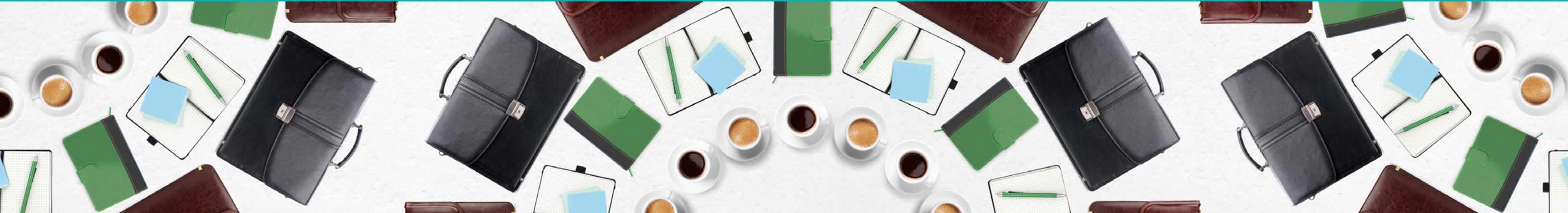
MARKET PERSPECTIVES

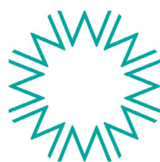
DECEMBER 2016



THE LAST QUARTER...

- World stock markets continue to go up, led entirely by the US: Europe (including the UK) and Asia (including Japan) are down in US dollar terms.
- In advance of the presidential election, the S&P500 index experiences its longest daily run of losses since 1980; in December it goes on to reach a new all time high.
- Bonds have a difficult quarter, with yields up materially across the board.
- The pound falls to a 31 year low, but the UK is set to be the fastest growing G7 economy in 2016.
- US dollar climbs to a 14 year high; jobless claims fall to a 43 year low.
- US Federal Reserve raises its benchmark rate by 0.25% to 0.5% - 0.75%.
- Brazil experiences its second year running of economic contraction.
- The Greek economy grows for the first time in 2 years.

> "I will tell you at the time. I'll keep you in suspense. Okay?"
>
> Donald Trump, President-Elect of the USA, 19 October 2016.



WAVERTON

INVESTMENT MANAGEMENT

OUTLOOK FOR INTEREST RATES

US interest rates rise both at the short end...

At last, after numerous false alarms and for only the second time in a decade, the US Federal Reserve raised interest rates on 14th December. This was, in the words of Janet Yellen (Chairman of the Fed), "a reflection of the confidence we have in the progress that the economy has made and our judgement that progress will continue." The stock market agreed with the positive outlook: the enthusiastic reaction to Donald Trump's election is accounted for by the realisation that his proposals – namely increased government spending on infrastructure, tax cuts to incentivise companies to invest and deregulation of the banks – will, if they get through Congress, be beneficial for US economic growth. This has had a corresponding impact on inflation expectations, which have moved from c. 2% to 2.5% during the quarter, with the bulk of this move occurring immediately after the presidential election.

... and the long end.

The impact on bond yields has been dramatic: the US 10-year jumped from 1.6% at the end of September to 2.6% by mid-December. A similar move in the 30 year yield led to price falls of over 15% in long dated US treasury bonds during the course of just a few weeks. This is exactly the kind of volatility we warned about in the last edition of *Market Perspectives* and why we do not believe that long dated government bonds can any longer be considered an entirely safe haven. We have been reducing our exposure to this asset class for some time (having increased it early last year when there was a deflation scare) and we decided to accelerate this immediately after the election. There is no doubt that 'Trumpism' has the potential to be fundamentally reflationary for the US economy.

The strong dollar will keep the lid on US inflation.

However, as is so often the case in financial markets, Newton's Third Law ("For every action there is an equal and opposite reaction") springs to mind. The impact of Trumpist economic stimulation on inflation will be somewhat counterbalanced by the rapid rise in the value of the US dollar relative to other currencies: more imports will result in the availability of cheaper goods domestically and lower exports will dampen the growth of US manufacturing sectors. Moreover, higher bond yields are apt to draw money away from real assets and could ultimately lead to asset price deflation, especially in sectors like real estate. In a freely moveable system there are a lot of natural checks and balances which make runaway directional moves rare even at the beginning of a fundamental change in trend, and it will not be clear for some time whether long term deflationary forces have been consigned to history. It may well be that Mr. Trump does not get his policies through to anything like the degree that he wants: the Republican party tends to be ill disposed towards loose fiscal policy, and has a commanding position in Congress.

So far, inflation in the UK has been subdued in spite of a weak pound.

