Whitechurch Asset Views
Award Winning Wealth Managers

Whitechurch Securities Ltd
WEALTH MANAGERS

Monthly Round Up - January 2019

Strategic Overview

The good, the bad and the ugly

December was another tough month for global equities after the relative respite seen in November as the prospect of fading US policy support in 2019 together with the US/China trade conflict, reduced monetary stimulus and global growth concerns took their toll on investor confidence.

Best & worst sector performance

Developed equity markets were the hardest hit over the month. US and Japan stocks, in particular, suffered the steepest declines. The IA North America index ended down 8.9% as investors became increasingly concerned about rising rates, the US / China trade war and Trumps threat of a partial Government shutdown, which he followed through on at month end. The turmoil in global equity markets saw a flight to perceived safe-haven assets such as gold and bonds (particularly Government bonds) which saw the strongest returns over the month.

No place to hide in equity markets

European and UK markets also pulled back although to a lesser extent over the month, hit by global growth concerns and the ongoing Brexit debacle. Theresa May survived a vote of no confidence at the start of the month tabled by some of her own party but the challenge continues to find a brexit solution in time for the end of March. Until this is resolved, one way or another, both business and investor confidence will remain muted.

Asia and Emerging Markets – Getting warmer.

Whilst both the Asia Pacific and Emerging Market indices posted losses over the month they were decidedly more muted than those felt in the developed markets. Whilst fears of a US trade war continued the markets managed to shrug this off to some degree and ended down 2.6% and 2.7% respectively, aided by India managing to avoid the stockmarket falls and end the month flat.

Little differentiation across sectors

Over the period there was little differentiation between sector performance globally. The best performer was the utilities sector only down 2.5%, followed by the materials sector only down 4.1%. In the UK this was reflected in the performance of the large cap mining stocks which were one of the only positive contributors to performance over the month.

Bonds were back

Bonds were the best place to be in December (other than Gold) as investors sought out safe-haven assets. UK Government bonds were the best performers, whilst US Treasuries were up 1.7% (based on the Vanguard US Government Bond Index) shrugging off any concerns over rising US interest rates.

The best of the rest

Commercial Property continued to grind out marginal 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 continued their risk off mentality over December with global markets pulling back. In the UK the Mid 250 was again the hardest hit area of the UK market as the Brexit debate continued and dampened investor sentiment towards more domestically focused stocks. Sterling fell sharply at the start of December as Theresa May pulled the Brexit Vote and was subject to a vote of no confidence (which she survived) but it rallied again towards the end of the month as a little more political stability returned in the short term.

Very few sectors showed positive performance over the month, with the mining sectors being one of the few in the black. Key underperformance was seen from the Oil Equipment sector (which suffered due to the fall back in oil price in late 2018), Automobiles & parts and General Retailers. The latter was particularly hard hit after a number of high profile profit warnings over the month from the likes of ASOS and Boohoo.

The UK economy has been more robust than expected for much of 2018 although during November and December there is some evidence that this has weakened as Brexit uncertainty impacted. This has particularly been the case for consumer spending and business investment. If Brexit is clarified in Q1 then GDP trends could pick up if real wage growth continues to strengthen and inflation falls back.

Brexit concerns continue to be 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, although we should see some clarity for better or worse in Q1.

Despite the political uncertainty creating negative sentiment we do see opportunities for UK equities. 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 was the hardest hit of the global equity markets during December as the US economy showed some signs of slowing and Trump forced the US Government into a partial shutdown as he increased the pressure to get funding for the border wall.

The Fed increased interest rates again during December and adjusted its forward expectations for future rate rises with most Fed members now expecting two rather than three rate rises in 2019.

The small cap area of the US market was the hardest hit with the Russell 2000 down 11.9% whilst the larger cap S&P 500 was down 9.1%. Technology stocks were hit again during the month with some weak results from some of the high-profile US tech names; this had a knock-on effect across all markets and particularly those exposed to the tech component suppliers.

