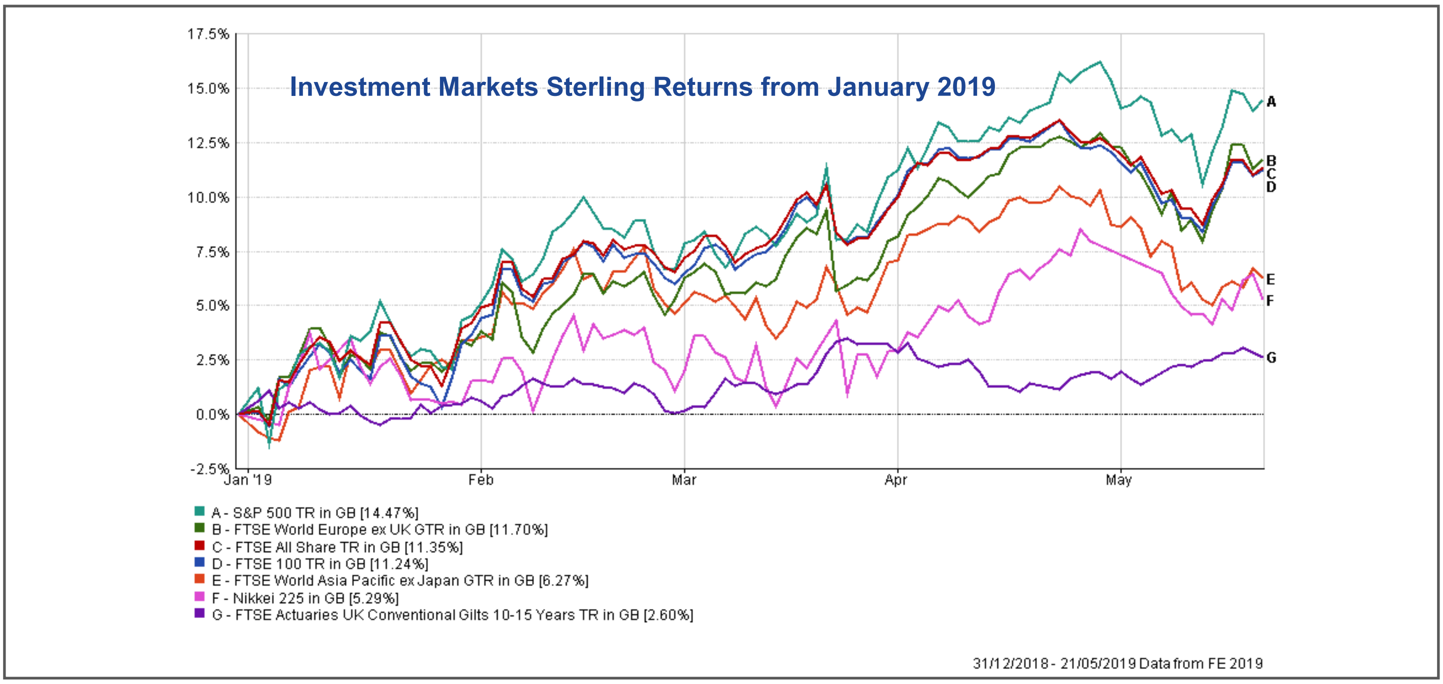
INVESTMENT COMMENTARY

May 2019

CARTLIDGE MORLAND

Equity markets have made strong returns since the start of 2019 as sentiment had improved due to US interest rates not rising, optimism over agreement between the US and China on a trade deal and the Chinese economy being supported by fiscal stimuli. However since the end of April equity markets have fallen as the US/China trade talks have stalled and both sides are to introduce further/higher tariffs from June. European economic growth continues to weaken and a Brexit solution is still being sought, with little conviction that a UK exit agreement will be agreed by Parliament whilst Theresa May remains Prime Minister. If her next attempt to have such an agreement approved by Parliament fails, Mrs May has undertaken to resign the Conservative Party leadership which will result in both a new Conservative Party leader and (presumably) Prime Minister.



