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Investment Update

Spring 2015

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Overview

The post-financial crisis recovery in global stockmarkets is now entering its seventh year, and it is pleasing to conclude yet another quarter where solid investment returns have been achieved from virtually all asset classes.

Mark Robinson
Director
Chief Investment Officer

Seeing the UK stockmarket's FTSE 100 Index finally break through its December 1999 high point, and then nudge through 7,000 points was, if nothing else, a symbolic moment that laid some ghosts to rest, but perhaps more pertinent was the fact the index had recovered by more than 100% from its March 2009 low. America's S&P 500 Index has been the front-runner for some time within developed stockmarkets in terms of breaking into new territory, and it has added yet another positive quarter to a winning streak that extends as far back as 1998. But having the UK's blue-chip companies join the party, and indeed those of Germany, has introduced a new sense of market confidence and made investors realise that we are now looking at something much more entrenched than just a one-dimensional, US-led, economic and market recovery.

As always, successful stockmarket investment is about identifying those companies that are well placed to benefit from a whole range economic, sector or market conditions, and avoiding those companies that are not. This is the task of the active fund managers with which we are entrusting day to day stock decisions, and it is encouraging that those with whom we have spoken recently are not short of investment ideas in whatever market, or sub-section of a market, their particular expertise lies. We cannot expect markets to rise uninterrupted, or in a straight line, but we are confident that having active management at the fund level, and having an active asset allocation policy ourselves, can help deliver further returns for clients in the months ahead.

Mark Robinson

1 April 2015

Election fever

Improving indicators may also become pivotal in the outcome of the forthcoming UK General Election, where the impact of any alteration to the incumbent position is, in the shorter term, more likely to be reflected in currency rather than stock markets, with sterling potentially coming under some pressure; economic adjustments to a change in government are likely to take much longer to manifest in corporate results and general market sentiment.

It is also worth noting that the UK stockmarket encompasses a diverse mix of businesses, with significant global economic exposure. For example, around 80% of the FTSE 100 Index's revenues come from overseas, so a weaker pound would flatter results for many businesses and improve their export competitiveness. Furthermore, given the broader global recovery, the UK market is highly unlikely to perform poorly in isolation, since any politically-induced weakness or undervaluation, should any occur, would in all likelihood be exploited very quickly by international investors.

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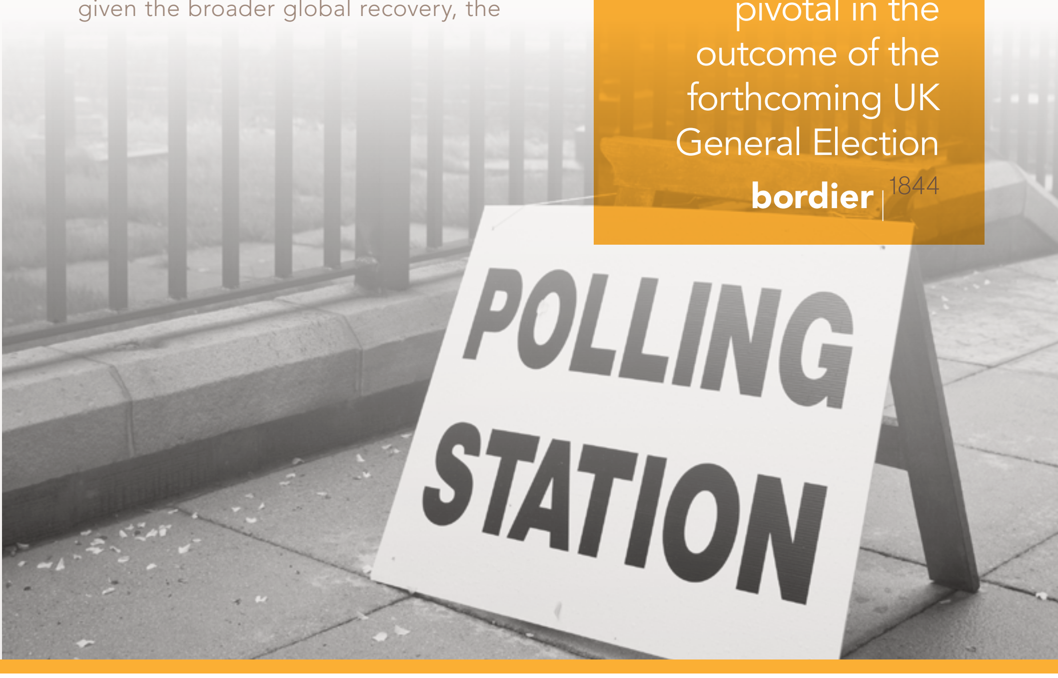

A shift away from the USA

Europe & Japan seem to be starting to pick up the economic growth baton from the USA: both are being reinvigorated by similar huge amounts of monetary stimulus and are seeing their export markets become more competitive through weaker currencies and the fall in the price of oil. European consumers are also benefitting from the collapse in energy prices, with real incomes rising and greater confidence now being expressed in retail sales and service sector surveys, reflecting greater levels of spending, aided by the commencement of the European Central Bank's €1.1trillion Quantitative Easing programme.

