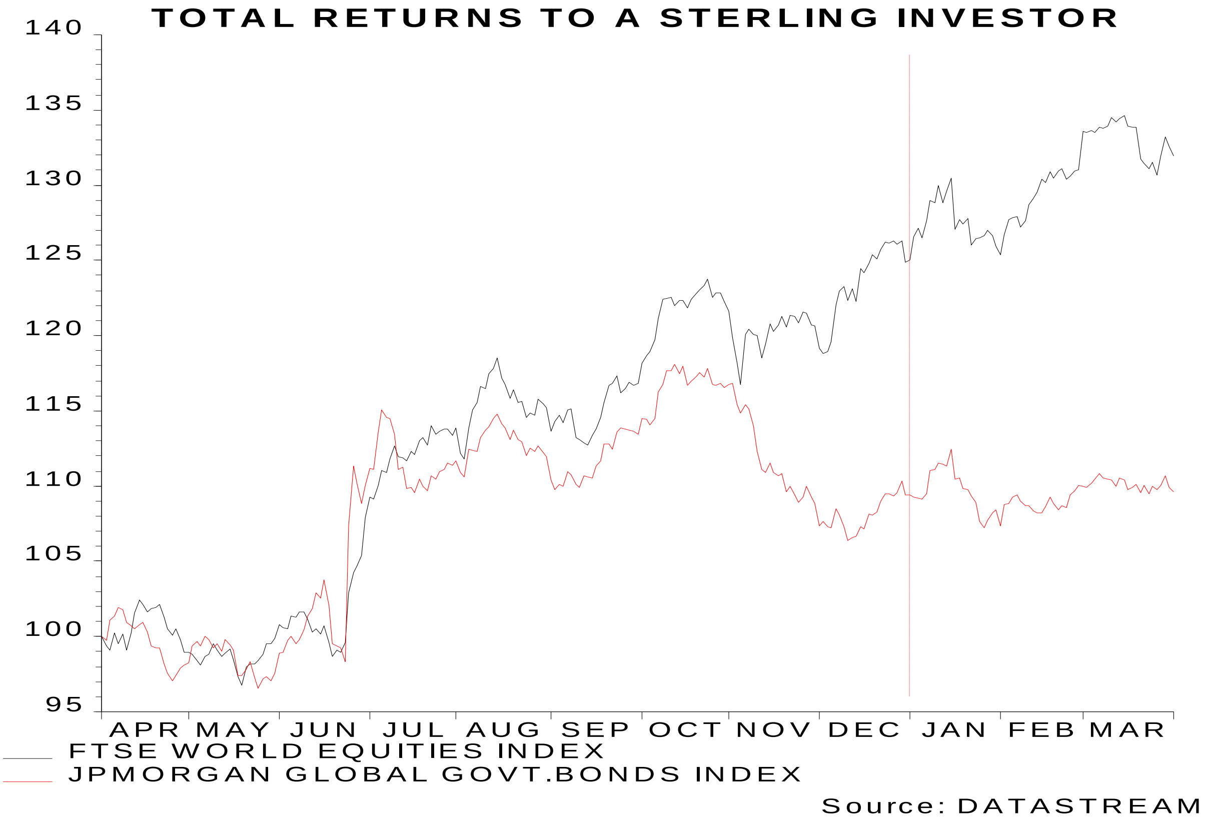
Market Comment

After the political machinations of 2016, investors started this year with a degree of nervousness given there were a number of (principally European) opportunities for the electorate to register further populist stances which could be deemed to reflect disillusion with the prevailing economic and political framework. Offsetting such nervousness was a sense that economic momentum around the world, if not in total much faster than in recent years, was at last becoming more widespread and consistent. Such a sense had begun last summer, but had been cemented in place by the pro-growth reflationary stance of the newly-elected President Trump. An expectation of a concerted pattern of global recovery also meant that investors believed the US Federal Reserve (Fed) would be able to implement a more significant tightening of monetary policy during 2017, building on the single rate increases they had been able to announce in each of the two preceding calendar years. Indeed the Fed was able to take the first step along that path in March but such action did not derail any sense of animal spirits which investors displayed during the quarter.



As 2016 ended, investors were looking forward to a period of growth in the global economy that might potentially be turbo-charged by reflationary measures to be introduced by President Trump. Despite the heady rhetoric of his campaign trail, nothing concrete emerged from his first two months in office to encourage such belief. Nevertheless forecasts for global economic growth continued to edge up during the first quarter. Consensus is now around 3.5% for 2017 and the same again for 2018; such a rate would signify the best outcome since 2011. UK, US, Europe and Japan are all now predicted to grow at the same or a faster rate than last year (which reflects an upgrade of expectations for all except the US), whilst most of the commodity-heavy parts of the emerging world should also experience rather better growth conditions than predicted in December. Forecasts for growth in China have been stable in recent months and India, after the downward jolt to forecasts following its currency replacement programme before Christmas, appears to be back on track to record more than 7% growth for each of the next two years. Overall global growth can be apportioned roughly between the developed world at around 2% and the emerging world at around 4.7%.

