MARKET PERSPECTIVES

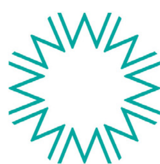
APRIL 2017

THE LAST QUARTER...

- World stock markets continue to go up, led by Asia (ex-Japan). Europe outperforms the US.
- Bonds generally grind higher, in spite of the rise in US Fed Funds.
- The FTSE100 experiences its longest run of gains (14 days in a row) since its inception in 1984.
- The S&P500 has more than five months, 110 sessions, without a 1% reversal.
- After Theresa May's Brexit speech, Sterling sees its biggest one day rise since 2008, up 3%; UK employment reaches a record high.
- Swiss 10 year rates briefly turn positive for the first time since 2015, but finish the quarter back in negative territory.
- Australia completes 25 years without a recession.
- John Lewis declares its lowest bonus pay-outs in at least 63 years.

"But if America recalls for a moment what Europe has meant to her and still means to her…will she not reject these counsels of indifference and isolation?"

John Maynard Keynes, *The Economic Consequences of the Peace* (1919)



WAVERTON

INVESTMENT MANAGEMENT

OUTLOOK FOR INTEREST RATES

US rates go up again, but financial markets yawn.

On the 15th March the US Federal Reserve Board of Governors raised interest rates – the second quarter in a row. Again, far from taking this as a signal to correct, markets shrugged off both the move itself and the accompanying statement with insouciance. Janet Yellen, the Fed Chairman, pointed out that whilst inflation has ticked up, excluding energy and food prices it is little changed and continues to run somewhat below the 2% target; moreover, longer term inflation expectations remain low.

How far will rate rises go, and how quickly?

Financial markets did not react because it has been obvious for some time that short rates would have to rise from what were artificially low levels. The matter for concern centres around the degree and pace of those rate rises, and the consequent impact on asset prices. One could construct a case whereby inflation takes hold, fuelled by rising commodity prices, President Trump's reflationary politics and a stirring of animal spirits generally – in which case, under the long established 'Taylor rule' and as repeatedly predicted by the Fed Governors themselves, short rates could head to 3% or 4% in fairly short order. On the other hand predictions like this have repeatedly fallen short for some years; in fact ever since the advent of QE, 'printing money' seems not to have led to any inflation except in asset prices. Now, however, we are definitely on a rising path and it is central bankers' stated aim that this should continue, so there is a risk that the long period of ultra-low interest rates and the calmness with which the first few rises were greeted has lulled financial markets into a false sense of security. We have grown used to central bankers and commentators 'crying wolf', but we should be alive to the risk that monetary policy may now be 'behind the curve'.

Inflations is on its way...

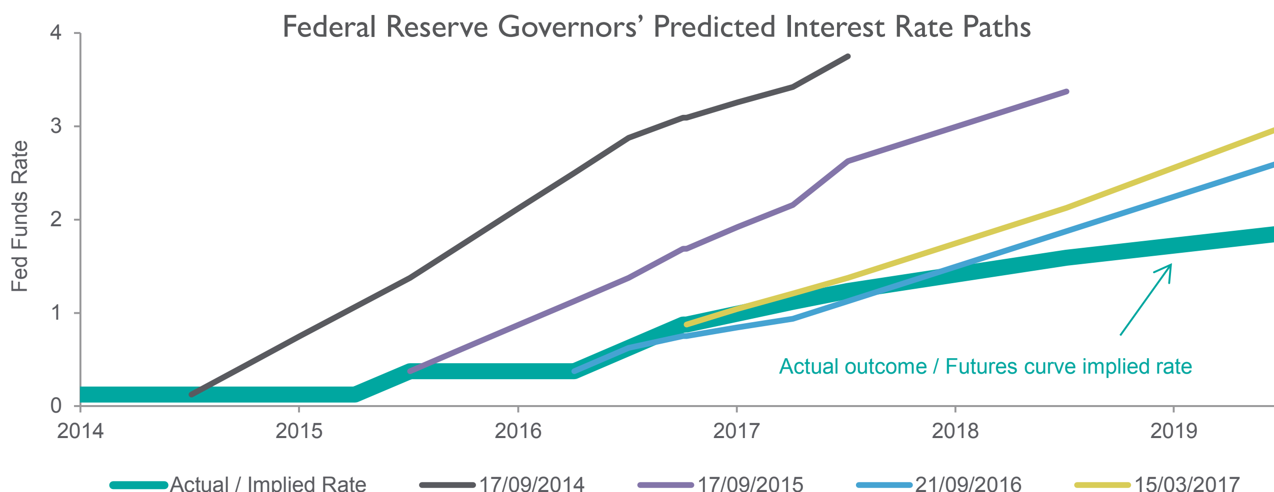
Much depends on the level of inflation and the amount of spare capacity in the economy. There is no doubt that we are back in economic recovery: unemployment is falling, consumer spending is rising and prices are edging up. There is every expectation that this will feed through into the retail price inflation numbers. The question is, will it go materially above 2%, and if so will real interest rates need to move towards the 3% level (which has been typical in the past) in order to curtail it? If the answer in both cases is 'yes', then short rates will go to 5% or more and we will most likely experience a material correction in asset prices and a proper bear market in bonds.