UK

At its latest meeting the Monetary Policy Committee (MPC) of the Bank of England (BoE) kept Bank Rate at 0.75% against a backdrop of continuing Brexit uncertainty. The BoE warned that interest rates may have to rise faster than the market is currently anticipating if there is a smooth Brexit and high levels of spending in the UK economy. UK Gross Domestic Product (GDP) grew by 0.5% in Q1 2019 as companies built up stocks ahead of Brexit deadlines. This boost is expected to be temporary with quarterly growth falling to 0.2% in Q2. The BoE expects economic growth to be 1.6% in 2019 (up from 1.3% predicted in February). Inflation has increased to 2.1% pa in April 2019 from 1.9% p.a. in March 2019, just above the 2% pa BoE target - energy prices and air fares contributed to the rise. Consumer spending has improved - helped by higher earnings and warmer weather, together with the extension of the Brexit deadline. The labour market remains tight as employment hit a record high with the unemployment rate the lowest in 44 years at 3.9%. Growth in annual real earnings rose to 1.5%. Some economic indicators turned positive in April with the Purchasing Managers Index (PMI) showing expansion in the services and construction sectors. The manufacturing sector, which has been expanding strongly due to stockpiling ahead of Brexit, saw less robust growth in April due to the Brexit delay and new export orders falling as a result of weaker global demand, particularly from Europe, China and the US.

US

The US equity market reached record highs at the end of April but more recently has fallen as a result of the impasse in the US/China trade talks. A further round of tariffs are to be imposed due to lack of progress in the trade discussions. The US Federal Reserve (Fed) maintained interest rates at a range of 2.25-2.50% at its latest meeting. Jay Powell, Chair of the Fed, commented that its “policy stance is appropriate right now – we don’t see a strong case for moving in either direction”. The Fed has indicated that the recent softness in the inflation rate is likely to be transitory. Economic data has been positive with the unemployment rate falling to 3.6% and 263000 new jobs created in April. Economic growth of 3.2% in Q1 was stronger than expected. Quarterly earnings results have been generally good with Apple, Amazon and Twitter reporting strong numbers. Alphabet, the parent company of Google, posted disappointing results with revenue falling short of expectations. Most companies in the financial sector have posted stronger than expected results, even against the backdrop of interest rates remaining at current levels for some time. However, the slowdown in global trade and the escalation of the US/China trade war is having an impact on the US economy as growth in the manufacturing sector was relatively weak.

FIXED INTEREST

Corporate bonds have been delivering positive returns with the major central banks maintaining accommodative monetary policy whilst corporate earnings have been relatively good. Demand for corporate bond issuance has remained high. Government bond yields had been rising as Chinese economic data had been strengthening but recent equity market weakness saw yields decline as investors seek safer assets. It would appear that interest rates globally, including the UK, are likely to remain relatively low for some time and there appears to be little inflationary pressure in the short term. This provides a positive backdrop for fixed interest assets.

EUROPE

The European equity market has made strong returns since the beginning of 2019, but in common with other markets has fallen recently as fears for global growth pervade. Eurozone GDP grew by 0.4% in Q1 2019 – a welcome increase from 0.1% growth in the last quarter of 2018. Economic indicators point to weakness in the region with the manufacturing sector contracting further and German business confidence slipping again. German consumer demand has now declined. The European Commission (EC) has halved its growth prediction for the German economy to 0.5% from 1.1% forecast in February. New car emissions tests have disrupted production. The Italian economy is predicted to grow at 0.1% this year. The whole euro area is forecast to grow at 1.2% in 2019. Italy's budget deficit is expected to breach the EU's 3% x GDP limit in 2020 which will cause further strain between Italy and the European Central Bank (ECB). The Italian banking system remains heavily reliant upon ECB support and this could be undermined by the Italian budgetary indiscipline to which the ruling Five Star movement and the Italian electorate have committed. The Italians observe that the French budgetary indiscipline occasioned by President Macron's appeasement of 'Les Gilets Jaunes' appears tolerable to the ECB.

ASIA PACIFIC

Chinese economic growth expanded at 6.4% pa in Q1 2019. This was higher than expected. Factory output, industrial profits, retail sales and fixed asset investment have all showed stronger growth in March. The People's Bank of China lowered the reserve requirement for banks so that lending could increase to support the economy. However, the Chinese equity market and other Asia Pacific markets have fallen as the US/China trade war has escalated. As investors' fears rose, safe haven assets such as the Japanese Yen strengthened. The Bank of Japan (BoJ) did not change policy at its most recent meeting with monetary likely to remain accommodative. However, the BoJ's equity buying programme has distorted the pricing of Japanese stocks as they have become more correlated as a result of the BoJ's large purchases. At some point the programme will be unwound and the market will normalise providing opportunities. The Japanese economy is linked to Chinese economic growth so if China's economy does start to recover, the BoJ may be under pressure to wind down its quantitative and qualitative easing. Many Japanese companies are making significant changes to boost productivity and profitability to enhance shareholder returns. Corporate governance is now better aligned with shareholder interests. These actions should be supportive of domestic equities going forward. The South Korean equity market has been weighed down by poor corporate earnings and its economy contracted unexpectedly in the first quarter.

