QUARTERLY MARKET OVERVIEW – JANUARY 2018

"Be fearful when others are greedy and greedy when others are fearful"
– Warren Buffett

2017 surprised many - the year started with political trepidation in Europe, uncertainty over BREXIT and much debate on how long Trump would last. There was also a feeling that 2016 was a year of catch up after two previous lack lustre years, and that 2017 couldn't repeat.

Well it did!

Elections in the Netherlands and France produced the opposite to what the press were reporting, and the far-right parties didn't sweep to power. The real surprise was in France which showed a new party could take over from the establishment.

Theresa May perhaps provided the big surprise of 2017, calling an election which by all accounts she should have won comfortably. There was no outright winner in the election, and an uneasy coalition saw the Conservatives hold onto power…just.

Despite all the negative noise from the press, Mrs May limped towards the end of the year perhaps a little stronger than before; moved Brexit talks forward, and managed to hold back any serious rebellion (from her party not the country!). But can she survive this year?

Trump is still in the White House but has the lowest approval rating of any modern-day president. The worry for Republicans is what will happen at the mid-term elections in November, especially after suffering two defeats in 'Red States' in the last couple of months.

We can't see any indication that markets are in bubble territory, however after two fantastic years we are more cautious about this momentum continuing.

As we entered the closing stages of 2017, we saw a Santa's rally for the second year running and a new year brimming in confidence. Leading economies continue to display strength and resilience, but we wait to see if markets repeat the returns of 2016 and 2017, or has the best happened?

If returns lag behind those of the previous years, then we could see more volatility in the market (something lacking in 2017), and performance closer to more normalised figures of around 5%.

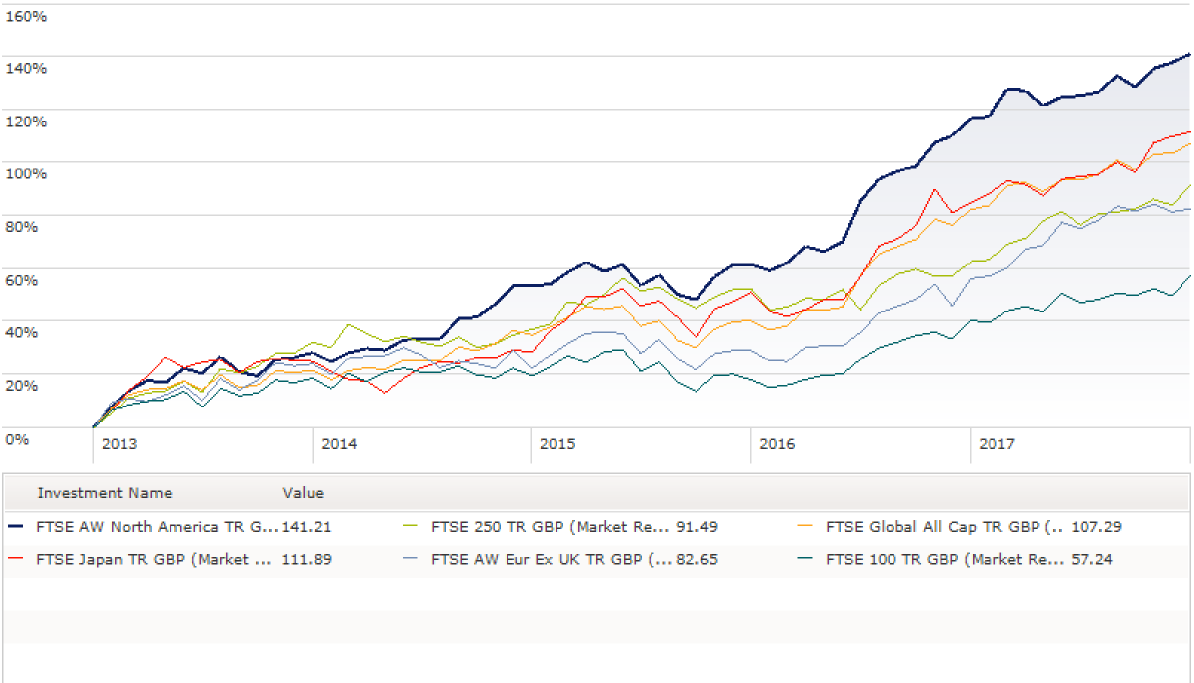
In this review we will outline some thoughts across global economies, and how these might impact the potential returns for 2018.

