Market Commentary

Quarterly update April 2018

Economic & Market Overview

- Global equity markets rose sharply in January, with the US markets registering their strongest start to a year since 1987.
- The early optimism in markets ended abruptly in February, as higher than expected US wage inflation figures prompted fears of more rapidly rising interest rates, causing a sell-off in both US Treasuries and equities.
- Equities suffered further as President Trump announced tariffs on Chinese imports, raising fears of a trade war.

Equity markets started the year off 'on a tear' as a pickup in global growth, combined with tax cuts in the US, led to a wave of optimism washing over investors. The US market registered its strongest start to a year since 1987, rising more than 5% in January alone, with many other markets reaching record highs. By contrast, bond markets had a poor start as expectations for rising interest rates led to a continued sell off in government bonds, particularly US Treasuries, with corporate bonds being hit in turn. Concerns about a steeper path for these same interest rates caused the euphoria in equity markets to come to an abrupt halt in February as wage inflation data exceeded expectations. The sell-off was broad and sudden, with few places to hide, with much of the blame being attributed retrospectively to funds that had bet on a continuation of the low volatility environment, becoming forced sellers into a falling market. Further shocks around the security of Facebook's data and the imposition by the US of import tariffs on a range of Chinese goods sent markets down further, and the period ended with global equities having had their worst quarter in more than 2 years. However, in truth, the turbulence had barely blown the froth off markets from an over exuberant start to January, whilst global growth remained intact.

Data released in Q1 showed that global growth accelerated in Q4 2017, with US GDP coming in at an annualised rate of 2.9%, having grown at 2.3% for the year as a whole. Despite the strengthening of the US economy, and a further interest rate rise by the US Federal Reserve under the stewardship of its new chairman, Jay Powell, the US dollar continued to weaken, to the surprise of many. However, this allowed Emerging Markets to continue in their positive vein, with Brazil leading the way as hopes ran high that the former left-wing President, Luiz Inacio Lula da Silva, would not be able to stand for office again after an appeals court upheld a corruption conviction. China also had a strong quarter following news that the economy had expanded by 6.8% at the end of 2017, ahead of forecasts.

The improving economic outlook was also felt in the Eurozone, with GDP expanding by 0.6% in the fourth quarter, marking 19 successive quarters of growth. Along with an oil price that broke through $70 a barrel for the first time in 3 years, this all helped to drive markets higher over January. UK equities were a notable exception, ending January in negative territory, as a resurgent Sterling reduced the reported profits of UK listed companies deriving sales from overseas.

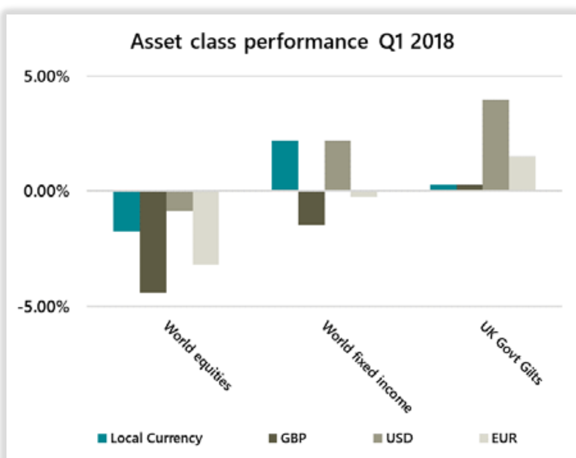
The cracks in markets appeared with US wage inflation coming in above expectations at 2.8%, and the fear of rising inflation led to a sell-off in US Treasuries, taking equities along for the ride. This was despite US inflation remaining below target and wage inflation remaining modest by historical rate tightening cycles. Amongst the major markets, US equities sold off the most, at one point losing 10%, a so-called 'market correction'. Emerging Markets and Asia proved to be relatively defensive against a background of strengthening global growth.

By mid-March, Facebook became embroiled in a major data scandal as The Guardian and The New York Times reported that 50 million Facebook profiles were harvested for Cambridge Analytica. Technology stocks, which had remained amongst the strongest performing sectors year-to-date, fell as investors feared a regulatory clampdown on the sector, hitting the so called FAANG stocks (Facebook, Apple, Amazon, Netflix and Alphabet's Google). Despite these falls, the technology sector remained the best performing sector over the period.

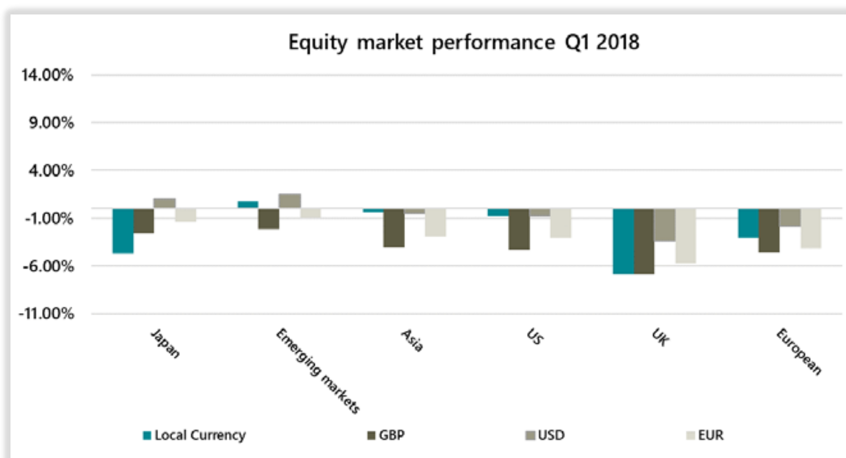
By the end of March, a further escalation in the burgeoning trade war between the US and China sent equities down once more, as President Trump announced a further $60bn of tariffs on Chinese imports, having imposed import tariffs on steel and aluminium earlier in the month. The risk of a global trade war that had hung over markets since Trump came into power was becoming a reality.

