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General Economic Overview – Quarter 1 2017

The first quarter of the year has seen a continuation in the momentum set by the post Trump reflation rally that took place after the US elections, taking many investors by surprise. This momentum led to value strategies performing well in the months immediately following the elections but it has slowed in the first quarter of 2017 as doubts started to surface over the ability of the new US administration to overcome some of the internal political barriers that would facilitate the tax and fiscal policy reforms that was driving markets ahead.

Economically, the global picture appears healthier with stronger data coming from western markets including improving employment numbers and PMI surveys but the strength of the soft data, such as consumer confidence, has yet to be reflected in the hard data such as industrial production and retail sales. There is normally a lag in the reaction of companies to rising consumer confidence, but the lack of progress is concerning to investors and has perhaps led to the re-emergence of the demand for quality growth stocks in markets such as the US and UK. Uncertainty remains across the globe despite the confidence seen in consumer surveys, and the political volatility has far greater impact than in previous decades as populist parties and unconventional policies are more common and have greater influence. There is now a sense that America is retreating from its global role and that there is the potential for tensions to erupt, together with threats to free trade through protectionism. If America / China tensions rose China could change tack and support North Korea.

Monetary policy divergence continues, with Europe and Japan keeping expansionary policies in place, in contrast to the US, which is likely to support a stronger US currency. The US is also moving to a policy mix of looser fiscal policy and tighter monetary policy which would also generally result in currency strength. Potential political problems in Europe are also likely to keep a check on a significant Euro rally until elections are out of the way.

Inflation has started to rise in most western economies and this would normally start to threaten bond yields but as we have seen in the last quarter, despite US rates rising in March, yields have not followed suit and in fact have declined in the last few weeks from recent highs. The traditional economic levers are working differently in this environment and are less easy to interpret.

Another point to note is the length of the US bull market which on the 15th March 2017 was the longest on record, surpassing the 1921-29 bull market. If broad valuations are satisfactory this would be less of a concern, but long bull markets can breed complacency.

The quarter has seen a more positive environment for global growth and this has been reflected in market levels and consumer confidence, but markets are high and many company valuations in western markets need improving earnings to justify such levels. There remain many challenging issues to overcome in 2017 both politically and economically.

Equity Markets Overview

This year equity markets have ploughed ahead despite various concerns which have arisen such as geopolitical changes and flat industrial data. The consumer is more confident which has driven

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investor confidence, continuing global growth, and resulting in stock markets around the globe reaching all-time highs with some valuations at uncomfortable levels, particularly in the US. With economic growth improving, the question for many investors is how long markets can push forward without stronger evidence of improving industrial production and earnings. There are pockets of value for investors, with Europe and emerging markets offering opportunities, given valuations are not as stretched – although clearly the economic picture for both is more fragile with European elections and a fluctuating oil price being just two of a number of concerns. The question for many investors in 2017 is whether this momentum can be sustained or if a setback occurs to readjust valuation levels.

UK

The economy has continued to show surprising strength despite the threats of a rising inflationary environment and the impending exit from the European Union. Now that Article 50 has been triggered the negotiation process can begin with the legal profession being the largest beneficiary in the early stages. Growth is expected to be over 2% in 2017 maintaining an improving trend over the last twelve months.

A recent survey by the Bank of England of 700 businesses found that companies were planning to invest more despite higher business costs based on the belief that risk had declined in the European and emerging market areas. There is still an overriding belief that business will get more difficult as we move closer to Brexit and as more details are known of the terms of exit. The final growth figures for the latest available quarter showed that the UK had grown by 0.7% in the final quarter of 2016 with annual growth at 2.4%. The consumer has been the strongest source of growth although this retreated in January as signs of higher inflation was met with lower spending levels. February however saw increased spending so the jury is out as to whether the January data was a blip. The services sector makes up 80% of UK GDP so any setback in this area generally hits the overall combined figure heavily and in January this was the case.

The main UK market is up over 4% so far this year indicating positive growth, but this is some way behind the strongest markets in the emerging economies whose growth has been over 10% and this with limited currency strength.

