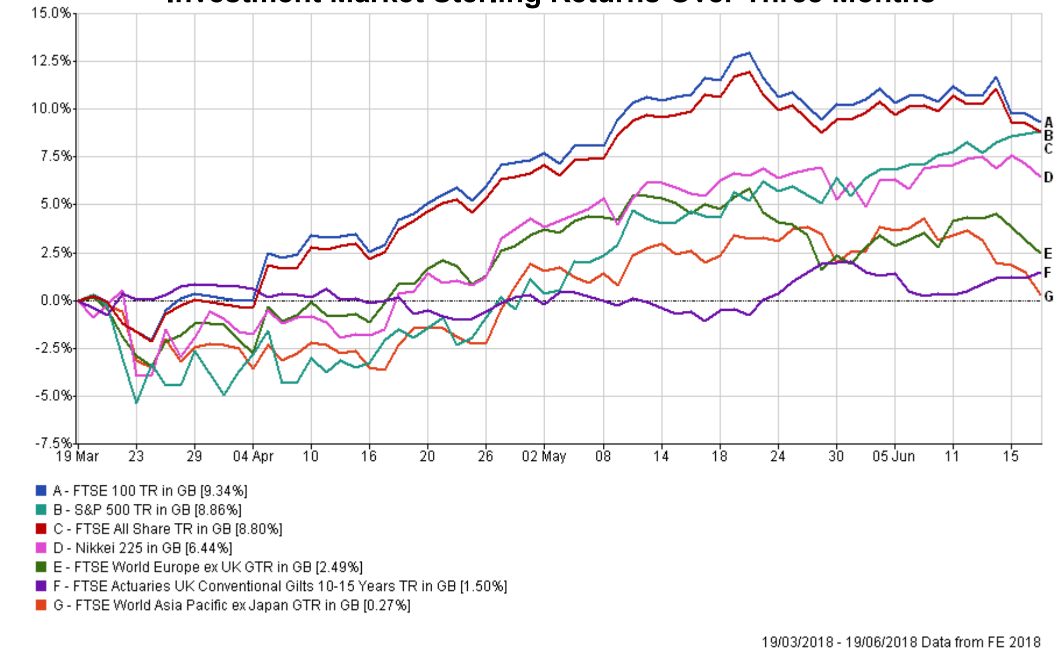
# INVESTMENT COMMENTARY

CARTLIDGE MORLAND

## June 2018

Over the last three months, sterling returns from the major investment markets have been positive although within that time frame there have been bouts of weakness. Sterling has fallen about 8% in value against the US dollar since mid-April, which has resulted in those UK listed companies with considerable overseas earnings performing better as those earnings are worth more. In addition, the increasing oil price has been supportive of the energy companies in the main UK indices. Trade tariffs imposed on China, the EU, Canada and Mexico by the US have added to volatility. Very recently markets have fallen as further tariffs were announced and the countries affected look set to retaliate. The political uncertainty in both Italy and Spain led to equity markets falling at the start of June. There is now pressure on Angela Merkel in Germany from her main coalition partner over migrant policy. Against these international concerns is also the continued wrangling over any Brexit deal in the UK. Central banks remain keen to normalise monetary policy with the US Federal Reserve (Fed) raising interest rates once more with further rises expected. Even the European Central Bank (ECB) is to taper its asset purchase programme. As liquidity tightens, investment markets will need to adjust accordingly.

**Investment Market Sterling Returns Over Three Months**




## UK

The UK equity market as measured by the FTSE All Share index has performed well recently. The weakness in sterling and the rise in the oil price has helped overseas earners and oil companies in the index. There are still concerns about UK domestic companies with high street retailers, such as House of Fraser and Debenhams, in particular, suffering from the rise in internet shopping and the squeeze on incomes. There has been better news for the workforce as average wage rises of around 2.8% pa are now outstripping inflation of 2.4% pa. The unemployment rate is at a relatively low level of 4.2% or 1.42 million people. Retail sales figures have improved, increasing by 3.9% pa in May with good weather and the Royal Wedding bringing out the shoppers. Economic indicators show the economy is still expanding at a slightly higher rate in May. It remains to be seen if the first quarter Gross Domestic Product (GDP) of 0.1% growth was just a blip due to extreme weather conditions or if economic growth is actually slowing. The Monetary Policy Committee of the Bank of England is unlikely to increase interest rates quickly if growth is muted and inflation is reverting to its 2% target. A rise had been expected in May but was not forthcoming due to the weaker economic backdrop.

## US

The US equity market has made a good return in sterling terms over three months as the US dollar has strengthened as interest rates have been rising. At its June meeting, the Fed increased interest rates by 0.25% to a range of 1.75-2.0% This is the highest level since 2008 and two further rate rises are expected this year as the Fed tries to get rates back to a more 'normal' level.

The 10 year US Treasury (Government Bond) on which equities are priced is now at around 3% - a relatively attractive yield on 'safe' government bonds. The US economy continues to grow with a rate of 2.8% expected this year. Inflation is at the target rate of around 2% and unemployment is low at around 3.6%. The Fed anticipates that against such a supportive background, interest rate rises will not impact greatly. Statistics indicate that the economy is in good shape with the all-important services sector growing strongly. However, there are concerns over President Trump's imposition of trade tariffs on Chinese goods as well as specifically on steel and copper imports from the EU, Canada and Mexico. Those countries affected are likely to retaliate in kind and US GDP may be negatively affected.