Whilst US economic data did show signs of slowing over the month it remained in a growth phase and US jobs data for the month was particularly strong although this cannot be verified at the current time due to the partial US Government shutdown! Companies did continue to cite US/China trade wars, slowing global growth and rising interest rates as causes of concern moving forward although the Fed has taken some action to alleviate this by suggesting fewer rate rises than originally forecast were likely now in 2019.

The US Yield curve inverted in early December as the three-year treasuries yield fell below the five year treasuries yield although it is normally viewed over a full quarter and economists are not currently expecting a recession in 2019.

December saw another warning from a high-profile tech firm as Apple warned on weakness in Chinese sales. It was the company's first cut to revenue predictions in 16 years and shares fell 10% on the news and helped fuel a wider sell off in equities.

Over the course of 2018 our underweight position to the US stockmarket has been a drag on performance although our favour for US smaller companies has been a major positive (although not this month!). At the end of December we used the market weakness to reduce our underweight position. Long term we think that the US will perform, although we acknowledge the issues around Fed rate rises and stock valuations and still remain underweight versus Global benchmarks.

European Equities

European stockmarkets fell again in December although they were among the better performing of the Developed markets. Worries over rising US interest rates, trade tariffs, slower Chinese growth and Brexit continued to weigh on investor sentiment.

The flash PMI for December showed business activity slowed to the weakest level in over four years, with the protests in France and ongoing weak demand for new cars among the factors weighing on activity.

December saw the ECB confirm the end of its bond buying program and they reiterated that interest rates would remain on hold at least through the summer of 2019. December also saw the end of the long running dispute over Italy's 2019 budget with the government agreeing to delay some spending measures, although the agreement failed to quell concerns about the health of the country's banks.

The Eurozone inflation rate hit an eight month low in December falling to 1.6% as the oil price fell back and is now well under the 2% ECB target, although it should provide relief to the regions manufacturers as core input costs fell.

Looking forward Eurozone growth forecasts for 2019 have dropped to fresh lows as global trade war concerns and political uncertainty weigh on economic activity, with Eurozone GDP expected to grow just below 1.6% in 2019. Germany is currently forecast to grow more slowly than France in 2019 whilst Italy is expected to be one of the regions worst performers growing only 0.7%. However, consumer spending is expected to be supported by a relatively tight labour market and low interest rates and domestic demand is expected to hold up.

European markets have lagged wider developed markets over 2018 and our reduction in European exposure has been prudent. We will continue to hold a reduced weighting to Europe at the current time, however, we continue to believe that Europe looks attractive on valuation metrics.

Japanese Equities

Japanese stockmarkets were particularly weak in December falling towards the end of the month as the yen strengthened and as the currency continued to be viewed as a safe-haven in the global sell-off. Investors continued to be concerned over global economic growth and the falls in US markets fed across into Asian markets. Japanese technology stocks were hit the hardest.

After a long run of incremental positive data there are now some signs that the rate of improvement in the labour market may be peaking out.

Growth in the Japan Service sector slowed in December due to poor weather and weaker demand, slowing PMI growth down to 51 from 52.3. The PMI survey showed a modest improvement in demand and a weaker increase in new export orders. Improvement was seen in the manufacturing sector with the PMI rising from 52.2 to 52.6.

Japan inflation remains an issue as it fell back again in November despite higher prices for food and utilities. This slowdown is expected to run for longer and it is likely that underlying inflation won't approach 1% next year, even as domestic demand strengthens ahead of the sales tax hike. Over the period the Bank of Japan kept rates on hold.

On the corporate front the headlines were still dominated by the re-arrest of the Nissan Chief Carlos Ghosn. The backdrop for investing in Japan has appeared unexciting this year but politics is stable, and the economy continues to grow albeit at a slower rate. Japanese companies are better placed than ten years ago to withstand a downturn with lower debt piles and higher levels of profitability. Improving relations with China could also result in an uptick in trade between the two countries which should help soften the impact of a global slowdown.

