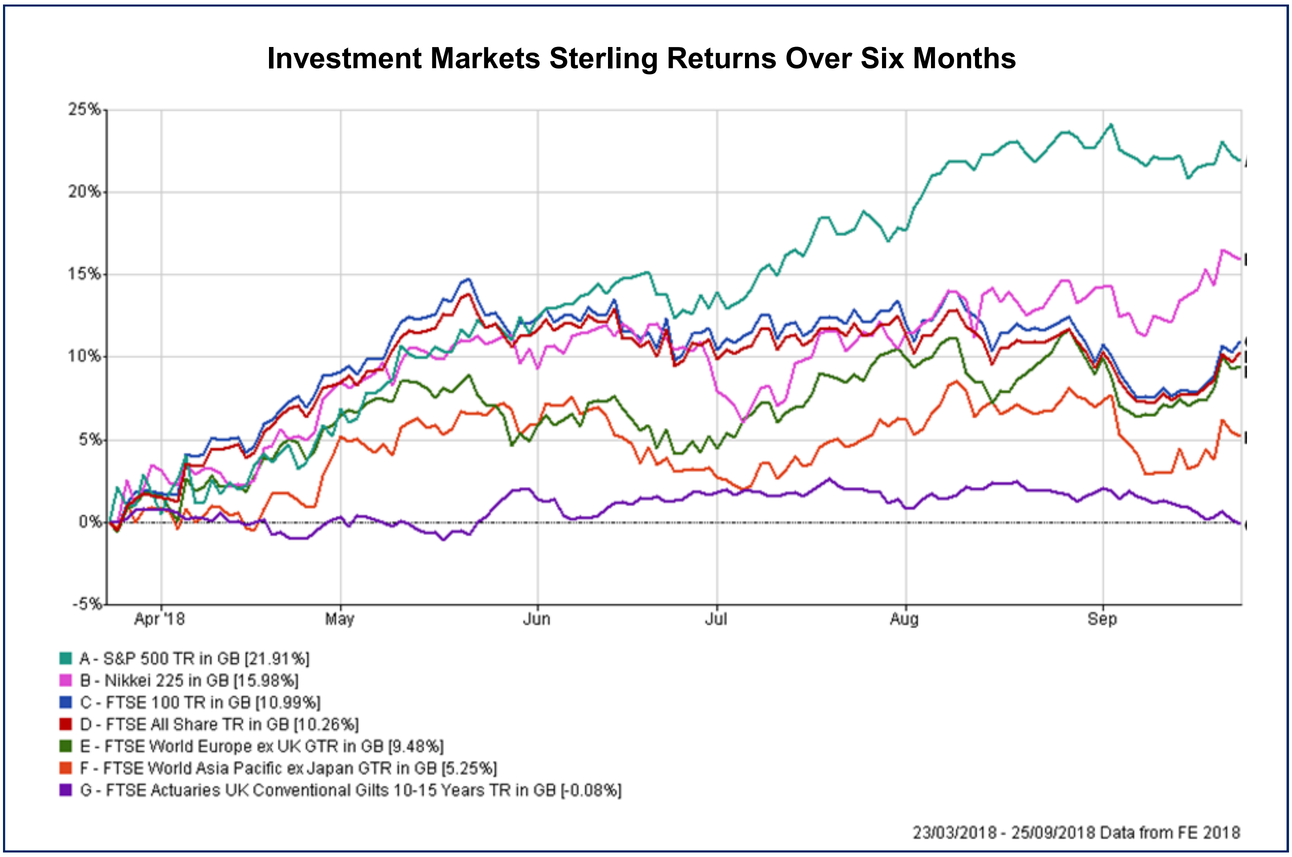
INVESTMENT COMMENTARY

CARTLIDGE MORLAND

September 2018

From March 2018, equity markets have recovered with returns flattered in sterling terms as the pound has weakened over the last six months. The news flow on the possibility of a ‘no deal’ Brexit has driven the level of sterling. The recent impasse over Brexit at the Salzburg European summit led to further falls in the pound. The US economy and equity market continue to power on with growth expected to get back to the 2005 level this year. Sentiment towards Asia has remained negative as the US administration continues to impose further tariffs on China. Generally, emerging markets have also suffered as currency crises hit Argentina and Turkey which does nothing to help investor confidence. Emerging market returns are also dominated by the relative level of the US dollar. The oil price is now at a four year high due to supply constraints with OPEC countries and Russia refusing to increase production which will impact on the level of inflation globally.



