Market Views

January/February 2018

It has been a turbulent few weeks in global markets which saw a strong start to the year and then a sharp fall from the January highs. While rising interest rate expectations in the US may have triggered the falls, technical factors kicked in which made things much more dramatic. We should keep in mind that, whatever the explanation is, the global economy is broadly in a healthy state with low unemployment and companies' earnings continuing to grow. Thus, beyond the noise and day-to-day market moves, there is underlying long-term support for equity investment.

The economic picture in the US particularly is robust. Soft economic survey data is at multi-year highs, the recent earnings season has been strong and Trump's tax reforms are likely to bring a further boost in the coming year. Jerome Powell has been sworn in as Federal Reserve (Fed) Chair and has stated he will continue on the path drawn by his predecessor, whilst paying attention to market developments. In this environment, the equity market moves in recent weeks may have come as a surprise to some.

With easy money, the potential for a rise in inflation has been a concern for some time but the deflationary influence of technology, globalisation and an ageing population has helped to keep it low. In January, US bond yields started to rise and the market priced in about three further rate rises in 2018. The Trump boost to an economy, that was already doing well, raised fears of overheating with rates having to go up faster and further than expected as a consequence. This caused US equity markets to start to sell off and the move was exacerbated by volatility and systematic trading. With interest rates rising, some commentators speculated that the Fed would be unlikely to step in and loosen monetary policy if markets take a hit. We believe however that a further dramatic fall could encourage the Fed to delay their scheduled rate rises, although we think that this is an unlikely scenario.

Where the US leads, others follow but the FTSE 100 was in less good shape already. The Bank of England (BoE) had raised rates in November and Gilt yields were moving higher. Talk of a softer Brexit and these higher yields pushed the pound higher, particularly against the US dollar. Since the UK market is an index where a majority of revenues come from overseas, the rise in the FTSE was much smaller and the fall more painful than the US market. The BoE Monetary Policy Committee provided little relief with, if anything, a more hawkish stance predicting rates would rise sooner and faster than they expected in November. If economic growth goes on as expected, we should see another rate rise in May. While the FTSE 100 Index is very international, the bond market is more susceptible to economic changes and these are mired in the fog of Brexit negotiations.

European markets were not spared from the market sell-off despite economic data indicative of robust growth and a good results season. The European Central Bank (ECB) made no change to policy at its latest meeting and stressed that it will be patient in normalising, conscious of a strong currency and weak core inflation. Thus, any hikes are likely a long way off. Political concerns in Germany have faded as it now seems likely that Merkel will be able to form a coalition government, yet the Italian election still poses a risk as the populist Five Star Movement are leading in opinion polls.

At the time of writing, markets have given up some of the strong gains from the previous year and the move is unlikely to have much economic impact. However, if it was to fall further then there is a danger that moves on Wall Street spill over into the wider economy. If this were to occur we could see the Fed moving any future rate rises further out. For now, the central bankers here and in the US appear to see this as a healthy correction.

Market View Changes

No change

Currencies

US dollar	◀▶
Sterling	◀▶
Euro	◀▶

Trump's tax reforms and continued strong economic data in the States should support the US dollar. Its safe haven status also gives us comfort during any market downturn. The strengthening of economies elsewhere in the world however offsets these positives and hence we remain broadly neutral on the dollar at this time. In the UK, our currency view is also unchanged given that sterling is likely to remain a function of the domestic political situation and Brexit negotiations for some time to come. With little clarity on how these will play out in the coming year, we see a neutral position as prudent. Our stance on the euro is supported by the broad-based economic recovery in the region but we are cautious of moving too positive with the political headwind of the Italian election on the horizon. Hence, we hold our neutral view on the currency.

Fixed Income

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

Our negative stance on conventional government bonds was vindicated by the continued sell-off in government bonds. Gilts came under increased pressure following the Bank of England's more hawkish stance which could see the next rate hike in the UK coming sooner than was previously priced in. On inflation-linked gilts, we remain neutral as they offer protection in anticipation of some impediments to supply chains in a post Brexit world. The flattening of the US Treasury curve, which led us to turn negative, reversed as stronger employment and inflation data paired with Trump's fiscal policies led investors to price in a faster pace of interest rate increases. Inflation expectations have risen of late but there is further scope for them to build up further as the effects of the tax plan become more apparent. 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, reiterated by the recent ECB meeting, 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 reflect a year with low corporate defaults. As expectations for asset class volatility remain benign, we see little merit to remain invested in benchmark strategies as liquidity has declined and central banks are likely to tighten further. In this new environment, we are likely to see declining returns but increasing volatility. 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 and a stronger pound. 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 sparked in the US, they fell back into negative territory. There are certainly reasons to be attracted to the region, with growth accelerating, strong economic data and earnings looking encouraging. However, the uncertainty and risk surrounding the forthcoming Italian election tempers our view and hence we remain neutral on the region.

US Equity

Markets in the US started the year as strongly as they they finished the last. The S&P 500 Index was up as much as 8% in January. The subsequent downturn in global equity markets, driven by rising interest rate expectations and worsened by volatility trading, has taken the index back to almost in line with where it started the year. This drop comes amidst a solid economy buoyed by Trump's tax reforms finally passing, wage growth coming through and survey data at multi-year highs. Additionally, the recent corporate earnings season has been 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

Our outlook on Japanese equities moved positive in November and the equity market then pressed on to multi-year highs. However, in recent weeks it also fell victim to the global equity market fall. This was exacerbated as the yen has strengthened and the Japanese equity market tends to be negatively correlated with this given that it is a large exporter. We are constructive on the market given Abe's policies towards improving corporate governance, dividend payouts rising, earnings improving and sustained economic growth. The landslide victory for Abe in the election last year further reassured us and this has only been enhanced by the recent reappointment of Bank of Japan Governor, Kuroda.

Asia ex Japan Equity

Asian markets experienced the knock-on of the US sell-off and MSCI Asia ex Japan sits broadly flat on the year, at the time of writing. 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, at least for the duration of the Winter Olympics. We see selective appeal in Asia ex Japan and particularly, we believe that India is an attractive long-term growth story providing Modi's reforms remain intact.

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

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. However, we retain our neutral stance given the diversity of returns between different strategies. 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.

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