...but likely to peak at a relatively modest level.

However, there are reasons to believe that, whilst cyclical inflation is picking up, the long term structural forces for deflation have not gone away and will continue to keep the lid on both retail prices and the level of real interest rates for the foreseeable future. Inflation spikes have been falling ever since the 1970s and secular inflation appears to be behind us, largely because of demographics, but also thanks to the internet, technology, free trade and globalisation. The bond markets are telling us that there is no need to panic: US long-dated treasury yields have moved from c. 2 ¼% last summer to 3% now – painful for long bond investors (which is why we sold ours last year), but not much of a threat to asset prices generally. So far in 2017, the yield curve has been flattening – i.e. the long end of the curve has come down as the short end has risen. We think the big risks in bond markets are probably the illiquidity of corporate bonds (likely to be exacerbated one day by the current fashion for index funds) and defaults from lower rated credits when the economic cycle turns.

Bonds will remain under pressure.

In summary, whilst we remain cautious on bonds, and particularly wary of gilts (where the 10 year yield is still as low as 1.1% in spite of Brexit uncertainties and the devaluation inspired-inflation that we <u>know</u> is on the way), we don't see yields going to levels which will wholly undermine the existing order.



Source: Bloomberg

OUTLOOK FOR EQUITY MARKETS

In January we talked about how the US stock market strongly outperformed following Trump's election, and how a sudden bout of sector rotation had led to many long term growth stocks underperforming. So far in 2017 the US has slightly lagged other markets and growth stocks have come back into fashion; world stock markets as a whole did well (up 7% in US dollar terms, nearly 6% in sterling terms). Many commentators have been surprised at how strong equities have been, especially as valuations already looked full. The US is on a historic price / earnings ratio of 22 times, which is expensive relative to its history and is at a c. 25% premium to the rest of the world.

Equities continue to do well...

The 'correct' valuation of equities has been a matter of greater than usual debate in recent years because ultra-low interest rates, from which all asset prices are to a great extent derived, are unprecedented. On the one hand equities should be expensive relative to history if yields on competing asset classes, and the discount rate generally, are at all-time lows; on the other hand, very low interest rates reflect a low growth environment, too much debt and elevated levels of risk – all of which would argue in favour of lower equity valuations. Looking back at the behaviour of equity markets over the last few years one can conclude that investors are comfortable with share prices being somewhat elevated in a low interest rate environment so long as the financial system is stable and there is the prospect of some earnings growth; if, on the other hand, there is a hint of systemic risk materialising (e.g. during the Euro crisis of 2011) or of serious deflation (as there was in the early part of 2016), then equity valuations can rattle back alarmingly quickly.

...but valuations are high and require some earnings progression to be justified.