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 fluctuate and 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

There was no respite for Global Emerging Markets (GEM) during December. Although the downside was limited when compared to developed market performance, not one GEM index ended the month in positive territory in either local currency or sterling. India and Brazil were the best performers for sterling investors but still achieved a negative performance.

In China, growth has also slowed, explaining part of the weakness in global exports, with Chinese imports having slowed from 37% year-on-year. Following a clampdown on lending from the shadow banking sector, Chinese money supply growth has slowed, coinciding with a slowdown in the pace of retail sales growth and industrial production. In response to this slowdown, China is seeking to stimulate the economy with a combination of monetary and fiscal measures, particularly in the face of external headwinds emanating from the ongoing trade dispute with the US. With the potential for either a deal or further escalation in the trade negotiations, there are two-way risks for investors.

India saw domestic stockmarkets finish the last session of 2018 on a flat note after a choppy session. Sharp advances in metal stocks were marred by weakness in energy, infrastructure and real estate sectors. The Sensex and Nifty logged their third consecutive annual gain, rising 5.9% and 3.2% for the year respectively. Continued pro-growth policies in India are having a positive effect on the economy but India does now stand as being one of the most expensive GEMs.

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 provide good opportunities for investors seeking long-term growth who can accept the high volatility.

Fixed Interest

During the month of December, the trade war tension between China and the US continued to affect and drive the market sentiment. We saw the Global bond markets enjoy their best month in more than a year in December. This is as a result of the growing concerns over the future of the global economy and fading optimism over global economic growth outlook for 2019, which directed investors to return to the safety of fixed income assets.

Following the rate hike, Powell responded to the market volatility by stating that he is willing to adjust the central bank policy if it is required, which demonstrates that if necessary he will take a step back from rate hikes.

The rally in US Treasuries carried on its momentum in December, pulling down long term yields. Yields are now 2.64% from 2.88%. The move in the market does suggest to us that investors believe the US cental bank will not continue tightening its monetary policy after four rate hikes in 2018.

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 in the event of a soft Brexit. We have some excellent diversification benefits at play with US Government bonds vs UK domestic equities at present.

Overall, we have constructed a basket of complementary and diverse bond funds for the cautious and balanced income orientated portfolios. We will continue to avoid UK Government bonds (in favour of US Government bonds).

We continue to favour our fixed interest exposure in corporate bonds and less interest rate sensitive areas of bond markets.

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 only exception to this being Kames which fell back due to a change in pricing method. 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. November saw a very mixed bag of results for our Alternative exposure with the IA Targeted Absolute Return sector down 0.4%.

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

The oil price plunged this quarter as rising supply, led by US shale production, caught up with demand. Fears around the outlook for global growth and hence demand for oil have also weighed on the price. Falling oil prices create both winners and losers. Oil producers will be hurt and business investment in the energy sector will fall. However, oil consumers - both households and many businesses - will benefit from lower energy costs, providing a potential upside surprise to the currently gloomy mood in markets.

Overall, the risks are probably higher now than they have been at any point since the eurozone crisis. But there are risks both to the downside and the upside.

Things that could potentially help the global economy in 2019 include Chinese stimulus, avoidance of a no-deal Brexit, a potential trade deal between the US and China and lower oil prices boosting growth and slowing the pace of interest rate rises.

Gold was amongst the best performing asset classes globally returning close to 5% during December. As anticipated, the Fed Reserve increased rates in December but cautioned on its 2019 timetable, stating decisions on further rate increases will be dependent on data. This provided a further boost to gold which started December trading at $1,222 per ounce and closed at $1,285. The run has extended into January with gold touching an intraday high of $1300 per ounce on the 4th of January.

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 remained at 2.2% as measured by the Consumer Price Index (CPI) as commodity prices plunged. Cash ISA deals improved marginally over the month with the best Cash ISA deals showing instant access at 1.66%, which is 0.21% higher than last month.

For investors taking a medium / 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 on 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, January 2019

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