INVESTMENT COMMENTARY

CARTLIDGE MORLAND

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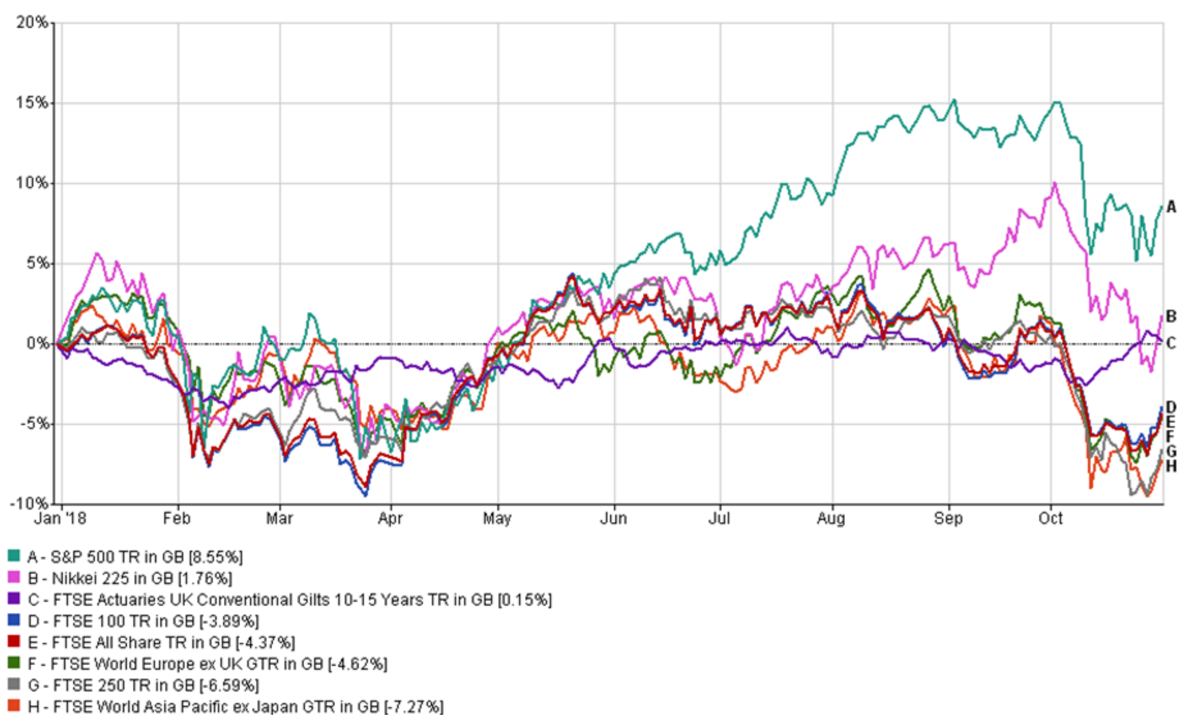
Global equity markets had a torrid October with all markets falling in sterling and local currency terms. Markets have sold off as investors have become more concerned about a range of financial and geo-political issues. For sterling investors, the losses have been mitigated to some extent by weakness in sterling as a result of ongoing Brexit uncertainty. The US Federal Reserve continues to tighten its monetary policy with a further interest rate rise expected in December, as the US economy is growing strongly. There are concerns that US economic growth has peaked and growth areas of the market, such as the technology sector, have been adversely affected. With the prospect of higher interest rates, US Treasury values have fallen and yields increased, consequently investors may consider the risk-free Treasury rate attractive relative to riskier equities. Not only have rising US interest rates hit sentiment in Asian markets, especially those with US dollar indebtedness, but the impact of US trade tariffs on China has also added to negativity in the region. There seems little progress on the US and China reaching agreement of their trading relationship currently. With weakness in the Chinese equity market, the Chinese authorities have intervened to increase liquidity to try to rebuild confidence. The weakening Chinese economy has also impacted exporting economies such as Germany, as demand decreases. The clash between Italy and the European Commission over Italy's expansionary budget has also added to market stress in Europe. Against this backdrop the International Monetary Fund (IMF) has revised down global growth estimates, which has further exacerbated negative sentiment. As we go to print, equity markets have recovered losses to a limited extent as Q3 earnings newsflow has been supportive.



UK

The UK economy grew by 0.7% in the three months to August, buoyed by the hot summer, although August GDP growth was flat. This was the fastest three-month pace of growth since February 2017, although long term growth continues to lag behind its historical trend. Average earnings in the three months to August rose 3.1% pa whilst inflation fell to 2.4% pa in September. This should lead to incomes of consumers feeling less squeezed, although retail sales did experience some weakness in September. Manufacturing new orders fell at the fastest pace in three years in the quarter to October, reflecting falls in both domestic and export orders. UK productivity grew in the second quarter of the year but is still behind rates achieved before the global financial crisis in 2008. The Office for National Statistics said output per hour was up 1.4% compared with the same period last year. It rose by 0.5% compared to the first quarter. New car sales in the UK plunged in September. The number of total vehicles registered was down 20.5% on the same period in 2017. Carmakers have struggled with 'a raft of upheavals' including adjustment to stricter emissions standards. Consumer credit levels also fell as new borrowing for cars fell. At its November meeting, the Monetary Policy Committee (MPC) of the Bank of England (BoE) maintained Bank Rate at 0.75%. The BoE said that rate rises would still be 'gradual' but indicated that it would need to raise interest rates to 1.5% over the next three years to keep inflation under control. This forecast is based on the assumption of a smooth Brexit, with a transition deal starting next March and without any disruption when Britain leaves the EU.