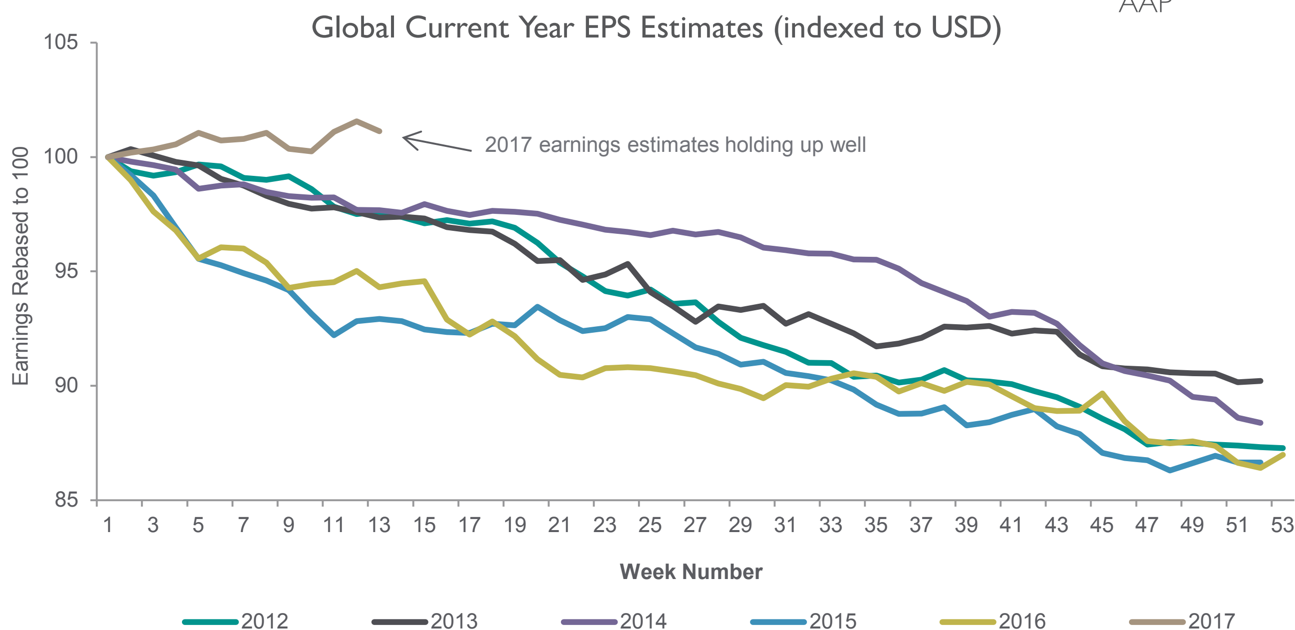
A notable feature of the last few years has been the inability of company earnings in aggregate to grow. The frustrations behind this have variously been currency gyrations, falling commodity prices and endless write-offs in the banking sector: the net result is that equities have only been able to make progress by re-rating to a higher valuation. This year, for the first time in some years, global earnings expectations in aggregate have been holding up or slightly increasing instead of being downgraded. It is difficult to pin down exactly what is behind this because the aggregate global earnings picture is clouded by currency moments (especially the US dollar), what is happening to oil prices and the preponderance of exceptional items in companies' profit and loss accounts – but, regardless to the cause, the fact remains this represents momentum in the right direction and is indicative of economic recovery. It is also beneficial to equity valuations, which continually moderate over time as earnings progress.

At long last earnings growth is in fact coming through.

We do need to see some earnings growth this year: if it does not materialise, equity valuations are vulnerable. It is encouraging that leading economic indicators are in positive territory and analysts' earnings expectations are generally holding up; in Europe the earnings revision ratio is the highest it has been in six years. Set against this, our analysis of the leading indicators suggests that it is mainly the 'soft' data points (i.e. those concerning sentiment and expectations) which are showing most confidence, whereas the 'hard' ones (i.e. solid economic data regarding output, shipments etc.) are more subdued. Moreover, corporate profit margins are already high by historic standards, so it's not obvious that materially higher earnings are overdue. It is therefore all the more important that we examine carefully the specifics of every company we invest in and focus on sectors which are capable of delivering sustainable underlying growth, such as technology and healthcare. In this context, we continue to focus on quality global franchises, which so far this year has been of benefit.

Economic recovery is providing a tailwind, but we prefer secular growth stories.