As can be seen from the chart, equities continued their upward march during the first quarter, with total returns in positive territory in local currency from all the principal indices. The UK generated around 4%, matched almost exactly when converted into sterling by the markets of Wall Street and Japan. Europe did better than those regions, whilst Asia and Emerging Markets topped the tree with gains in excess of 10% as post-Trump concern about protectionism eased on the absence of anything more concrete than rhetoric. By contrast bond markets produced only a slightly positive outcome and not with any degree of consistency during the quarter.

Bond Markets

We discussed in our last Review the relative balance of supply and demand for sovereign bonds. The Bank of England (BoE) finished the deployment of its additional £60bn announced in the wake of the referendum result last summer, but the authorities in both Europe and Japan kept their foot firmly on the fuel injection pedal. However the increased belief in economic growth around the world is both supportive of risk assets relative to sovereign bonds and also of expectations for somewhat higher rates of inflation. The chart here illustrates that the rate of headline inflation expected over the next five years across all three economies of the US, UK and Germany bottomed in the spring of last year – the turning point was the recovery in the price of oil. As last year passed, so investor perception of reflation also gained ground.

Source: M&G

This was reflected in rising inflation expectations (or at least falling fears of deflation); such forecasts were also given a tailwind by comments from Mr Trump that he would create faster growth in the US through measures designed to reduce regulation and taxes and increase spending on infrastructure. Although forecasts for inflation in the UK will have received an upward adjustment from the currency weakness that followed the referendum outcome, it can be seen that the direction of inflation forecasts is common across all three major economies during the past twelve months.

The first quarter of 2017 began with bond markets in retreat as such increased inflation predictions outweighed the liquidity being injected by Central Banks. In late January however, concerns over the outcome of French elections caused some shift in direction, with investors selling French bonds and redeploying the proceeds into other areas – both Germany and the UK saw benefit from these cash flows and their sovereign bond prices rose. Subsequently in the quarter, President Trump's failure to convince Congress to support his policy of controlling the range of healthcare costs indicated that perhaps other parts of his pre-election rhetoric might also not pass smoothly into legislation – thus an element of the faster US growth forecast for later this year and more substantially for next year might not materialise, giving some support to the pro-bond stance. Overall in the quarter gilt stocks generated a total return of a shade over 1%, investment grade bonds about the same and high yield and emerging market bonds moved in a relatively narrow band, eking out small positive returns.

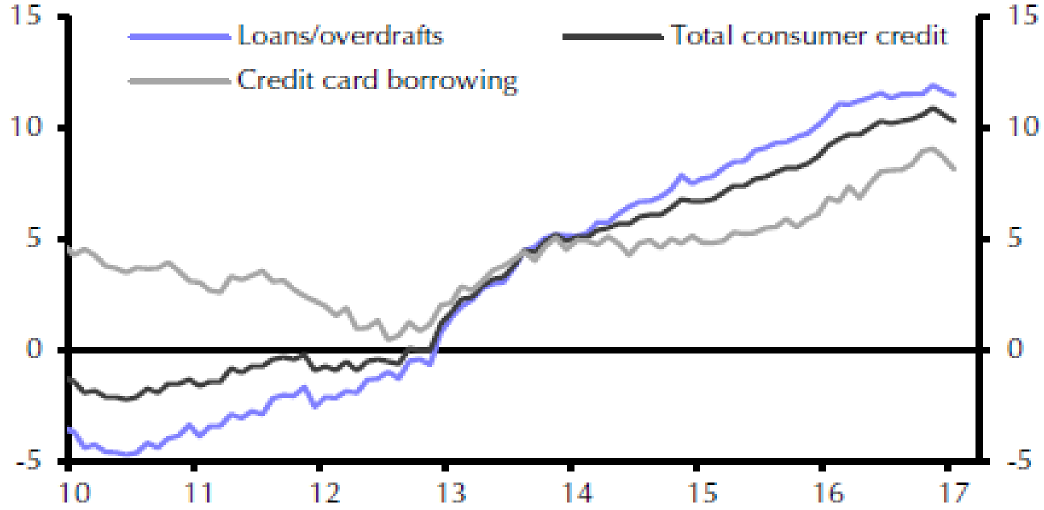
The outcome of the Fed meeting in March was notable not merely for sanctioning another rise in US rates (an action which had become almost totally expected in the preceding few weeks), but also for reaffirming that it still believed that two further rate increases would prove justified in the rest of the calendar year, with a further three earmarked for 2018. Such action would continue the march towards normalisation in US interest rates, but has also prompted investors to consider how other Central Banks would start such a movement of their own. The current programme of the European Central Bank (ECB) has already been tapered from €80bn to €60bn per month with effect from April 2017, to run at least until December, but its head Mr Draghi had to move to quash rumours (fuelled by better than expected growth and faster than expected inflation) that it might move the (currently negative) deposit rate closer to zero before the year end.

