Market commentary **April 2018**

"..our programme for reducing our [Federal Reserve's] balance sheet, which began in October, is proceeding smoothly. Barring a very significant and unexpected weakening in the outlook, we do not intend to alter this programme."

Jerome Powell, Chairman of the Federal Reserve, March 2018.

Overview

Global economic activity remained robust coming into 2018 as the world economy continues to enjoy a synchronised upswing which has been in place since the beginning of 2016. All the major (G7) economies experienced positive, albeit relatively low levels of economic growth in 2017, whilst China and the broader emerging markets fared much better. Global economic growth is expected to reach 3.5% in 2018 which is the strongest it's been since 2011 but still nowhere near the 5% plus levels reached in the early part of the millennium. Business confidence in Germany is close to all-time highs and economic projections suggest that the economy is likely to be one of the strongest of the G7 in 2018. Unfortunately, the UK economy has gone from being one of the strongest in the G7 between 2013 and 2016, to being the weakest in 2018. Higher inflation continues to squeeze the living standards of households, while Brexit uncertainty is weighing on business confidence.

There were strong retail sales in the US following a buoyant Black Friday and Cyber Monday, no doubt helped by the sales of the new iPhone-X. One of the key elements in the global upswing is the revival in capital investment (investing in business plant and machinery for example) which is positive for the US, German and Japanese economies. The recently passed Tax Cuts and Jobs Act in the US will also boost capital spending. Unemployment has continued to fall in the US, Europe and the UK and there are tentative signs that some of the long-term unemployed in the US are being tempted back into work.

Stronger economic growth is currently leading to higher inflation expectations particularly in the US potentially bringing an end to the 'goldilocks scenario' of recent years (growth and inflation are 'just right'). As a consequence, short-term interest rates are rising sharply in the US from just above zero soon after the financial crisis to 2.3% in recent months, which is the highest they have been since 2008. Longer term interest rates as measured by the 10 year Treasury Bond Yield for the technically minded, also pushed above the critical 3% level. Financial markets are sensitive to interest rate rises as it raises the cost of borrowing for consumers, companies and governments and this level is seen as a step-change to possible higher interest rates in the future.

Quantitative Easing (QE) policies have been enacted by all of the major central banks across the globe over the last decade including the Bank of England, the US Federal Reserve, the European Central Bank, the Bank of Japan, the Swiss National Bank and the People's Bank of China. According to Bloomberg, central banks have pumped in close to $10 trillion to help keep the global economy afloat since 2008 but analysis points to mid-2017 as now representing the peak of this monetary support. In this respect, 2018 is likely to be characterised by the start of a financial environment with higher levels of market volatility (measured by the extent of daily variations in market prices) than we have hitherto experienced as central banks withdraw their intervention. Indeed, the interest rate rises in the US clearly spooked both equity and bond markets in January of this year as most of the major stock markets fell by circa 10%. There has been a recovery of sorts since then but it is clear to investment managers that we are transitioning to a new market environment.

Likewise, policy makers are acutely aware that the time has come for central banks to extricate themselves from these extraordinary monetary measures and 2018 is likely to herald the start of a period of transition to the next economic phase. The risks looking forward are more finely balanced with fears of an inflationary 'bond yields surge' entailing a sharp rise in interest rates alongside other inflation sensitive assets such as commodities set against the deflationary fears of falling asset prices associated with 'economic stagnation' caused by debt laden economies. The true optimist would hope for a global 'trade boom' with rising trade levels and little or no impact on inflation and interest rates.

UK equities FTSE All-Share Index (excl. Inv Co's) -2.4%

The FTSE 100 Index returned -2.5%, the FTSE 250 Index -1.9% and FTSE Small Companies -2.2% in the period under review. Economic growth in the UK is forecast to be 1.7% in 2018 supported by an upturn in exports. However, with the implementation of Brexit still expected in 2019, forecasts have become more uncertain than usual. The prospect of the UK's departure from the European Union appears to have been a key influence on companies' investment decisions over the last year. There is evidence from the Bank of England that anticipation of changes to the UK trading arrangements, uncertainty around what shape trading arrangements will eventually take and a weak pound is causing firms to delay or cancel investment decisions.