A word also on the UK. It seems extraordinary, given the huge uncertainties this country faces, that in local currency terms gilts were the best performing major bond market of 2016, recording a total return of 10.1%. Regardless of the political upheaval, the fact that the pound is down 15% on the year (trade weighted) should lead to significantly higher inflation and therefore a correspondingly weak bond market. Five year inflation expectations for the UK have indeed moved from 2.9% last summer to 3.6% now, but counterweights (retail prices in shops are still falling) have conspired to keep this move and the corresponding change in bond yields to manageable levels – so far. However, we remain of the view that on any long term view bond yields are too low.

Protectionism and the imposition of tariffs would lead to higher inflation

There is one major caveat to Newton's Third Law as it applies to financial markets. It relies upon a free exchange of capital in liquid markets. We have talked in the past about how the artificial constraints imposed by the existence of the Euro threaten to upset this order through the eventual imposition of capital controls. There is now another equally menacing, though very different, source of potential imbalance: tariffs and protectionism, both seemingly espoused by Donald Trump – and apparently by the European Union's Brexit negotiators.

Source: Bloomberg 09.01.2017

OUTLOOK FOR EQUITY MARKETS

The performance of equity markets during the last quarter was very polarised – both geographically and by sector. Whilst the Dow Jones Industrial Average was up nearly 9%, all other major regions were down in US dollar terms. It has therefore been very difficult for active global equity managers to outperform the world index unless they have had at least 60% of their portfolios invested in North America – arguably not an easy thing for anyone who was remotely concerned about the US presidential election to do in the fourth quarter of 2016. There is no doubt that the focus on shareholder value in corporate America tends to be higher than elsewhere and the region's exposure to high growth technology companies is unrivalled: this justifies a higher valuation for US equities than other parts of the world. But one cannot ignore the fact that US equities, on a trailing Price/Earnings (PE) multiple of over 20 times and a forward PE multiple which is the highest since 2000, are now looking expensive relative to their own history and therefore vulnerable to disappointment if the anticipated boost to earnings growth doesn't materialise.

The US stock market has strongly out-performed...

Of perhaps more relevance to stock-picking fund managers was the polarisation in sector performance which took place in 2016, especially during the last quarter. Looking at the year as a whole, the recovery in oil and metals prices together with a general move away from a deflationary mindset has turbocharged resources stocks, which are typically highly cyclical in nature and have low returns on capital across the economic cycle. The last quarter has seen another cyclical sector, banks, roar upwards on the back of the US interest rate rise and Mr. Trump's election. Higher interest rates should be beneficial to bank profitability, a more robust economy will mean lower bad debts and the mooted repeal of the Dodd-Frank Wall Street Reform and Consumer Protection Act (2010) would be a boon for the sector.

...as have the more cyclical sectors of the market.

Conversely, long duration assets such as highly rated technology, healthcare, consumer discretionary stocks and 'bond proxies' such as real estate & utilities have underperformed. We have for some time been concerned about the valuation of bond proxies and consumer discretionary stocks – the former because we have been nervous about bond yields and the latter because we do not believe the valuation of companies like Proctor & Gamble, Coca-Cola and L'Oréal is justified by the earnings growth being produced by these entities. Defensive (i.e. non-cyclical) sectors have been pushed up in price on the perception that they represent a safe haven from worrisome and volatile equity markets. We do not believe this gives due consideration to the valuation risk inherent in these stocks in the event that bond yields rise and / or earnings growth disappoints – a lesson that should have been learnt after the tech bubble of 2000. Ironically, the latest surge in the US stock market has bypassed many of the companies and sectors which were at the epicentre of that boom and bust a decade and a half ago. Companies like Alphabet, Facebook, Baidu and Shire have been materially de-rated in recent months in spite of their superior current and projected earnings growth. This sector rotation explains why the Dow Jones Industrial Average, which is a concentrated index of just 30 stocks largely representing traditional corporate America, has so strongly out-performed the wider US stock market in the form of the Standard and Poors indices, which contain hundreds of companies across a broad range of sectors. It is notable also that value managers have outperformed growth managers for the first time in a long while (prior to 2016, the last calendar year in which the MSCI Global Value index outperformed the Global Growth index was 2006).

Defensives, 'bond proxies' and technology have under-performed.

The big question is whether this marked change in sector leadership is the beginning of a new trend, or an aberration. In favour of it being a new trend would be a sustained rise in bond yields, inflation & economic growth plus a deregulation of the banking system; against would be a continuation of low growth & interest rates, or a cyclical downturn. Backing 'cheap' and lower quality companies at this juncture does require a certain faith in sustained economic recovery because usually the returns made by deep cyclicals are transient in nature and do not cover the cost of capital over the cycle. Conversely, quality growth stocks, whist they can be subject to periodic (often quiet savage) falls in valuation and sometimes remain out of favour for a considerable period of time, should be able to ride out economic and market storms if the nature of the industry in which they operate and the quality of management enables returns on capital to be preserved. Our natural tendency is towards 'quality growth' over 'cyclical value' and we believe that the former will come back into vogue as soon as the recent euphoria in the US dissipates and bond yields stabilise. Thus far, the observed equity re-rating (most prevalent in the value-orientated sectors) largely represents 'hope value'. Presidents and prime ministers seem determined to keep markets in suspense about the crucial elements of policy which will govern returns in the coming years; one almost feels that the quotation on the front page could just have easily have been Theresa May speaking about Brexit. What we hear from companies in the first quarter of 2017 earnings seasons and what we see from the Trump administration in its first 100 days will play a big part in determining sector leadership from here. In the meantime, we concentrate our cyclical exposure on quality names and we remain suspicious of high risk plays like lower quality European banks.

