Top 10 Investment Themes For 2018

2017 has been a year where risk has been rewarded and most global stockmarkets have posted double digit returns, with a supportive "goldilocks" environment of steady global economic growth and low interest rates outweighing the uncertain political backdrop at home and abroad.

So what will be the key themes that the Whitechurch investment team believe will drive investment markets in 2018? And how will we position portfolios to combat what will undoubtedly remain an uncertain backdrop with many known unknowns?

We provide our top ten count-down of what we believe will be the key drivers of investment markets and the strategies we will employ in our portfolios as we move into 2018.

10 "White Noise"

Political uncertainty influencing investor sentiment

White noise is defined as a sound, especially of a loud, continuous, or unpleasant kind, that seems to have no pattern or rhythm'. This seems to us to provide an excellent definition of the uncertain political backdrop that will continue to influence investor sentiment in 2018.

In 2016, we witnessed the seismic and unpredictable political events of Brexit and Trump driving investment markets. In 2017 trying to position a portfolio based on the political climate has been an equally thankless task. At the beginning of 2017 the US was favoured by many but Trump euphoria quickly faded with a weakening dollar diluting returns for UK investors. In the UK, despite Brexit uncertainty, and an inconclusive general election, more domestically focused UK mid and smaller companies have outperformed and provided double digit returns. The sabre rattling of Kim Jong Un in North Korea could have been unsettling but this has had little effect on Asian markets. Whilst in Europe political anxiety was at the highest levels since the Greek crisis at the start of this year. However, since the French Presidential election there has been little disruption allowing investors to focus on economic recovery on the Continent, which has led to strong gains in stockmarket and currency.

These events have reinforced our belief that basing investment strategy on politics is a guessing game. Political uncertainty will continue to influence short-term investor sentiment in 2018 but we will leave it to others to predict the daily twists and turns of Trump's Tweets, or second guess whether there will be a Brexit deal or no deal, and trade on short-term stockmarket sentiment

We take a longer-term perspective based on relative valuations. Of course we need to be aware of political risks and if the facts change we will be quick to change strategy. There are opportunities to be had from political noise. If we see extreme sentiment over the political environment mis-pricing assets this will influence our portfolio positioning. For example, at the beginning of 2017 we felt investors were over-optimistic regarding Trump and very negative on Europe due to political concerns. This led to a significant disparity in valuations and our contrarian stance was to overweight Europe and underweight US. This has been beneficial this year and this is a trade that remains in place going into 2018.

9 "The Long (Un) Winding Road"

Central bankers will be the drivers in 2018

So if we cannot second guess the political environment what should we focus on when positioning a portfolio? Well for us it is Central Bankers rather than politicians who we will be paying more attention to as the long un-winding road of Quantitative Easing (QE) comes to the fore. We believe that interest rate policies both at home and overseas will be key in dictating how investment markets perform in 2018.

At home we have seen UK inflation increase to 3% recently and this has resulted in the Bank of England raising interest rates sooner than markets had previously expected. This has dominated headlines in recent weeks and investing in a rising interest rate environment is certainly a key focus when positioning our portfolios in 2018.

But the withdrawal of QE is likely to be a long drawn out process that outgoing chair of the US Federal Reserve (Fed), Janet Yellen, described recently as "like watching paint dry". Unlike unpredictable political leaders, Central Bankers are expected to act in a much more measured way and communicate their intentions clearly so as to not surprise investment markets. The risk however, is if they move too slowly, economies may overheat and inflation rears its head.

The Whitechurch strategy is based on the central case scenario that both at home and abroad any interest rate increases are likely to be cursory due to a lack of sustained inflationary pressure, and the risk of higher rates derailing the recovery of highly indebted economies. But with risk of policy error we see little value in holding highly interest rate sensitive assets that have benefited from loose monetary policies and have been the star performers in the low interest rate environment.

But the question is, with all asset classes having performed strongly where do we find value when positioning a portfolio for 2018?

8 "The Times They Are A Changing"

Where to find value in bond markets in a rising interest rate environment

One of the greatest challenges for us is bond markets and where to find value in a rising interest rate environment. For UK investors the recent rate rise is the first since July 2007, since that date you would have seen an exceptional return of nearly 90% from 10 year UK gilts.

But the concern over rising interest rates has seen the rally run out of steam and conventional UK gilts have posted negative returns so far this year. This has been good news for our portfolios as we have been avoiding gilts on valuation grounds with yields providing a negative real return. Just because text books and benchmarks include allocating to gilts in a portfolio we are focused on the absolute risks of holding this area and going into 2018 we continue to believe that the risk/reward trade-off for investing here remains unattractive on valuation grounds.

