Chase de Vere

Investment Update
Autumn 2018

“Autumn is a second spring when every leaf is a flower.”

Albert Camus

Investment Update – Autumn 2018

The summer months have passed with plenty for investors to digest. Generally, markets held their ground but when volatility picked up as expected, they took a turn for the worst, particularly towards the end of the quarter.

With the exception of the Italian government's budget announcement late last month, none of the concerns spooking markets are new. In no particular order of importance, investors are still coming to terms with the likes of: Brexit, trade tariffs, US interest rate policy, quantitative tightening, to name but a few. While our view is firmly longer term, we are cognisant of the shorter term risks so it is probably of no surprise that some of the areas we are currently focusing on include:

Brexit: Our view on Brexit and UK equity markets has remained constant. We believe that a lot of the 'Brexit risk' is being reflected in UK equity valuations and that certain parts of the UK market are trading on undemanding valuations, which we believe will be re-evaluated by investors when we see some clarity over Brexit, whatever that looks like.

Trade wars: We are hoping these are short-lived and do not escalate further affecting global trade. Our view is that the US will dominate as talks progress. Equities remain our favoured asset class over the long-term and so we aim to ride out the short-term volatility and noise, preferring to focus on fundamentals, such as valuations between markets.

Central Bank policy: Ultra-loose monetary support is being removed and in the US and UK we have seen interest rate rises. Although these are being carefully telegraphed to markets, bonds are coming under pressure after years of strong returns, although certain areas of the bond market still provide opportunity and are still useful for diversification purposes.

UK Equities

UK markets were broadly up over the quarter with no particular market cap emerging as a clear winner or loser. September saw large caps deliver relatively strong returns, their overseas earnings boosted by sterling weakness toward the end of the month. The market's Oil Majors and the Miners, which continue to have meaningful weight in leading UK benchmark indices also performed well off the back of strong energy and commodity prices. Unfortunately, most of these gains have been given up since as investor sentiment has created waves in global markets.

Despite tepid growth, the UK economy has remained resilient. Second quarter GDP growth may have been revised marginally lower but still came in at 1.2% year-on-year. The 12-month Consumer Price Index ("CPI") came in at 2.7% in August, up from 2.5% in July, while the unemployment rate held steady at 4%, its lowest rate since 1975. Meanwhile pay rose by 3.1% in the three months to August, compared with a year ago but we think comments that the UK is seeing a 'new dawn' for wage growth may be a bit premature as a good deal of the growth increase came from the recent public sector pay rise.

Government spending has come in under target prompting speculation that the Chancellor may have some giveaways up his sleeve in the autumn budget. However, as the austerity theme continues we think this unlikely. There have already been indications that personal tax rates could rise to help fund the NHS and we believe the Chancellor's preference would be to keep some powder dry in case the UK's departure from the EU does not go to plan.

The base rate was kept on hold at 0.75% at the latest Bank of England Monetary Policy Committee ("MPC") meeting. Relatively consistent data, has helped the MPC raise the base rate this year but we feel, if core inflation remains stable, 0.75% is probably the peak until some clarity is reached on Brexit.

Despite tepid growth, the UK economy continues to remain resilient.

UK Equities (cont.)

The current base rate is supportive of UK dividend paying companies, where some attractive yields remain on offer and which we believe will continue to be a sought after area of the market. Brexit uncertainty makes the UK stockmarket the most unloved developed market amongst global investors, which means that there are opportunities to be had. UK markets are trading on undemanding valuations and companies with good business models, good cash flow and strong balance sheets should have plenty of scope for recovery as the Brexit dust gradually clears.

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Developed Market Equities

The US remains at the forefront of global growth prospects pushed on by solid data and fiscal stimulus.

US equity markets continued their positive display over the quarter despite September being a rare lacklustre month, the S&P 500 making only a marginal gain in local currency terms. The US remains at the forefront of global growth prospects pushed on by solid data and fiscal stimulus. This quarter has seen the announcement of further trade tariffs on Chinese imports, equating to 10% on $200bn worth of goods, and the US Federal Reserve (the "Fed") raise interest rates while continuing to indicate another 0.25% rise in December and three more increases in 2019. Although this was clearly signposted, and widely anticipated, the move seemed to spook investors creating, what we believe to be, a sentiment-driven market fall.

Treasuries have been issued to fund the recent tax cuts, the purchase of which is reducing the volume of dollars in circulation and impacting liquidity. This is something that the bond markets have been keeping a watch on for months but the equity market seems to have been caught napping.

Thinking positively, liquidity driven market movements can be quite sharp but can also be over quite quickly and the recent falls mean that US equity markets, which are increasingly viewed as overheated, have a chance to pull back, helping to provide some value opportunities.

European equities were marginally up over the quarter despite coming under pressure at the start of the September on the back of further trade war talk. By the end of the month, investors had become unduly preoccupied with disharmony in the Eurozone as the newly announced Italian budget weighed on sentiment. Liquidity worries from the US added to investor concerns. During the month, the European Central Bank ("ECB") confirmed that Quantitative Easing ("QE") will be over by year end and that the net asset purchases will be reduced from to €15 billion from September to December this year. The market still offers more value than the US equity market and there is potential for continued earnings growth but our stance on Europe remains broadly neutral.

Developed Market Equities (cont.)

Japanese equities were positive over the quarter in local currency terms, pushed into solid positive territory with an impressive September performance. A weaker yen has raised expectations for corporate earnings growth for Japan's large export conglomerates which dominate its market. In addition, the US and Japan agreed to negotiations on trade agreements during the month, which boosted sentiment. Investing in Japan can be difficult and the economy is pretty unexciting but central bank support, dividend reforms and corporate earnings momentum make Japanese equities relatively attractive.

