MARKET PERSPECTIVES

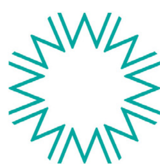
JUNE 2017

THE LAST QUARTER...

- World stock markets continue to appreciate; NASDAQ surpasses 6,000 for the first time.
- The US Dollar weakens – down 6% versus the euro; sterling strengthens against most currencies.
- US equity volatility falls to a 90 year low; VIX falls to its lowest level since 1993.
- UK 10 year gilt yields fall below 1%; meanwhile, inflation hits a five year high of 2.9%.
- Moody's downgrades China for the first time in three decades; serial defaulter, Argentina, issues a 100 year bond.
- Greece falls into recession for the fourth time in nine years.
- Tesla overtakes both Ford and General Motors to become the most valuable car manufacturer in the US.

"Invective and ridicule were showered unsparingly upon the Ministers whom, a few days before, the people had believed to be the saviours of the nation, because they were told so by the newspapers."

Benjamin & Sarah Disraeli, *The Election* (1834).



WAVERTON

INVESTMENT MANAGEMENT

OUTLOOK FOR INTEREST RATES

US interest rates are rising, but inflation is not.

For the third quarter in a row the US Federal Reserve raised interest rates, and once again markets shrugged off the move. We explained in the last issue of *Market Perspectives* that there are good reasons for the bond markets to be relaxed about this increase in short rates because long term deflationary pressure from demographics, globalisation and technological change has not gone away. However, it is nonetheless surprising that the healthy economic growth combined with high employment rates and rising inflation which have been observed in recent months have not caused long bonds to fall in value from their elevated levels. Quite apart from the price distortion created by central bank buying and regulation (which we have often written about in the past), government bonds seem to be looking through the present inflationary blip towards continued long term price stability. It is notable that, whilst US headline consumer price inflation peaked at 2.7% in February, the core inflation indicator (i.e. excluding food & energy) is now only rising at 1.7%.

The yield curve is flattening...

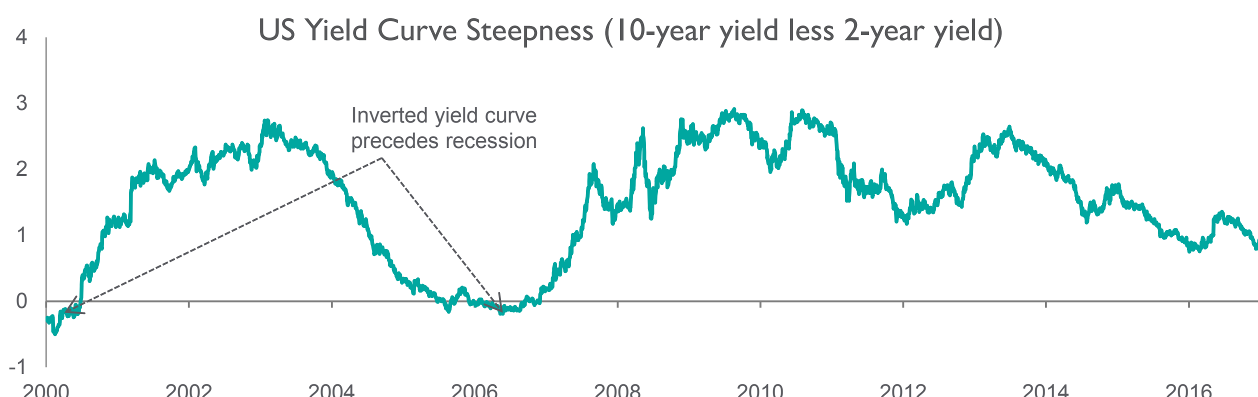
The problem is, if the Fed continues to raise rates at the same time as bond yields stay low, we will be in danger of seeing an inverted yield curve whereby long rates are lower than short rates. This almost always signals recession around the corner (certainly it did in 2000 and 2007 – see chart below) and is something that we are watching very carefully. It is tempting to dismiss talk of an inverted yield curve as being a function of quantitative easing and abnormally low rates to start with, a temporary phenomenon which does not carry the same meaning as it would in normal times – but one must be mindful that many commentators dismissed the inverted yield curve when it first appeared in 2007 as being a false signal. Gilt yields of 1% in the United Kingdom can surely only be rationalised by an increased fear of recession following the general election because inflation in the UK is now running at nearly 3%: the very negative real return available on gilts now is a high price to pay for 'risk free' security.

...but credit markets are signalling a benign environment.