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US

The US economy continues to grow at a strong pace, although a little slower than earlier in the year. Q3 GDP growth was 3.5%, above the 3.0% expected, but below 4.2% seen in the previous quarter. Household spending is at its highest since 2014. The US labour market continues to tighten, with the number of US job openings in August hitting a new high, whilst wage growth rose to the highest level since 2009. The US unemployment rate fell to 3.7% in September, the lowest rate since December 1969. Inflation was held back by a slower increase in the cost of rent and falling energy prices; the annual Consumer Price Index (CPI) level increased 2.3% in September, slowing from 2.7% pa in August. Nevertheless the tightness of the labour market could well see pay increases fuel inflation. In September, US consumer confidence hit its highest level since 2000, with small business surveys showing that they are at their most optimistic since the survey began in 1974. US consumer prices rose less than expected in September. There are worries about future economic growth, as the all-important housing market seems to be slowing as interest rates rise. This weakness was reflected in the number of house sales, as well as a fall in new home loans demand evident in bank results. The US Federal Reserve (Fed) is expected to raise interest rates at its December meeting if economic growth remains robust. There are concerns that growth is slowing and these were exacerbated by mixed Q3 results from some of the bellwether industrial companies such as Caterpillar, as well as disappointing reporting from Amazon and Alphabet. Although it increased its profits, Apple's hand-set sales growth is now falling short of its forecasts.

ASIA PACIFIC

The Chinese equity market has fallen significantly over this year with the latest falls coming over the past month, in common with other equity markets. The recent falls came in spite of the People's Bank of China cutting banks' reserve requirement ratios to free up Rmb750bn ($109bn) of capital. This intervention is part of efforts to calm concerns about slowing economic growth and the impact of a trade war with the US. Although the Chinese services sector grew at its fastest rate in three months, manufacturing expansion flat-lined in September. Car sales in China fell 11.6% in September for the third month in a row of year-on-year decline, reflecting the slowdown in the economy, which in turn has impacted on the performance of global vehicle manufacturers around the world. Further stimulus measures are expected as a recent meeting of the Politburo dedicated to the economy, pledged to "stabilise employment, stabilise finance, stabilise foreign trade, stabilise investment and stabilise expectations". Tax cuts have already been announced and further tax reductions on cars, in VAT and corporation tax may follow. The Chinese economy grew at 6.5% in the third quarter, the weakest quarterly expansion since 2009, though still in line with the government's official target of 6.5% pa. The impact of US trade tariffs have not yet shown up in the trade data, with Chinese exports still growing at 12.2% in the first three quarters of 2018. South Korea has also taken action to bolster confidence in its domestic equity market. A fund is to be set up to raise $180m to invest in local stocks and

ASIA PACIFIC continued

also a further $260m is to be invested in shares listed on the technology-heavy secondary index. Although relatively small amounts, the intention is to try and reassure investors. The recent bout of investor risk aversion saw foreign investors as net sellers of the Japanese equity market. The Bank of Japan (BoJ) moved into the equity market buying ¥870bn of shares – a relatively modest amount. The BoJ kept interest rates unchanged at its October meeting and reduced its core consumer inflation forecast to 0.9% for the 2018 financial year from its 1.1% July forecast. It would appear that monetary policy is unlikely to be tightened in the near term as the inflation outlook does not necessitate action.

EUROPE

The European Central Bank (ECB) did not change its main interest rates at its last meeting but it is still to stop its highly supportive bond purchase programme in December. A range of indicators point to economic growth slowing further in the eurozone. Q3 GDP growth increased by 0.2% falling from 0.4% in Q2. The annualised rate of GDP growth was slower than expected at 1.7% pa in Q3 from 2.2% in Q2. The withdrawal of monetary stimulus appears to be having an impact. A drop in exports linked to trade wars and tariffs has affected economic confidence in the region and increased risk aversion. Sentiment has also been affected by the rift between the populist Italian Government and the European Commission over Italy's draft budget. The Italian government's proposals for a larger deficit would break the EU fiscal rules as well as Italy's previous commitments. The Italian government has been given three weeks by the European Commission to alter the budget or face fines. Italy's debt costs rose as a consequence, which is of concern given Italy's debt level is second only to Greece in the eurozone relative to GDP.

