Whitechurch Asset Views
Award Winning Wealth Managers

Whitechurch Securities Ltd
WEALTH MANAGERS

Monthly Round Up - December 2018

Strategic Overview

When the going gets tough...

Investors had some respite in November, although market volatility continued, and there were a number of bright spots. After October's market freefall the sell-off in global equity markets somewhat abated with a more mixed set of results. Geopolitical events continued to dominate market moves over the month. Concerns around global growth continued, although US/China trade war fears reduced after the meeting between Trump and Xi at the G20 showed an inclination to de-escalate tensions.

Best & worst sector performance

November saw reversals to October's trends with IA China and Greater China seeing the biggest gains up 6% as fears of a trade war eased. More modest gains were seen in some of the other global markets with IA North America up 2.2%. Closer to home European and UK markets struggled with IA Europe down 1% and the IA UK All Companies down 1.6% as Brexit concerns continued. In a complete reversal from October, UK Index Linked gilts were the worst performer with the IA UK Index Linked Gilts down 3.8% whilst Corporates did not fare much better with the IA Sterling Corporate Bond down 1.31%.

Volatility spikes across the globe

After October's falls global equity markets recovered marginally and some managed to post modest gains in November, despite expectations for global growth continuing to drift lower over the month. Europe and China were at the forefront of those concerns as PMI data remained sluggish, particularly in the industrial sectors. However, this did not affect the Asian and EM markets which were the standout performers over the period both in sterling terms and local currency. The US markets also fared reasonably well over the month whilst the key detractors were the UK and Europe which were particularly pulled down by the DAX.

UK blue chips prove relatively resilient

The markets remained volatile over November. The Mid 250 was the hardest hit area as the Brexit impasse continued and lower crude oil prices and broader concerns around the global macroeconomic outlook weighed on large cap resource sectors. Performance trends in November remained distinctly defensive with particularly strong performance from the telecoms sectors. This was partly driven by the continued decline in global markets, creating a rush to perceived safe areas, and partly, by the ongoing concerns around Brexit.

Asia and Emerging Markets were the place to be

Asia Pacific and Emerging Markets saw a strong reversal in fortunes during November and were the stand out performers amongst all asset classes and regions. China saw the strongest returns with the IA China and Greater China gaining 6% as fears of a trade war eased. Asia Pacific and EM markets followed suit with the IA Asia Pacific ex Japan up 4.7% and IA Global Emerging markets up 4.3%.

A bad month for bonds

Traditional defensive Government bonds and investment grade bonds sold off over the month (the IA Gilt sector fell back 1.5%) as concerns over inflation and rising interest rates increased. This led to the Index linked sector being the hardest hit area of the market with the IA UK Index Linked Gilts down 3.8%. Following some weakness within the US economy, US Government bonds were the pick of fixed income investments over the period.

The best of the rest

Commercial Property continued to grind out gains whilst providing a good income and is proving a good bedrock within our cautious and balanced portfolios. The asset class is again displaying the two attributes we seek – attractive yields compared to Government bonds; and a lack of correlation with equity and bond markets. It is during times of turbulence that absolute return funds should come into their own so it was disappointing to see such a mixed set of results from our alternatives exposure.

Looking ahead

We do not try to second guess short-term market movements, although less demanding valuations following the market falls do provide more opportunities for those who can invest without being fixated on short-term market fluctuations.

However, we are cognisant not to be over-confident. We cannot be certain that a combination of rising rates and a trade war will not see a fundamental slowdown in the global economy. Therefore, it is prudent to have a well-diversified portfolio across different regions and asset classes combined with 'insurance' positions to cover different scenarios.

Our view remains that any interest rate increases are likely to be cursory going forward, due to a lack of sustained inflationary pressure and fragile economic growth outside of the United States. As a result of low interest rates, our strategic view remains focused on the belief that there is value to be had in several areas of global stockmarkets and other assets, compared to the miserly return that is provided by holding money in cash.

Risks posed by short-term uncertainty will be managed through diversification (not second guessing unpredictable events and sentiment). We believe that a well-diversified portfolio can provide cash beating opportunities in a number of areas for those prepared to ignore short-term noise, focus on valuations and take a long-term perspective.

On the following pages we provide a more detailed review of the markets and touch on how we are positioning our portfolios.

UK Equities

The markets remained volatile over November. The Mid 250 was the hardest hit area as Brexit impasse continued and lower crude oil prices and broader concerns around the global macroeconomic outlook weighed on large cap resource sectors.

Performance trends in November remained distinctly defensive with particularly strong performance from the telecoms sectors. This was partly driven by the continued decline in global markets, creating a rush to perceived safe areas, and partly, by the ongoing concerns around Brexit.