United Kingdom

Although press headlines during the quarter focused almost exclusively on Brexit, the Parliamentary process by which the serving of Article 50 would be authorised and finally the formal triggering by way of a notification letter to the EU President, it was broadly "business as usual" for the economy. After surprisingly strong data for growth in the second half of last year, and upward revision subsequently to estimates for Q4, it is unsurprising that the economy has been unable to maintain such a heady rate into 2017. In part this is down to rising prices (especially food and energy related) weighing down on consumer disposable income. Headline inflation reached 2.3% in February, the highest since the autumn of 2013 and effectively now offsetting the stimulatory effect on consumer spending of the rise in wages. With utilities typically announcing price increases to take effect later in the spring, and little sign of the fall in unemployment increasing employees' bargaining power for more generous wage awards, it seems likely that real wage growth will slip back into negative territory for the first time for more than a year.

Although business confidence is stronger than predicted last summer, it seems difficult to be too confident that it will lead to increased sanctioning of investment plans until there is more clarity on our separation from Europe and the potential terms of trade. With Government unlikely to increase its own spending in light of the existing public sector deficit, that leaves trade volumes to carry growth hopes in the near term. Thus far the sharp fall in sterling which followed the referendum vote has meant that UK exports are now very competitively priced and order intake is beginning to accelerate (last month the CBI export survey hit its highest level for more than three years). However a number of industrial surveys indicate that many firms are preferring to take the opportunity to boost margins by increasing sterling export prices rather than trying to expand volumes.

Household Lending (% change y-on-y)



Source: Capital Economics

One dilemma for the authorities continues to be the high level of consumer debt. The chart here shows that consumer credit has been growing at around 10% per annum for the past six months, which is too fast for comfort should interest rates need to be increased. Dealership and other finance for car purchases and leases accounts for half this growth. Overall consumer credit levels are now close to £200bn and rose by almost £4bn during the latest three months; this pace of growth is the fastest since 2005 and, whilst a material slowdown would on the face of it be popular with the BoE (which is concerned at the acceleration in the past year and a half), it would likely dent the rate of consumer spending activity and therefore subdue economic confidence more widely. Although it is unlikely that interest rates will increase in the near term (the market's best guess as to the timing of a first move by the Bank is during the autumn of 2018), the Office for Budget Responsibility increased its forecast for the ratio of gross UK household debt to income in 2018 from 144% to 148% since last November; this would be the highest recorded since the end of 2010.

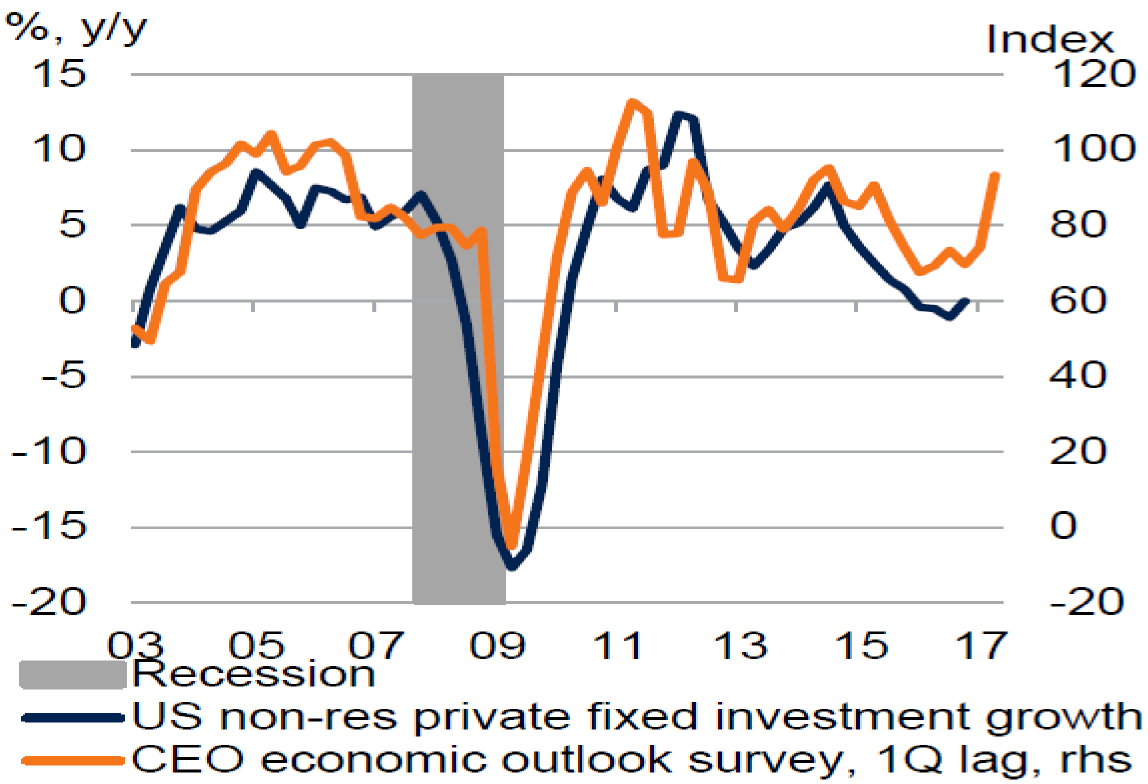
As highlighted earlier, equity indices in the UK recorded solid progress during the quarter. In contrast to the preceding three months in which large and small companies performed equally well, this time there was a marked contrast. Shares in the FTSE 100 produced a total return of 3.7%, whereas those making up the Small Cap Index returned 6.1%. At a sector level, the strongest performance during the quarter came from tobacco (ahead by more than 15%), drinks (10%) and pharmaceuticals (8%), with the oil sector (down nearly 7%) the principal laggard as energy prices failed to hold on to all their winter strength. Although merger activity in Q1 contained two agreed new deals amongst UK larger companies (the agglomerations between oil service businesses Amec Foster Wheeler and Wood Group and between Aberdeen Asset Management and Standard Life), the headline-catching event was the abortive attempt by Kraft Heinz to mount a hostile bid for Unilever, at the time the UK stock market's third largest company.