Much will depend on Donald Trump's first 100 days and Theresa May's stance on Brexit.

AAP

TOTAL RETURN INDICES TO 31ST DECEMBER 2016

STERLING ADJUSTED	3 MONTHS	6 MONTHS	9 MONTHS	1 YEAR
FTSE UK All Stocks Gilt Index	-3.4%	-1.2%	4.9%	10.1%
Citigroup World Govt Bond Index	-3.8%	-0.7%	10.4%	21.2%
FTSE All Share Index	3.9%	12.0%	17.2%	16.8%
FTSE 100 Index	4.3%	11.7%	19.0%	19.1%
FTSE All World Index	6.7%	15.7%	25.9%	29.6%
FTSE All World (ex UK) Index	6.8%	16.0%	26.4%	30.4%
FTSE All World (ex US) Index	4.1%	14.5%	22.7%	25.4%
US Dow Jones Industrial Average	14.2%	20.8%	32.6%	39.0%
S&P Composite Index	9.2%	16.7%	28.5%	33.6%
FTSE World Europe (ex UK) Index	4.8%	14.2%	19.0%	19.7%
Tokyo TOPIX Index	4.9%	17.2%	27.8%	23.4%
FTSE All-World Asia Pacific (ex Japan) Index	0.9%	13.3%	23.0%	28.7%
Waverton Growth Index	4.5%	11.4%	19.9%	23.5%
Waverton Balanced Index	3.1%	8.9%	16.4%	20.1%
Waverton Cautious Index	1.8%	6.5%	13.0%	16.6%
Waverton Defensive Index	1.1%	4.7%	10.0%	13.0%
Return on Cash £ (1 month deposit rate)	0.1%	0.2%	0.3%	0.4%
Inflation - UK CPI	0.5%	1.0%	1.6%	1.2%
Gold Price (£936.75)	-7.9%	-5.2%	9.1%	30.0%
£ vs US$	-4.9%	-7.6%	-14.0%	-16.2%
£ vs Euro	1.3%	-2.6%	-7.1%	-13.7%
£ vs Yen	9.6%	5.1%	-10.8%	-18.7%

US DOLLAR ADJUSTED	3 MONTHS	6 MONTHS	9 MONTHS	1 YEAR
FTSE UK All Stocks Gilt Index	-8.2%	-8.7%	-9.8%	-7.7%
Citigroup World Govt Bond Index	-8.5%	-8.3%	-5.1%	1.6%
FTSE All Share Index	-1.2%	3.5%	0.8%	-2.1%
FTSE 100 Index	-0.8%	3.2%	2.3%	-0.2%
FTSE All World Index	1.5%	6.9%	8.2%	8.6%
FTSE All World (ex UK) Index	1.6%	7.2%	8.6%	9.3%
FTSE All World (ex US) Index	-1.0%	5.9%	5.5%	5.1%
US Dow Jones Industrial Average	8.7%	11.7%	14.0%	16.5%
S&P Composite Index	3.8%	7.8%	10.5%	12.0%
FTSE World Europe (ex UK) Index	-0.3%	5.6%	2.3%	0.4%
Tokyo TOPIX Index	-0.2%	8.3%	9.9%	3.5%
FTSE All-World Asia Pacific (ex Japan) Index	-4.1%	4.7%	5.7%	7.9%
Waverton Growth Index	0.5%	4.6%	5.9%	6.8%
Waverton Balanced Index	-0.1%	3.1%	4.5%	5.7%
Waverton Cautious Index	-0.6%	1.7%	3.1%	4.5%
Waverton Defensive Index	-0.7%	1.0%	2.2%	3.5%
Return on Cash $ (1 month deposit rate)	0.1%	0.3%	0.4%	0.5%
Inflation - US CPI	0.2%	0.5%	1.8%	1.7%
Gold Price ($1157.49)	-12.4%	-12.4%	-6.2%	9.0%
US$ vs £	5.2%	7.9%	16.4%	19.5%
US$ vs Euro	6.5%	5.3%	8.0%	3.0%
US$ vs Yen	15.2%	13.7%	3.8%	-3.0%

Source: Thomson Reuters DataStream

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