thesis
asset management

Market commentary and outlook

December 2017 to May 2018

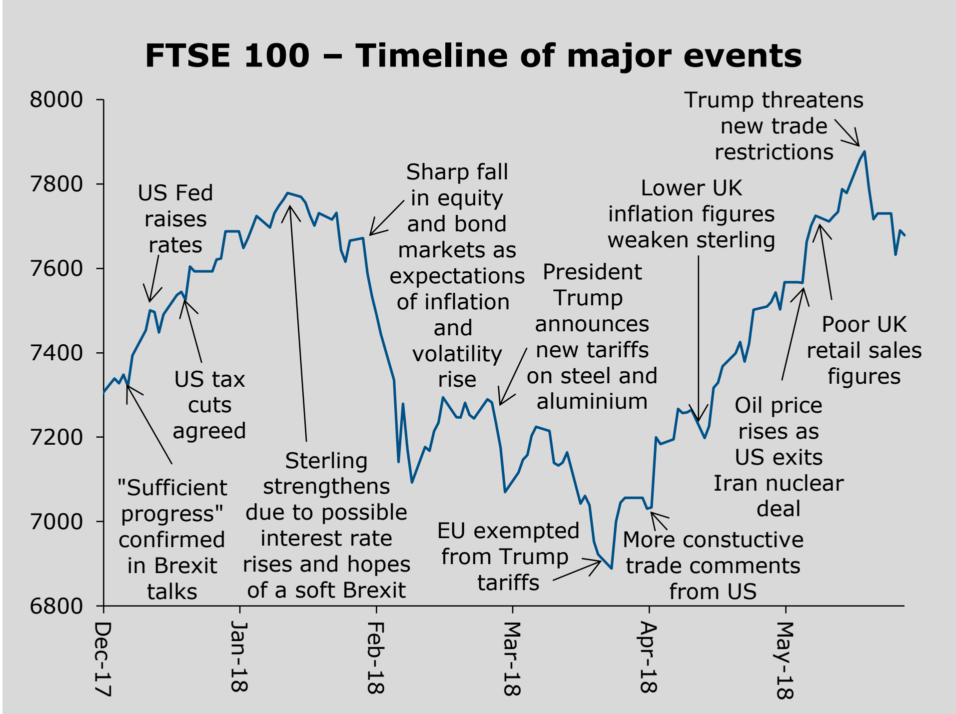
Market commentary and outlook

Commentary

Business as usual
Following the weak start to 2018 markets reached their lowest point towards the end of March but have since recovered largely back to where they started the year. US economic data is still supportive with growth solid and initial jobless claims figures falling. Elsewhere there does appear to be some dislocation to the synchronised growth story at the end of 2017 the US and China the two engines of global economic activity appear to be ticking over nicely. So really it has been a cessation in the trade war rhetoric and blowing over of scandals such as the Facebook Cambridge Analytica face-off that calmed investor nerves and allowed them to focus on the fundamentals.
Towards the end of April expectations of a May rate hike in the UK saw Sterling trade to its highest point versus the dollar since the Brexit vote in June 2016, however comments from Mark Carney along with inflation data reduced the chances of this hike significantly and Sterling began to sell off. This aided the UK equity market where large companies derive the majority of their earnings overseas.

Falling inflation but rising oil price
The latest UK CPI data reveals annual inflation at 2.5% which with wage growth at 2.8%, means wages are now outpacing inflation for the first time in a year. The Bank of England forecasts inflation falling to 2.1% in a year's time. The US, France and UK bombed research centres in Syria in response to the Assad regime's use of chemical weapons, however the strikes appear not to have escalated geopolitical tensions, and the market impact was small other than on oil. Here, Trump's new Iran sanctions and comments regarding OPEC fuelled a rise in the price of oil where Brent was trading at over $70p/barrel by the end of the period. Combined with weaker Sterling this could fuel UK inflation.

Repositioning in alternative assets
February's volatility showed that equity and bond prices can fall together which makes it all the more important to be positioned defensively in fixed interest. Otherwise we added to gold exposure and reduced UK commercial property to take advantage of lower prices amongst infrastructure assets. Growth has slowed a tad, which on the one hand has reduced expectations of a sudden monetary tightening, boosting asset values, but is also worrying in itself, especially when central banks have few tools left to counter any recession. We are cognisant that we are late in the market cycle.



Economic risk

- Many asset classes are at high valuations.
- Further interest rate rises are likely. Central banks are less willing to intervene in markets.
- Trade is increasingly contentious and new tariffs have been put in place.
- Debt levels remain high in the West and have grown in emerging markets such as China.
- The midterm elections in November may limit President Trump's freedom to implement further policies to promote growth.

Market momentum

- Synchronised growth across the globe.
- Corporate profits are showing better growth than in recent years.
- Consumer and business confidence are generally at high levels.
- Further US interest rate rises look set to be gradual and communicated well by the Federal Reserve.
- Monetary stimulus continues in Europe and Japan.

International view

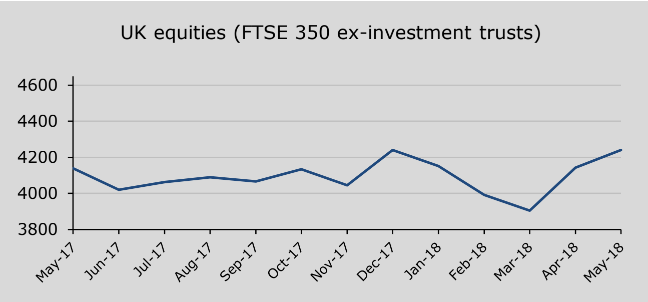
Belt tightening?
Although UK consumer spending is weakening, many UK companies are still attractive.