It is very easy to be taken in by these attractive returns and assume that it will continue. Warren Buffett sums it up well and perhaps now is the time to exercise a little bit of caution.

George Ladds
George Ladds, Director, January 2018

DEVELOPED MARKETS

<u>Five year returns 1 January 2013 – 31 December 2017</u>



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It is worth highlighting the US and European markets to show how extraordinary 2017 was:

The S&P 500 finished 11 of the 12 months in positive territory. Its only negative month, March, saw the index down 0.04%, which is effectively when rounded up, zero! Furthermore, on the 13th December, the S&P 500 experienced its 60th all-time high of the year – a total only surpassed in 1964 and 1995.

One further statistic from the S&P 500 was that the largest percentage drop by five of the 11 S&P 500 industry sectors for the first six months of 2017, was the smallest for any half-year period since 1990.

Europe (ex-UK), on average, has a 10% correction every 166 days; there have been 31 10% corrections since 1986. However, it is now 382 days since Europe experienced this level of correction.

So, what does this all mean and are we heading towards a correction? It is nearly ten years on from the financial crash of 2008; this was a traumatic event and remains vivid for many investors. As we entered 2017 there was a feeling of uncertainty, but this now seems to have given way to optimism. There is a real flip-flop sentiment between optimism and pessimism. The global recovery is 10 years old and it is starting to feel long in the tooth, so although for the first time we might feel optimistic because of the strong economic data, the events of 2008 remain upper-most in our minds and this recovery feels like may have has stretched as far as it can go.

With this in mind what is happening with the global developed economies?

In the US, it is becoming very clear that you can't run a country via Twitter; it is the fundamentals that investors need to focus on. The US is showing positive signs. Interest rates are expected to continue to rise to between 2% and 2.25% by the end of 2018. The Fed is likely to increase the reduction of their balance sheet from $10 billion per month to $50 billion per month, by the final quarter.

The country is seeing benign inflation, strong labour figures and good retail data helped by Black Friday and Cyber Monday. Approval came through on the tax reforms and this could have a significant impact on the economy. The headline grabbing change was the reduction in tax for companies which will drop from 35% to 21%. In addition, there will be a temporary tax discount on the repatriation of overseas earnings, along with moderate and temporary tax reductions for individuals. This could see increased capital spending which in turn would be good for the economy.

The US consumer is displaying signs of optimism; the percentage of US households with assets invested in the stock market stood at 40% - the historical average is 28%. US retail investors have five times as much in equities as cash.

For the first time since 2008, this sense of optimism is actually backed up by strong economic data. But there are risks. The Fed needs to be cautious as its actions could impact long term interest rates which in turn could squeeze bank lending growth.

This is important because the creation of wealth is produced collectively. To quote Yanis Varoufakis "workers need entrepreneurs to hire them, who need workers to buy their goods. Entrepreneurs need bankers to lend to them, who need entrepreneurs to pay interest. Bankers need governments to protect them, who need bankers to fuel the economy. Investors cannibalize the inventions of others and plagiarize the ideas of scientists. The economy relies on everyone."

If the Fed moves too quickly and there is a squeeze on bank lending growth, this in turn can start to slow the economy because it feeds across all areas. If this happens it could impact other major economies causing a global slowdown.

The second "worry" is the mid-term elections in November. In November 2017 we saw the Democrats hold Virginia, and then in December they overturned a massive Republican majority in Alabama. Trump's approval ratings are at the lowest level of any modern-day president and there is considerable concern that the Republicans will suffer a significant defeat, handing the House to the Democrats. This would mean gridlock in Washington and would not be good for markets.

Turning to Europe there is a lot of good news; growth is strong but commercial banks need to create credit more rapidly than at present. Debt is the key that makes everything move, if this is squeezed then everything slows.