Market Data

Asset class Returns



Equity Market Returns



Source: Lipper

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Sector Review

Fixed Interest: US Treasuries sold off over the quarter after stronger than expected wage inflation data prompted investors to position for further US interest rate rises. In particular, the new Federal Reserve Chair, Jerome Powell, noted that the economy had improved since December, giving him confidence that inflation was moving towards the central bank's target. However, government bonds did rally at quarter end, as equity market volatility drove the demand for their perceived safety. Overall, corporate bonds underperformed government bonds, with investment grade credit performing worse than the High Yield sector.

Property: UK commercial property remained robust, with the IPD All Property Index returning 2.3% over the quarter. Preliminary transaction data for February remained strong despite slowing marginally from January, as total year-to-date volumes reached £7.4bn. Despite ongoing Brexit uncertainty, overseas investor demand remained stable, accounting for approximately half of all purchases. In particular, within the offices sector, overseas investors accounted for 60% of activity as demand for grade A and refurbished grade B office space remained strong. However, the industrial sector continued to be the standout outperformer, with returns driven by a combination of yield compression and good rental growth as the popularity for e-commerce led to further demand for local fulfilment and distribution warehouses.

US equities: Optimism about Republican tax cuts, as well the end to a US government shutdown, helped US equities register their strongest start to a year since 1987. However, markets suffered a swift correction at the start of February, as rising wage inflation increased fears of a steeper path for interest rates. Markets falls were further compounded later in the quarter by escalating global trade tensions, as well as a correction in technology stocks. President Trump's announcement of planned tariffs on $60 billion worth annually of Chinese imports heightened concerns that a trade war could hurt global economic growth. The financials, materials and technology sectors, all of which have benefited the most from strength in the global economy, saw the sharpest falls. Meanwhile, the pressure on technology stocks was increased further by speculation about a regulatory crackdown related to data privacy after Facebook admitted a data breach concerning 50 million of its users.

UK equities: The UK equity market performed poorly throughout the quarter, with the largely international constituents of the FTSE 100 under further pressure over fears of a potential trade war between the US and China. Furthermore, sterling continued its rally as the pound broke through $1.42 against the US dollar, a post-EU Referendum peak. While this shift benefitted companies with domestic exposure, it weighed on companies with material overseas earnings, many of which are large multinational companies. Brexit negotiations progressed during the quarter, with agreement achieved on the terms of a transition period after the UK formally exits the EU. The deal secures existing trading conditions for an additional 21 months, meaning that businesses will be able to operate 'as normal' until December 2020.

European equities: Despite the continuation of supportive leading economic indicators, European equities posted negative returns over the period, with the majority of losses coming at the end of the quarter. Given the escalating trade tensions between the US and China, investors were somewhat relieved when the White House announced a temporary exemption for the European Union and other nations regarding steel and aluminium tariffs. However, this was not enough to reverse quarterly losses. On the political front, Italy's general election saw the anti-establishment Five Star Movement gain the most support but the result yielded no outright winner and a coalition government must now be formed.

Japanese equities: Japanese equities followed the same pattern as the rest of global markets, finishing the quarter lower over global trade concerns. Consequently, defensive stocks such as pharmaceuticals and utilities outperformed, whilst trade-related and cyclical sectors declined the most. The broader market decline and heightened uncertainty also resulted in a stronger Yen against other major currencies. Meanwhile, Prime Minister Abe faced a political crisis domestically, with suspicions surrounding a land sale to a school operator with ties to his wife. Though the long-term trend of economic improvement remains intact, the Japanese economy experienced slightly weaker economic data, with many leading indicators of production and consumption falling marginally.

Asian equities: Asian equity markets sold off at quarter end over fears of a trade war between China and the US. Despite the tensions, China's overall fundamentals remained robust, with industrial production and exports for February coming in ahead of expectations. In addition, the government maintained its 2018 GDP growth target of 6.5%. Elsewhere, Thailand was among the best performing markets, supported by strong performance from energy and utilities stocks. Although less reliant on exports for its growth, India lagged the Asian region over domestic concerns including reported fraud at a State bank and weak performance from the ruling political party in state by-elections. Higher oil prices also acted as a headwind for the Indian economy, which is a net importer of the commodity.