EMERGING MARKETS

Emerging markets equities have sold off as they have been impacted negatively by rising US interest rates and a stronger dollar, which have tightened financial conditions. With interest rates/US Treasury yields higher, investors have not sought higher yields outside the US market and capital has been withdrawn from emerging markets so putting pressure on emerging markets exchange rates. Turkey and Argentina, in particular, have suffered but in general local liquidity has tightened and pushed up borrowing costs. The International Monetary Fund (IMF) has agreed to an increased credit line of $56bn for Argentina as the government is taking action to fix its economy. Brazil has elected Jair Bolsonaro, a right wing and somewhat controversial politician, as its President. His government will need to address the country's fiscal position of high indebtedness through government expenditure cuts, particularly addressing Brazil's expensive state pension provision. There is some optimism about the new government, as Bolsonaro appears to have tempered his views and perhaps deferred investment may now actually take place.

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FIXED INTEREST

The US Fed is continuing to raise rates and drain liquidity from the financial system. It is ensuring that it will have policy tools available when the economic cycle turns. Inflation is close to the Fed's 2% target and the unemployment rate is at 3.9%; a further interest rate rise is expected in December with more rises expected next year, so that rates in 2020 are around 3.25%. The Bank of England increased Bank Rate to 0.75% in August. No further rises are expected in the short term but if the Brexit deal is smooth, pent-up demand may grow and interest rates may have to rise. For now there will be little pressure on the UK bond market. Investors turned to gilts over the recent period of equity market volatility as they sought safer assets. Inflation linked gilts have performed well as inflation expectations have risen due to growth expectations being revised upwards. With rate rises continuing in the US and the ECB due to increase rates from mid-2019, their respective bond markets may become pressurised.

COMMERCIAL PROPERTY

According to the latest RICS survey (Q3 2018), occupier demand fell slightly in the third quarter but there are disparities between sectors. Demand for industrial space has continued to rise but at a more subdued pace. Demand for office space is largely unchanged, whilst the number of businesses looking to take up retail space continued to fall for the sixth consecutive quarter. Rents for primary and secondary industrial property are expected to post solid growth, with moderately positive growth for prime offices. Expectations for retail sector rents remain negative over the next year. Investor demand reflects the strength in the industrial sector and weakness in the retail sector. Overseas demand remains at similar levels to the last quarter. Capital gains are expected in the industrial and prime office sectors, but retail sector capital values are likely to fall further.

OUR VIEW

In recent issues of our monthly bulletin we have commented on the difference in momentum between the shares prices of the so-called FAANG stocks and that of other stocks forming the broadly based Standard & Poor's 500 Index. This fear of certain tech/social media stocks becoming over-valued or falling in value due to missed forecasts has led our reduction of index-tracking exposure in the US in favour of equity income over the past couple of years. We have therefore taken what action we can to reduce risks in our US equity exposure but even after recent falls, one should not ignore the exceptional returns achieved from US equities in recent years. It rarely pays to underweight the US dollar and the world's most dynamic equity market too much.

Our comments on the rising dollar and the effect on emerging markets and the Asia Pacific region have been similarly prescient and for that reason we have been

OUR VIEW continued

holding very modest emerging markets equity positions, with reduced Asia Pacific equity exposure too. The beneficiary has been our increasing position in Japanese equities, the prospects for which remain highly favourable in our view.

In the UK, we have had a contradiction between depressed 'Brexit discount' corporate valuations and the spectre of corporate earnings suffering under 'no-deal' especially the earnings of mid-cap companies. We have been reluctant to sell UK equities and have continued to reap high dividends from substantial 'equity income' positions. Our overweight position in small/mid-cap stocks has been disadvantageous over the past 12 months because the FTSE 100 has delivered a better overall relative return, proving more resilient to market turbulence, as we would expect. We see no reason to alter our current exposures presently.

We had made a conscious decision to include more significant exposure to gilts in ALL balanced portfolios last year, with an informal minimum threshold introduced. We have also increased credit quality in the investment grade corporate bond sector, whilst virtually eliminating high yield bond exposure where we have considered the additional income yield ('risk premium') to have been insufficiently attractive. Gilts did rally last month and thereby reduced portfolio losses as equity markets fell. Investment grade corporate bonds held up pretty well too. Although the yields are unattractive, we remain of the view that our UK fixed interest positions confer valuable protection for clients holding UK equities.

Europe is causing fresh concerns as the Italian government wrangles with the European Commission and Mrs Merkel becomes a 'lame-duck' Chancellor of the continent's most powerful economy. Leadership of the Eurozone may be found lacking at a critical time. Growth is shrinking, business optimism in Germany has shrunk and there is no sign yet of the mooted Q4 revival in growth. Added to this, Brexit is deflecting attention from equally urgent problems elsewhere. None of this is helpful. After a period of very strong returns, European bourses have reversed and may recover less quickly than US/UK for all that Europe remains home to many highly regarded companies. We have been consolidating profits in Germany and reducing our positions as the export-led German economy will possibly suffer more than most from global trade tensions.

The global economy is still predicted to grow at more than 3.5% pa over the next couple of years and a recession seems most unlikely. Against this background, corporate earnings should continue to increase and until there are signs of a recession, equity prices should continue to increase and dividends to flow too. A return to greater volatility is now likely and consolidating profits whilst they are available will become more important especially for those drawing income or dependent upon capital withdrawals; it will be important not to sell equities at the wrong time.

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