EMERGING MARKETS

Emerging markets had been performing well since the start of 2019 as US interest rate policy appeared benign for these markets and global growth concerns were moderating. However, the escalation in the US/China war led to falls. Indian economic indicators point to the economy expanding albeit at the slower rate against the backdrop of the general election. The Russian economy has been helped by higher crude oil prices whilst Mexico has performed well as the labour reform bill was approved in advance of the US-Mexico-Canada Agreement being approved. Brazil is dealing with pension reform, one of the pressing concerns on the economy with legislation likely to be voted on in June. Whilst industrial production has declined recently, the fiscal deficit has narrowed and unemployment has fallen slightly.

COMMERCIAL PROPERTY

The industrial sector appears to be based on solid fundamentals and is driving overall growth in the asset class whilst the struggling retail sector shows little signs of improvement. There

COMMERCIAL PROPERTY continued

is some evidence that Brexit uncertainty is weighing on investor and occupier decisions across all sectors. Demand for retail space is very weak whilst demand for offices is broadly stable and the 'industrial sector' (largely distribution related) has seen rising demand for space. Available space and rental growth prospects reflect this demand with a sharp rise in the number of retail assets available with rents expected to decline over the next three years. Buyer demand follows a similar trend with only the industrial sector better than offices and in turn retail. Overseas investment demand is now slightly down.

OUR VIEW

We reduced US equity weightings progressively over the past two/three years on valuation concerns, whilst maintaining a core position. Over the past 12 months, our caution has cost clients dear because the US equity market continued to rise strongly, based on strong domestic economic growth and supported by share buy-backs at the expense of dividends and in some cases by gearing balance sheets. US corporations with strong domestic businesses should perform well against a background of economic growth running in excess of 3% pa, full employment and rising wages. Our caution stems from valuation levels and the spectre of correction but we will maintain current weightings with significant exposure outside the tech/social media areas.

The UK economy is performing strongly given political turmoil and uncertainties caused by the prolonged Brexit stalemate and unknown future terms for EU/UK trade. This relatively strong performance is not unexpected as we have previously expressed belief that UK GDP growth is being under-reported and that it will be revised upwards. Domestic consumption is the dominant component of the UK economy with manufacturing exports a comparatively minor factor. Whilst undesirable, the scope for potentially faltering exports to slow the economy has been exaggerated. The UK economy is forecast to grow slightly faster than those of many of its EU neighbours – including Germany – over 2019 but still very much below trend. Slower growth makes it more difficult for domestically focussed companies to prosper. As previously explained, we believe UK equities offer strong medium term opportunities, as the sector has been shunned and its underlying strengths under-estimated by financial markets. Potential Sterling instability on a 'bad' Brexit is a deterrent to overseas investors.

EU exporters are suffering from lower demand from China and vehicle emissions problems continue to disrupt vehicle production. Concerns are growing over the China/US trade impasse and over potential implications for EU/US trade relations. Like that of the UK, the EU economy has seen low growth since early 2018 – but expectations are better for the second half of 2019. EU markets continue to offer access to investment in some of the world's most profitable and stable companies. We maintain our weightings and have added German exposure, often taking profits from European smaller companies in order to provide the necessary liquidity.

Where portfolios have been underweight, we have increased exposure to both Asia Pacific and emerging markets equities as relative prospects have been much better than for some time. The much gentler upward trajectory in US interest rates/the dollar is enormously helpful to sovereign/corporate debtors in these regions.

As observed in our more recent bulletins, volatility has definitely returned with a vengeance. This makes the discipline of taking of profits critical especially for those reliant on a combination of capital growth/underlying portfolio income for personal income/ capital withdrawals. As always, balancing risks alongside opportunities is a matter of judgement based on risk attitudes, income/withdrawal requirements and capacity for potential loss.