Emerging Market equities: Though equities declined globally over the quarter, Emerging Market losses were less severe in comparison with the rest of the world. Latin America had a relatively strong quarter, with Brazilian equities being the standout performer. The Brazilian economy continues to benefit from lower inflation and looser monetary policy, as main interest rates were cut again from 7.0% to 6.75%. Elsewhere, Russia benefitted too from interest rate cuts, whilst the country's debt was upgraded to investment grade by the ratings agency Standard & Poor's. Turkey and South Africa were notable equity market laggards and, although South Africa avoided a downgrade from Moody's, Turkey's sovereign debt rating was lowered by the credit ratings agency.

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Performance Review

Positive contributors to performance were:

- Fund selection in US equities.
- Fund selection in UK equities.
- Fund selection in Strategic Bonds.
- Fund selection in Absolute Return.
- Underweight position in US equities.
- Underweight position in UK equities.
- Underweight position in Asian equities.

Negative contributors to performance were:

- Fund selection in Japanese equities.
- Fund selection in Asian equities.
- Fund selection in Emerging Market equities.
- Fund selection in High Yield.
- Overweight position in US equities.
- Overweight position in European equities.
- Overweight position in Strategic Bonds.

Our lower risk portfolios delivered small negative returns from -0.5% to -1.3%, whilst our medium risk portfolios returned -1.5% to -2.1%. The high-risk portfolios also produced negative returns, from -2.9% to -3.7%.

Our equity holdings were the biggest detractors to returns as stock markets were rocked by fears of a global trade war. The MSCI World Index fell 4.7% in sterling terms during the quarter to deliver the first negative quarter for global equities since Q3 2015. However, the portfolio positioning was helpful in limiting losses. Being underweight UK equities was beneficial, as it was one of the worst hit markets, and strong fund selection in this area helped as well. With few hiding places, overweight positions in US and European showed losses, so hurt performance. However, the falls were less than were seen in the UK market and strong fund selection in US equities helped to offset some of the pain. Elsewhere in our medium and high-risk portfolios, fund selection in US equities was beneficial but was detrimental in Emerging Market equities.

Away from equities, fund selection in Absolute Return was particularly strong, with the standout performers being Old Mutual Global Equity Absolute Return and Old Mutual Absolute Return Government Bond, returning 3.1% and 2.8% respectively over the quarter.

(Performance figures source: Lipper)

Portfolio Changes

Tactical Asset Allocation

- No change.

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Outlook

As we enter Q2, many of the risks cited in recent years have come to the fore. Concerns about inflation, the withdrawal of central bank liquidity, a Trump-inspired global trade war, the potential for economic slowdown in China and rising geopolitical risks have moved markets abruptly from an environment of extremely low volatility to a more normal one. Global growth remains robust, with leading business activity indicators continuing to point to expansion and the full effects of US tax cuts yet to be felt, whilst inflation is rising but far from out of control. Even so, having moved from an environment where deflation was the chief concern, investors are undoubtedly nervous about the prospects of rising rates. However, the tightening of monetary policy, led by the US Federal Reserve, should be viewed as normalisation rather than an attempt to slow economies down.

We continue to favour equities where valuations, whilst by no means cheap, are not out of kilter with the later stages of previous cycles, when equities have performed well. There are increasing signs of a willingness by businesses to reinvest in themselves, a feature that has been noticeably missing from this recovery, although it remains to be seen whether the cuts in US corporate tax rates provide further impetus to such investment or the money is used for share buybacks or increased dividends. However, whilst the latter would benefit Wall Street over Main Street, it would still be supportive to equity prices in the short term. Emerging Markets continue to benefit from the recovery in Developed Markets, with commodity prices having stabilised, and in the case of crude oil, strengthened meaningfully. By contrast, Fixed Interest continues to face the headwind of rising rates, and we continue to hold an overweight position in alternative strategies which, after several years of low returns, should benefit from the return of volatility.

Overall, we think markets can continue to make headway with an improving global economy. However, investors will have to adapt to lower returns and higher volatility, with both having been unusually favourable in recent years. Geopolitical risks and the possibility of economic shocks remain. However, we think it is upside risks to inflation that markets will be focused on in the coming months.

Important Information

Please note that this document should only be read in conjunction with the Investment Mandate. The portfolio may not be suitable for all investors, and if you have any doubts you should contact your Financial Adviser.

The portfolios are managed by Smart IM. There is no certainty that the investment objectives of the portfolio will actually be achieved, and no warranty or representation is given to this effect. The value of investments and any income may go down as well as up, and, as a result, an investor may not get back the amount originally invested. Past performance is not indicative of future performance, and any reference to a security is not a recommendation to buy or sell that security. Investors should note that the views expressed and information given are current at the time of publication but, at the time of reading, may no longer be so and/or may have been acted upon by the Discretionary Portfolio Manager.

All figures in this document are sourced from Lipper and are total return in sterling (unless otherwise stated). The asset allocation and performance information provided represents the model portfolio. However, the actual returns experienced by an investor may vary from the model information provided due to the timing of investments, differences in taxation and charges. Portfolio performance is quoted net of the cost of the underlying investments but gross of fees, so the returns stated do not take account of Adviser fees, product and platform costs or investment management fees. Any figures shown have not been externally audited.

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