

Chase de Vere

Investment Update
Summer 2019



*“Keep your face to the sun and
you will never see the shadows.”*

Helen Keller

Investment Update – Summer 2019

Markets started the quarter on the front foot but were derailed in May by fears over escalating trade wars between the US and China. Thankfully they regained their poise, making gains over June as investor concerns dissipated and both parties were ready to come back to the table. Sentiment has improved and is helping to create a positive outlook as we head into the summer months, a traditionally quiet time in equity and bond markets.

Theresa May stepped down as UK Prime Minister in June causing sterling to weaken. The leadership contest has now reached its conclusion, with Boris Johnson now focussed on taking the UK out of the EU on 31 October 2019. We can only hope that it may signal the beginning of the end of Brexit-related uncertainty and lead to a re-rating of what is now one of the most unloved markets.

The spotlight is now back on the central banks. The market is pricing in a US interest rate cut at the US Federal Reserve's (the "Fed") next meeting at the end of July as it aims to keep the US economy on track. Meanwhile, the European Central Bank ("ECB") has lifted markets with its announcement that any possibility of raising rates has been pushed out to mid-2020 at the earliest and that it would be prepared to undertake further QE if needed.

UK Equities

The UK equity market continued its upward trajectory over the quarter, the FTSE All Share returning 2%, hampered only by its first full month of negative returns for the year in May. Although the market lags its US and European counterparts, these returns are impressive given the political situation in the UK with regards Brexit and the leadership contest and the fact that the UK is distinctly unloved and under-owned. It is exactly this point, however, that currently affords the UK its defensive qualities, seen in Q4 2018 and more recently in May where the UK held up better than other Developed Markets. It would seem simply that you cannot sell what you do not own.

The economy remains resilient, despite the Bank of England (“BoE”) reducing the forecast growth rate from 0.2% to 0% for the quarter. The Base Rate was once again left on hold at 0.75% at the June meeting. Inflation held fairly steady across the quarter with May’s figure coming in at 2%. The labour market remained tight as unemployment levels are at multi-year lows and because there is wage inflation in the system. Wage inflation has been helped significantly by some NHS staff having had pay increases and the new National Living Wage and National Minimum Wage rates being introduced, which fed into the 3.6% seen in the year to May figure.

Sterling strengthened marginally towards the end of the quarter after showing weakness in May as the prospect of a no-deal Brexit was perceived to shift several notches higher.

When the Prime Ministerial leadership contest was in force, concerns of a no-deal resurfaced. However, both Boris Johnson and Jeremy Hunt distanced themselves from a no-deal scenario and promised to deliver Brexit before the end of October deadline.

UK equities are under-owned by global investors and this is reflected in the market’s valuations, making the UK one of a few genuine investment cases for those seeking long-term returns. From a contrarian perspective, there are opportunities to be had with UK markets trading on undemanding valuations and plenty of scope for recovery but we need to make progress over Brexit before anything can move forward.

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Developed Market Equities

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The Trump trade tweet in May derailed the positive market trend enjoyed by equity markets in the first quarter but conciliatory tones from both the US and China in early June and a distinct change in tone from the central banks meant Developed Markets resumed the trend, posting positive returns in June. Over the quarter the US S&P 500 and MSCI Europe ex UK delivered in excess of 6% and 8%, respectively, in sterling terms, while Japan's TOPIX was the laggard returning in the order of 2.7%.

US

On the economic front, the US economy continued to tick along with robust GDP growth and high consumer spending. The annual inflation rate fell to 1.6% in June 2019, representing a 0.4% fall across the quarter, as food prices rose at a softer pace and energy costs continued to decline. However, the core inflation rate, which excludes more volatile items such as food and energy, rose slightly to its April level of 2.1%. The unemployment rate crept up a little in June to 3.7% from a 49-year low of 3.6% in May.

The market has been buoyed by expectations of a rate cut as the Federal Reserve looks to keep the economy firmly on track but US corporate earnings may have peaked after a phenomenal run. Estimated earnings growth for the S&P 500 over the second quarter is -3.0% and this has made investors fearful of a US recession. In valuation terms the forward 12-month P/E ratio for the S&P 500 is 17.1, above both the 5-year average (16.5) and 10-year average (14.8).

This gives us reason to pause. It is important to participate in the US equity market, it has been and remains at the vanguard of equity market returns and we do not think that recession is imminent but its valuations are at a premium, in relative and historical terms.