The Purchasing Managers Index (PMI) survey of economic activity climbed to 60.1, just shy of the record set in April 2000. This is broad based with Switzerland, Sweden, Germany, the Netherlands and Austria all showing readings above 60, and well into expansion territory. The global average is 54.0 and 97% of countries surveyed are growing.

The bogeyman in the room is Brexit; the UK-EU trading relationship remains unclear and the clock is ticking. We shouldn't underestimate the importance of the agreement in December which covered citizens' rights, Northern Ireland and the divorce bill. Some believe that the EU got around 80 to 85% of what they were looking to achieve. This is positive on both sides as it seems the approach to the recent negotiations is more constructive with a softer stance from the UK. The EU seems more confident following the political results in 2017, alongside a general eurozone recovery. It therefore feels that they are less likely to make an example of the UK with a particularly punitive deal and instead aim to avoid a near-term supply chain dislocation that could come from a "no deal" scenario.

There are risks to the EU, if there is a "no deal" scenario this could have an impact on growth but there are political risks which the markets seemed to push aside in 2017. Italian sovereign debt is being sold off by institutions. This puts the country in a difficult place as they need to re-finance e300 billion and no one wants to buy it. This is reflective of a lack of reform and political deadlock. If this escalates, this could have an impact on the EU.

There remains considerable uncertainty in Spain over Catalonia, with no immediate solution in sight. In Germany there could be an election if no coalition can be formed.

Turning to the UK; I cannot write with much optimism. Economic growth is below trend, inflation is high, wage growth is below inflation and there is a real risk of interest rates rising. We have already seen a significant slowdown in car sales.

What will keep the UK engine running is consumer and business spending – if there is a decline then this could be a concern. One important factor is that the labour market remains strong, and if this continues it will be good news.

Weaker sterling has helped exports but not at the level that would have been expected. Having said that Theresa May seemed to have pulled the rabbit out of the hat and has entered 2018 with a spring in her step. She managed to secure the next move in Brexit talks, and to get the levels of concession should be seen in a positive light. She also seemed to assert more control over her cabinet which was in danger of derailing her.

If the government collapses, an election called, and Labour come into power then in the short term this could have a negative impact on consumer and business sentiment. Combined with complex Brexit negotiations this would not be good for the UK.

In summary calling the UK is difficult because there are so many variables.

Just touching briefly on one success story – Japan. Abe won the election in 2017 and the markets continue to respond well to his reform programme. The election means he can reinvest the proceeds from the 2019 increase in VAT rather than reduce the deficit. He can also put in place constitutional change to allow its military a more active stance in response to the growing threat from North Korea.

In summary, in the developed markets there are clear positive signs although it is hard to identify how this will play out. There are risks in the US and perhaps the biggest two issues are the Fed and the mid-term elections. Europe continues to grow strongly but could be de-railed by political uncertainty in Germany and Spain and debt concerns in Italy. The UK has too many variables to guess but there are some positives to hold onto.