We don't see bond prices collapsing. With economic growth fragile, high political uncertainty and inflationary pressure likely to subside, we see little scope for material increases in the UK and it may be a case of "one and done" from the Bank of England.

Going into 2018 we continue to prefer corporate bonds and particularly funds investing in special situations such as bonds of financial companies. We also believe that a global approach makes sense when investing in bond markets with economies at different states of the cycle. Many highly regarded bond managers favour emerging market debt as offering value given the higher yields and the fact that many of these economies have scope to cut interest rates.

7 "Higher Than The Sun"

Investing when stockmarkets are trading at record levels

It is not just bond markets where investors approach 2018 worrying about where to find value. Many of the major stockmarkets are trading at record levels and have generated double digit returns in 2017, which makes us a little nervous.

But whilst market levels may be sky high this is not true of valuations in many areas. With the global economy in the midst of the most synchronised growth for a decade and rates still low this should provide a supportive "goldilocks" environment for equities going into 2018.

We remain towards the higher end of our equity weightings but with stockmarket performance having been positive for such a sustained period this does mean it is important to not be complacent. Those familiar with our investment approach will know that we look at both active and passive strategies. But at this stage of the cycle, we would urge caution that simply buying the index is the best way to invest across global stockmarkets, with many areas looking expensive. Our favour is to invest with managers who are focused on seeking value and those who produce their best relative numbers in falling markets.

We believe that companies that can provide attractive and growing dividend streams will remain sought after as equity yields remain significantly higher than bonds and cash. However we have been taking profits in areas that have seen particularly strong performance and investor sentiment is showing signs of euphoria.

6 "Heaven Knows I'm Miserable Now"

Are investors too pessimistic over UK equities?

One area where there is little sign of euphoria is in the UK and "Heaven Knows I'm Miserable Now" describes the gloomy investor sentiment regarding prospects for the UK which has been the laggard across global stockmarkets in 2017. Looking at fund flows, the UK appears to be unloved by international investors worried by the political uncertainty, and a recent Merrill Lynch survey of global investor sentiment saw pessimism for the UK at the highest levels since the global financial crisis.

Yes, Brexit focused "white noise" will remain a headwind but UK equity valuations do not look stretched compared to previous market peaks and the reluctance to invest based on political noise has seen UK equities look particularly cheap on a number of valuation metrics against global equities. The widely used Shiller PE of 17x certainly appears compelling versus a figure of 31x for the US stockmarket!

The UK stockmarket is influenced by a number of factors which will play out in different ways. It is dominated by very large global-facing businesses, with somewhere between two thirds to three quarters of revenues derived outside of the UK. With sterling

historically weak this provides a tailwind for large cap, overseas UK plc.

We see opportunities in the UK stockmarket in 2018; and we maintain a focus on defensive UK equity income funds that invest in multi-national blue chip stocks. But as contrarians by nature we are also looking for opportunities that have emerged in domestic cyclical companies where valuations appear to price in a very negative environment with low growth expectations. In fact, after significant underperformance in 2016 medium and smaller UK benchmarks have outperformed the FTSE 100 in 2017 and we believe this recovery can gain momentum.

5 "It's The End Of The World As We Know It"

Managing the risks of Corbynomics

Given that the last hard line socialist Government was in 1979, the election of Jeremy Corbyn as Prime Minister would be "the end of the world as we know it" for most investors as we would be facing a very different domestic investment backdrop.

The Whitechurch investment approach is very much focused on risk management whereby we look at the probability and the impact of an event and assess the risks to our portfolios. We cannot second guess politics but at present the probability of a 2018 general election is fairly low. However, if this probability increases then this would be a reason to fundamentally alter our investment strategy, given that the odds of Labour getting most seats is more than 50% and the impact would be high on asset prices.

"What does your Corbyn portfolio look like?" is something that we are asking UK fund managers at meetings and to not be prepared for this curveball in 2018 is negligent. The key expectations would be a fall in the pound and significant underperformance of more domestically focused mid and small caps. Sectors such as Utilities and Infrastructure would also be hit hard.

Our contingency portfolios would see a significant increase in overseas exposure across all asset classes.

4 "All Around The World"

Global diversification makes more sense than ever

Irrespective of the Brexit and Corbyn risk, we believe that it is in clients' best interest to diversify away from the UK and have a globally diversified portfolio. We see many bright spots to invest overseas in 2018.

However, the US stockmarket is not one of them. With Trump having been in office for nearly a year, there is little sign of the promised growth stimulus materialising and it appears that the US stockmarket is at least fully valued on most measures. We have only a small position in US equities going into 2018 as a US market correction is a key risk.

We are much more positive regarding European equities and, although political noise will continue to feature, it appears that the economic recovery on the Continent is gaining momentum. Unlike the US it is in the early stages of recovery so we expect monetary policies to remain supportive.