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Europe

Eurozone markets were lifted by accommodative tones from the European Central Bank (“ECB”) in June, which pulled back from its progressive withdrawal of quantitative easing and pushed out the timing of any rate hikes to the middle of 2020 at the earliest. A weak inflation outlook and concerns over trade and global growth were the primary drivers of the supportive stance. While figures for June are not yet in, the inflation rate fell from 1.9% in April to 1.6% in May.

The unemployment rate continued to fall over the quarter and, correspondingly, consumer spending grew but it would seem that confidence is lacking. The Consumer Confidence Index began the quarter at -7.3% and, after a minor rally abruptly halted by May’s equity market falls, it ended the quarter at -6.9%. Business confidence among manufacturers also fell and is now firmly in the negative. The manufacturing sector in the Eurozone has seen a drop in new orders, reflecting the trade war and a delay in investment decisions. Although this has been partly offset by the services sector, it is little wonder that the ECB has hinted at further QE in the form of more bond buybacks if the economic data gets softer and the inflation outlook deteriorates.

This dichotomy of trade tensions and a dovish central bank has pushed European government bond yields to fresh lows and caused bond-sensitive sectors to climb higher, stretching valuations. While there are still some sectors where valuations are difficult to ignore, it is once again becoming increasingly important to focus on fundamentals as sentiment can change rapidly.

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Japan

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Moving to Japan, the second quarter was typified by weakness in equity markets following a strong start to the year. Trade concerns and political posturing proved to be the primary impediment to its export-led economy and stockmarket.

The economy is what it is. After reaching 0.9% in April, consumer price inflation fell to 0.7% year-on-year in May 2019. This was, however, in line with market consensus so was not a shock. The slowdown was mainly led by electricity, housing and transportation & communication while food prices rose for the second straight month. The seasonally adjusted unemployment rate held steady across April and May, with June's figures yet to come in, but wage growth declined 0.2% year-on-year in May 2019 following a 0.3% fall in April, the fifth consecutive month of a decrease in earnings. It is unsurprising then that consumer spending has stalled and confidence is falling.

Japan exported a total of \$142.6 billion to the US in 2018 making it the US' fourth largest supplier of goods. The top import categories were vehicles, machinery, electrical machinery, optical and medical instruments and aircraft. It is understandable that manufacturers are wary given President Trump's current approach to trade.

The Bank of Japan ("BoJ") remains committed to accommodative monetary and fiscal policy, which provides a level of support for Japanese equity markets. In relative and historic valuation terms, Japan provides opportunity, its domestic markets in particular. The structural, corporate reforms taking hold are showing dividend payouts at all-time highs and plenty of companies are still awash with high levels of cash.



Asia Pacific & Emerging Markets

China continued its orderly slowdown in growth in line with forecasts for the quarter.

The generally positive quarter for Asia Pacific and Emerging Market equities was dented in May by the re-ignition of the trade spat between the US and China. However, fears were reigned in as both parties appeared amicable leading up to the G20 summit in Japan. As a result, strong returns from both markets followed in June redeeming the quarter's performance, with the MSCI Emerging Markets Index returning 3% and the MSCI AC Asia ex Japan 1.7%.

China finished the quarter strongly, the MSCI China delivering just shy of 7% in June, a direct response to a more positive outlook on trade talks with the US. However, that did not help the damage done over the quarter, which returned a loss of 1.7%. May's heavy losses, were not just driven by trade tensions, Chinese telecom Huawei was placed on a trade blacklist during the month, which negatively impacted on China's technology heavy stockmarket. At the other end of the scale, MSCI Russia returned a hefty 19.6% for the quarter, helped significantly by rising energy prices. As a net importer of oil, India suffered relative to rising oil prices, falling back in June but still ending the quarter in positive territory. While Brazil put in another positive turn on the back of political stability and reforms.

China continued its orderly slowdown in growth in line with forecasts for the quarter. Latest figures show that in the three months to June, the economy grew 6.2% from a year earlier, down from 6.4% in the first quarter. It is currently spinning many plates, transitioning from a manufacturing to a service based economy, reigning in consumer and corporate debt and continuing trade negotiations with the US. Policy stimulus has been put in place to boost spending and deliver tax cuts but this is a work in progress and may not have as significant an impact as it has done in the past. Nevertheless, the figures presented to the market are positive enough and, although there are downward pressures, where there is political will there is usually a way.

Asia Pacific & Emerging Markets (cont.)