EMERGING, ASIA AND FRONTIER MARKETS

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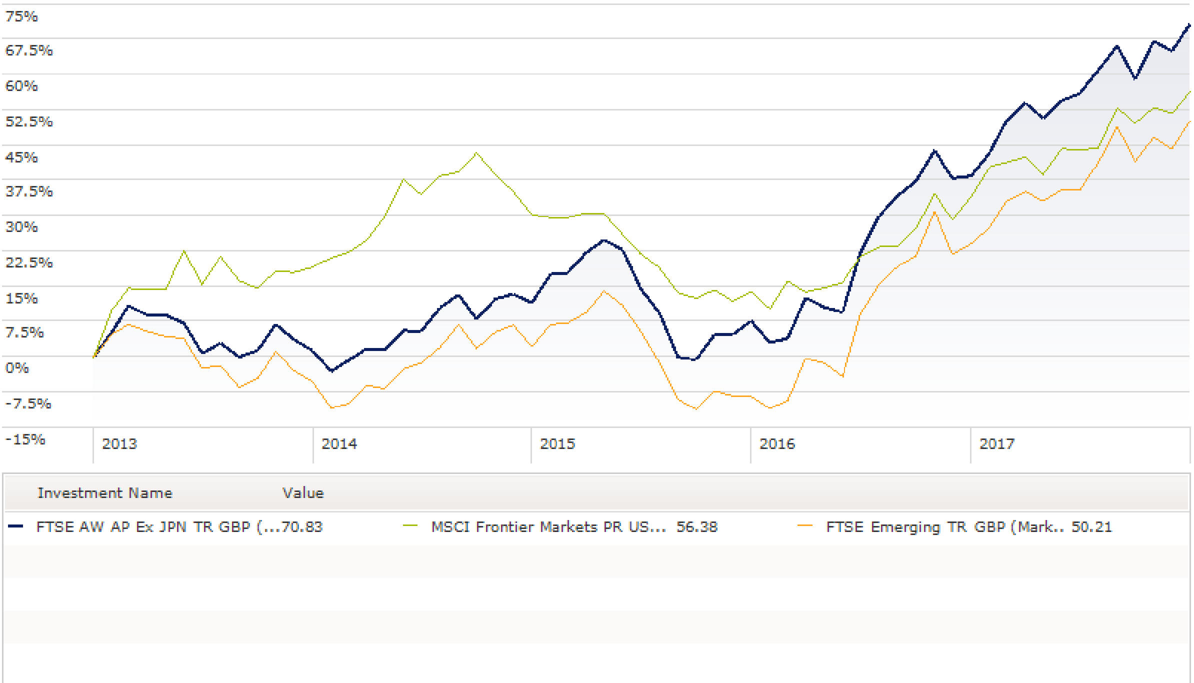

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It is easy to forget that emerging and Asian markets have had a difficult few years. 2017 seemed to reverse that trend ending years of underperformance versus developed markets. There is a general feeling that this could run higher.

Emerging markets are seeing progress in key markets, offering potential growth across a broad range of economies. There is positive progress in Russia, India, Brazil and Argentina but there remain challenges in Turkey, Mexico and South Africa.

South Africa came close to losing its local currency investment grade rating and the ruling party's leadership contest saw a narrow victory for the pro-reform candidate. This helped to stabilise the currency, but considerable uncertainty remains.

Brazil and Russia emerged out of recession, and India seems to have bounced back from a reform-induced slowdown.

It is worth expanding on Chinese debt as this continues to dominate talk in the region. It is important not to analyse China in the same way as a Western economy. China is a command economy (where the government rather than the market determines what happens), and the distinction between the government, banks and corporates is often less clear. When the Chinese authorities want to expand activity, projects are often conducted by other affiliates, but the final liability ends with central government. So, when comparing debt in China to other countries, we should consider the total debt to avoid comparing apples with pears.

Aggregate debt in China is on par with that of the US and Italy and below that of Japan. China is still at a very early stage of development. Only 56% of its population lives in urban areas, compared to more than 80% in the US and UK. Its potential growth rate should therefore be considerably higher than the developed world, during this period of economic convergence. Put differently, would you lend an equivalent mortgage to a young graduate with a career ahead of them or someone nearing the end of their career? It is also worth pointing out that Chinese borrowing is internally funded by domestic savings and the capital account is still largely closed; there is no external lender to pull the plug, even if there were doubts about repayment, as there were with subprime.

Rather than imploding China was one of the strongest markets in 2017. We expect this to slow in 2018 but all indications are that it will still be in excess of 6%.

In summary, the global "boom" is feeding out to emerging markets and Asia. These markets have seen some of the strongest returns for a number of years and this is supported by reform and an improvement in well run companies. There are always concerns over China's debt, but the reality is this is on par with the US, but with very different age demographics. There continues to be optimism that there is still more to come from these economies, but we should be mindful that if the US starts to wobble then this could spread out and will naturally hit emerging economies.

