KING SHAXSON & PhillipCapital | 1866-2016: Celebrating 150 years

Fund Managers Report 5th October 2016 to 5th April 2017

The Vintage Year – part II

The last half year has seen a strong rally in global equities (MSCI World Index returned +10.72% in sterling terms over the above period, source Bloomberg) building on the foundations of the strong previous half year. Against this we have seen losses in the bonds markets with negative returns in the FT Sterling bond index of 3.08%.

Economic Growth Continues

Since the US elections the US equity market has rallied and this has led to some to conclude that the growth programme and tax reforms proposed by President Trump have driven stock prices higher. Simultaneously, those bearish to US stocks have pointed out that the market rally is in danger if he does not succeed. We regard this analysis as a little lazy as this flatters politicians. Our view remains that there is more depth to the US and global economy and the recovery than meets the eye. Likewise, the distinct change in political tone, which is in sharp contrast to the previous gloomy narrative, has just brought a significant degree of confidence forward in both the UK and the US.

Economic growth has just been upgraded by the IMF and it is positive in all the key global regions with the US and UK leading the charge at 2.3% and 2.2% respectively. Growth is also expected to remain firm in 2018. With the exception of the Eurozone (where unemployment is still an unacceptable 9.5%) unemployment is below 5% in the other regions (source The Economist 12/4/17).

With this backdrop we would expect to see interest rates begin to rise. This is already underway in the US and the Federal Reserve are managing market expectations very well. We do not anticipate any changes in the UK as there is already enough uncertainty around the General Election and Brexit. Likewise China and Japan have debt issues that will keep rates in check. Europe is still in the process of aggressive QE, the lack of serious economic reform in many Eurozone countries leaves the European Central Bank and QE as the only option for stimulus. The problem is this is not the solution and it is damaging the European banking system, it is nothing more than a short term fix with long term complications. This means we only realistically expect interest rate rises in the US. Another 3 rises this year are already priced in the market.

The biggest economic risk is the other part of monetary policy and this is beginning to be discussed (there was a good article in the Wall Street Journal 3/4/17), and that is how the central banks begin to reverse their bond buying programmes that underpin QE and shrink their enormous balance sheets. As the first out of the crisis we expect the US to lead the way and Federal Reserve in the US expanded their balance sheet by $3.5 Trillion (from $1Trillion to $4.5 Trillion). There are expectations that this process will begin in the autumn and whilst it should be orderly with plenty of warning (as it has been with the interest rate rises) we see this as the biggest risk to markets.

Inflation is going to rise, especially in the UK after Sterling's 20% decline, and to some extent this is no surprise. To some degree this is a welcome return to normality and will help with debt levels, on the other hand it will hit the already hard squeezed majority in the UK. We are now seeing both cost-push inflation, driven by rises in the minimum and living wage (something we also feel is good for the economy) or by higher business rates and other government charges and business rates. There is also some demand pull inflation with shortages in some vegetables that have made the headlines. However oil and currency remain the key drivers for inflation. The oil price remains under pressure and we see no major reason for the oil price to rise too sharply as US shale has taken the market power from OPEC. This will help temper global inflation as it rises with the economy. Since the depths of the financial crisis we have been adding index linked exposure to portfolios with strong performance seen. As the inflation story now materialises we wait to see whether inflation continues to catch on or begins to moderate.

The seismic changes we have seen in the global political landscape over the last 12 months have generated a lot of noise. We now have a UK election in June, 2 years of Brexit talks and we are only a few months into a new style of US government. Add to this the fact we also have elections in France and Germany which already guarantee a change of leadership in France and may well mean the UK will be discussing Brexit with different and material leaders. A communist party convention in China in the autumn will lead to them becoming more domestically focussed and political. All in all, we have another year of noise and change.

We have to make investment decisions based on facts and expectations. A key fact remains that we still have very few hard facts about Brexit. With the key European leadership changing and distracted by domestic politics, we expected little to change and stick to our view that both sides are so important to each other we will get a pragmatic deal in the end.

It seems business is also taking the same view, and as the increasingly integrated global economy continues to recover we expect to see more business investment regardless of the noise from the media, and as we have seen with Facebook, Nissan and Google, the UK remains the destination of choice. In fact our biggest irritation, by far, remains the copious volumes of nonsense we have to hear each day, not only from tabloids and low grade politicians, but more so from the business media and more respectable press.

And that is how we feel markets will develop this year, there are a number of flashpoints, the next being the first round of the French Presidential election on April 23rd , yet despite these the global economy looks set to speed up a little and this should underpin the markets over the year, even if we get the odd wobble.

Portfolio Changes

We have continued to reduce fixed income exposure as the outlook for this asset class remains neutral at best. The issue is less about rising interest rates and steepening yield curves (that means higher longer term interest rates) but more about the expected changes in Central Bank policy. Demand has been inflated by QE and Central Bank buying and we expect this to reduce at a time in the economic cycle when demand for bonds would naturally fall. The reduction in demand will not be matched by a reduction in supply as governments invest in infrastructure, so we see more risks than usual for this asset class and have reduced portfolio exposure to fixed income. We have also reduced duration by selling longer dated bonds (that have larger price swings) in favour of more stable shorter dated paper.

To replace the income and to keep portfolios diversified we have increased property and infrastructure exposure slightly. We used the post weakness for REITS to add to this sector (if ethics permitted) buy to more London focussed REITS. The bulk of our property exposure, however, remains in more ethically focused areas of care, health and social infrastructure.

We have also increased equity exposure as the economic outlook improved, and this is noted in more detail below. Shortly after the valuation point we began to take some profits and reduce risk a little, although asset allocation to equities is still higher than a year ago. In the short term we enter a period of elections in the UK and France, as well as company reporting season. In addition it is also the time when we undertake some portfolio micromanagement, making new tax year ISA subscriptions etc. if appropriate, so in the very short term we do want to have some cash to enable us to take advantage of any opportunities that arise.

Outlook

We feel the global recovery is picking up steam and therefore remain positive in our outlook. The risk is no more geo-political than economic, and we do expect markets to get buffeted by some key events, stating with elections in late April.

From an ethical perspective we are taking a keen interest in the CEO pay rounds. Having seen some success a few years ago (we voted against Andrew Moss's package at Aviva) we are now seeing a much more aggressive stance being taken again this year by a number of shareholder groups. This will make for a far more interesting and dynamic AGM season this spring. We subscribe to advice services in this sector and intend to vote for change where it is needed.