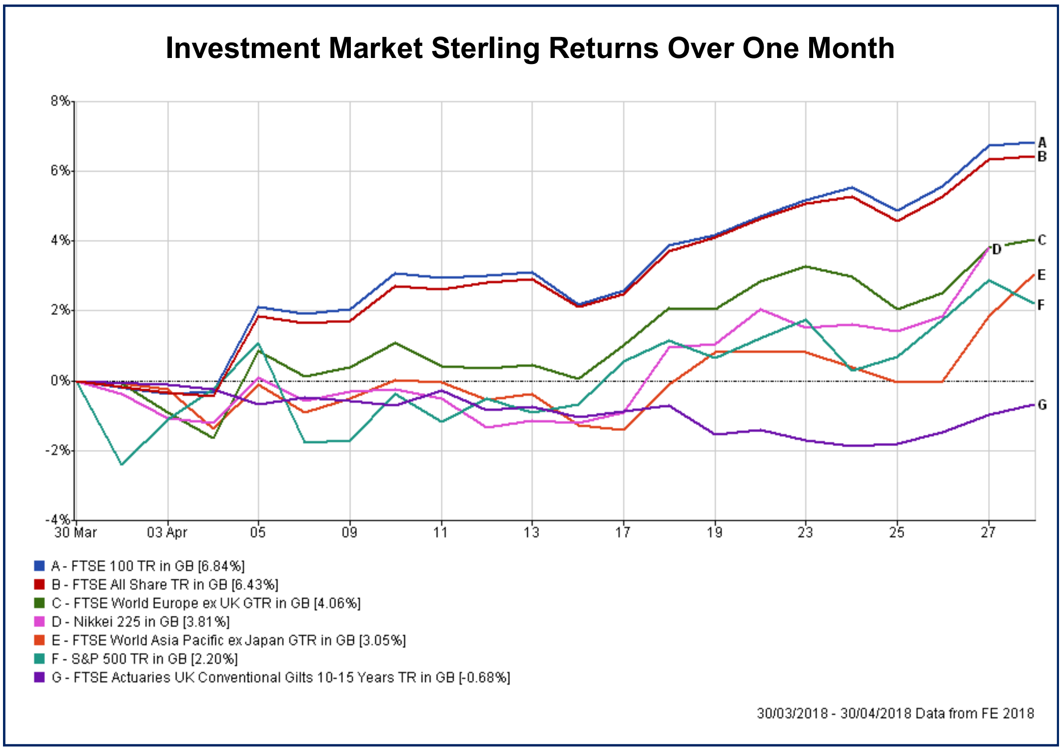
INVESTMENT COMMENTARY

CARTLIDGE MORLAND

April 2018

After the equity market jitters of February and March based on rising US interest rates, trade wars and US sanctions on Russian oligarchs, the major markets have recovered to some extent over April. However, they have still not returned to the levels seen in late January. As mentioned in our last commentary, the UK equity market has been the least favoured among global asset allocators but over the past month it appears that it has found greater support. Sterling has recovered from post Brexit lows as it is anticipated that interest rates will rise again this year. The stronger pound has held back returns from overseas unhedged funds for sterling investors over the past year. With weaker economic data reported, sterling has fallen very recently which makes UK listed companies with overseas earnings appear more attractive.



UK

Economic indicators have shown that the economy slowed in the first quarter of 2018, which has been borne out by the initial Gross Domestic Product (GDP) figure for the first quarter of 2018 of 0.1% growth. The manufacturing and services sectors are still expanding, albeit at a slower rate, whilst the construction sector is contracting. The severe weather conditions in February and March have contributed to overall weakness. Sterling had reached a post-EU referendum high of around $1.43 and has also been higher against other currencies. The expectation was that interest rates would be increased if economic data looked stronger. In the light of a weaker than expected first quarter GDP figure, it is very likely that interest rates will not increase imminently. Inflation has also fallen to 2.5% in March, the lowest rate for a year. Unemployment is at 4.2% with over 75% of the working age population having a job. Wages rose at 2.8% in February so consumers may start to feel less squeezed.

The pound has weakened recently against the background of an interest rate rise being less likely. Mark Carney, the Governor of the Bank of England, also hinted that softer economic data may mean that interest rates are not increased quickly. The UK stock market was impacted by the US sanctions on Russian oligarchs and their companies, which saw those listed in London, such as Rusal and EN+, fall dramatically.

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FIXED INTEREST

The US and UK central banks continue to slowly normalise interest rates. The US economy continues to grow and unemployment is relatively low, so the economy should be able to cope with higher rates. A further two rate rises are expected in 2018. The 10-year Treasury yield has breached 3% recently against this backdrop. The Bank of England also intends to increase interest rates marginally over time although the recent weak economic growth figure may curtail any imminent rate rise. Any increases are likely to be marginal and gradual given the Brexit negotiations. UK gilt yields are likely to rise. The European Central Bank continues with its asset purchase programme and very low interest rates. Economic growth in the region has slowed and inflation is still below target so the policy is likely to be maintained in the short term. As the central banks scale back their bond purchases over the next few years, yields are likely to rise and some normality should return to the bond market which has been distorted by the indiscriminate buying of price-insensitive buyers, such as the central banks.

