thesis

asset management

Market commentary and outlook

July to December 2018

Market commentary and outlook

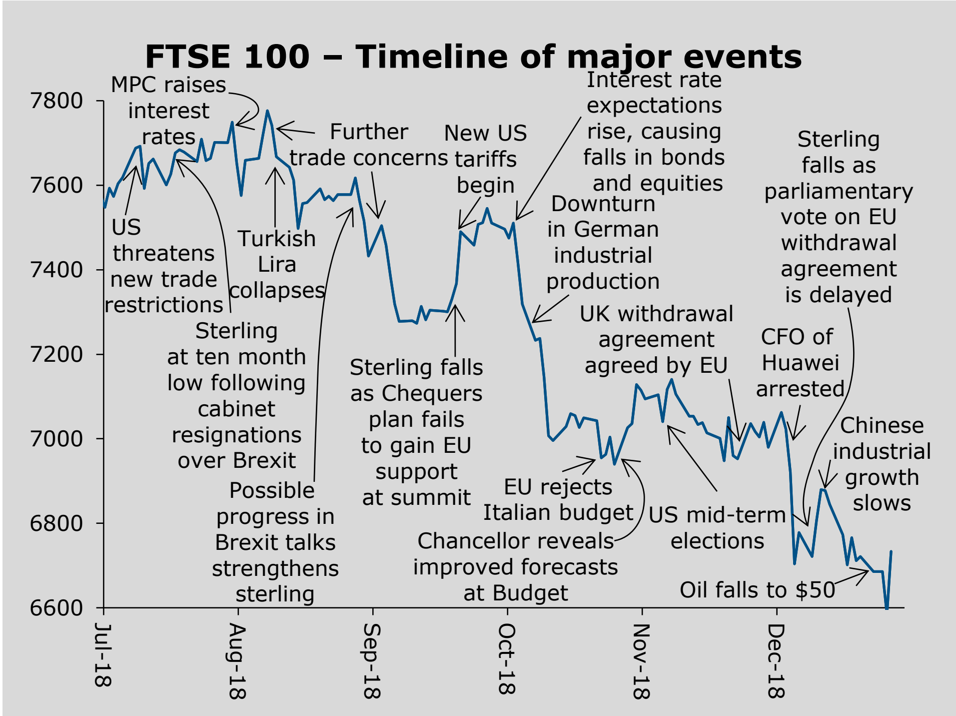
Commentary

2018 saw the return of market volatility
A relatively substantial pull-back in equity markets occurred during the last quarter of the year. The FTSE 100 was down just over 10%. Falls of this magnitude tend to occur in five years out of every ten on average, but the very calm market conditions of the last few years have meant that before the start of this year corrections on this scale were last seen in 2015 and prior to that in 2012.

Rising interest rates sparked profit-taking in growth stocks
In October Federal Reserve chairman Jerome Powell gave a speech lauding "remarkably positive" conditions in the US economy. Although he predicted that growth would continue, he pointed towards faster interest rate rises than the market had previously expected. While rates are likely to stay low by historical standards, this does potentially increase costs for businesses and consumers in a way which will eventually begin to cool the US economy. Potential higher costs and slower growth can lead to lower profit forecasts for companies, which has put pressure on stock market valuations, particularly for growth companies in sectors such as technology. The US market, where growth companies have performed extremely well in recent years, fell by more than the UK market.

Trade tensions continue to lower market confidence
Meanwhile the imposition of trade tariffs also potentially raises costs and continued heated rhetoric in this area has not helped market confidence. President Trump was particularly vociferous ahead of the mid-term elections in early November. A further spell of market falls was sparked in December by the arrest of a senior executive of Chinese technology company Huawei at the behest of the USA, which threatened to undo the recently agreed pause in escalation of trade barriers between the US & China.

Long-term investors should look past political events
Other political issues are having an elevated effect on markets. The US government shutdown, French *Gilets Jaunes* riots, brinkmanship over the Italian budget, to say nothing of uncertainty over Brexit, have all reduced market confidence. However investors need to look past this to the situation of individual companies. Many stocks are trading at attractive levels for investors who are happy to take a long-term view. The UK equity market now has a dividend yield of almost 5%. Global growth remains solid and the recent fall in the oil price should help profitability. Early resolutions to the trade wars and Brexit issues, and confirmation from the Federal Reserve that it might not raise interest rates so far or so fast, would all help to prompt a recovery in share prices.



Economic risk

- Further interest rate rises are likely, raising costs for companies and consumers.
- 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.
- Volatility of sterling exchange rates can have a significant positive or negative effect on portfolio values.

Market momentum

- Corporate profits remain strong.
- Consumer and business confidence are generally at high levels.
- Further interest rate rises look set to be gradual and communicated well.
- Lower oil prices should aid corporate profitability in many sectors.
- The weak pound favours returns to domestic assets.

International view

Brexit discount

Brexit uncertainty has weakened confidence in the UK, but sterling and UK stocks could rise if a deal is agreed.

QE comes to an end

The European Central Bank has stopped buying more bonds, however Eurozone interest rates are set to remain low.