US

The US market was the strongest for a sterling investor during 2016 thanks to a significant fall in the value of the currency and the strength of the US dollar. 2017 has seen some stability in currencies with the dollar actually showing signs of weakness as US policies have struggled to get through congress. The US market has driven the recent rise in world stock markets more through expectation than effective policy, as the promise of fiscal expansion and tax cuts looked to improve economic growth in the US with a positive global knock-on effect.

In practice, it is unlikely to be that simple, markets are overbought so there could be a short term setback – US research firm Ned Davis has said that since 1928 the average number of days before a 20% market correction was 625, but in secular bull market periods this rose to 1,105 days. Today there has been 1,950 days without a 20% market correction. On the other hand technicians would say that the break in the S&P above 2130 / 2140 after a continuous sideways move since 2015 could

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indicate another market leg up. Although the US market looks fully valued to overvalued, if there were significant tax cuts at both the individual and corporate level, earnings could rise significantly, bringing the PE ratio back more in line with longer term averages. It is possible that the policies announced by Trump may validate the rise in the market. Policy and how it is pursued will be important, and is likely to be different to what we have seen in the past as Trump has appointed business managers who are used to negotiating in a different way. Investors will have to wait to see whether reality will be different to rhetoric. Of the Trump 3P's identified in the December Market Outlook – the 'personality' one – is causing most concern at present. Trump is a populist President who wants to stay popular so has backed down after some announcements went down badly with the electorate, we must wait to see what of his manifesto becomes legislation. The US growth rate is likely to be 3% or above in 2017 and inflation over 2% on the Fed measure, so interest rates will move up. In this environment the US 10 year Treasury yield may well move over 3%, which would be in keeping with a 2% Fed Funds rate which is not tight policy, but is likely to limit market upside although secular forces will contain and restrain inflation.

Europe

Europe faces some of the same headwinds as the UK, with the Brexit negotiations taking centre stage and both sides aiming for a positive compromise. This may be viewed as a distraction to other issues in Europe, where the peripheral countries are struggling to come out of the recession caused by the GFC. More recently investor sentiment has turned more positive with data from the recent earnings season much stronger, and relative valuations in Europe are better than other areas of the globe, which is another factor fuelling investment in the regions companies. On a forward looking basis European equities are trading at their widest discount versus US equities in the past five years, and overall Europe delivered faster than expected growth in 2016 and PMI levels are higher than they have been since 2014. Political uncertainty continues, with the rise of populist parties – although they are unlikely to be strong enough to win elections in France, Germany and Italy.

It is likely a deal will be done to recapitalise the Italian banks that satisfies the ECB, and there is likely to be further softening of austerity. Monetary policy in Europe will remain loose, although the ECB will continue to taper its asset purchases. As valuations in Europe look sensible this may be an area which sees stronger market growth in 2017.

Asia

Quarter one 2017 again saw the news in Asia mainly focused on China and the US dollar. The most recent data from the Chinese market has shown positive momentum so far in 2017 with growth having re-accelerated following the 2016 stimulus package with both service and manufacturing PMI's above 50, indicating expansion. Significantly producer price inflation, which had been negative for a long period of time, sending deflationary impulses across the whole global economy, has turned positive and is running at around +7% year on year. It is clear that Chinese consumers once again have money to spend and outbound tourism remains strong, together with retail sales continuing to grow in the low double digits. This year sees the autumn Party Congress and China is therefore in the middle of its electoral cycle and President Xi will need to demonstrate strength ahead of political changes. This suggests that not only will the economy remain strong, but China will need to be seen to stand up to

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any external foreign policy threats which could increase tensions with the United States where another strong leader has been elected.

Indian economic growth continues to be robust despite the move to take out higher value bank notes from the economy. Overall the reform programme under Modi is continuing with a crackdown on corruption and this year the economy should benefit from the introduction of the national sales tax. Over the longer term, Modi is looking to utilise India's cheap labour force to expand low cost manufacturing.

