Market Views

February/March 2018

After the global selloff at the end of January, equity markets have recovered fairly well. This has been most noticeable in the US where the big tech stocks have led the bounce back, with the Nasdaq Composite index making an all-time high in the past week. Market volatility was largely absent last year and whilst we remain positive on the prospects for global equity markets, we expect to see more periods of heightened volatility in the year to come.

In the US, it has been a characteristically controversial few weeks for President Trump. At the start of March, he finally followed through on his protectionist rhetoric and announced a 25% tariff on steel and a 10% tariff on aluminium. Reaction around the world has been predictably averse and many fear the beginning of a global trade war, which is in nobody's best interest. China may take retaliatory action on US agricultural products but has done nothing so far. As a big buyer of US debt, and at a time when US treasury issuance is growing, it may well prove unwise for the US to antagonise one of the biggest holders. Following disputes on the tariff imposition and other policies, Gary Cohn resigned as head of the National Economic Council and Trump fired Secretary of State, Rex Tillerson. To top things off, voters in Pennsylvania elected a Democrat over a Republican candidate in a district that Trump had won comfortably in the 2016 election. This vote was seen by many as a referendum on Trump's presidency and may suggest that the President's popularity amongst his supporters is waning.

However, beyond the current White House disarray, the US economy appears robust. Economic survey data is consistent with annual GDP growth of around 4%, corporate earnings are solid and the labour market continues to strengthen. Fiscal spending and tax cuts are adding to the momentum. The only amber light preventing accelerated policy tightening continues to be meagre wage growth. Against this backdrop, new Federal Reserve ("Fed") Chair Jerome Powell has hinted at the possibility of four interest rate hikes in 2018 as opposed to the previously indicated three. A March hike by the central bank is fully priced into markets.

In the UK, Brexit negotiations remain shrouded in uncertainty. Theresa May's Brexit speech at the start of the month was criticised for a lack of detail beyond repeating the five red lines her government will not cross. Jean-Claude Juncker has warned that greater clarity is required from the UK government, especially on the Irish border issue, which continues to stall talks. May's current situation has not been aided by escalating tensions with Putin following the poisoning of an ex-Russian spy living in the UK as part of a spy swap in 2010.

In Europe, the European Central Bank ("ECB") voted unanimously to remove the language indicating that asset purchases could increase in size and/or duration if needed. The change of wording is another small step towards removing the support the ECB has been providing to markets. Germany finally has a government after the longest period of coalition negotiations in their post-war history. Angela Merkel has been sworn in for a fourth term as Chancellor after almost six months without a government, which should provide a relief to markets. The remaining concern lies in Italy, where the election resulted in no party gaining power. The anti-EU Five Star Movement won the highest proportion of the vote and a coalition government will have to be formed. People are now trying to guess what the possible coalitions could be. Recent rhetoric appears to be that a coalition between Five Star and the Eurosceptic League party could be possible, which raises the concerning prospect of two radical groups running the country. We will continue to monitor these events closely and it serves as a timely reminder that the wave of populism is not dead.

Market View Changes

- **US Conventional Treasuries** from ▼ to ◀▶
- **Hedge Funds/Target Absolute Return** from ◀▶ to ▲

Currencies

US dollar	◀▶
Sterling	◀▶
Euro	◀▶

Our outlook for the US dollar remains neutral. There are various factors which should support the currency, namely the recent tax reforms and continued strong economic data. Its 'safe haven' status also gives us comfort during any market downturn. However, strengthening economies elsewhere in the world offset these positives. In the UK, our view is also unchanged. We believe that sterling is likely to remain a function of the Brexit negotiations and the domestic political situation for some time to come and with little clarity on how these will play out, a neutral stance seems prudent. We have also retained our neutral position on the euro. Despite the broad-based economic recovery in the region, there remains a fair amount of political uncertainty, with Brexit ongoing and the Italian government still to be formed. Across all three currencies, we expect there to be significant volatility throughout 2018.

Fixed Income

Government Bonds	Conventional	Inflation-linked
UK Gilts	▼	◀▶
US Treasuries	◀▶	▲
German Bunds	▼	◀▶

The move higher in interest rates has taken a pause as political noise has clouded the positive global growth outlook. Gilt yields initially reacted to the more hawkish stance from the Bank of England but have since been choppy on further Brexit uncertainty. There is scope for more pressure on the market as a tight labour market may warrant a response by the central bank which is not priced in. We retain our neutral stance on inflation-linked gilts as they offer protection in anticipation of some impediments to supply chains in a post-Brexit world. Over the past few months, investors in US Treasuries have moved to price in higher inflation and thus a more aggressive monetary policy stance. US Treasury Inflation Protected Securities (TIPS) have outperformed their conventional counterparts in this period to a point where we now feel a move back from positive to neutral is warranted. Given the moves in conventional Treasuries, we see better value in the belly of the curve and have therefore moved them up to neutral. Considering the ECB's trajectory, we see more value in inflation-linked bunds over their conventional peers.

Investment Grade Corporate Bonds ◀▶

Despite continued support for these securities by investors and central banks alike, we retain our neutral stance given the tight valuations within the asset class. Whilst tax reforms may encourage companies to reduce debt, this appears to be mostly priced in. Over the past few months, we have seen the results of several large issuers disappoint the market which has led to a sharp re-pricing of their debt. Hence we retain a preference for select exposure given the indiscriminate buyers ability to distort pricing in the market.

