LGT vestra

LGT Vestra Quarterly Report

Q4: October 2017

Macro summary

It has been a horrendous year thus far for many innocent men, women and children. There have been ISIS inspired terror attacks, the Grenfell tower fire, hurricanes, earthquakes and as we enter the final quarter of the year, the worst mass shooting in US history. Our first thoughts and sympathies are with the victims and their families and friends. Despite these terrible events and a number of potentially damaging geo-political developments, equity markets have been relatively benign for investors as can be seen in Figure 1. The Korean nuclear tests caused some alarm and a lot of sabre rattling in Pyongyang and Washington, but the volatility in markets was short lived. In Europe, Mrs Merkel has retained the leadership but will have to form a new coalition following the German election. In Spain, the Catalans are threatening to declare unilateral independence. Closer to home, the fall-out from the UK election and the Brexit negotiations continue to make the outlook uncertain.

In general, economic data has been positive and the second quarter earnings season was better than expected. The stronger data means that the central banks are looking to withdraw some of the supportive measures they put in place after the financial crisis. In the UK, the governor of the Bank of England (BoE) has indicated that they may reverse the rate cut that was put in place after the Brexit vote as soon as November. The BoE have a difficult task balancing the impact of Brexit with generally better than expected economic numbers. However, central bankers on both sides of the Atlantic appear wary of unsettling markets and are likely to be slow making changes.

Figure 1. MSCI World Local Index

Source: MSCI

Hurricane Harvey and Irma hit two of the most economically important states in the US. While the damage and hardship for individuals has been significant, they will rebuild and in the long term, the economic impact may be relatively short lived. However, the data in the months to come will be skewed by the hurricane season, making the economic progress in the largest economy in the world difficult to analyse. The emergency funding required for hurricane relief did make it possible for Trump and the Democrats to agree to extend the debt ceiling until December. However, this is just delaying the inevitable fight in congress over approving a budget. Trump's repeated attempts to reform healthcare have failed and this has delayed his plans for tax reform and infrastructure spending. Progress on this could see a return to the Trump trade that saw materials and financial stocks rally in the final quarter of last year.

When we look at the UK investment markets, we cannot ignore the Brexit negotiations.

There is an impasse with the EU, who have stated they will not begin trade talks until a divorce bill is agreed. The UK refuses to agree a bill without discussing a trade deal. Both sides want to get a deal that favours them and, as with most EU negotiations over the years, this may go on until the last minute or beyond. Despite this, with better than expected data and the BoE talking of interest rates going up, the pound managed to recover some of the post Brexit vote losses. Following the ill-conceived election campaign, Theresa May was left looking like a lame duck Prime Minister. Her unfortunate party conference speech more recently has raised further questions. At a time when the country needs strong leadership, speculation about Theresa May's future is likely to continue.

As we reached the end of the quarter, the political landscape continued to prove volatile. Escalating tensions on the Korean peninsula were sparked by repeated missile tests by North Korea. What makes this situation particularly concerning is the nuclear threat and the possibility of a fractured relationship

between Washington and Beijing. The Chinese are North Korea's principal source of trade and oil supplies and are the most effectively positioned to deal with the threat. Whilst we continue to believe that a military solution is in nobody's interest, this cannot be completely ruled out given the unpredictable nature of the leaders involved. Surprisingly, the South Korean Kospi index has marched on amidst these geopolitical problems, and was broadly flat over the quarter.

Elsewhere in Asia, the Japanese Prime Minister, following a recovery in his standing in the opinion polls, called an early election. His reform agenda has been key to supporting equity markets and his re-election would be a positive sign. We should hope that he has not fallen into the same trap as Theresa May.

At the close of the quarter, the Catalan vote for independence was deemed illegal by the Spanish government. The heavy-handed response to this by the police may bring into question the future of the coalition formed after the national elections. Catalonia is one of the wealthiest Spanish regions and a formal split would be bad for Spain and would encourage other separatist movements across Europe. Just when the European economy is beginning to look better, this is the last thing any national government would want.

Despite the various disasters and political uncertainties, we must remember that the economic data has been positive and we have seen earnings growth from many companies around the world.

Thus, the equity markets are likely to find continued support even after the steep rises we have seen over the last few years.

Fixed income

As we entered the summer months, the environment for government bond markets turned more volatile. Central bankers met earlier in June at a European Central Bank (ECB) conference in the Portuguese town of Sintra to discuss monetary policy. At the conference, the tone coming from policymakers was clearly more positive on global growth prospects and with that in mind, they indicated that a tighter monetary policy stance was warranted in the near term. Bond yields pushed noticeably higher as investors started pricing this in however a lot of this talk failed to translate into action. The Bank of Canada was the one central bank who followed through on their rhetoric as they hiked interest rates twice over the quarter from 0.5% to 1%.