Whilst firm government bond markets indicate a considerable degree of risk aversion and concern about a possible economic downturn, the current state of the credit markets signals the opposite – i.e. a willingness to back more vulnerable credits, both sovereign and corporate. The yield on non-investment grade bonds has never been lower and retail inflows into European corporate bonds are running at record levels. Argentina, which has defaulted six times since 1950 and in 2001 was responsible for the world's largest ever default, is now able to borrow money for 100 years at less than 8%. This buoyancy in credit markets is much more in tune with the equity bull market than it is with highly priced government bonds. It is difficult to see how these opposing dynamics can be reconciled. At present, we remain in the camp that favours risk assets over 'risk free' government bonds because the latter are almost guaranteed to lose money in real terms; we are especially nervous of the UK gilt market – both on account of basic maths but also thinking about the extraordinarily uncertain outlook for the United Kingdom as a long term investment proposition. As an example of how risky government bonds are at these levels, look no further than the experience of euro denominated bonds on 27th June after a speech by Mario Draghi of the European Central Bank: the yield curve steepened sharply and holders of 10 year German bunds lost 4 years' worth of coupon value (yield) in 24 hours.

An inverted yield curve would be ominous.

That said, we are very conscious that developed world bond markets, which are extremely large and liquid, send signals about the long term economic outlook which cannot be ignored. Whilst yield curves are still far from inverted, the differential between short rates and long rates has been falling markedly. Interest rates are also kept low by central banks' increasing use of macro-prudential measures to control credit creation (such as mortgage regulation and counter-cyclical capital buffers for banks) in preference to using higher interest rates as the lever of choice. It is unfortunate for investors that the pricing of government bonds has become so distorted by state intervention – and correspondingly no wonder that active investors are forced to look elsewhere if they want to achieve any sort of return that is ahead of inflation.



Source: Bloomberg

OUTLOOK FOR EQUITY MARKETS

Our enthusiasm for equities over the last year has largely been based upon the good earnings growth we anticipated and are now seeing, which is a real contrast to the last five or six years, during which aggregate earnings have stagnated. Not only has this been helpful for dividends and valuations, it is also beneficial for sentiment and money flows. Cumulative flows into equities since the financial crisis are still far behind flows into bonds, and fund manager cash weightings remain slightly higher than average so, whilst valuations look rich on a number of measures, it is far from obvious that investor sentiment is excessively bullish and riding for a big fall.

We continue to favour equities.

One notable feature of recent equity flows has been the fashion for using exchange-traded funds (ETFs – i.e. index funds). These do have some advantages in that the big ones are very liquid, provide cheap access to markets and are relatively easy to explain to investors. However, ETFs are not a suitable vehicle for all investment propositions – especially those which are illiquid, complex or opaque. One senses that there are many exotic opportunities (such as junior gold miner and rare earth metals ETFs) being marketed to people who, as 'passive investors', are by definition not inclined to look at the individual securities within those vehicles. The true risks of investing in vehicles of this type will probably only become apparent in a downturn when sentiment turns the other way – in which case some sectors could see forced selling of illiquid assets, which is a recipe for disorder and potentially serious financial distress.

Some index funds should be treated with caution...

Having rejected the proposition only a year ago, major index provider MSCI have recently decided to include China's domestic A shares in their emerging market universe. However, they consider that only a small proportion of A shares are sufficiently investable to be eligible for the MSCI indices. All this goes to show that, when you look 'under the bonnet' of these indices, the mechanism by which they are constructed is far from passive: it requires both quantitative analysis and a degree of qualitative judgement. One can argue whether a 'passive' or active strategy leads to better outcomes for investors in the short run, but capital allocation (either on an individual basis or systemically) is more efficient if investment fundamentals rather than the weighting of any security in an index are the primary determinant of portfolio construction. An index-based strategy necessarily leads to momentum-driven investing whereby the decision to purchase a security is dictated by how well it has done in the past: the more expensive it is, the more it attracts additional buyers who regard valuation as irrelevant.

... and they are not as passive as they may seem.

For many years we have advocated the merits of global investing based on company fundamentals, and as a result the UK equity weighting in our portfolios has fallen behind that represented in the indices which are commonly used by UK wealth managers; in fact our UK equity weightings typically don't necessarily reflect the weighting in the MSCI World index either. However, we nonetheless do spend a lot of time considering the outlook for the domestic economy as that is important for the outlook for domestic fixed interest and for the currency impact that movements in sterling have on portfolios.

Our UK equity exposure is relatively low...

In the immediate aftermath of the Brexit vote a year ago we felt that the precipitous, albeit short-lived, stock market fall showed undue pessimism about the United Kingdom's prospects, especially given the devaluation of sterling and another four years of relatively benign Conservative majority government. Economic confidence gradually recovered in the following months. Since the general election, however, we feel that this situation is now reversed: neither sterling nor the FTSE100 index have moved significantly since Theresa May lost her majority and a hard left government became a real possibility. The Brexit vote, in spite of all the prior warnings, ultimately seemed to have little impact on the economy in 2016-17. Perhaps this is because there were as many people who welcomed the economic opportunities of Brexit as who feared it, and this differential was expressed across all strata of society from rich to poor, business to consumers, capital to labour; on the other hand, if a Marxist government came into being it would be greeted almost universally by businesses, wealth creators, property owners and prospective overseas investors with extreme trepidation – especially as the UK is uniquely vulnerable whilst it is going through a risky transition phase in its trading relationships. Even if a hard left outcome doesn't materialise, the mere possibility of it coming to pass will nonetheless affect consumer and business confidence, and most likely foreign investment. We are therefore much less relaxed about the outlook for the UK than we were six months or a year ago and we feel that the markets have not taken into account this increased downside risk – perhaps because they have been lulled into a false sense of security by the muted economic impact of the referendum last year and by talk of a 'softer' Brexit.

