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Fund Managers Report 5th October 2017 to 5th April 2018

This will be our last half-yearly report, we will now produce full reports every quarter and the next report will be the 30th June. We send out a brief monthly report, by email, to all clients who wish to receive it and portfolios can of course be viewed online.

A number of the risks we mentioned in our last report materialised over the last six months, both in the general market and in the more specific ethical investment space. This led to equities and bonds producing a small negative return over the period.

It was in fact a period of two halves, there was strong optimism in to the year end and early January, with equity markets peaking in late January. Much of this rally was driven by the FAANG stocks: Facebook; Amazon; Apple; Netflix; and Alphabet (aka Google), which with their large capitalisations now dominate US and global equity markets.

This trend turned very abruptly in February as the fears centred on trade wars and interest rates began to rise. This led to a very sharp correction in February and a more volatile market since then. We will examine them in turn:

Risks and Opportunities are rising in a number of areas

Trade

Fears of a US-China trade war escalated in March after the US announced their long awaited tariff threats. As always, whilst there are some rights and wrongs in the arguments, markets prefer unfettered free trade and dislike uncertainty and have reacted. The real question amid the bluster is where the new lines will be drawn and right now this remains uncertain.

The main issue with Brexit is that we are only half way through the process. The markets have developed immunity to the news as, put frankly it's been nothing but a continuous stream of hot air. We have another year of the same but expect things to heat up as we get closer to the real facts towards end of the year. Unwinding 40 years of partnership remains a difficult process and had we not voted for Brexit we would expect the UK economy to be much stronger, with interest rates probably a little higher. Ironically the Brexit slowdown may actually be helping the markets.

Politics

UK politics had a far bigger impact than Brexit on UK equities, in particular on the income generating utilities, infrastructure and public transport sectors. Many equities in this area were hit hard after the UK election raised uncertainty over the lifespan and makeup of the current UK government. These fears have now abated, but we expect the recovery on UK government sensitive equities to remain subdued for another year.

The renewable energy sector had weathered the US government's actions to help coal and oil, but it was the tax reforms that had an unexpected sting in their tails for the sector. This coincided with delays on market reform in India, which has become the key market in renewables, led to an impact on wind turbine stocks. The tax reforms in the US will provide a short term boost, but begging the outstanding question as to whether this will give the economy enough of a boost to absorb the higher tax (and interest) rates that will come later. We see this as a calculated move, that we suspect may pay off, and therefore see the main political risk from the US as trade and geopolitics.

The German election results were worse than the UK's, with Merkel's government taking four months to form a three way grand collation, but this was of little consequence to the markets. The main risk has moved to Italy which has a government that has made breaking a number of Eurozone budgets its policy. This will lead to noise and friction, but little more in our view.

Political risks have bitten both the general market and specific ethical areas (notably renewable energy, public transport, water and waste). We feel this is now fully priced into the markets and if anything may have peaked providing opportunities rather than threats.

Debt Risk

The normalisation of the US debt market continues as the Federal Reserve slowly and steadily reduces its balance sheet. The most significant change has been the shift in interest rate rise expectations in the US, rates are now expected to rise a little further and faster, peaking now at 2.5% in 2020. This has featured more as an excuse rather than a reason for the correction in US equities, but the current strength in the US economy leads us to expect higher US rates.

We see a UK interest rate as also imminent, whist in Europe the end of aggressive QE is anticipated. The future leadership of the European Central Bank will come under discussion in the near future as Mario Draghi's term expires at the end of the year. This is always a highly political affair that will determine the future pace of Eurozone normalisation. The European economy has been growing strongly as it catches up with the US and UK. Unemployment is still too high but a normalisation of European monetary policy will signal the final return to standard.

With this in mind we remain cautious to fixed income as economic growth and the end of abnormal demand from central banks will change the landscape for this asset class.

Economic Growth

We continue to see all G7 countries enjoying sustainable economic growth with expectations for 2018 having edged higher ranging from 6.6% (was 6.4% in April) in China to 1.4% (was 1.2%) in Japan. The UK expectations for 2018 are at 1.6% growth even with all the Brexit noise and the Euro area now stands at 2.4%. If anything we feel these numbers may be too low.

Portfolio Changes

We sold some of the investments that had been hit hard by the political risk in the UK, mainly Go-Ahead Group and United Utilities, but also National Grid where income was less of issue, and later GlaxoSmithKline where held. We also trimmed Target Healthcare as a property investment, to reign back some of the exposure we built up earlier in the year with Triple Point Social Housing and the PRS REIT. We shifted the focus towards growth investments adding to Vestas Wind Systems, Renewi, Svenska Handelsbanken, SAP, Vodafone and the new Siemens Healthineers.

We also added the latest IFFim bond issue, a US$ floating rate note, where the income will rise with US interest rates. We see this as a better low risk (AAA rated) option than fixed income bonds in a rising interest rate environment.

Outlook

The volatility and negative market returns of the last 6 months have led to a more cautious and in our view more sensible valuation from the market. By May a number of investments will have reported their annual results and provided up to date outlooks. Given the improving global economic outlook, expectations are still high, but also tapered from where they were in February. In the meantime we continue to contend with trade barbs, Brexit noise and political concerns. This leaves us more optimistic for the midterm, but also anticipating some more volatility in the short term.