The ECB language that led German bond yields to their 18-month highs was eventually toned down as currency markets came into focus. Investors brought forward their expectations of tapering and the eventual rise of interest rates. This, combined with a more stable political environment, led to a sharp upward correction in the trade-weighted euro. Such a quick upward move in the currency is likely to be a drag on inflation thus warranting a more sanguine outlook on monetary policy. The central bank indicated that it would announce its plan for tapering its asset purchases in 2018 at its October meeting, which could induce further volatility in Eurozone government bond markets and beyond. In a sign of further strength, Standard & Poors upgraded the sovereign rating of Portugal back to investment grade, which led to a sharp compression in yield spreads between their debt and that of Germany.

On the political front, the election in Germany led to a more challenging outcome. Whilst Angela Merkel's party remained the largest party, they lost many votes from their electorate. It was a similar story for their coalition partner, which prompted them to announce that they will now move into the opposition. The far right AfD party gained in the election making it the third largest party. With this fragmentation, the most likely coalition will involve making a deal with the Free Democratic Party and the Green Party. Considering the middle ground that these three parties will have to find, it is unlikely that Germany will continue to seek

further integration in the Eurozone despite a move in that direction in France. This election only took place at the end of September so the longer-term effects on markets are still too early to tell but the euro fell modestly as a result of this obstacle.

In the US, the Federal Reserve (Fed) was able to steer towards their pre-set course. After setting out the plans for reducing their balance sheet in June, they announced that they would implement this strategy imminently at their September meeting. The wind down will start at a modest pace, with a reduction of reinvestment by $10bn a month. This is intended to gradually accelerate to a maximum of $50bn a month. Considering how well they flagged this to investors, the market reaction was muted, but their outlook on future interest rate increases was more aggressive than anticipated.

During the summer, the mainland United States was hit by a series of hurricanes, which brought significant destruction and disruption to major population centres. Taking into account the scale of the damage, investors had expected the Fed to remain on hold whilst they assessed the impact to the wider economy. Much to their surprise, the Fed retained a resilient tone and indicated that the rate hiking cycle should proceed as envisaged. This pushed two-year US Treasury yields to their highest level since 2008 whilst longer maturities still remain a fair bit below the higher levels that we saw earlier this year.

As the inflation prints were more subdued over June and July, the hawkish rhetoric from the Bank of England (BoE) faded as this tempered the rationale behind changing interest rates.

Although gilt yields moved gradually lower over the summer, this fall was short-lived.

In September, the BoE voted largely in favour of keeping rates unchanged but they noted that they see scope for tighter monetary policy. The subsequent reaffirmation by some of the more dovish members put further pressure on gilts. Despite a potential large shock to the economy in the form of Brexit, it has become increasingly difficult for the BoE to justify such a loose policy stance considering the multi decade low unemployment rate at 4.3% and an inflation rate of 2.9% as measured by CPI. Earlier in the year, the central bank reduced its estimate of the natural rate of employment from 5% to 4.5% to give itself more room to keep policy unchanged. As the labour market has tightened beyond that, it would have weighed on the credibility of the BoE if they continued to toe the line. With its credibility re-established, gilt yields rose to 8-month highs (Fig. 2).

Figure 2. UK 10y gilt yields year-to-date

Source: Bloomberg

Corporate bond markets continue to see strong inflows into the asset class despite a compression of the premium offered over equivalent government bonds. The seemingly global synchronised activity uptick, with steady but unspectacular growth, is supportive for corporate bond investors. This has kept default rates outside challenged sectors at very low levels, justifying to some extent the compression of premiums. As the ECB continues to operate a negative interest rate policy, retail investors are trying to find a home for their cash with the corporate bond market being the next best avenue for low risk investors. The market is also supported by the purchase program by the ECB but this is likely to reduce in the next year.

Equities

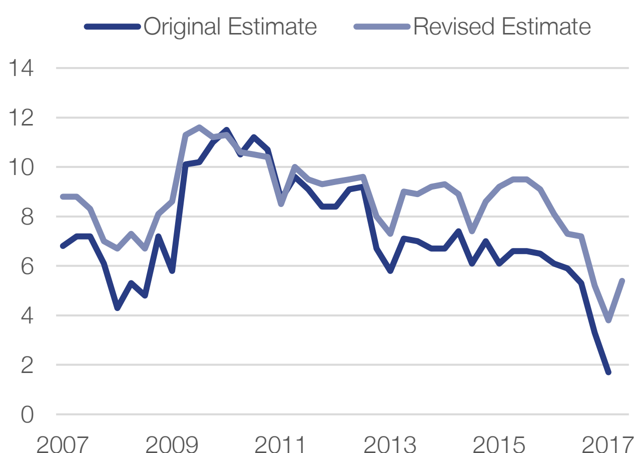
UK Equities

Close observers of the UK stock market had plenty to focus on in the three months to 30th September. The