UK

Inflation unexpectedly rose in August to 2.7%, the highest level in six months fuelled by increases in the prices of recreational goods, transport and clothing. This rise may only be temporary given the nature of the goods/services increasing in price. Wages (excluding bonuses), grew by 2.9% in the three months to July so still above the rate of inflation. In its latest inflation report, the Bank of England (BoE) expects inflation to settle down to just above its 2% target in two years' time. The Bank of England Monetary Policy Committee voted unanimously to keep Bank Rate at 0.75% at its September meeting with further increases very gradual against the backdrop of Brexit. The Office of National Statistics (ONS) figures show the economy growing by 0.3% in July, and by 0.6% over the three months to July - the fastest pace in almost a year. The service sector grew strongly, with retail sales boosted by warm weather and the World Cup. The construction sector expanded but industrial output contracted. Economic indicators show that the manufacturing sector, whilst still expanding, did so at a slower rate in August with new orders slowing and foreign demand declining. Manufacturing growth remains supported by the lower level of sterling and relatively healthy global economy, but risks remain because of trade tensions and Brexit uncertainty. Following the Salzburg summit with no Brexit deal imminent and the Prime Minister commenting that “no deal is better than a bad deal”, sterling fell sharply. Consequently, the FTSE rose as larger companies with significant overseas earnings benefit from weaker sterling. The value of sterling is likely to be volatile on the back of Brexit news flow. Government borrowing rose by more than expected following a lower tax take and an increase in expenditure in August. Borrowing jumped to £6.75bn from £4.35bn a year earlier but the year to date figure is 30.5% lower at £17.8bn, potentially giving the Chancellor, Philip Hammond, room for manoeuvre in the October Budget. Tax receipts rose by 1.6% last month from a year ago, while spending rose 5.4%.

83-85 Mansell Street London E1 8AN T: +44 (0)20 7709 5560 F: +44 (0)20 7709 5561
E: enquiries@cartlidgemorland.co.uk W: www.cartlidgemorland.com

US

The US equity market has recently reached a record high. The economy is booming with technology and economically sensitive sectors, such as materials and banks, performing particularly well. The economy continues to expand and corporate earnings remain very healthy. Consumer and corporate confidence are at their strongest levels since 2000. Corporate investment is at a 25 year-high. Economic growth is expected to be 3.1% for 2018 which is the highest rate of growth since 2005. The market is focussed on domestic growth not trade wars. Since the beginning of August, more sanctions have been imposed on Russia whilst a further £200bn worth of tariffs were placed on Chinese imports with another $267bn 'ready to go on short notice'. If this final tranche of tariffs goes ahead, it would mean virtually all of China's exports to the US would be subject to new duties. US core inflation (excluding energy and food) is rising at its fastest rate in 10 years to 2.4% pa in July. Annual wage growth has hit a nine-year high as the economy has continued to create more jobs than expected. Average hourly earnings rose by 0.4% in August, pushing the annual rate of increase to 2.9%. Against this backdrop of a strong economy, low unemployment and wage rises, the US Federal Reserve (Fed) increased short-term interest rates for the third time this year. The Fed's key rate was raised by 0.25% to a range of 2 to 2.25%. Jay Powell, the Fed Chair, commented that although there were concerns from companies about trade, "it was hard to discern any impact on the aggregate performance of the US economy." However, it may take some time for the tariffs to impact on prices. Another rate rise is expected in December and further rises over 2019 so that rates reach around 3.0% in 2020. Retail sales in July increased 6.4% from a year ago. Consumer spending is being supported by a tightening labour market, which is steadily pushing up wages. Tax cuts and higher savings are also underpinning consumption. There remain concerns that the so-called 'FAANG' stocks accounting for a combined 15% x Standard & Poor's 500 market capitalisation and 48% of the growth in the NASDAQ this calendar year are over-valued. Heavy 'short' positions in stocks such as Apple and Tesla (70% of its stock on loan to hedge funds) are potentially ominous signs.