The picture is broadly mixed in the UK as investors try to reconcile largely unstable and transitioning global financial conditions with the fortunes of individual companies. Brexit negotiations are clearly creating great uncertainty. There appears to be little absolute value from an investment perspective in the UK market although many companies continue to benefit from borrowing at historically low interest rates. There is also stubborn investor demand for higher dividend income streams than that afforded to them from traditional bank deposit rates. The dividend yield from the FTSE 100 is above 4%, significantly higher than the sub 1.5% offerings from traditional deposit rates. The sustainability of dividend pay-outs by UK companies' yields is debatable at this stage of the economic cycle but boards are acutely aware that they will be punished by investors if they reduce the dividend so are tending to cut costs elsewhere. If higher share price volatility is maintained going forward, then good active investment managers should be able to regain some of the assets lost to the tracker funds in recent years. We continue to monitor these outcomes closely.

We're observing that the prospects for investment managers to successfully invest actively in the UK equity markets is becoming more difficult the longer this current economic cycle continues. Many of the main FTSE All-Share sectors, by which stocks are categorised, including beverages, chemicals, general industrials, industrial engineering, household goods, non-life insurance, leisure and personal goods, utilities, tobacco and technology have all benefited from low interest rates and favourable borrowing terms since the crisis. However, a combination of high stock market valuations, high debt levels, rising interest rates and higher wage costs could turn these tailwinds into headwinds.

There is anecdotal evidence of rising financial pressures within these sectors over the last year with a combination of profit warnings and/or significant share price falls. Centrica, which resides in the utility sector, is suffering from high levels of borrowing, political pressure for consumer price caps, loss of customers, pressure to reduce its dividend and government opposition plans to nationalise the industry. Poor sentiment has weighed heavily on the share price. Provident Financial, the door-to-door lender, attempted to introduce technology into its collection process to disastrous results. Supermarkets remain in a holding pattern operating in a saturated market squeezed by competitive pressures from all sides and consumers moving to simpler, lower budget stores with increased demand for online deliveries. Capita, Mitie, Serco and Carillion have all suffered a torrid period with the failure of tightly priced out-sourcing contracts. Banks are making progress behind the scenes to re-capitalise their businesses following the crisis but continue to pay compensation to customers for their past misdemeanours. Whilst there does look to be some value in this sector, it is difficult to invest with conviction at the end of a decade long credit binge although mild rate rises will largely be positive for bank profitability. Other sectors like oil and equipment services have been in cyclical decline since 2012, although the valuations look compelling at this juncture provided the industry can manufacture a meaningful recovery with oil prices now above $70 a barrel. Mining has also been in decline due to falling commodity prices since 2010. The nadir for this sector appears to have been the crash of 2015 but the industry has done well to stabilise the supply chain, mothballing poorly performing projects and focussing on profitability which has made investing for stable and rising dividends look more compelling for investors.

International equities MSCI All Companies World (ex UK) Index 3.5%

The S&P 500 Index, a broad measure of the performance of the largest 500 publicly quoted companies in the US returned 5.4% in the period. US economic growth remains strong at 3.1%, spurred on by the Republicans tax cutting package. The intentions of corporations to invest in their business is the highest it's been in 20 years as the 'animal spirits' have been maintained following Donald Trump's inauguration. Profits from US corporations are still growing in their high teens and there is a sense from investors that the numbers can't improve much further from here. This is the second longest economic expansion on record from trough to peak. Consumer confidence continues to rise and US unemployment is at record lows whilst the average American is seeing wages rise by 2.4% per annum.

A weak US dollar has been a striking feature of the Trump administration as its value has fallen by roughly 10% against a basket of other currencies. Whilst the President likes to be associated with strength, he has made it clear since last January that he thought it was "too strong" and "it's killing us". Meanwhile, US exporters and firms with international operations are enjoying the benefits. In many ways, the weak dollar is a puzzle as a strong economy and rising interest rates should be the conditions for a strong dollar. However, the dollar was very strong from 2014 to 2016 and so the weakness comes from a return to more normal levels although the levels stated in the widely followed 'Big Mac Index', from the Economist magazine, suggest it is still not quite weak enough.

In Europe, the MSCI Europe (excl. UK) index returned -2.3%. Unemployment in the Eurozone has improved considerably over the last 5 years from a high of over 12% to 8.5% currently. 2017 was the fastest growth the region has seen in a decade at 2.5% and is forecast to be even higher at 2.6% for 2018, double that of the UK. The Netherlands is the fastest growing economy, followed by Spain and Germany. Italy is the usual laggard. The European Central Bank (the ECB) has provided extraordinary monetary stimulus since the European Debt Crisis driving interest rates to below zero and providing cheap finance to financial institutions. There is growing consensus that it's time for this artificial support to end and it is likely to be in September of this year when the ECB will withdraw from their QE programme. This ties in with our general theme for 2018 as a year of global transition as the global economy attempts to stand on its own feet.