Japan appears to us to be one of the lower risk overseas markets. Valuations are undemanding and it offers a stable government and easy fiscal and monetary policies.

Finally, Asian and Emerging Markets have performed strongly this year and we continue to favour exposure here both in equities and bonds. A weak dollar and a recovery in commodity prices has been supportive. However, a key question is whether the Chinese authorities are able to manage sustainable growth without it leading to debt defaults. This needs to be monitored carefully in 2018.

3 "Pounding"

Managing currency risk

Understanding currency risk is key when investing overseas. Sterling took a pounding in 2016 and this resulted in a significant boost to UK investors with overseas exposure. Although this year the slide in sterling has halted, the swings in currency movements have been much more pronounced than stockmarkets in their reaction to political and economic uncertainty.

For example, although the US stockmarket and European benchmarks have largely matched each other this year. In sterling terms, Europe has produced a much stronger return for UK investors as the euro has strengthened and the dollar has weakened. Whether the dollar continues to weaken in 2018 is going to be determined by the speed of Fed tightening and whether Trump can stimulate growth.

For sterling, the strength of the pound will be largely determined by ongoing political uncertainty. Although it does look historically cheap, a worsening Brexit outlook could see it test the lows of 2016.

Our overseas exposure is unhedged going into 2018. This provides protection from Brexit and Corbyn risks. However, it also provides insurance if risk aversion increases as the UK is not seen as particularly stable so the pound could weaken if investors go into risk-off mode. If we do see the pound fall further on overly negative sentiment we would take the opportunity to hedge some overseas exposure.

2 "Don't Look Back In Anger"

Investing in areas that have underperformed

Our contrarian approach means that we are cautious investing in some of the areas that are top of the past performance charts following the strong rising market, as this often means they are taking more risk. At the same time though we are always looking to introduce out of favour areas that may not look great from past performance but offer valuation anomalies and recovery opportunities.

An example in 2017 has been our decision to reintroduce UK commercial property into portfolios during the first half of the year. At the time, past performance was looking pretty bleak following the shock to the asset class from the EU referendum. However, with UK economic growth proving resilient, a weak pound stimulating overseas demand and yields looking much more enticing than government bonds we have added exposure (with a focus on funds with little London weightings).

With rising rates a key risk in 2018, and traditional bond markets not providing protection from an inflationary shock, it will be important to have an increased level of diversification and one sector to consider is Absolute Return funds. Many of these have seen disappointing past performances, but with bonds and equity valuations looking expensive in many areas, it seems to be that this is exactly the time when these strategies cannot be ignored and they provide much needed ballast in cautious and balanced mandates and grind out a return greater than cash.

Finally, within our equity exposure we are underweight in both much loved high quality growth areas and highly rated technology trophy assets, both of which appear expensively valued. We believe that value investing looks well placed to perform in a rising interest rate environment.

1 "Reasons To Be Cheerful" Why a stockmarket crash is unlikely in 2018

In his annual shareholder address during the summer, Warren Buffett stated that "stocks are dirt cheap" which may provide some comfort. We don't totally agree but we understand his rationale that if rates stay low for longer than average and US rates peak at around 3%, well below the long run average of 5%, shares remain relatively attractively valued versus other asset classes.

Certainly if you want to make a return in 2018, the "TINA" acronym applies. *'There Is No Alternative'* than to buy risk assets to make a return above inflation. This is illustrated by the unusual phenomenon of negative gilt yields in the following table.

	UK CPI Inflation	10 Year Gilt Yield
1987	3.7%	9.5%
1999	1.2%	5.5%
2007	2.1%	4.9%
2017	3.0%	1.3%

The table shows the yield you receive today from a 10 year gilt (traditionally viewed as a benchmark for a risk-free asset) compared to those at the time of the last three stockmarket crashes. In 1987, 1999 and 2007, a shrewd investor selling their stockmarket investments prior to the top of the stockmarket cycle would have been able to make a very attractive return in excess of inflation from rotating into UK gilts. This is not the case today, where your returns are significantly less than inflation and this lack of an attractive alternative could support demand for stockmarket investments.

And finally, although the political backdrop remains fraught with uncertainty, the global economic backdrop of synchronised growth and historically low interest rates is traditionally a supportive one for stockmarkets so maybe it is not quite time to run for the hills!

So to summarise; although we are aware of many risks that could derail markets, we continue to find opportunities across asset classes going into 2018. It seems likely that cash savings are going to remain meagre and will show a negative real return in 2018, with savings accounts continuing to be eroded by inflation. This in turn can support investment markets and the benefits of remaining invested in a well-diversified portfolio of risk assets versus cash savings remains compelling.

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