EUROPE

The European Central Bank (ECB) did not change interest rates at its latest meeting in September although its asset purchase programme will alter as planned. Monthly asset purchases will reduce from €30bn to €15bn until the end of December 2018. Mario Draghi, the President of the ECB, commented that the eurozone economy continues to experience "ongoing broad-based growth". Rates could rise as early as June 2019 – previously September 2019 had been expected. Core inflation of 1.1% remains below the ECB target of just below 2.0%. It is unlikely that there will be pressure to increase interest rates in the near future. Q2 economic growth in the eurozone was revised up to 0.4% from 0.3%. Economic statistics show that the eurozone manufacturing sector is still growing but at a slower pace with the level of new orders rising less quickly. Concerns about trade tariffs and global trade weighed on confidence. The German manufacturing sector has shown signs of weakening as foreign demand for its exports slows. The eurozone services sector grew at a similar rate in August as it did in July. Price pressures intensified due to wage (especially in Germany) and fuel

EUROPE continued

costs. Business confidence was the lowest in 21 months, mainly due to geo-political concerns. IHS Markit, which compiles the PMI market indicators, reported a "near stagnation of exports". The eurozone's manufacturers appear to be beginning to rein in spending and delay hiring plans as trade tensions between the US and China escalate, according to a poll of business sentiment.

ASIA PACIFIC

China announced new trade tariffs on $60bn of US goods in retaliation for US imposing duties on $200bn of Chinese imports which came into effect on 24 September. The US had offered not to impose these tariffs if China returned to the negotiating table. China will target goods such as liquefied natural gas, produced in states loyal to the US President. In China, fixed-asset investment growth slowed to 5.5% during the first half of 2018, the lowest rate since data began. Retail sales were also lower than forecast at 8.8% but only slightly below the 9.1% expected. GDP growth decelerated by 0.1% to 6.7% in the second quarter. The Chinese stock market reached its lowest level in nearly four years due to trade war fears and the worsening economic backdrop. Asian markets have also been affected by recent devastating typhoons with the Hang Seng index hit badly.

JAPAN

Shinzo Abe won a third term as leader of the governing Liberal Democratic Party so he can now remain in office for another three years. His rival secured more votes than expected from regional party officials so it is likely that the government will direct more resources to these areas. Abenomics appears to be working – full employment (70% of 15-74 age group), wages rising ahead of inflation rate, booming business investment (in particular automation as there is a shortage of workers) and the corporate sector profitable. Structural changes are starting to have a positive impact on the economy with more women and older people in the workplace. Consumer spending remains relatively weak but the proposed increase in consumption tax is to go ahead. There are still challenges but the economy appears to be changing permanently.

EMERGING MARKETS

Emerging market sentiment continues to be affected by ongoing currency and economic crises in Venezuela, Argentina and Turkey. Argentina's economy shrank by 4.2% in the second quarter, its sharpest year-on-year slowdown since 2014. There has been a steep quarterly fall of 14% in exports after a drought hurt the country's agricultural sector. Private consumption also declined by about 1%. Its currency crisis has prompted the central bank to raise interest rates to 60% and the government to cut spending. The government has requested a bailout from the International Monetary Fund. India's economy has seen its fastest quarterly growth in two years, even as its currency continues to fall. GDP expanded by 8.2% in the three months to June, compared with a 5.5% rise in the same quarter last year. The economy was boosted by a strong performance in consumer spending and manufacturing. However, the rupee remains weak; since the start of 2018, it has lost 10% in value as foreign investors sold the currency over concerns about the Indian economy's trade deficit, as well as inflation on high oil and commodity prices.

83-85 Mansell Street London E1 8AN T: +44 (0)20 7709 5560 F: +44 (0)20 7709 5561
E: enquiries@cartlidgemorland.co.uk W: www.cartlidgemorland.com

FIXED INTEREST

Prices for most developed market government bonds, which are seen as safe havens, have been supported as worries persist over trade wars, Brexit, Italian politics and economic as well as currency crises in Turkey and Argentina. UK gilts have suffered more recently as investors are concerned about the possibility of the UK leaving the EU without a deal and sterling weakening further. In the US, the strong economy has been supportive of investment grade and high yield bonds. The US 10 year Treasury is now yielding around 3% which has led to a flow of capital into the US from overseas. Sterling investment grade bonds have been relatively unaffected by Brexit-related headlines. It would appear that this part of the market has been supported by institutional investors de-risking away from equities into fixed income as Brexit concerns mount.