The Asean region suffered a sharp setback following the election of Trump, but this year's softening of the US currency should be a benefit at the individual country level. The Philippines have suffered from the political uncertainty post the election of strongman leader Duterte, so this over-owned market has suffered outflows from foreign investors. Indonesia needs to continue with its reform programme and actual implementation of its planned infrastructure programme. This remains a country with excellent long term potential due to its demographics and low cost labour force.

Japan

Japan has been through some interesting swings in the first quarter of the year, starting well as the weaker yen gave exporters and the market a boost but then weakening as the yen strengthened against the dollar at the beginning of March. This theme is likely to dominate sentiment in 2017 as investors evaluate the longer term effect of the Abe policies.

The level of government debt continues to be a major concern for some, although with the bond market mainly owned by domestic investors, a major loss of confidence is unlikely. Interest rates remain at very low levels and 10-year bond yields are capped and so Japan should be able to service this debt for some time without any major issues. A widening trade surplus with the US could potentially raise tensions in the face of Trump's proposed protectionist policies.

Valuations remain attractive, both on a PE and Price to Book basis, and the greater focus on shareholder value encourages out positive view. Corporate governance has improved as the number of independent directors has increased dramatically since 2010, and since 2013 shareholder returns in the form of either dividends or buy backs have been ramped up reflecting this better corporate governance code. Some companies which have recently made share buyback announcements have been Toyota, the Japanese Stock Exchange and Bridgestone together with some internet companies.

Japan continues to have the lowest payout ratio of the developed markets at c35% compared to c110% for the UK and even the US pays out c50%. High company cash balances mean that there is now more scope for Japanese corporates to return money to shareholders.

Emerging Markets

This has been strong quarter for emerging markets as a whole given the previous strength of the dollar, and China has played a significant part in the recovery in the regions with policies that have stabilised markets across much of Asia. It is generally felt that the economic cycle in EM has bottomed with improving current account balances and increased competitiveness on the back of lower wage growth.

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The issues in India over demonetisation have drifted away and the mid to long term outlook now appears more positive. The continued improvement in commodity prices seems to have helped the region, in particular the exporters such as Brazil and Russia.

One of the longer-term arguments against emerging markets is that higher interest rates cause the US dollar to strengthen which is a burden on developing countries with significant dollar denominated debt. Today EM's are on a stronger financial footing, have much higher financial reserves and have more flexible currency regimes to weather shocks. In reality the correlation between EM relative returns and changes in US interest rates has been low even when US rates have risen steeply.

Stronger commodity markets driven by the Chinese stimulus package have been a positive for Latin American countries together with Russia. As a result, prospects for earnings growth are better for 2017 than 2016. Stronger EM currencies are likely to result in a decline in inflation and lower interest rates supporting economic recovery. Eastern Europe is benefitting from the pickup in European economic growth.

Emerging markets entered the year as an under-owned asset class so any improvement in economic conditions is likely to have a positive impact on stock market performance, as has been the case in Q1. Whilst the region remains vulnerable as a whole to either a strong US currency or falling commodity prices, valuations versus developed markets remain attractive.

Fixed Interest

At the end of the last quarter our expectations of bond yields finally rising seemed to be coming to fruition with the US rate hike and a rising global inflationary environment suggesting higher future interest rates would be needed. In 2017 we have seen a further rate hike in the US but relatively little movement in yields, indeed the US ten year treasury has fluctuated around levels seen over much of 2016. Bond markets have become less sensitive to this shift in policy within the US Federal Reserve regime shift and more reflective of the political uncertainty in the US and Europe. The Fed has however maintained a cautious outlook for 2017 which, allied to the political issues, has kept US treasury rates flat to falling thus far in 2017.

Fixed interest markets will have to contend with rising inflationary expectations and the prospect of more aggressive US monetary tightening in 2017. Investors have grown accustomed to many years of falling bond yields and disinflationary pressures, and estimates for fair value in core government ten year yields vary considerably, but traditional thinking would suggest ten year yields should be around nominal GDP levels, and so there could be further price weakness in government bonds over the next 12 months. Whilst secular forces suppressing inflation remain in place, such as demographics and the post-GFC debt overhang, there are cyclical pressures pushing inflation higher, such as the rise in the oil price from Q1 lows – estimates for when the oversupply situation in oil comes to an end remain sharply divided. There are signs in certain economies, including the US, of wage inflation picking up as labour markets continue to tighten but on balance, further weakness in government bonds with higher yields seems likely over the course of 2017, although periods of consolidation after the recent falls are equally likely.