United States

A lot of investor attention fell on the US in the first quarter, not merely because of Fed action, but also prompted by scrutiny of Mr Trump's first months in office. Having not been short of ideas and propositions whilst on the stump, levels of expectation were high that he would unveil a raft of new policy measures designed to tackle healthcare costs, introduce tax cuts, implement infrastructure stimulus and reduce the burden of regulation. Thus far the principal outcome has been a singular failure to carry his own party in Congress to back his proposals for reducing the reach and cost burden of the Affordable Care Act ("Obamacare"). Expectations for a positive impact on growth from Mr Trump's policies remain in place, although timing of the requisite legislation will mean little impact will be felt this year. Moreover the savings expected to be reaped from the paring back of Obamacare, which were estimated to amount to more than $300bn, would have effectively paid for tax cuts both for high earners and for the corporate sector. Without such savings to hand, those measures will require increased fiscal deficits to be agreed by Congress, as the Republicans, despite their majority in the Senate, do not have sufficient votes to pass legislation that would add to debt levels. This will delay implementation and also mean a closer scrutiny from the Fed, given the tightness of labour markets and potential scope for wages to rise more rapidly in the event of fewer cuts to personal taxation.

Nonetheless the momentum in the US economy remained solid. The final revision for Q4 2016 GDP was upward, to 2.1% and therefore ahead of expectations. The principal factor behind this upgrade was a better than first thought estimate of consumer spending, where the revised data showed an increase of 3.5%. Rising levels of optimism amongst consumers, reflecting the steady trend in new job creation, is supporting this more buoyant activity and is now also being felt among business leaders as well. The chart herein reflects this recent improvement and suggests that the rise in corporate capital spending should not be far behind. It may be that company management is awaiting further details of President Trump's rumoured corporation tax cuts before proceeding, in which case there could be a six-month delay until greater clarity is obtained.

US Capex should turn positive



Source: Schroders

Wall Street continued to make new all-time highs for much of the past quarter. In part that was because of the solid year-on-year performance of corporate profits, thanks to improving trends in both the energy and banking sectors. The market was notable for passing almost the entire quarter without suffering a single day on which the index fell by 1% (the run being broken only on March 21st – the largest daily fall apart from this was a decline of a mere 0.6%).

