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Economic Commentary – February 2017

Overview

Markets have continued their general upward trend in 2017. After falling slightly in January, February saw the FTSE 100 index make headway once again, ending the month at 7,374.

At a global level, equity prices remain elevated, with all of the major US equity indices at or near their record highs, buoyed by President Trump's promise to spend $1 trillion on infrastructure projects and to cut taxes. However when considering the outlook going forward, it is important to view this improving economic data against an uncertain political environment. We are also concerned that much of the recent growth in the UK economy has been fueled by personal debt.

Cyclical sectors performed well in the latter part of 2016, which presented a headwind for some of our carefully selected UK fund choices. In contrast February proved more positive for our core funds with the FTSE All-Share pharmaceutical sector up 11%, whilst tobacco and consumer goods also had positive total returns of 4% and 7% respectively. Conversely the resources sectors of the FTSE All-Share, where our core funds have very limited exposure, declined last month with mining down 3%, and basic materials, oil and gas all down around 2%.

Whilst short term data is useful, it is more important to remain focused on the long term picture, looking for consistent returns.

We have had a number of positive fund manager meetings since the beginning of the year including meetings with Sebastian Lyon of the Trojan fund and Suzanne Hutchinson of Newton Real Return in February, which gave us the opportunity to review a range of asset classes. We are due to meet with Neil Woodford in March and also have meetings scheduled with Francis Brooke of Trojan Income and Nigel Thomas of Axa Framlington UK Select Opportunities.

Cash and Bonds

UK inflation as measured by the consumer prices index (CPI) reached 1.8% in January, up from 1.6% in December, which is the highest annual rate since June 2014. UK inflation may soon exceed the Bank of England target of 2% inflation target, although the Bank seems more concerned with maintaining employment and economic growth at this time.

Clearly inflation has an impact upon cash deposits, which is magnified by the extremely low interest rates available. However we believe it remains important to hold some tactical cash to be "phased" into markets should a correction occur rather than to deploy funds into equity markets when prices remain comparatively expensive. Our own internal analysis and a number of external studies support the view that a key determinant of returns obtained from equities is the initial prices paid for them.

Sovereign debt in developed countries continues to deliver low yields and trade at high prices, although there were signs of a change in the last quarter of 2016 with the emergence of higher inflation and the

Federal Reserve increasing interest rates; however the process of reaching more reasonable prices and yields is likely to be protracted.

Gilts prices rose in February (with yields falling) and the FTSE Actuaries UK Conventional Gilts All Stocks index was up 3%; however if we look back over 6 months the index is down 4.4%. Our long standing view is that both gilts and Sterling denominated bonds will eventually come back to more realistic pricing, which will create the potential for real and irreversible capital losses, hence our lack of exposure in this sector. In the meantime, yields remain poor with the 10-year benchmark gilt yield at 1.21%, significantly down from the 4% yield before the global financial crisis in 2008. A further example of the extreme pricing of gilts came towards the end of February when the UK treasury issued £4.5 billion of 50 year index linked bond with a negative real yield of -1.5%.

UK

One of the themes emerging from our ongoing fund manager meetings is that Sterling is potentially undervalued, with multinational companies listed in the UK benefitting from Sterling weakness via revenues denominated in US Dollars. Whilst these effects are likely to be less prominent in 2017, we may see more re-ratings of domestically focused companies. We are satisfied that our UK Equity Income and UK growth fund selections have sufficient differentiation but retain their focus on quality companies with good cash flows and some capital growth potential.

US

The picture is slightly different in the US, where inflationary pressures are rising and the labour market seems to be at or close to full employment, with the unemployment rate at 4.8%. It remains to be seen whether the very gradual and moderate path of interest rate increases being adopted by the Fed will act as a brake on inflation.

US companies reported fairly robust earnings for the last quarter of 2016, with earnings in the technology and healthcare sectors up 5%, which is good news for our US and global funds which include exposure to quality companies in both sectors. Generally, we remain cautious on US equities on valuation grounds and due to political uncertainty and will continue to monitor our exposure to this area.

Europe

The Eurozone had a better year, with all 28 EU economies registering positive GDP growth, the first time this has happened since 2007. However the improving economic picture in the region is being overshadowed by political concerns, although there are some outstanding individual companies which simply happen to be located there. Our core funds in the region focus on companies with robust business models, many of which pay dividends and are well diversified and complementary in their positioning.

Asia Pacific and Emerging Markets

Asia-Pacific markets fell in November when the election of Trump raised the possibility of a trade war with Asian exporters. Since then the FTSE World Asia Pacific ex Japan index has bounced back quickly and is up 8.4% in Sterling terms and 4.4% in local currency terms in the year to date. It is important to recognise

that the many of the largest companies in the region are tilted towards exports and dependent on the behaviour of the global economy.

Our fund selections in the region are biased towards companies with resilient balance sheets and business models, which should prove relatively defensive in more difficult market conditions.

We retain a negative view on direct investment in emerging markets, instead preferring to achieve exposure into growing affluence and consumer demand in these areas through investment in UK and international companies in the developed world which obtain a proportion of their revenues from these countries.

Alan Torevell and Georgina Ogilvie-Jones

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