for a sterling investor the return has been over 5% thanks to the strengthening dollar, and closer to 15% for a euro investor! Currently US markets remain flat as investors continue to try to second guess the Federal Reserve on the likely timing of an interest rate rise, coupled with the fact that US equities look expensive both historically and relative to other markets. But the US is still the most robust of the large economies and remains the economy we all look to in this lacklustre growth environment.

Developing markets continue to struggle

Many developing countries have suffered from a slowdown of growth in China and a strengthening US dollar which weakens the environment for commodity pricing; however, this does not apply to all developing countries. Those that are exporters of manufactured goods, predominantly in Asia, should benefit from a strengthening dollar making their goods cheaper, whilst cost inflation should be kept under control in no small part due to the weakness in the oil price

Solid returns in Fixed Income

Fixed income has had a solid if unspectacular couple of months, with the pressure on rising yields from increasing interest rate expectations in the US being dampened down by European QE. Negative interest rates are no longer a laughable idea but are now a reality with the ECB, the Swiss National Bank and the Danish central bank all displaying such rates in a bid to encourage banks to lend money out rather than let it languish with central banks. This has led several countries' sovereign debt to trade at negative yields including Germany, Finland, Austria, the Netherlands, Switzerland and Denmark. This phenomena is not confined to sovereigns; the corporate debt of Royal Dutch Shell and Nestle amongst others are also trading in negative territory. If this wasn't enough, Germany has recently managed to sell €3bn of five year bonds at a yield of minus 0.08%, a record low. As unlikely as this seemed, all occurred ahead of the ECB actually commencing their QE buying programme which started on the 9th March.

What can we expect going forward?

We believe that markets can make further headway this year, but as witnessed with QE in the US and the UK, markets tend to reflect the positive impact of QE early so we should not expect returns to continue their upwards journey at the same pace. We are mindful that the same geopolitical risks such as Russia, Iran and ISIS that we have been talking about previously, all still exist, as well as the uncertainty around US interest rate rises. On a positive note we increasingly believe the stronger US dollar is likely to temper the scale of any interest rate

rises that we see certainly see this year, which is a positive for investor returns.