FTSE All Share index was up 2.1% in total return terms, and this took the year to date gain to 7.8%. However, during the period in question there were a number of high profile profit warnings. The share price of the consumer credit firm, Provident Financial, plummeted by more than 60% during a single day in late August. Investors reacted with horror to the combination of a profit fall, a dividend cut, the resignation of the CEO and a regulatory investigation. There were also warnings, and large share price falls, from Carillion, Interserve and Dixons Carphone among others.

We have been concerned about consumer names like Dixons for a while and our fears appeared to be fully justified by the 'revelation' earlier this year that the UK savings ratio had fallen to a 40-year low. Ironically, however, the last quarter saw sweeping revisions to UK National Accounts data, and the resulting numbers suggest that UK households are in a better financial position than previously thought. Specifically, the UK savings ratio for the first quarter was revised up from 1.7% to 3.8%, while the savings ratio for the second quarter was recorded as 5.4% - the highest figure seen since Q3 2016. The scale of the revisions was noteworthy, as it suggested that UK households are not as beleaguered as many feared, but it has not pushed us into a major reassessment of UK consumer opportunities.

Figure 3. UK savings ratio



Source: ONS

We remain concerned about structural threats from Amazon and other fleet-footed online competitors, a general slowdown in the UK economy and an inflation-led squeeze on real incomes.

Many commentators suggested that the fall in the pound after the Brexit vote would boost the UK's export prospects. The suggestion therein was that this would be an offset to pressures elsewhere, but that has not materialised thus far. The new National Accounts data mentioned above saw the UK's current account deficit for 2016 revised from 4.4% of GDP to 5.9%.

Budget deficits have been a feature of UK life for some time, but that does not mean that there are no ramifications. In the words of the Bank of England Governor, Mark Carney, we rely on the "kindness of strangers" and that means that the overseas enthusiasm for UK gilts can never be taken for granted. At the end of August, UK public debt hit a new high of £1.77 trillion. The rating agency Moody's duly downgraded the UK's debt rating in late September 2017 and they stated that they were 'no longer confident' that the UK Government will be able to secure a free trade agreement with the EU that will compensate for the negative economic impact of Brexit. They pointed out that even a best-case scenario will not give the same access to the single market that the UK currently enjoys. It will likely involve additional costs, more red tape, and put at risk close-knit supply chains linking businesses here with the EU.

A look back on previous quarterly publications from ourselves will serve as a reminder that this is very much the message that we have been giving for some time now. With UK politics also looking more problematic, our emphasis continues to be placed on the safety and solidity of large multi-national companies with diversified earnings streams, and UK stocks that have safe and secure income streams.

International Equities

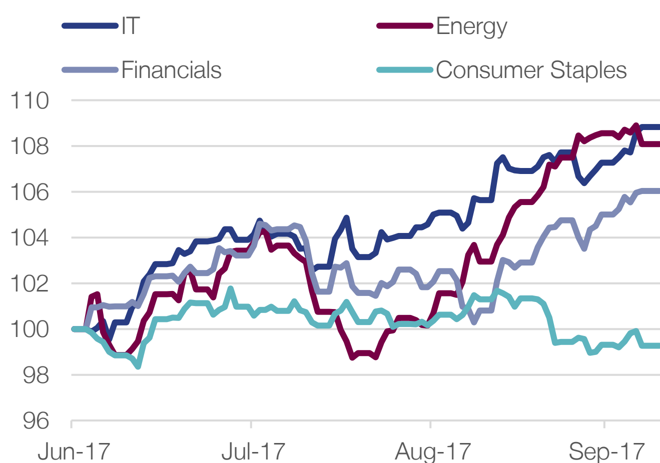
There was no let-up in the strong moves of global markets over the previous quarters. The S&P 500 rose

+4.5%, the Topix in Japan +4.7% and Europe was +4.1% in Q3 2017. Emerging markets once more led the way with the MSCI Emerging Markets index rising +7.7% over the three months to the end of September.

The impressive rise in technology shares continued once more though and much like in Q2, some of the gains were given up in the final month of the quarter. The MSCI ACWI IT sector rose +8.6% QoQ. The next best sector, snapping previously poor performance, was Energy as crude oil stocks drifted higher and oil stockpiles moved further down. It rose +7.9% over the quarter.