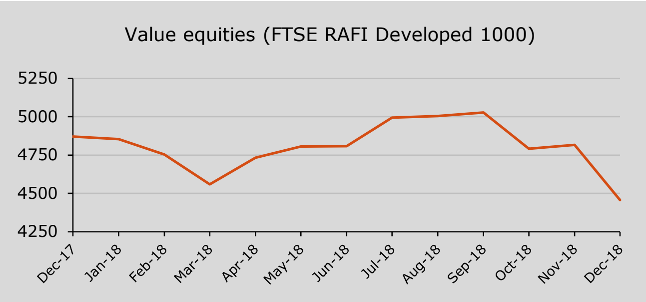
Growth goes on

Rising US rates are a symptom of its growing economy. Job creation and consumer confidence remain high.

Avoiding a contraction

Chinese authorities have the tools to boost growth to offset lower trade. Not all emerging markets are so fortunate.

Market commentary and outlook



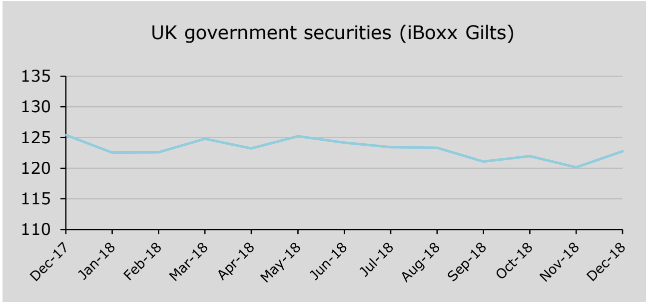
Value equities

“Buy low, sell high” is a fundamental maxim of investing. To make money you should aim to purchase assets when they are relatively cheap and sell them when they are relatively expensive. This is known as value investing, and a number of academic studies demonstrate that it delivers returns ahead of the overall market over the long term.

Over shorter periods it can underperform however, as expensive stocks can sometimes get more expensive. The last three years have been an example of this. Growth stocks, such as technology giants Facebook, Amazon, Apple, Netflix and Google, have risen to ever higher valuations. This has been driven partly by good earnings, but even more by optimism about how much earnings might grow in future.

At the same time companies in the UK, Japan and certain sectors in the US and Europe have stayed cheaper than their fundamentals would suggest, held back because their markets are out of favour. We continue to believe that these cheaper stocks have better long-term prospects, with higher dividends, less far to fall in a sustained market correction and potential for outperformance when the factors holding their markets back (e.g. Brexit uncertainty) are removed.

+ Academic studies show that value stocks outperform the market over the long term
+ Value companies have higher dividends
+ World class companies could be takeover targets
− Growth stocks can continue to lead in the short term



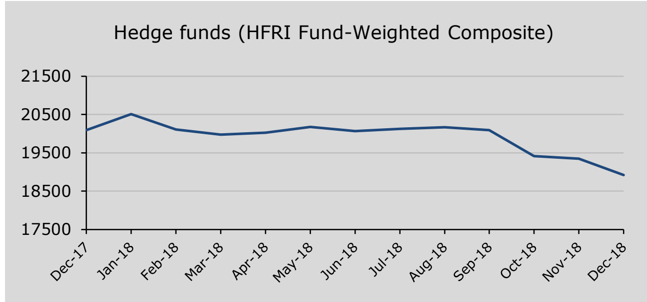
UK fixed interest

Interest rates have stayed at historically low levels for a very long period since 2009, keeping bond prices high and income yields low. This has the double disadvantage of reducing the income that can be derived from bond holdings and also increasing the potential for bond prices to fall when interest rates do go up.

We have taken a relatively defensive stance on fixed interest, favouring less interest rate sensitive areas of the market and focusing on corporate bonds, which provide higher yields and are backed by generally strong company balance sheets, over government bonds. This strategy is paying off now that interest rates have begun to rise, with volatility in our bond fund holdings staying low and funds which are positively exposed to rising rates, including the Monument Bond Fund and Insight LIBOR Plus, delivering higher levels of income.

In recent months we have taken further steps to reduce interest rate risk in our lowest risk portfolios, believing that capital preservation is most important for fixed interest holdings and that this is not the time to take undue risks in pursuit of higher levels of income.

− 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



Hedge funds

Hedge funds aim to generate returns irrespective of whether other asset classes are going up or going down. This low correlation with other assets can make them a very useful diversifier in a portfolio, helping to generate returns but control risk. The low volatility, low interest rate environment of recent years has not been ideal for many hedge fund strategies however, and they have struggled to achieve their objectives.

With interest rates higher today than they have been for many years, cash funds can now generate a reasonable return with a very low level of risk, making them more attractive than they previously were as a component of a portfolio. As a result we have reduced the hedge fund weightings in portfolios in favour of higher cash allocations. In the remaining hedge fund allocation we are focusing on conservative funds such as the Premier Defensive Growth fund which do not take too much risk and should rise when other assets fall, and higher risk diversifiers such as the BMO Global Equity Market Neutral fund which will rise and fall from month to month but should do so out of step with the market as a whole and should generate a reasonable return over the long term.

+ Aim to generate “absolute returns” which can provide diversification alongside other asset classes
− Conditions have been difficult and many funds have failed to preserve capital in market downturns
− Returns to cash funds now look relatively attractive

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