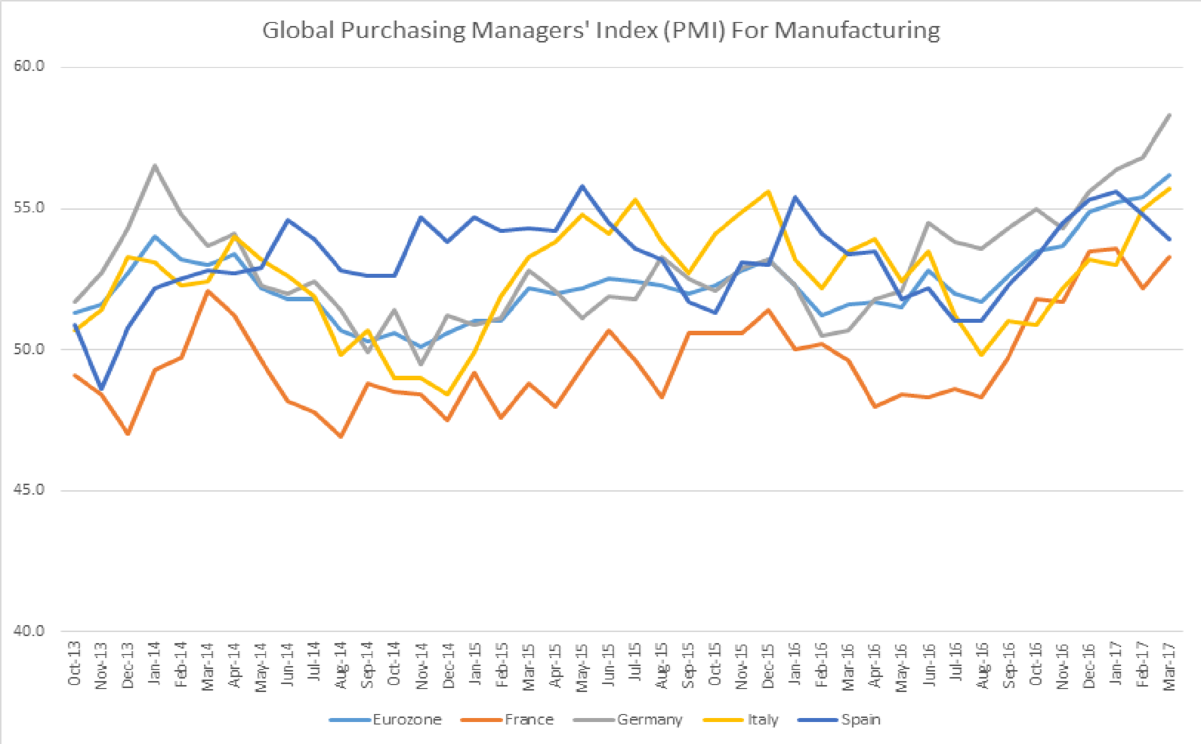
As mentioned above, US equities generated a total return of around 6% in dollars for the quarter, a little less when adjusted to sterling. Although for quite some time most commentators have agreed that American blue chips are not cheaply rated, the growth in corporate profits, if consensus forecasts of 9% for 2017 are correct, could be sufficient to sustain share prices at current levels.

Europe

The political spotlight moved to Europe at the start of 2017. In part this focus will be on the Continental end of the bilateral discussions with the UK on the terms of Brexit, but principally it will fall on the electoral processes in France (Q2) and Germany (September). Additionally there will need to be an Italian election by no later than May 2018, although it is unlikely that it will be held in the next six months. While there were investor concerns about Italy last year ahead of the referendum on the constitution called by the Prime Minister Mr. Renzi, his failure to record a victory (and subsequent resignation) did not lead to any wider ripples of uncertainty. Investors were aware of the election to be held in the Netherlands in March but, despite the strong showing by the populist Mr Wilders' Freedom Party in the pre-election polls, they dismissed any chance of his having a role in government. Unlike the poll results in 2016, this proved accurate, as the proportional representation system meant that the Freedom Party ended up with only 20 of the 150 parliamentary seats.

A much bigger issue for investors during the first quarter was in France, where the two-stage Presidential Elections are due to be held in April and May. The bookies' favourite before Christmas, Francois Fillon, was revealed to have employed various members of his family on the state payroll, which caused his ratings in the polls to collapse by more than ten full points. The first reaction was to inflate fears that Marine Le Pen, the National Front leader, could become President – her advocacy of protectionism and opposition to the EU would be a serious blow to the chances of the single market remaining a viable concept.

Although Le Pen might win the first round of the elections, her chances of winning overall have not increased (according to pollsters) since January, so such inflated concerns have dissipated again. This is not to say that markets and investors were unmoved during the quarter: the yield on French 10yr bonds, which had sunk as low as 0.1% last summer on continuing deflationary fears across the Continent, rose sharply to over 1.1% in January, before ending the quarter at 0.96%.



Source: JPMorgan

As can be seen from the chart, economic momentum (measured by Purchasing Manager Indices) remained positive and indeed gained further strength as the first quarter progressed. Unemployment rates across the EU fell to 8%, whilst the Euro area hit 9.5%, the lowest since the financial crisis. Such an average does of course disguise a huge range of individual country experience, with the Czech Republic (now known as Czechia) registering a mere 3.4% whereas Greece recorded 23.1%. Increased optimism among both business leaders and consumers prompted upward revisions to forecasts for economic growth, which now exceeds 1.5% for each of 2017 and 2018, and vanquished any continuing concerns about deflation. Although inflation year-on-year currently is reflecting the depressed level of commodity prices last year, the annual rate is not expected to persist at such an inflated level: core annual inflation however, which is still below 1%, is expected to nudge up further as 2017 progresses.