US financials were pushed higher in Q2 as the US Federal Reserve signaled their rebuilding of capital was re-done and that banks were allowed to return 100% of 2017's generated capital to shareholders. This continued in the third quarter of the year with US financials +4.9%, while global financials +4.4% also benefited from generally improving global economic sentiment. By contrast, the once leading MSCI ACWI Consumer Staples sector actually fell -1.1% in Q3 as organic growth continued to stagnate and US bond yields moved higher (Fig. 4).

Figure 4. MSCI Sector Performance in Q3



Source: Bloomberg/MSCI

Earnings in aggregate were good, and we continue to see the best opportunities for high quality long-term compounding companies in the US where the rise of the internet has created some of the largest oligopolies since the US railroads.

Alternative investments

Hedge Funds/Targeted Absolute Return

Targeted Absolute Return strategies continued to post positive returns in the third quarter of 2017. Best performance has come from long/short equity managers, up around 7%, followed by event driven funds. Whilst equity strategies benefitted from overall market moves, most of the managers profited from stock selection, with stock dispersion remaining high within the market and within sectors. Leverage and net exposure have remained modest during this period, indicating that managers have not increased risk. Within the event driven strategies, the number of large mergers have reduced considerably in the last quarter. In addition, the total number of US deals are low at 45% of the global universe. This can be attributed to uncertainty surrounding US tax and general government policy.

As growth firmed across all major economies, it is becoming evident that there will be a convergence in Central Bank policy. This has driven a reversal in bonds and currency markets during the year, and in general continues to be a difficult environment for macro trading. Systematic trend following strategies had a decent quarter with positive returns from equities offsetting losses from rates and currencies. Multi-asset absolute return funds, as expected, had a more difficult quarter with gains from equities offset by the negative performance in bonds and increasing correlation between the asset classes.

Our outlook remains broadly unchanged and we expect the strong performance of long/short equity and event driven strategies to continue.

Overall, we believe an allocation to non-traditional strategies in a diversified portfolio is appropriate at this time given the shift in Central Bank policy. As economic growth continues, the high valuation within equities and bonds offers a better opportunity for stock pickers. Although growth is firming, the level remains below historic norms. Therefore, companies will have to grow via mergers and acquisitions, which

should lead to a continuing positive outlook for event driven strategies. Deal and regulatory risk remains high and so the preferred option is a strategy with strict risk controls. We remain less optimistic for the outcome for multi-asset funds as the correlation between asset classes is increasing and the expected return is lower than the last two years. Although we do not expect the fortunes of macro funds to dramatically change, the indication that central banks will raise rates and reduce their balance sheets should provide a better trading environment.

Property/Infrastructure

Real estate and infrastructure assets delivered positive returns for the quarter. However, the returns in some UK listed infrastructure were weak at the end of the quarter, following concerns raised during the Labour party conference on the possibility of nationalising utilities and turning back the clock on PFI investments. The twin deficit of UK public finances make it difficult for any new government to fund their fiscal policies. These may be vote winners but in reality, they are hard to implement. However, we cannot ignore this threat entirely, as an irrational government policy can become reality.

Post the Brexit vote, we saw foreign investors flock to the UK commercial property market to benefit from the weak sterling.

UK listed real estate investment trusts (REITs) have used the opportunity to reduce debt by selling to foreign buyers. These REITS are trading at below their net asset values; however, we need to view these discounts with caution. Anecdotally, we are hearing that transactions are going through at a discount. Assuming this is correct, this would appear to be the first transactional evidence of a softening in values and therefore the discount on the REITs may not appear as attractive as the initial optics suggest. As yields increase, the cushion between property and bond yields looks less appealing.

Within the commercial property segment, we continue to prefer the specialist segments of the market like storage units, long lease assets and healthcare properties. However, we would caution that investors need to be discerning on each individual investment. As investors have moved up the risk spectrum, some of these listed entities are trading at premiums that do not justify the capital growth outlook. In the residential segment, there appears to be a rebalancing of prices within the country, with South East prices falling whilst the rest of the country is still seeing growth. The supply/demand dynamics coupled with the current minority government's commitment to readdressing the property imbalance means that prices are expected to remain range bound in the medium term. The higher end property prices may continue to see softness as the weak sterling support from a year ago fades.

We remain cautious on US listed real estate as the rising bond yields coupled with changing GDP composition creates pressure in the space. However, the European property segment remains attractive as the region's economic outlook is showing signs of revival and valuations do not appear extended.

Listed infrastructure will likely see short-term pressure as bond yields increase. However, debt levels in these companies are not excessive as they were in the period before 2008 and as long as the economy does not reverse, the safety of the return stream remains a compelling investment case.

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The market views herein are drawn from the minutes of the LGT Vestra LLP Investment Committee which meets on a monthly basis.

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