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Asian & Emerging Markets

In mid-September the US announced a 10% tariff on $200 billion worth of Chinese goods, increasing to 25% by the end of the year.

Australia helped the broad Asian market to a small positive over the quarter while Emerging Markets were flat, having been subject to a run of negative events this year.

In mid-September the US announced a 10% tariff on $200 billion worth of Chinese goods, increasing to 25% by the end of the year. It also threatened additional tariffs if China retaliated, which China promptly did. So far, China has either imposed or proposed tariffs on $110 billion of US goods, representing most products it imports from the US. Although on paper these moves seem harsh, the market was preparing for much worse, nevertheless, the ongoing talks between the two countries weigh heavily on investors' minds and we hope that the current position does not escalate much further and become more harmful, as this is in no-one's interest.

Emerging Markets have also had country-specific factors to deal with, such as Turkey's credit-fuelled growth running out of steam and numerous elections, plus the region is dealing with tightening global financial conditions, driven by higher US rates and a stronger dollar. In the main, Emerging Market fundamentals have improved so it feels like the market falls have been driven, in part, by indiscriminate selling.

Asian and Emerging Markets continue to be affected by external factors including a strengthening dollar, rising US rates and a Chinese debt crisis. Overall though, fundamentals across regions look attractive. Structural reforms, improving corporate governance, greater consumerism and, not least, relative equity valuations, particularly in Emerging Markets, are providing good opportunities but only for those with a long-term perspective and who can stomach the associated risk.

Fixed Interest

Fixed interest markets have endured a fairly torrid three months. Interest rate sensitive areas of the market have been under pressure while High Yield and shorter duration assets offered some relief. It was a surprise to find that Emerging Market Debt performed well in September given that the Fed raised US rates again, however, a weaker dollar over the month clearly helped the asset class. It remains an asset class that we view from a distance given the volatility it can harbour.

Developed world central banks are becoming more cautious as liquidity begins to leave the system. The US continues along its rate raising path with another increase set for December and clear signposting for next year's expectations. The UK has followed suit but is taking things steadily and we think that base rate will remain static for the next few months if inflation remains contained. The ECB has not raised rates but announced that its bond buying programme was to be halved, down to €15 billion per month, before ending in December 2018. The Italian government's budget deficit came in much higher than anticipated at the end of the period spooking investors and at this stage it is not clear where Europe is in the cycle.

US corporate credit spreads have tightened and offer little protection over Treasuries which have now priced in most of the expected interest rate rises. Meanwhile European corporates are being affected by policy tightening and political risk. Local currency and Emerging Market bonds offer a good yield but country selection is absolutely crucial to balance the many associated risks.

The bond market is being challenged by liquidity concerns and as we move into a phase of tightening monetary policy, diversification becomes more and more important. We want limited exposure to interest rate sensitive bonds and our preference remains for corporates over gilts, which we feel do not offer any value.

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Commerical Property

Bricks and mortar property has produced another quarter of steady, incremental gains. Retail continues with its uncomfortable structural reform. UK GDP growth is lower but positive and still capable of surprise. This is an important figure to be aware of as the fortune of commercial property is closely linked to it. As GDP growth has slowed, as Brexit lingers and as structural changes take place, prime sites once again become the top of the list of requirements in property portfolios.

Capital uplift looks set to become more of a challenge from here on in but this is not uncommon, as an asset class, commercial property is often driven by income. Property is still delivering attractive yields versus government bonds and aids portfolio diversification due to its lack of correlation with equity and bond markets. We remain positive on commercial property but are mindful of its illiquid nature.

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Cash

UK CPI surprised in September with the 12-month figure coming at 2.7%, RPI rose to 3.5%.

Cash looks set to provide another year of negative real returns as UK CPI surprised in September with the 12-month figure coming at 2.7%, RPI rose to 3.5%. For investors taking a medium to long term view we continue to believe that there are more attractive opportunities across other asset classes that beat cash. However, it can still have a use to counterbalance higher risk assets.

Summary

Monetary policy has been tightening and the threat of a worsening trade war between the US and China still looms, threatening the wider global markets. While the summer months were fairly unexciting, volatility picked up as expected and looks set to continue. Bond markets will be watching liquidity closely, while falls in equity markets bring a chance to check those regions that have become too rich, namely the US, and also provide an opportunity to buy into the unloved, such as the UK and more recently Emerging Markets.

A greater focus is being placed on fundamentals as volatility kicks in. Strong companies, with good cash flows and balance sheets, sustainable dividends that aren't being paid from debt should be the focus and if you can get them at an attractive valuation then all the better.

Although unwelcome, we all know that risk assets can fall. Our top-down view remains focused on the belief that there is long-term value to be had in equities, corporate bonds and commercial property versus both government bonds and cash.

Ultimately, a well-diversified portfolio that includes a mix of assets can continue to provide inflation beating returns for those prepared to ignore short term noise and adhere to a long-term perspective.

If you have not reviewed your holdings recently, contact your Chase de Vere adviser. If you do not have a Chase de Vere adviser, please contact us on **0345 300 6256** so we can arrange for an adviser to contact you.

The value of your investment can go down as well as up and you may not get back the full amount you invested. Past performance is not a reliable indicator of future performance. Investing in shares should be regarded as a long-term investment and should fit in with your overall attitude to risk and financial circumstances.

Commentary correct at time of writing.

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