QE to continue
The ECB will continue to buy bonds until at least September 2018, albeit at a reduced pace of €30bn per month.

"Something phenomenal"
President Trump's ambitious tax plans have made their way into law and are likely to support faster growth.

Xi Jinping cements power
Xi has consolidated his rule at the Party Congress. China can now address its debt worries and economic rebalancing.

Market commentary and outlook



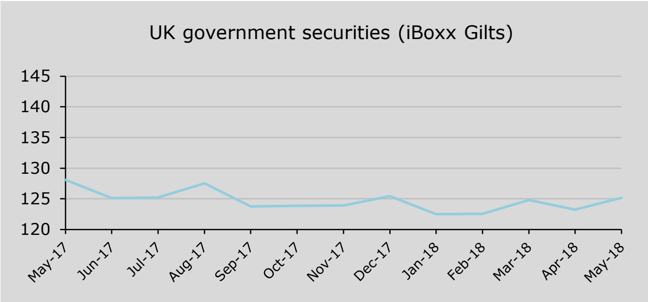
UK equities

The UK equity market has not risen as fast as other international markets over the last year. We see this as an opportunity and have used the recent market weakness to add to our UK equity holdings.

We feel that UK equities, and particularly a number of domestic stocks, have been held back by uncertainty since the Brexit referendum in a way which does not fully reflect their prospects. In the long run politicians and their decisions do not drive markets. Portfolio returns are fuelled to a much greater extent by choosing well-managed companies with strong fundamentals and buying them when they are trading at cheap levels relative to the rest of the market. Despite possible changes in trade patterns we are therefore maintaining a substantial weighting to UK equities, including several relatively unloved companies which we think are trading too cheaply.

Beyond these domestic "bargains" there is a wide choice of world class companies, making the UK market a microcosm of the wider world. About 75% of FTSE 100 firms' revenues are earned outside the UK, and sterling weakness means investors could benefit from further foreign takeovers.

- + Valuations less stretched than other markets, especially the US
- + Exposure to significant overseas revenues
- + World class companies could be takeover targets
- – A disorderly Brexit could cause disruption



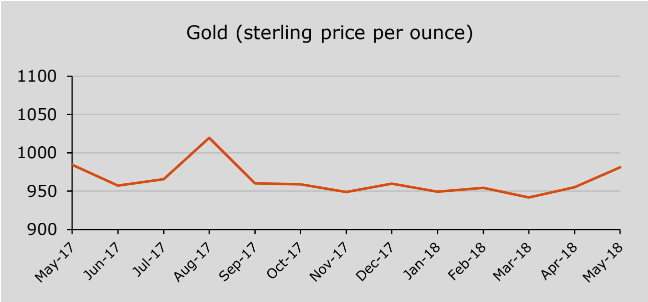
UK fixed interest

The Bank of England's Monetary Policy Committee (MPC) raised the Base Rate back to 0.5% in November. Inflation in the UK has now begun to fall as the effect of the weakness in the pound after the EU referendum has begun to lessen. Despite this, the MPC has hinted that further interest rate rises could be necessary to prevent the economy from overheating as wages rise.

With the yields on bonds still low, we believe that a cautious stance should be taken. If rates rise significantly then losses could be substantial, whereas the likely returns from income and gains are limited. We therefore have relatively low bond fund holdings in clients' portfolios and are using a variety of bond funds which aim to derive returns from different sources in order to spread the risk.

We continue to prefer corporate bonds over government bonds. They are potentially more volatile than gilts, however corporate balance sheets are generally healthy and corporate bonds offer higher returns in compensation for the additional risk. Alongside these we hold strategic bond funds which can be nimble in adjusting their exposure to different areas of the bond markets as opportunities arise.

- – Yields are set to rise as monetary policy returns to normal and interest rates rise
- – Likely returns are low compared to the risks
- – Liquidity is challenging in corporate bond markets
- + Corporate balance sheets are generally healthy



Gold and silver

Although most countries no longer use coins made from gold or silver in general circulation, precious metals are generally still seen as a store of value. Since 1971, when free convertibility of the US dollar into gold ended, these metals have traded almost as currencies in their own right. Just like currencies, the factors affecting their value are numerous and complex. This has the potential to make them a useful diversifier in a portfolio, as their value will vary differently from mainstream equities and bonds. Gold can often rise in value in times of geopolitical stress for example. It also has the potential to benefit if paper currencies see a period of stress as unconventional monetary policy is unwound by central banks.

We have added exposure to precious metals to portfolios by buying the Old Mutual Gold and Silver Fund. This blends highly secure bullion holdings with gold mining equities. The manager seeks to vary the blend of bullion relative to equities and gold versus silver to optimise exposure for the market conditions. Although we believe the present time is a good entry point we see a gold holding as a long-term part of the portfolio, and may enlarge the holding in future if we judge that conditions are right to purchase more.

- + Long term store of value can provide diversification relative to other asset classes
- + The end of exceptional monetary policy could cause stress in paper currencies
- – Can be volatile and does not provide an income

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