CASH

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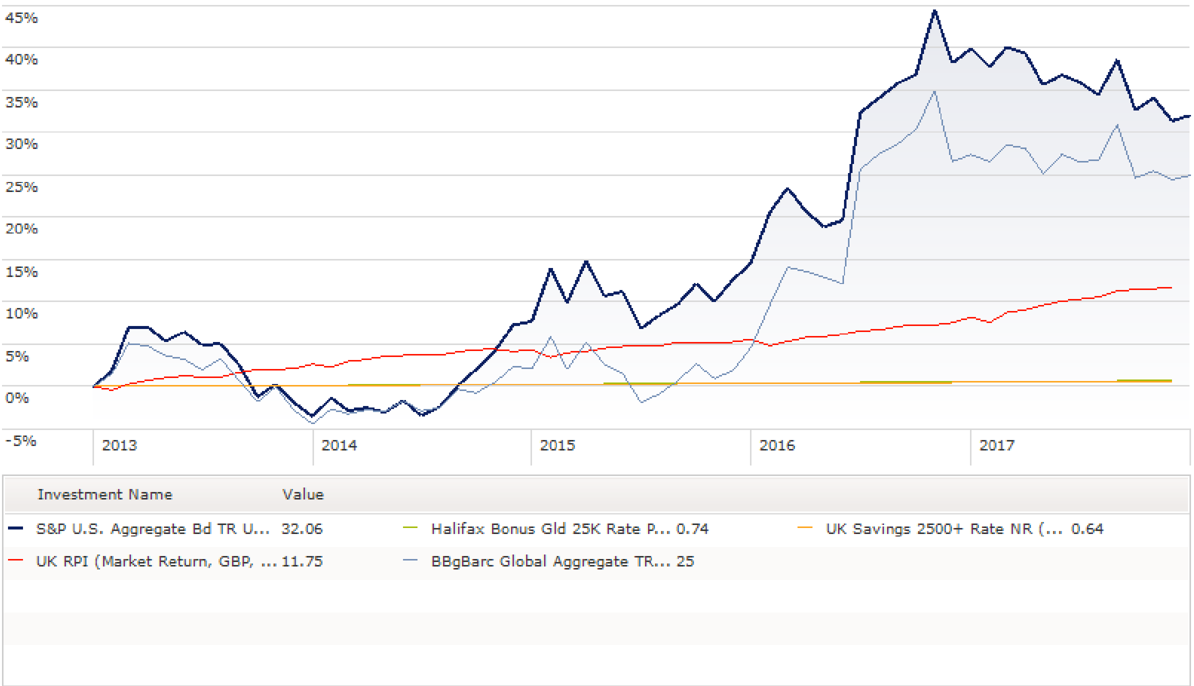

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Cash continues to be seen as a “safe” asset class. But inflation in the UK of 3% is eroding the real value of cash savings.

There was a brief ray of light when interest rates went up to 0.5%. However, this is only back to the previous low level. The Bank of England indicated that rates will now start to rise, but the pace of this is unknown as is the final new norm.

In summary, investors in cash may therefore need to accept that the last ten years of low rates will continue for some time to come, but added to the mix is the impact of inflation which is effectively delivering negative returns.

CONCLUSION

Volatility was exceptionally low in 2017; although the global picture remains strong with greater confidence from the business sector, we shouldn't be surprised if volatility makes a return in 2018. Whilst the US continues to grow this naturally feeds out to the global markets. However, this recovery feels like there is not reliance on just one economy.

Emerging markets and Asia have had a stellar year; this reflects reforms across these economies, demand from a growing domestic market, and they benefit from growth in Europe and the US.

Markets are fickle creatures and whilst optimism abounds, a few months of disappointing data could make them stumble. Populism hasn't gone away and there are pressure points in Germany, Italy, Spain, UK and the US which could equally unsettle markets.

In summary, there is strong global expansion with room to run in 2018 and beyond, however there is perhaps is less scope for upside growth surprises. Whatever happens with returns in 2018 it is fair to accept that the ride is unlikely to be as smooth as we saw in 2017.

Source: Charts have been sourced from Morningstar. Other data sourced from BBC, Fidelity, Standard Life, BlackRock, Schroders, Neptune, Templeton, Hermes and JPMorgan. Any reference to a fund or share is not a recommendation to buy or sell that asset. Past performance is no guide to future performance and investments can fall as well as rise.