Tobacco was the key exception here being the worst performing UK sector as tobacco companies saw poor performance in the face of growing concerns around a possible US regulatory crackdown including tough restrictions on menthol cigarettes.

The other feature of November (and October) was the lack of market focus on valuation. The oil and mining sector performed poorly during the month, the former driven by the fall in the oil price noted above. Most stocks in these two sectors dropped between 4-8% relative.

In terms of economic data, figures remained reasonably positive. Wage data pushed higher again in November to 3.2% (for the three months to September) and job vacancies, at 845,000, again hit a record high.

Business confidence continues to fall as uncertainty around Brexit drags on. There are signs that consumers are being slightly more cautious in their spending, with sales in the supermarket sector, for example, falling back after the long, hot summer.

Growth in the service sector hit its lowest level since July 2016 with PMI sinking to 50.4 in November down from 52.2 in October. The suggestion is that if firms did not have a backlog of orders to fulfil the sector would have contracted. Manufacturing PMI rose over the month up to 53.1 from 51.1 in October as strong domestic orders linked to pre-Brexit stockpiling compensated for a slowdown in exports. Construction PMI was relatively flat rising to 53.4 from 53.2 in October with business optimism increasing slightly. House building activity rose at the fastest pace in three months whilst Infrastructure and commercial property work also picked up.

Brexit concerns are naturally at the forefront of UK investors' minds. Like many investors, we learnt lessons from the Brexit referendum of the risks of positioning a portfolio based on probability only to see an unexpected result materialise! Our positioning will be more balanced going forward given the huge uncertainty surrounding the Brexit negotiations.

Despite the political uncertainty creating negative sentiment we do see opportunities in UK equities. Although we expect to see the noise increase around Brexit over the coming months, our belief is that UK shares with high overseas earnings benefit from a weaker pound and those with more of a domestic focus are deeply unloved and undervalued by investors, thus representing a contrarian opportunity. Furthermore, we expect a lower for longer rate environment to continue which is supportive for dividend producing shares and with the UK stockmarket yielding over 4%, this is a very attractive feature.

US Equities

The US had a better month in November as the latest round of tariffs in the trade war with China were put on hold. Shares climbed early in the month before giving up much of the gain in the second half but the S&P 500 rose by 2% whilst the small cap focused Russell 2000 was up 1.6%.

Our US exposure performed well over the month. Artemis US Smaller Companies outperformed the Russell 2000, gaining 2.6% whilst core passive positions of, Schroder US Equity Income Maximiser and L&G US Index both gained 1.5%.

The US November labour data points to a very tight employment market with the non-farm payrolls softer than expected. The weakness in hiring in November was led by sectors including construction and mining with pockets of softness in service employment. As US inflation slows, due largely to a fall in energy prices, consumers are enjoying faster gains in take home pay which is a positive for household spending. Average hourly earnings grew to 3.1% year on year, the strongest pace of wage gains seen since 2009. Consumer confidence remained at a high, although down from a peak earlier in the year.

During the month the Fed altered the commentary around further monetary tightening to suggest that interest rates were now just below neutral, suggesting additional rate hikes may be limited. The Fed left rates unchanged as expected. There has been some evidence of slowing within the US economy over the months such as home-building sales as well as shorter term inflationary pressures from commodity prices. However, lower oil prices will help to reduce shorter term input inflation. The US headline inflation rate increased to 2.5% year on year.

Although trade concerns persist and a number of high profile tech firms warned on profits, markets made modest progress and overall the Q3 results season was very positive. Most market sectors gained ground with healthcare and real estate companies sectors amongst the best performers. Technology firms - notably Apple - were weaker as investors digested the prospect of slower earnings, whilst energy firms were hurt by the sharply lower oil price.

Fundamentally, although a relatively cautious view of the US stockmarket has been a drag on performance year to date, our favour for US smaller companies has been a major positive (and this was rewarded again in November). On valuation terms our preference is for other developed markets versus the US remains intact, but Trumps' growth stimulus policies could see one final leg of the US bull market. However, we are seeing a number of fund managers starting to question the sustainability of the US economic strength. On this basis the strong run of corporate earnings could begin to falter and high valuations, rising interest rates, and the political uncertainty over Trump are key reasons that make us remain cautious on the wider US market.

European Equities

European stockmarkets fell again in November with the FTSE Europe ex UK down marginally, by 0.7%. German markets were particularly hard hit with the DAX down 1.84%.