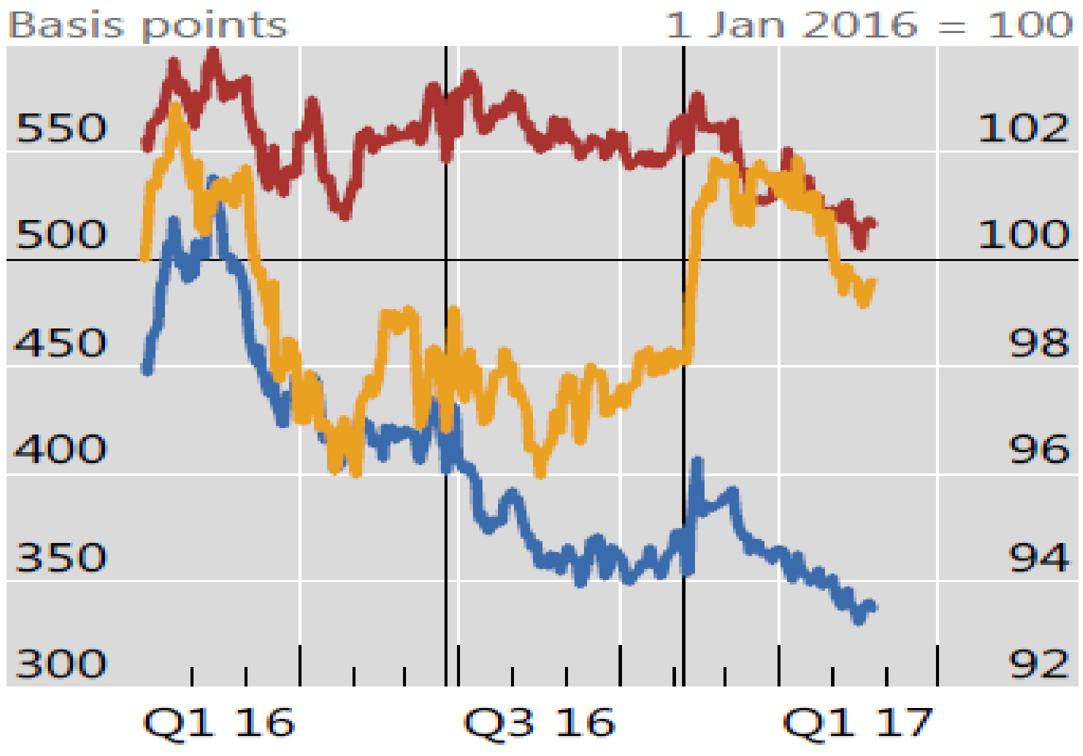
Those upward revisions to economic growth supported similar trends to consensus forecasts for corporate profits for European stock markets; this reflects a broad advance at sector level, but is especially pronounced for the banks, which are such an important component of Continental equity indices. Broad earnings growth is now expected to be around 17% which, given that we are still early in the cycle for Europe, leaves the market looking comparatively well-priced. Unsurprisingly therefore stock markets recorded the strongest gains in the first quarter of any of the major developed economic regions. With some volatility in both the single currency and sterling, it was a little surprising that the cross-rate between the two for Q1 as a whole moved by less than a quarter of a percent.

<u>Far East and Emerging Markets</u>

This is an important year for China, both in domestic political and economic stewardship and also in relation to negotiations with the newly-elected President Trump. Policymakers achieved their growth target for calendar 2016 of 6.7% and this stable growth trend is likely to continue during 2017 at a fractionally slower rate, given that the National Congress in March set out a target of around 6.5% for the year ahead. In November the 19th Party Congress is due to be held and this will mean that the authorities will endeavour to maintain a sense of practical stability in the run-up to it. The targeted growth rate in money supply was lowered although it remains above last year's actual outcome; this is designed to contain financial excesses in the economy by limiting overall leverage whilst seemingly remaining accommodative. Additionally several key ministerial positions were re-shuffled to consolidate power and this should reduce the risk of further policy errors this year. Economic data released thus far in 2017 suggests growth is well on track and the degree of currency volatility against a basket of international exchange rates has fallen. This should mean that the chances of an accord with the US are better than might have been feared last autumn; both sides have a lot to lose in the event of an escalation in acrimony. Trade with the US represents about 15% of China's external flows and the US has a similar exposure to its flow with China.