We focus on China as it has such an influence not only in the region but globally. However, its slowdown is well documented, and Asian and Emerging Market companies are some of the fastest adapters of new processes and opportunity so in spite of the controlled slowdown, investment opportunity remains.

On valuation grounds, Asian and Emerging Markets are looking relatively attractive, particularly the latter which continues to trade at around a 25% discount to Developed Markets. The outlook for these regional markets is looking more promising with external headwinds such as further US interest rate hikes and US dollar strength both abating. In addition, structural reforms, improving corporate governance, greater consumerism and, not least, relative equity valuations and earnings growth potential are providing good opportunities but only for those with a long-term perspective and who can stomach the associated risk.

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Fixed Interest

The market became increasingly concerned about how much fall out from the trade war would spill into the economy and there were calls for the Fed to cut rates.

The first part of the year was characterised by a positive “risk on” environment where markets were well supported. Credit spreads had tightened and yields on government bonds had crept higher. This was all but brought to a standstill in May by the sudden escalation in the US China trade war, the inclusion of China’s technology firm Huawei on the US’ “Entity List” and China’s subsequent retaliation with new tariffs on US goods and its own “unreliable entities list”.

Equity markets fell, credit spreads came under pressure and it came as no surprise that during this uncertain and volatile time, perceived safe havens, such as government bonds, produced the best monthly returns while riskier areas of the market, such as high yield bonds, suffered. The market became increasingly concerned about how much fall out from the trade war would spill into the economy and there were calls for the Fed to cut rates. Central banks acted accordingly, taking a dovish stance, which was retained at the end of the quarter.

Over June the markets moved to price in more QE from the ECB and three rate cuts by the Fed before the end of 2019. The longer end of the bond market was rewarded accordingly as interest rate risk diminished, while some government bond yields dropped further.

Low inflation and accommodative monetary policy has been supportive for government bonds, with recent figures suggesting that the amount of debt on a negative yield worldwide recently tipped \$13 trillion. This is an incredible figure and highlights how distorted markets have become. While the Fed and ECB’s dovish tone have provided a welcome lift for bond markets and could be the market driver for the rest of 2019, the idea of holding negative or low-yielding government debt does not seem like good investment sense, neither does holding more specialist or higher yielding areas as markets have the potential to be more volatile as sentiment can change rapidly. As such, we continue to favour corporate credit and retain our core preference for Strategic Bond funds, while short-dated bond funds can provide for any short term market shocks.

Commercial Property

UK commercial property produced another quarter of marginal gains. Brexit and its impact on the UK economy continues to hamper the outlook for the asset class as political uncertainty and lack of availability hold the market back. Nevertheless, it held up in May as equity markets took a battering.

Pressure continued to be felt in both high street retail and shopping centres over the quarter, pushing prime yields out moving into June; the leisure sector was also burdened. Investment volumes have been muted for much of the year but buyers appear to be hovering in the wings waiting for political clarity. The near term outlook for the asset class is encumbered by Brexit but we still like property for its lack of correlation with equity and bond markets and its relatively attractive yield.

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Cash

The UK inflation rate floated around 2% for the quarter while core inflation (excluding energy, food, alcohol and tobacco) dropped to 1.7%, the lowest annual rate since January 2017. There is currently little scope for the BoE to raise interest rates in light of Brexit and cash has continued to provide a negative real return, which is likely to continue throughout 2019. This is supportive of risk assets and for investors taking a medium to long term view, as such, we continue to believe that there are more attractive opportunities in other asset classes. However, money market funds can be beneficial within portfolios to counterbalance higher risk assets.

There is currently little scope for the BoE to raise interest rates in light of Brexit and cash has continued to provide a negative real return.

Summary

Political shenanigans and central bank policy, continue to drive investor sentiment and market volatility but we have been here before, several times in fact, over the last decade. With dovish central banks potentially easing monetary policy again, sentiment is lifted and the immediate outlook for risk assets, equities and corporate bonds, looks promising in the near term. However, there is a reason for this current round of central bank support; growth is slowing and inflation targets are being missed so we are cognisant that we are nearing the end of the cycle.

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 and that diversification within portfolios is crucial. However, investor sentiment is fragile and we maintain a degree of caution as we move through 2019. Ultimately, a well-diversified portfolio that includes a mix of assets can help provide inflation-beating returns and, to some extent, defend against global political manoeuvrings, for those who are prepared to ignore short term sentiment and adhere to a long-term investment 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.

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