Worries around global growth, trade wars and corporate profits continued to weigh on markets with economically sensitive sectors such as materials and IT being the worst performers whilst defensive sectors such as telecoms, utilities and consumer staples provided the best returns. Economic data within the Eurozone continued to slow with the flash composite PMI coming in at 52.4, a 47 month low, and GDP growth estimates for Q3 remaining at 1.7% year on year. The German economy contracted by 0.2% in Q3 largely due to a trade slowdown as car manufacturers struggled to prove that vehicles can meet the new emissions standards.

Italy's 2019 budget continued to be a sore point and Q3 GDP contracted 0.1% on the previous quarter. The persistent political uncertainty and increased friction in Europe have seen some tightening in financial conditions which is affecting corporate activity and both manufacturing and services PMI fell below 50.

Consumer confidence in the Eurozone declined more than expected and the flash PMI indicators for November were disappointing with future output and employment being hit the hardest. The slowing activity will make it more difficult for the ECB to lift inflation which remains stubbornly low. The ECB is still expected to end its QE programme by year end but whether it still manages to raise interest rates in H2 of 2019, as per current guidance, is now in doubt.

European markets have lagged wider developed markets year to date and our reduction in European exposure has been prudent. The strong recovery of 2017 has been losing momentum this year. We have been trimming exposure to bring monies back home to the out of favour UK stockmarket. However, we continue to believe that Europe looks more attractive than the US on valuation measures and with more stimulatory monetary policies likely to remain in place for some time.

Japanese Equities

Japanese stockmarkets posted modest gains in November with the TOPIX up 1.3% in local currency terms and 0.83% in GBP. There were no strong trends in major currencies with the yen weakening slightly against the dollar.

Sector performance was very mixed with financials, including banks under performing sharply and returning to the relative lows seen in June whilst value stocks broadly underperformed reversing the upward move seen in the prior month.

Third quarter GDP growth contracted by 0.3% quarter on quarter but was expected. Economic data released in November shows a clear rebound from the previous month's weakness and there are now some signs that the labour market may be peaking. The economy has effectively been operating at full employment for some time and there is continued evidence of this flowing through to higher wage growth.

On the corporate front the headlines were dominated by the arrest of Nissan boss Carlos Ghosn and his removal as Chairman. This deflected attention from positive data trends which are showing that Japanese companies had announced record levels of share buy backs in the wake of interim results and the trend continuing to improve shareholder returns continues.

The backdrop for investing in Japan has appeared unexciting this year but the politics is stable and the economy is growing at a steady pace. The Bank of Japan is likely to continue with quantitative and qualitative monetary easing and this should provide a supportive backdrop.

Valuations appear relatively attractive compared with other developed markets given the potential for dividend policy reform, the ability to return cash to shareholders, and scope to improve return on equity. However, corporate earnings within Japan will remain volatile as the value of the yen fluctuates/. There is no doubt the market is highly sensitive towards global economic activity, but the yen does help reduce the cyclicality for unhedged exposure.

Asia Pacific & Emerging Market Equities

Asia Pacific and Emerging Markets saw a strong reversal in fortunes during November and were the stand out performers amongst all asset classes and regions. China saw the strongest returns with the IA China and Greater China gaining 6% as fears of a trade war eased. Asia Pacific and EM markets followed suit with the IA Asia Pacific ex Japan up 4.7% and IA Global Emerging markets up 4.3%.

Optimism over a more gradual pace of interest rate hikes in the US coupled with positive earnings news provided support whilst net oil importers such as India benefited from the plunge in crude oil prices.

Emerging countries continue to face challenges. So far there is little to suggest tensions between the US and China will abate. In the face of hostility from Washington, China has launched a new round of fiscal stimulus to be implemented in 2019. Additional monetary stimulus is also expected, with a possible cut of the reserve requirement ratio to support regional banks and small enterprises.

In Latin America, Fitch recently downgraded the outlook for Mexico to negative due to the political uncertainty created by the current administration. The central bank unexpectedly announced a rate hike to 8.0% with the intention of stabilising the currency and reducing inflation. In Brazil, markets have looked favourably on the appointment of President Bolsonaro given his reform agenda and focus on fiscal control.

Emerging market valuations have been driven down by the sell off and given that there is scope for earnings recovery across many Asian and emerging markets they are beginning to look relatively attractive. But, with such negative momentum if feels like catching a falling knife at present.

It will remain important to be selective when investing in these higher risk markets. As we have seen with concerns of a trade war, the optimism over China can be checked very suddenly. Furthermore, if we see a continuance in the recent rally in the dollar this will prove to be a headwind for many of these markets. However, long-term fundamentals across Asia and Emerging Markets still look attractive with structural reforms, better corporate governance, greater consumerism and cheaper valuations providing good opportunities for investors seeking long-term growth who can accept the high volatility.