## EUROPE

Equity markets were impacted by the length it took for Italy to form a government. Simultaneously, the Spanish government collapsed on a no confidence vote and was replaced with a minority socialist government. Angela Merkel's German coalition government now looks fragile as disagreements have arisen over migrant policy. The ECB is set to end its bond buying programme by the end of December 2018. The level of purchases will be reduced to €15bn from €30bn after September 2018 as long as the economic data is supportive. According to the ECB, underlying growth is still strong in the eurozone although it has stuttered recently. Industrial production is lower in both Germany and France and the level of German imports has increased whilst exports fell. Economic growth in the eurozone was 0.4% in the first quarter of 2018 – the lowest level since the third quarter of 2016. Inflation is now just under the target of 2%. The ECB kept the main interest rate at 0% and do not expect to raise rates until summer 2019. On this news, the euro weakened.



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

## EMERGING MARKETS

Increasing US interest rates still have a negative impact on emerging markets as investors look to invest capital in "safer" assets (US Treasuries) which are producing a reasonable yield. Where governments have borrowed in US dollars, the rising US dollar then makes servicing those loans more expensive. To protect capital, governments are forced to raise their own interest rates which has been seen India and Indonesia, for example. Sentiment has also been affected by the ongoing imposition of tariffs by the US coupled with a run on the Argentinian peso. Brazilian economic activity continues to improve with retail sales figures stronger. There is an election in Brazil in October. Currently the mainstream candidates are polling badly but whoever wins will have to address pension reform or face a fiscal crisis during their term in office. The Russian central bank left its policy rate unchanged at its latest meeting following its most recent monetary easing cycle. The Russian economy has benefited from the rise in the oil price over the last few months.

## ASIA PACIFIC

Asia Pacific markets have been negatively affected in the wake of further tariffs imposed on Chinese goods by the US. China is to retaliate with more tariffs on US goods as the trade war escalates after talks have not reached agreement. Infrastructure spending in China has decreased as the government has adopted a more prudent credit issuance policy. Manufacturing activity has continued to improve particularly in the private sector. A small number of technology 'STAT' (Samsung, Tencent, Alibaba and Taiwan Semi-Conductor) have been driving returns in the region. The calming of tensions in the Korean peninsula is welcome but the outcome has had little impact on the South Korean market as returns have been relatively flat.

Lack of inflation in the Japanese economy still remains a problem with the Bank of Japan (BoJ) recently revising down its assessment of the level of core inflation to 0.5%-1%. Whilst negative interest rates and an aggressive bond purchase programme had helped Japan achieve a reasonable level of economic growth, the first quarter of 2018 saw a contraction of 0.6%. The BoJ has indicated that the economy is expanding moderately with private consumption higher, solid business investment and higher corporate profits. There was no change to its monetary policy and its present strategy is expected to be maintained for some time. Wages are increasing and unemployment is low so household spending should increase further. Japan's ageing population has led to a smaller workforce and made it more difficult to grow the economy. Therefore the government has now announced a new residency status to bring up to 500000 foreign workers into the agriculture, construction and social care sectors.

## FIXED INTEREST

Geo-political concerns around trade tariffs, European political uncertainty as well as Brexit over the past month have seen core government bonds (US Treasuries, UK Gilts, German Bunds) rise in price and yields fall as investors have sought less risky investments. Economic growth remains strong in the US with tax cuts and government spending leading to growing volumes of Treasuries. Inflation is rising and therefore the 10 year Treasury yield has risen to around 3% for the first time in many years. Investment grade bonds still provide reasonable returns over government bonds with the more interest rate sensitive,

## FIXED INTEREST continued

investment grade (IG) corporate bonds benefitting from increased caution recently. However, with rising government bond yields this margin is likely to tighten. As central banks continue to unwind their supportive bond purchase programmes, volatility could again return to the markets. High yield bonds have performed well against strong corporate fundamentals and low default rates but do look a little overvalued.

## COMMERCIAL PROPERTY

There is still a growing divide between the struggling retail sector and the industrial sector which remains healthy according to the latest RICS survey. The rise of internet shopping continues to have a strong impact on retail together with squeeze on incomes. Demand for industrial (distribution) space has continued to rise and enquiries about office space have increased for the first time since Q1 2016. In contrast, the demand for retail space has declined and at a faster pace. Rental growth has moderated rising at around 3% in the first quarter of 2018. However, the retail sector is weighing on the average, whilst the industrial sector remains robust and the office sector positive. Prime industrial and office space have the strongest prospective rental growth over the next year. In London, prime office rents remain positive whereas all other sectors in the capital appear more pessimistic. Retail capital values are expected to decline over the next year with the outlook for secondary assets very poor. Prime office capital values are expected to grow for the first time since Q1 2016. Prime industrial capital values are also likely to experience good gains in the next year.

## OUR VIEW

We remain optimistic in terms of securing relatively favourable returns for investors over the current calendar year. Interest rates are rising in the US but only to the extent predicted towards the close of last year, whilst the US economy continues to strengthen. Although the European economies are slacking presently, expectation remains that growth will tick upwards towards the close of the year. Any rise in the US dollar will be unhelpful to indebted emerging market and Asian economies however. In both Europe and the UK any sudden upward trajectory in interest rates appears unlikely – this and low inflation are supportive of the bond markets.

Although US Treasury yields have risen, this is insufficient to make equity returns unappealing and with corporate earnings strengthening in the developed economies, a sustained decline in equity prices appears unlikely.

The effects of deteriorating trade relations between the US and Europe/China are an unfolding and unpredictable story. Trade wars have the potential to upset equity markets, especially over the short term. Whether US import tariffs prove injurious to the overall interests of US businesses is difficult to assess but evident that President Trump at least gambles otherwise. We assume such tariffs would negatively affect Chinese exporters and potentially European and Asian ones too. As a major exporting economy this could place particular stress upon Germany which Mr Trump regards as one of the 'bad guys' in the trade and defence expenditure contexts.

Please email
commentary@cartlidgemorland.co.uk
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