COMMERCIAL PROPERTY

The commercial property sector has produced a positive total return over the year to date. The greatest proportion of the total return has been derived from rental income with capital values only rising marginally of late. The retail sector has been weak in recent months with both capital and rental values falling in August. Capital values in the office sector were stronger outside London with rental values increasing very slightly. The industrials sector performed relatively well due to higher levels of capital value growth. UK property fundamentals remain strong with transactions likely to reach £55 billion in 2018. Rental growth is positive in all sectors apart from retail. The asset class is expected to generate mid single digit annual returns over the next five years with some weakness in capital values moderating returns. The retail and Central London office markets are likely to remain lacklustre. It is felt that new technology-led changes in the economy will have a greater impact on the sector than political uncertainty.

OUR VIEW

The ‘long bull run’ that has characterised financial markets since Spring 2009 may not be at an end but it is now more a case of most bulls plodding on steadfastly, with just one or two of the herd continuing their charge. This produces particular challenges in generating the returns investors require, whilst protecting more recent gains against downside risks.

Mature sovereign/corporate bond markets have benefited from central bank buying. Once the ECB abandons its quantitative easing programme in December, there will only be the Japanese central bank left in the field. The result of quantitative easing has been that investors have enjoyed exceptional capital returns from bonds but the consequence of this is that yields have been driven down to the extent that the yields on investment grade Sterling debt are now 2.5 to 3.5% pa and far less on gilts. Whilst capital values appear likely to remain fairly stable presently, yields and returns from the sector are likely to be modest. UK commercial property is in a similar position; capital values have not entirely recovered their losses during the ‘financial crisis’ because valuations

OUR VIEW continued

were far too bloated in 2007. Nevertheless, a period of relatively strong returns has drawn to a close with investors now receiving net of expenses yields of 2.5 to 4.0% pa, with the ‘total return’ being 4.0 to 5.0% pa assuming capital values keep pace with inflation. Whilst still better than deposit rates and higher than inflation, these returns are far less exciting than those enjoyed in recent years.

Those investors requiring income from their investments, or indeed a reasonable rate of growth, therefore need to leave adequate risk ‘on the table’ and to accept the inevitable fluctuations in capital value that flow from this. Blue chip UK equities are yielding 3.80 to 4.00 % pa and similar income yields are available in Europe/Asia and to a lesser degree in US/Japan. Unlike bonds and property, the returns from shares are not ‘fixed’. Companies are able to take advantage of a growing global economy to increase profits, grow their businesses and shareholder value. These opportunities are still there but with much of the global financial system ‘fixed’ or ‘almost fixed’ and with assets having found a reasonable price level, the selection of opportunities is increasingly important.

UK blue chips remain subject to a ‘Brexit discount’ but ‘no deal’ will result in a fall in sterling and the domestic value of the FTSE 100’s (69%) overseas earnings increasing, thereby driving prices strongly upwards. This is what happened in the wake of the EU referendum result. Some sort of deal will produce more certainty for business and investors, resulting in a weaker ‘relief’ rally. Whilst sentiment on Wall Street remains bullish, UK/European equity markets should continue their progress. With the US economy set to remain strong for some time yet, valuation concerns in particular sectors may be shrugged off but exposure to those areas should be reduced in the interests of preserving cumulative gains. Many European exporters, those owning valuable brands for example or the strong German manufacturing companies, should all benefit from the growing global economy. Trade tensions with the US are very unhelpful to this and to some degree, European leaders will need to assuage President Trump’s concerns. Potential trade tensions with the US and UK (its largest ex-EU export markets) are now having a very negative impact on German business sentiment, although this appears largely confined to Germany presently.

Our exposure to emerging markets equities is very light presently as we realised exceptional gains towards the end of the commodities boom. We re-invested such profits with some of those harvested from Asia Pacific equities in Japanese equities. After the US, of the major markets the Japanese equity market is the strongest performer this calendar year (Nikkei 225 up 7.25% in sterling terms); we prefer to hold exposure there. The Yen’s ‘safe haven’ status makes Japan a valuable diversifier of risk and a sound long-term opportunity.

Please email
commentary@cartlidgemorland.co.uk
to receive the commentary by email in future.