The MSCI Emerging Markets Index has returned 3.8%. In 2017, economic growth in China was 6.9%, India 6%, Brazil 1% and Russia 1.6%. Brazil and Russia are likely to grow their economies faster in 2018, whilst China and India will see slight downward adjustments. Exports have improved steadily from 2014 onwards in the broader emerging markets and currencies are now looking the cheapest relative to the dollar as they have been over the last 25 years. Latin America is experiencing a synchronised recovery which started in 2017 with Argentina and Peru growing at 3-4% and Columbia and Mexico growing at 2-3% in real terms. Compared to the developed markets, equity valuations are attractive and strengthening currencies over time should provide a supportive environment for investment returns provided global trade remains buoyant.

In Japan, the Topix 500 returned 3.4%. Japan's economy grew by 1.7% in real terms in 2017 and is forecast to grow by 1.8% in 2018. Corporate Japan has a very different culture to other G7 countries and the financial characteristics continue to provide a compelling investment case. The companies tend to retain high amounts of cash ready for investment into new projects, dividends are rising where historically they were very low, company valuations are relatively low particularly when compared to US companies and are generating high levels of returns. Profits grew by more than 20% per annum in 2017. Japanese companies have also had to undergo a great deal of re-structuring during very tough economic times over the last 25 years which should give them some resilience.

Fixed interest securities

FTSE British Government All-Stocks Index 1.5%

The ten year UK Gilt yield is 1.4% which is the approximate annualised return an investor should expect to receive over ten years. The US 10 year Treasury bond yield is 3.0%. UK investment grade corporate bonds are yielding 2.5% per annum, US investment grade bonds 4.1% and US high yield bonds 5.1%. As the global economy is decisively moving from the recovery phase to the expansion phase, countries start to experience shortages in spare capacity causing firms to pay higher wages to their employees, resulting in higher inflation across the economy. Interest rates are rising in the US and in part, this is due to the Federal Reserve stepping back from the bond buying programme (QE) which was put in place during the financial crisis to support the economy. Current projections suggest that they are going to reduce their stock of bonds by $50billion a month by the end of the year unless there is a significant downturn in the economy. The path to normalise interest rates is unlikely to be smooth.

Commercial property

MSCI IMI Liquid Real Estate 2.9%

Despite continued uncertainties generated by the prospect of a ‘soft’ or ‘hard’ Brexit, the underlying fundamentals of the UK commercial property market remain sound, with sustained tenant demand and restricted levels of supply across the majority of markets with the exception of the troubled high street. From a pricing perspective, the property market is still experiencing capital gains. This can be attributed to a number of factors. There is significant investor re-engagement from overseas investors who still view the UK as a ‘safe haven’ and benefit from sterling weakness. They are also able to take advantage of borrowing at very low interest rates and receive a relatively high income in return. The industrial sector is performing strongly with enthusiasm amongst investors to acquire industrial assets. There is growing demand for warehousing and logistical accommodation which is a logical product of the dramatic growth in online retailing.

Alternative asset classes

The mining sector is still trading at levels well below the peak of 2011 and trades at a significant discount to company valuations that we see in broader equity markets. Miners have spent many years re-structuring their businesses and the ongoing profitability of these businesses looks robust. Whilst commodity prices are probably fairly valued, investors are still shy to own the mining companies as the downturn after the financial crisis caused a great deal of distrust. Crucially for investors who wish to be more constructive towards the sector, there are appealing dividend yields for income and the dividends look stable given current levels of profitability, provided commodity prices remain relatively stable,.

Paul Farrant, Chartered Financial Analyst

If you would like to find out more or speak to one of our advisers, please contact us:

t. 01727 837128 e. info@ifpc.co.uk www.ifpc.co.uk

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Indices performance statistics are for the period 6th October 2017 to 5th April 2018, total return with income reinvested. Returns are stated in local currency terms unless explicitly stated otherwise.
Source of statistics: PIMFA, Financial Express, Alpha Terminal, Bank of England, Office for National Statistics, Investment Property Databank, CFA Institute (UK), Financial Times.

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