After the shock to economic growth precipitated by the move to demonetisation last autumn, growth in India has held up well in the latest data. Consumer spending, which had slowed sharply to a rate not much in excess of 5% during this monetary exercise, rebounded strongly in its wake and economists are targeting a rate of growth in excess of 7% for calendar 2017. This should allow overall GDP growth to more than match the c7% achieved for last year. Political reform continues to be a solid component of the bullish view of India and recent elections cemented the BJP in power ahead of the next General Election due in two years' time. This should enable the authorities to proceed with further reform packages over the next eighteen months without having to have at least one eye on re-election prospects.

Sovereign risk in EM normalising



Sovereign spreads (LHS) US$ vs simple average of EM currencies (RHS)

Local currency US dollar Exchange rate

Source: Bank for International Settlements March 2017

As can be seen from the chart here, markets reversed their initial reaction to the election of Donald Trump. His level of pre-election rhetoric was thought to be prejudicial to the prospects both of their currencies and their economic growth, but a more conciliatory tone subsequent to reaching the White House meant that most of this movement has been reappraised. A basket of emerging market exchange rates versus the dollar, which had fallen by around 4% in November, has regained around three-quarters of that decline subsequently. The risk premium in sovereign bond issues, whether issued in local currency or in US dollars (the excess of their Government bonds over that of US Treasuries), is also plotted on the chart and more than reversed the initial upward movement that resulted from investors' reaction to Mr Trump's election. Equities responded smartly to this lowered risk premium and were, as a block, the strongest component of the global stock market, even though the better tone to economic growth had yet to prompt any upward revision to consensus forecasts from analysts of corporate earnings growth (EM is almost alone in not experiencing any upgrades to profits forecasts during the first quarter). The best stock market returns during the quarter occurred in India and Hong Kong (in local currency terms), with gains in excess of 10%. The currency bounce added another 3% or so for sterling investors. The best overall gain in pounds came from Mexico, where specific Trump-related concerns had driven the peso down before Christmas: here the total return was more than 15% in the quarter.

Japan

The economy continued its recent pattern of growth, although it again proved to be relatively dependent on exports which contributed roughly half of the improvement in GDP for the year. Overall growth was recorded to have been 1.6%, compared with 1.2% in 2015. Consumer spending inched forward but sluggish wage growth continues to restrain faster expenditure patterns. Tight labour markets and the highest ratio of available jobs per applicant since before the economic crisis should bode well for some acceleration in wage growth for the forthcoming year but few economists are prepared to embody such optimism after years of false alarms.

Optimists for the stock market are in greater evidence however. Many seek to point out that prospects for equities are quite distinct from the economy, with a number of factors lending support to the bulls. First the composition of the Japanese stock market reflects a materially greater exposure to cyclical companies and sectors than any other developed economy, so the trend towards faster and more harmonised global growth should be a positive factor, Second Japanese companies still have very low operating margins compared with other parts of the world (on average 5% versus 7% in Europe and 10% in the US), so there is scope for considerable improvement as the Abenomics programme encourages management to enhance returns. Third (and connected to both the first two factors) the rate of corporate earnings growth is faster than elsewhere (expected to be around 16% for the year to be reported in May) and has benefitted from material upgrades in recent weeks (the trend in earnings revisions is close to its post-crisis high). Finally this faster growth is not reflected in share prices of Japanese companies, whose ratings are still at a discount of about 15% to the developed world average.

Alternatives

The real estate market continues to send mixed signals to investors. Activity in both the occupational segment and the direct investment arena has rebounded strongly since the post-referendum hiatus but the share prices of many leading property companies languish on comparatively wide discounts to last stated asset values. In the direct market transactions were strong over the winter and early spring, with sterling weakness encouraging a flurry of purchasing from overseas (especially Asian) buyers. UK capital values are still more than a fifth below the pre-crisis peak of 2007, but this does disguise the two-tier nature of UK real estate in the past decade. London capital values are materially (as much as a third) above the previous peak whereas the rest of the country remains a similar proportion below its cyclical high.