AAP



Source: Factset

TOTAL RETURN INDICES TO 31ST MARCH 2017

STERLING ADJUSTED	3 MONTHS	6 MONTHS	9 MONTHS	1 YEAR
Markit iBoxx £ Gilts Index	1.7%	-2.0%	0.4%	6.8%
Citigroup World Govt Bond Index	0.4%	-3.5%	-0.4%	10.7%
MSCI United Kingdom All Cap Index	4.0%	8.0%	16.3%	22.3%
MSCI United Kingdom Index	3.8%	8.2%	15.8%	23.6%
MSCI AC World Index	5.8%	12.7%	22.2%	33.0%
MSCI AC World (ex UK) Index	5.9%	12.9%	22.7%	33.6%
MSCI AC World (ex US) Index	6.7%	10.8%	22.0%	30.7%
US Dow Jones Industrial Average	3.9%	18.7%	25.6%	37.8%
S&P Composite Index	4.8%	14.4%	22.3%	34.7%
MSCI Europe (ex UK) Index	7.4%	12.7%	23.0%	28.4%
Tokyo TOPIX Index	4.0%	9.1%	21.9%	33.0%
MSCI AC Asia Pacific ex Japan Index	11.5%	11.5%	26.0%	36.2%
Waverton Growth Index	4.5%	9.0%	16.6%	25.1%
Waverton Balanced Index	3.9%	7.0%	13.6%	21.1%
Waverton Cautious Index	3.2%	5.0%	10.7%	17.1%
Waverton Defensive Index	2.5%	3.6%	8.1%	13.2%
Return on Cash £ (1 month deposit rate)	0.0%	0.1%	0.2%	0.3%
Inflation - UK CPI	0.0%	0.9%	1.5%	1.9%
Gold Price (£997.44)	6.5%	-2.0%	0.9%	16.1%
£ vs US$	1.2%	-3.7%	-6.5%	-13.0%
£ vs Euro	-0.2%	1.1%	-2.8%	-7.3%
£ vs Yen	-3.3%	5.9%	1.6%	-13.7%

US DOLLAR ADJUSTED	3 MONTHS	6 MONTHS	9 MONTHS	1 YEAR
Markit iBoxx £ Gilts Index	2.9%	-5.7%	-6.1%	-7.1%
Citigroup World Govt Bond Index	1.6%	-7.1%	-6.8%	-3.7%
MSCI United Kingdom All Cap Index	5.3%	4.0%	8.8%	6.4%
MSCI United Kingdom Index	5.1%	4.1%	8.3%	7.5%
MSCI AC World Index	7.0%	8.4%	14.3%	15.7%
MSCI AC World (ex UK) Index	7.2%	8.7%	14.7%	16.2%
MSCI AC World (ex US) Index	8.0%	6.7%	14.2%	13.7%
US Dow Jones Industrial Average	5.2%	14.3%	17.5%	19.9%
S&P Composite Index	6.1%	10.1%	14.4%	17.2%
MSCI Europe (ex UK) Index	8.6%	8.5%	15.1%	11.7%
Tokyo TOPIX Index	5.3%	5.1%	14.0%	15.7%
MSCI AC Asia Pacific ex Japan Index	12.8%	7.4%	17.9%	18.5%
Waverton Growth Index	5.3%	5.7%	10.0%	11.4%
Waverton Balanced Index	4.4%	4.3%	7.7%	9.2%
Waverton Cautious Index	3.5%	2.8%	5.4%	7.1%
Waverton Defensive Index	2.7%	2.0%	3.9%	5.4%
Return on Cash $ (1 month deposit rate)	0.2%	0.4%	0.5%	0.6%
Inflation - US CPI	0.9%	0.9%	1.1%	2.3%
Gold Price ($1247.25)	7.8%	-5.6%	-5.6%	1.0%
US$ vs £	-1.2%	3.9%	6.9%	14.9%
US$ vs Euro	-1.4%	5.1%	3.9%	6.5%
US$ vs Yen	-4.5%	10.0%	8.6%	-0.9%

Source: Thomson Reuters DataStream

This material is for your private information and should not be distributed further. The views and opinions expressed are the views of Waverton Investment Management Limited and are subject to change based on market and other conditions. The information provided does not constitute investment advice and it should not be relied on as such. It should not be considered a solicitation to buy or an offer to sell a security. It does not take into account any investor's particular investment objectives, strategies, tax status or investment horizon. We encourage you to consult your tax or financial advisor. All material(s) have been obtained from sources believed to be reliable, but its accuracy is not guaranteed. There is no representation or warranty as to the current accuracy of, nor liability for, decisions based on such information.

PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS AND THE VALUE OF SUCH INVESTMENTS AND THEIR STRATEGIES MAY FALL AS WELL AS RISE. CAPITAL SECURITY IS NOT GUARANTEED.

WAVERTON INVESTMENT MANAGEMENT LIMITED 16 BABMAES STREET LONDON SW1Y 6AH 020 7484 7484 WAVERTON.CO.UK

Registered in England Number 2042285. Authorised and Regulated by the Financial Conduct Authority