This, along with more upbeat forecasts for economic growth, have begun to lift the mood within European stockmarkets, where valuations generally remain lower than those of the US. Greece's financial difficulties still have the potential to cause shorter-term volatility in markets generally, but we still feel that the opportunities for recovery in the eurozone merit an increased allocation.

Similarly, we are increasing Japanese stockmarket exposure: here, a whole host of leading economic indicators are looking more positive as Prime Minister Abe's economic stimulus package, and a range of structural reforms, appear to be reflating the economy; domestic investors, led by pension funds, are buying shares again and consumers appear to be buying more goods, despite rising prices and a hike in sales tax last year; corporate profits in the manufacturing sector are rising as their export markets become transformed by the yen's significant depreciation since 'Abenomics' was introduced. The net result of the economic stimulus and other reforms is that there is now a wide choice of both domestically and internationally-exposed businesses, trading at attractive valuations, in which to invest. The skills of experienced and active stockpickers are still required to navigate carefully in what are still the early days of Japan's revival, but after many years of darkness, prospects do at last seem a lot brighter in this land of the rising sun.

Bond markets – where next?
Commercial property – still attractive

The question of when the tide will turn for fixed interest markets has preoccupied investors' minds for a long time, and it would have been very easy to lose one's nerve in this asset class on several occasions during the past few years; there have been several moments when strong economic data, particularly emanating from the US, have pointed to an imminent rise in interest rates, implying that the time has come to bail out of, or make significant adjustments to, fixed income investments.

But on each nervous occasion policymakers have smoothed the waters, reassuring markets that any shift in monetary policy will be very gradual and providing further reasons to stay invested. Global financial regulators are quite rightly looking closely at fixed interest markets to ensure that no systemic risks have been created not only in this asset class, but in markets generally. It is certainly reassuring to know that the very largest global fixed interest managers have allegedly been stress-testing their exposures, simulating how they might cope with the large outflows of capital that could occur when sentiment does turn. But the chance to put their individual dress rehearsals to a collective stress-test can only properly come when investor sentiment begins to alter in earnest. With aggregate demand still picking up from low base, everything currently points to very modest interest rate rises this year, if we actually get any at all, so there is no immediate cause for any concern.

Investment in direct commercial property still looks very attractive as an alternative income source and has potential to generate double-digit total returns this year and next, combined with low levels of volatility. Commercial property gives access to a secure income stream with prospects for income growth through upward rent revisions, as well as indirect participation in a recovering economy as occupier demand increases. As many will recall, the previous upward cycle for commercial property ended abruptly during the financial crisis as banks and over-leveraged investors were forced to liquidate positions to meet other demands. Today the picture is very different, with lending for development generally reserved for only the very best projects and lending practices having tightened significantly. Indeed, the Bank of England's Financial Stability Committee, tasked with removing or reducing systemic risks in the financial system, has acknowledged that UK banks are now resilient to shocks in the commercial property market, a reflection that we have come a long way in the past few years to restore both government and investor confidence in the sector

The markets' next direction

Recent stockmarket highs have caused some commentators to worry that a fall in market values is imminent. That would be logical if market valuations had become stretched or economic and business conditions generally were expected to falter, neither of which is the case.

The facts are that market valuations in the US, UK and Europe, based on forward earnings expectations, currently sit at levels around their long term averages, in contrast to the late 1990s boom in markets when valuations rocketed to more than one and a half times, or in some cases double, their historic levels. The current recovery in asset prices is clearly being fuelled through the extension of the extraordinary period of global monetary stimulus. But underneath all of this is a growing level of consumer and corporate confidence, where falling inflation, compounded by lower energy prices, is resulting in the rise in real incomes. This backdrop is ultimately supportive for asset prices and should comfort markets when the withdrawal of monetary stimulus begins. We believe that further new high ground can be scaled in the months ahead.

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