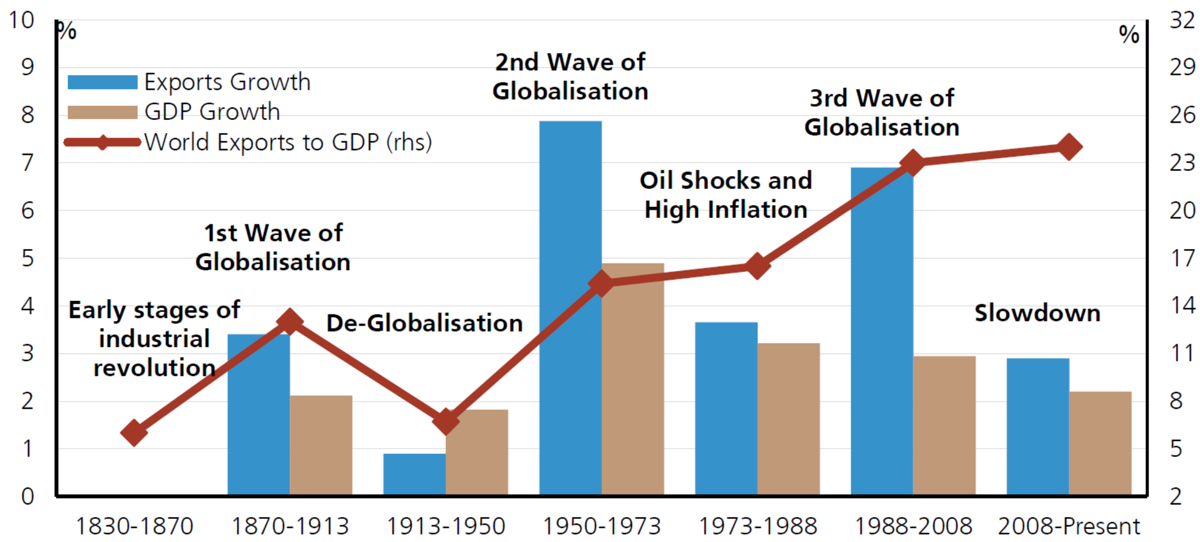
Although this international deal flow remains centred on London, where much of the Brexit uncertainty is located, yields of around 3.5% appear sufficient to attract these buyers. Vacancy levels remain very low (the City has less than 6% empty (compared to a range of 4.5% to 20% during the last 25 years) and the West End is even tighter (4% vacant versus a range of 3% to 8%). Around the country, evidence from commercial landlords over the past six months is that tenant confidence in renewing leases or in taking new space remains unaffected by concern over Brexit, although any softening in the pace of UK GDP in future is expected to cast more of a cloud.

Whilst capital values have regained almost all the precautionary markdown implemented by valuers in the immediate aftermath of the June vote, share prices of most of the leading REITs continue to reflect investor concern about stated asset values. In some cases the discount exceeds 25% which is as wide as at any point since 2009. This creates unease among other investors about the return prospects generally from real estate - "if share prices are right, then capital values must be about to fall, so I shouldn't buy any". The only exceptions to this pattern are among the specialist REIT operators, those owning healthcare, student accommodation or other assets which investors believe are invulnerable to any economic growth shortfall. Here share prices were much more resilient last summer and have regained all that was lost and in most cases pushed on to new all-time highs.

Outlook

There remains something for both bulls and bears in the current outlook. There has been for some months a greater belief in growth, both the amount of it at a global level and its degree of uniformity as for once almost all the pistons are firing together in the world's engine. This led to an increase in confidence amongst both consumers and industrialists and even the banking system, which for much of the post-crisis period had languished out of favour, appears now to be capable of being part of the solution rather than part of the problem. On the other hand, after a long period of share price performance, it is difficult to argue with the premise that markets are now relatively highly priced and, should interest rates rise materially, potentially overpriced.

Globalisation patterns since the Industrial Revolution



Source: UBS

We mentioned in our last review that execution risk remains high. Such risk can be attached to both politicians and Central Bankers. After the US election outcome, investors deemed the epicentre of this set of risks to be in Washington. Although the early days of the Trump Presidency have belied some of the campaign oratory, one theme that remains central to both investor thinking and the pattern of economic growth generally is that of protectionism. The chart on the previous page illustrates the waves of globalisation over the past one hundred and fifty years and the inexorable rise of global trade as reflected in the proportion of GDP represented by exports. What has made a number of commentators nervous is the potential threat indicated by increased protectionism to the free flows of goods and services around the world, which have both boosted global activity and allowed both lower inflation and lower interest rates to pertain in developed economies during recent years. In any analysis of trends in these data it is important to differentiate between cyclical and secular or structural patterns.

There were some major cycles behind the data shown in the chart: initially trade flourished in the wake of the industrial revolution, albeit mainly in raw materials moving from their country of origin to the newly industrialised West. Subsequently the 1930s depression suppressed output growth and the rise of protectionism following big tariff introductions in the US and retaliation by other countries stifled global trade. The major wave of more recent times was characterised by the rise of the global corporation, with foreign direct investment and labour migration well to the fore as drivers of this increased trade flow. Shareholders in these global corporations have benefitted from both increased volumes and higher profits, as costs were controlled by increased procurement from cheaper parts of the world. Employees however were not beneficiaries, as their wages suffered from both inward labour migration and the hollowing out of much of the more basic manufacturing and service level jobs and this lies behind the rise of populism. What is harder to appreciate for those who feel marginalised by these trends is the extent to which they have benefitted from (for example) lower mortgage rates as inflation was subdued and more freely and cheaply available goods and services for them to purchase than would have been the case if such globalisation had not occurred. Understanding how politicians intend to grapple with these issues in the next few years will be extremely important to the likely returns for investors.