High Yield Credit ▼

We moved negative on High Yield Credit given the historically tight valuations which were previously justified on low default rates. Highly levered credit was not immune from the recent equity market volatility with spreads widening rapidly. This sudden repricing led to some outflows from the larger index funds putting further pressure on the market. Our expectations remain that we are likely to see declining returns but increasing volatility and hence we would only seek exposure through managers who can be flexible and are not required by mandate to own debt of highly levered companies.

Emerging Market Debt

Local currency denominated debt	◀▶
Hard currency denominated debt	◀▶

As protectionist policies have yet to receive broad based support, emerging markets are able to benefit from the current cyclical upswing. Although external hard currency debt has become less of a concern, we have seen signs of exuberance with longer dated and lower quality supply attracting large interest at favourable financing costs. In this environment, index tracking has become incrementally more risky and we would encourage selective allocations to both local and hard currency debt.

Equities

UK Equity

The FTSE 100 index has underperformed other developed markets this year, as it has been hit by both the market sell-off at the end of January and a stronger pound. The index is currently down around 6% since the start of 2018. With a significant proportion of revenues coming from overseas, currency moves (particularly against the dollar) have a substantial effect on UK equity performance. We have remained neutral on the equity market given the political uncertainty and earnings growth being less attractive than other markets. However, our preference continues to be for multinational companies with diversified earnings streams who are less sensitive to the domestic economy.

Europe ex UK Equity

European equity markets started the year positively but after the sell-off, they fell back into negative territory and the Euro Stoxx 50 index is down 3% on the year at the time of writing. There are certainly reasons to be attracted to the region, with growth accelerating, strong economic data and earnings looking encouraging. However, the political risks that remain temper our view. While the German risk has passed now that Merkel has formed her government, the Italian political situation is a reason for caution and hence we remain neutral on the region.

US Equity

Markets in the US have rebounded stronger than other developed markets following the downturn earlier in the year. From the lows, the S&P 500 index is now up 6.5% and the tech-heavy Nasdaq Composite index has pressed on to new highs, up over 10% from the February low. The US economy appears robust, buoyed by Trump's tax reforms finally passing and survey data at multi-year highs. Additionally, the recent corporate earnings season was impressive and capital returns to shareholders will likely be supported by the tax changes. We continue to believe that the US is home to the most high quality companies who are able to sustainably compound growth over the long term. For this reason, we maintain our positive stance.

Japan Equity

The Nikkei 225 sold off earlier in the year as it was hit by both the global equity market correction and a strengthening yen, but has since recovered a touch. The Japanese equity market tends to be negatively correlated with yen moves given that it is a large exporter. We have been positive on the equity market since the back end of last year given Abe's policies towards improving corporate governance, dividend payouts rising, earnings improving and sustained economic growth. We see particular appeal in the excess cash flow and dividend growth story. Extended terms for Prime Minister Abe and Bank of Japan Governor, Kuroda, have further reassured us on the long-term attractiveness of the Japanese market.

Asia ex Japan Equity

We maintain our positive view on the region since earnings momentum looks strong and it is set to benefit further from the cyclical upswing in global growth. Whilst we are cognisant of the North Korea risk, this seems to have faded for now, with potential for a meeting between the rogue state and the US later in the year. We see selective appeal in Asia ex Japan. In particular, we believe that India is an attractive long-term growth story. Modi has unleashed India's potential with far-reaching reforms and we believe that the clock will not be turned back. GDP growth should be high and sustainable for many years to come because of population growth, rising incomes, reforms, infrastructure investments, and the rapid adoption of digital technologies. This sets the scene for good recurring growth in corporate earnings.

Emerging Markets ex Asia Equity

Whilst these countries stand to benefit from the cyclical global upswing, investors must remain selective in the region as evidenced by political turbulence in Venezuela and South Africa at the back end of 2017.

Alternative Investments

Hedge Funds/Targeted Absolute Return

We have moved positive on the asset class, whilst stressing selective appeal in the space, as it acts as a good diversifier to equity exposure. Greater dispersion of returns in equity markets presents opportunities for long/short funds. The opportunity for event-driven strategies remains supported by the potential for increased takeover activity, especially as overseas cash is being repatriated in the US. In balanced portfolios, trend following strategies have diversification benefits and have tended to do well when there is a sustained downturn in equity markets. Gold remains a useful risk mitigator in portfolios, given its protective nature during periods of heightened political risks.

Property/Infrastructure

We hold our neutral stance on property and infrastructure but encourage selective exposure. On UK commercial real estate, we are cautious due to the liquidity mismatch, but a yield differential with bond markets continues to support the asset class. The outlook for the market is muddied by Brexit and so our preference in the sector is for German residential real estate due to its attractive fundamentals. On infrastructure, it appears attractive in today's low yielding world but as interest rates rise, this will be called into question. However, it was a strong performer last year and is looking fairly valued. In the UK, there are significant political risks surrounding the sector, with Labour planning to pull out of public private partnership deals if elected.

For further information please contact:
Esther Clark
+44 (0)20 3207 8007
esther.clark@lgtvestra.com

LGT Vestra LLP
14 Cornhill
London
EC3V 3NR
Phone +44 (0)20 3207 8007
Fax +44 (0)20 3207 8001
info@lgtvestra.com
www.lgtvestra.com

LGT Vestra US Limited
14 Cornhill
London
EC3V 3NR
Phone +44 (0)20 3207 8007
Fax +44 (0)20 3207 8001
info@lgtvestra-us.com
www.lgtvestra-us.com

LGT Vestra (Jersey) Limited
Charles Bisson House
30-32 New Street
St Helier
Jersey, JE2 3TE
Phone +44 (0)1534 786400
Fax +44 (0)1534 786499
jersey@lgtvestra.com
www.lgtvestra.com