Fixed Interest

Risk-off sentiment again swept through financial markets in November, resulting in losses for credit investors. Following some weakness within the US economy, US government bonds were the pick of fixed income investments over the period. The Federal Reserve chairman has caused a willingness to slow the pace of monetary tightening. Rather than calming investors, this has caused investors to worry about the health of the US, and thus global economic backdrop.

Traditional defensive government bonds and investment grade bonds sold off over the month (the IA Gilt sector fell back 1.5%) as concerns over inflation and rising interest rates increased. This led to the Index linked sector being the hardest hit area of the market with the IA UK Index Linked Gilts benchmark down 3.8%.

US Treasuries fared better picking up the pace, pulling down long term yields. Yields are now 2.88% from 3.15% in November. Markets have been scaling back their bets that the Fed will raise interest rates beyond the three it has forecast for 2019.

We are in a monetary tightening phase. Whilst the market's realisation of this has led to volatility, we believe it is going to be a slow process with central banks telegraphing their intentions to markets along the way. This approach by the central banks leads us to believe that there will be no collapse in bond prices. Within Government bonds, given the US market is substantially further ahead in its monetary tightening phase, we are seeing contrarian value opportunities within US treasuries. We believe these assets provide greater scope for greater capital protection than UK/EU Government bonds whose yields remain well below inflation. US bonds also offer attractive yields, and provide some dollar exposure within our fixed income basket.

The bulk of our exposure is within global mandates – hedged back to sterling. We have little in the way of £IG or £HY. It may be worthwhile considering some dedicated exposure here. However, across our portfolios we are currently playing the undervalued UK asset theme via UK equity funds with a domestic bias, and should perform well because of a soft Brexit. We have some excellent diversification benefits at play with US Government bonds vs UK domestic equities at present.

Commercial Property

Returns from property were pleasantly modest over the month and continue to be based on income generation with modest capital growth performance. Our holdings in direct UK commercial property funds continued to provide steady positive returns during a volatile month. The IA UK Direct Property sector increased by 0.2%. On a 12 month view, property returns have significantly outperformed fixed income and property fund yields have started to improve over the past month.

Commercial Property forms a core source of income within our cautious and balanced portfolios. We have stuck with our favoured three of F&C, Henderson and Kames. The asset class is again displaying the two attributes we seek – attractive yields compared to government bonds; and a lack of correlation with equity and bond markets. It is also pleasing to see modest net inflows returning to our favoured funds.

Alternatives

What we are looking for within alternative assets is the ability to provide a portfolio with greater diversification than simply holding traditional asset classes, whilst generating attractive risk adjusted returns. It was pleasing to see that our equity long/short strategies provided positive returns during the stockmarket sell-off.

We have been reducing exposure to the large multi-asset absolute return mandates, where we have lost conviction. Our favour is shifting towards dedicated long/short specialists and looking at niche sector alternatives. We are also considering genuine long only alternatives that invest in physical assets (such as infrastructure and niche property).

Commodities

Oil officially hit bear market territory at the end of the month, declining more than 20% from its peak. The majority of this move downwards happened during October. The main reason was due to build ups in inventory levels through the month, although fears of an economic slowdown also added to the downside.

Gold provided some protection as investors looked for a hiding place from falling markets. The gold price rallied by 1.8% in October.

With further US interest rate rises expected non-yielding assets such as gold will appear less attractive so this makes us cautious that we are going to see a sustained period of upside for gold. That being said, a watchful eye should be kept on any further signs of distress in markets which could lead to a hunt for safe havens.

We do not have direct exposure to commodities within our portfolios, although mining and energy will feature within UK and overseas equity exposure and gold within absolute return mandates.

Cash

UK inflation fell from 2.7% to 2.4% in October as measured by the Consumer Price Index (CPI). With high commodity prices and a weak sterling it is hard to see inflation falling below this level in the near future. Despite the recent 0.25% interest rate rise the best instant access cash ISA deals are still only offering around 1.3%. It remains likely that a Cash ISA will provide a negative return in 2018.

For investors taking a medium to long term view we continue to believe that there are more attractive opportunities across other asset classes to beat cash. We are not going to see UK interest rates reverting to their long-term average for a long time. Therefore, cash is only held at present for tactical reasons or within lower risk strategies to enable us to counterpoint this with higher risk assets.

But it is a different story in the United States. With the current trajectory of interest rate rises, bank deposits may yield 3-3.5% in 12 months' time. Higher cash rates could have significant ramifications for financial markets as bank deposits become more appealing – food for thought.

Whitechurch Investment Team, December 2018

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