...but the health of the UK economy and its currency remains an important consideration.

In February 1868, in the wake of the 1867 Reform Act (whereby the Tories harnessed and indeed furthered a popular revolution in their own image), Disraeli became the last Conservative Prime Minister to lead a minority administration. By December he was out of office. *The Election,* quoted on the front page, was one of Disraeli's early novels; as he wrote in a later novel, *Endymion* (published in the same year in which he lost an election in real life), "There is no gambling like politics."

Political risk is very high.

AAP

TOTAL RETURN INDICES TO 30TH JUNE 2017

STERLING ADJUSTED	3 MONTHS	6 MONTHS	9 MONTHS	1 YEAR
Markit iBoxx £ Gilts Index	-1.3%	0.3%	-3.3%	-1.0%
Citigroup World Govt Bond Index	-1.0%	-0.6%	-4.4%	-1.3%
MSCI United Kingdom All Cap Index	1.3%	5.4%	9.4%	17.8%
MSCI United Kingdom Index	0.8%	4.7%	9.1%	16.7%
MSCI AC World Index	0.6%	6.4%	13.3%	22.9%
MSCI AC World (ex UK) Index	0.5%	6.5%	13.5%	23.3%
MSCI AC World (ex US) Index	2.0%	8.9%	13.1%	24.5%
US Dow Jones Industrial Average	0.1%	4.0%	18.8%	25.7%
S&P Composite Index	-0.8%	4.0%	13.5%	21.3%
MSCI Europe (ex UK) Index	4.8%	12.6%	18.2%	29.0%
Tokyo TOPIX Index	1.9%	6.0%	11.2%	24.2%
MSCI AC Asia Pacific ex Japan Index	2.3%	14.1%	14.1%	28.9%
Waverton Growth Index	0.3%	4.8%	9.3%	16.9%
Waverton Balanced Index	0.2%	4.1%	7.2%	13.9%
Waverton Cautious Index	0.1%	3.3%	5.2%	10.8%
Waverton Defensive Index	0.1%	2.6%	3.7%	8.2%
Return on Cash £ (1 month deposit rate)	0.0%	0.1%	0.2%	0.3%
Inflation - UK CPI	0.8%	1.4%	2.1%	2.7%
Gold Price (£957.29)	-4.0%	2.2%	-5.9%	-3.1%
£ vs US$	3.9%	5.1%	0.0%	-2.8%
£ vs Euro	-2.6%	-2.8%	-1.5%	-5.4%
£ vs Yen	4.7%	1.3%	11.0%	6.4%

US DOLLAR ADJUSTED	3 MONTHS	6 MONTHS	9 MONTHS	1 YEAR
Markit iBoxx £ Gilts Index	2.5%	5.5%	-3.3%	-3.8%
Citigroup World Govt Bond Index	2.9%	4.5%	-4.4%	-4.1%
MSCI United Kingdom All Cap Index	5.2%	10.8%	9.4%	14.5%
MSCI United Kingdom Index	4.7%	10.0%	9.1%	13.4%
MSCI AC World Index	4.5%	11.8%	13.3%	19.4%
MSCI AC World (ex UK) Index	4.4%	11.9%	13.5%	19.8%
MSCI AC World (ex US) Index	6.0%	14.5%	13.1%	21.0%
US Dow Jones Industrial Average	4.0%	9.3%	18.8%	22.1%
S&P Composite Index	3.1%	9.3%	13.5%	17.9%
MSCI Europe (ex UK) Index	8.9%	18.3%	18.1%	25.3%
Tokyo TOPIX Index	5.9%	11.5%	11.2%	20.7%
MSCI AC Asia Pacific ex Japan Index	6.3%	19.9%	14.1%	25.3%
Waverton Growth Index	3.5%	9.0%	9.5%	13.9%
Waverton Balanced Index	3.1%	7.6%	7.5%	11.0%
Waverton Cautious Index	2.6%	6.2%	5.5%	8.2%
Waverton Defensive Index	2.1%	4.9%	4.1%	6.2%
Return on Cash $ (1 month deposit rate)	0.3%	0.5%	0.6%	0.7%
Inflation - US CPI	0.4%	1.4%	1.4%	1.5%
Gold Price ($1243.47)	-0.3%	7.4%	-5.9%	-5.9%
US$ vs £	-3.7%	-4.9%	0.0%	2.9%
US$ vs Euro	-6.2%	-7.5%	-1.5%	-2.6%
US$ vs Yen	0.8%	-3.7%	11.0%	9.5%

Source: Thomson Reuters DataStream

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