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In relative terms, corporate credit remains attractive as investment grade spreads seem interesting when looking at the likely rate of defaults. A similar argument can also be made about high yield. High yield debt has always shown a stronger correlation to equities than government bonds and therefore the improved growth outlook is a positive for this asset class.

Property

The REITs / property securities sector is sensitive to interest rate movements and expectations and as the Federal Reserve's decision to increase interest rates in December and March was widely expected, it had little impact on the asset class – it will be interesting to see the reaction of the sector if the anticipated three rate rises happen this year. All discussions about interest rates and monetary policy are likely to be key drivers of this sector's performance over the coming weeks and months, perhaps even more so than fundamental economic factors.

The impact of the UK's vote to leave the EU on the direct UK commercial property market continues to lessen following the initial negative reaction. All the previously suspended UK direct property funds have re-opened and there have been either large reductions in, or removals of, the market value adjustments, suggesting a large degree of return to normality, although funds are holding higher cash balances than usual in the short-term and purchase activity has been very light.

It would appear that the fundamentals of the asset class have not changed that much, but there may continue to be a valuation impact on those properties, sectors, regions that have seen the highest price rises over the last few years, which would include central London. To counter this, the large fall in the valuation of sterling versus overseas currencies makes property more attractive to overseas investors and there has been anecdotal evidence of overseas buying. Returns are expected to remain reasonable in 2017 but with absolute returns much lower than recent years. Returns are increasingly likely to be driven by income with capital growth very limited or negative and rental growth becoming an increasingly dominant factor for performance. This asset class remains a solid option for income seeking investors and for diversification purposes but there is increased concern about the asset class' underlying liquidity given recent events. The yield gap for secondary markets versus prime property remains attractive but individual property selection will remain important here.

Summary

With strong overall market growth in 2017 and better soft data, which is continuing to improve, the broad outlook is more encouraging but this view anticipates that the pro-growth policies of the new US regime will come into place over the coming cycle. This is a large assumption given what we have seen so far. Market participants are hoping that the threats issued by Trump are merely that, and an opening shot in a bargaining process from a businessman rather than diplomat or politician, with the aim of securing fairer trading relationships for the US. The former Governor of the Bank of England, Mervyn King, in his recent book 'The End of Alchemy' stated that investors are now in a world of 'radical uncertainty'. In other words in an age of disruption in many facets of life it is harder, if not virtually impossible to forecast the future with confidence. No investor has lived through circumstances similar to those which have occurred post the GFC and the potential for extreme outcomes or what investors call 'fat tails' has increased.

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This is perhaps a time to focus on sentiment, valuations and fundamentals. Sentiment for the markets is positive and is occurring after a long bull market when valuations are relatively full. Whilst growth fundamentals are improving, monetary policy is likely to tighten to some degree. The prospects for equities continue to look more positive than for government bonds, providing extreme outcomes are avoided.

The most likely environment for markets is that the rise in interest rates will not yet derail the bull market completely, as the most extreme Trump policies will not happen. This also makes the assumption that China will not implode in 2017 and the EU stays intact following the UK's departure. Investors should focus on a more fundamentally driven market which is moving into the late cycle earnings phase. It is likely that overall PE valuations start to fall back, or in other words, market gains this year will not match earnings growth as the market will de-rate. This could be a 'muddle through' year with heightened volatility, and holding some cash for market setbacks and avoiding big positions seems prudent.

Successful investment is more a risk management game than the ability to forecast the future where crystal ball gazing rarely produces success over longer time periods. In today's environment investors should proceed with caution and hold pragmatic diversified portfolios, accepting the possibility that future events could necessitate a rapid change of tack. Investors should remember over time a 'back to basics' approach concentrating on fundamentals, sentiment and valuation should result in winning through fewer mistakes being made.

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