EUROPE

Although economic indicators still show that the eurozone economy is continuing to expand, the pace of expansion has slowed this year. Export levels appear to have been negatively affected by the strength of the euro together with uncertainty surrounding the US/China trade tariffs, as well as the credit curbs tempering export demand from China. Growth in the eurozone has slowed this year which could just be normalisation after robust growth last year. Inflation remains below target at 1.3% in March but not near the 2% targeted by the European Central Bank (ECB). Despite acknowledging the slowdown in the economy, Mario Draghi, the President of the ECB, did not signal any change to the current asset allocation programme nor to the interest rate policy following the recent ECB meeting.

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US

The US economy continues to grow at an above trend rate of 2.3% in the first quarter of 2018. The level is lower than the previous quarter's 2.9% but better than expected. Against a backdrop of steady economic growth and falling unemployment, private sector wages grew at 2.9% pa, the quickest pace since the recovery started. US ten year bond yields have increased to 3% on the prospect of higher inflation as commodity prices have increased. The consumer price index climbed to 2.1% in March. The US Federal Reserve (Fed) is expected to raise interest rates at least twice more this year. The spectre of a trade war presents uncertainty for the market. However, consumers are still spending with car sales remaining strong together with energy expenditure. Demand for new homes remains robust due to wage growth and relatively low mortgage rates.

Although the US dollar now appears to be strengthening from its January lows, its weakness is surprising given the premise that if interest rates rise faster in the US than in other countries, then the dollar should strengthen. Instead investors have been focused on the increased government borrowing in the US to fund tax cuts and government spending. This is an unusual occurrence as unemployment is at a very low level, so tax receipts should be higher and government expenditure lower.

When a US recession eventually arrives, US government borrowing will have to increase even more. Higher US spending is also expected to lead to more imports and hence a deterioration in the US trade balance (exports minus imports). Americans will be selling their dollars to buy more foreign goods without an offsetting increase in exports. Therefore both the increase in government borrowing and the deterioration in the trade balance have led to downward pressure on the dollar, despite interest rates being on a definite upward trend.

ASIA PACIFIC

After some weakness in the Japanese manufacturing sector, output has increased in April and business confidence has strengthened. A stronger yen saw export orders fall but this was compensated for to some extent by increased domestic demand. The Bank of Japan (BoJ) has abandoned its pledge to reach its 2% inflation target in 2019. Inflation is expected to reach 1.8% in 2020 but the change to the target gives the bank more flexibility. At its recent meeting, the BoJ kept interest rates on hold with the 10 year bond yield capped at 0% and its asset purchase programme continuing at a rate of ¥80 trillion (US$730 billion) per year.

According to official figures, China's economy grew at 6.8% pa over the first quarter of 2018 beating forecasts for the period. The growth was supported by strong consumer demand which reflects the government's impetus to increase domestic demand. Nevertheless concerns about rising debt levels still remain. The government has been adopting measures to try and contain debt levels and reduce the housing bubble without impacting on growth. As well as a cooling housing market, there is also the prospect of rising tensions between the US and China which could impact on the level of exports.

EMERGING MARKETS

The fundamentals of emerging markets appear to be improving with emerging markets out-performing the equity markets of developed economies over 2017. Profitability is coming through with expectations about earnings relatively optimistic. Over the past year it has been emerging Asia that has seen high levels of economic growth that have driven markets. The technology sector has seen exceptional returns, in particular. The threat of trade wars with the US is a concern as this would impact on economic growth. The recent declarations by North and South Korea to formally end the Korean War and the embarkation upon denuclearisation by North Korea are positive for the region and for the South Korean equity market. Ongoing corporate governance changes should also be supportive. The recent sanctions on Russian oligarchs by the US saw the Russian equity market fall. The level of risk premium has increased but opportunities do exist as the improvement in the oil price has led to higher economic growth. Brazil has also benefited from increasing commodity prices.

COMMERCIAL PROPERTY

The industrial sector remains robust with yields facing downward pressure. The only other sector with downward pressure on yield is the M25 office sector. The latter is looking attractive in comparison to major regional cities, so investor interest has risen. Investor sentiment towards the retail sector is weaker due to a number of high profile retail businesses failing recently and the prospect of mergers and restructurings bringing more stock on to the market. High quality shopping centres in central locations remain in demand. Trading volumes have fallen in the first part of 2018 as investors appear more cautious. Fears for the City of London surrounding Brexit have dissipated to some extent as four major banks have announced that hundreds rather than thousands of jobs will need to be relocated to the EU.

OUR VIEW

The UK market has made an attractive return over the past month but, in common with other major equity markets, has not yet regained the high levels seen in January. In the UK, companies deriving their earnings domestically have suffered following the EU referendum vote and those with international earnings have performed well. In the US, the handful of so-called FANG companies (Facebook, Amazon, Apple, Netflix, Google, (now within Alphabet its holding company)) have driven the returns from the US equity market until very recently. These distortions in the market present opportunities for good stock picking managers. However it can take time for value to be realised.

Against a background of a growing global economy and healthy corporate earnings reports from all regions, shorter term pessimism is probably misplaced. However, global markets are widely considered to be at the 'late cycle' stage and with market activity overwhelmingly based on algorithms, rather than fundamentals – the short term is dangerous to predict. Our expectation is that markets will only take a decisive change of direction once the economic cycle turns, which is probably some way off. In the meantime, investors ought to be able to earn reasonable capital profits and acceptable yields. The US Treasury yield having increased to 3% pa is an important factor, because those holding the US dollar – the World's reserve currency - can presently earn a real return without accepting meaningful risk, except that of inflation. The higher yield from US Treasuries may make international investors less willing to continue accepting the risks inherent in equities.

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