LGT Vestra Quarterly Report

Q3: July 2017

Macro summary

Following the attack on Westminster Bridge in March, the last three months have seen further distressing events with two major terrorist attacks and the Grenfell Tower fire foremost in our minds. Our first thought is for all those who have been affected by these tragic events. Apart from these sad events it is politics that has once again dominated the headlines. Despite the political noise we need to remember that equity markets have an ability to look through unexpected events.

Markets have performed relatively well over the Brexit vote, Trump's election victory and an inconclusive election in the UK all of which might have been expected to cause an upset in financial markets.

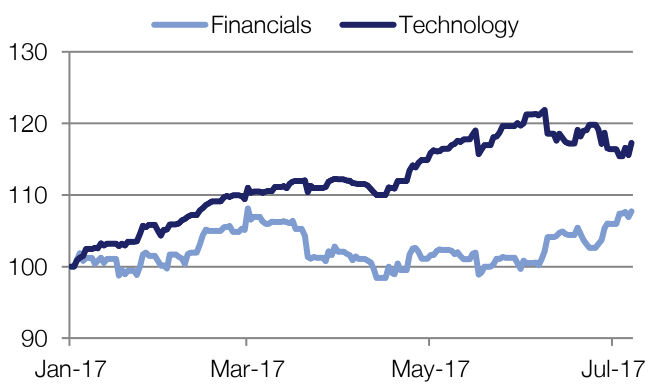
After the political surprises of 2016 we were looking for possible political upsets this year, with concern focused on the rise of populist parties across Europe particularly in Holland and France. However the second quarter of the year produced a political surprise from an unexpected source when Theresa May called an election in the UK. The attempt to achieve a strong mandate for Brexit negotiations backfired, as Jeremy Corbyn performed much better than expected. We are left with an uncomfortable coalition between the Tories and the DUP at the cost of £1billion extra spending on Northern Ireland. This makes Brexit negotiations harder and leaves Theresa May as a lame duck Prime Minister being undermined by her own party. This is undoubtedly not a good position to be in but it appears that it may result in a softening of austerity measures, and an attempt to get a less hard Brexit; the latter may provide support for the economy and the pound.

In the French presidential elections, the rise of a relative outsider, Emmanuel Macron, to the presidency was a surprise of a more welcome kind. With his new party En Marche gaining a substantial majority in parliament we may at last see some progress on structural reforms in France. In Europe we still have German elections later this year and possibly Italian elections before the year is out. These could pass off without incident but if the last eighteen months has taught us anything it is not to put too much faith in political predictions.

While Trump continues to talk big, he has failed to deliver on many policies despite a Republican majority in both houses of Congress. His revised healthcare bill is still not passing the Senate and his tax proposals are to some extent dependent on saving money on healthcare. The debt ceiling, which sets the amount of debt the Government can incur, will need to be extended by the end of September or it may force parts of government to close down. The negotiating around this will further constrain his ability to cut taxes and spend more.

Macron, Corbyn and Trump have little in common with each other politically. However they have all managed to use social media to great effect. Macron's party was effectively formed on the internet. Corbyn used social media to mobilise the youth vote and Trump's tweets have bypassed conventional media. In business, the internet is also having an impact with online retailers such as Amazon squeezing out high street shops. It is the growth stocks in the tech sector that have led the equity market higher this year. However, towards the end of the quarter they ran into some profit taking as comments from central bankers resulted in higher bond yields that meant money started to flow back into financials (Fig. 1). This was further supported by the US Federal Reserve allowing an increase in distributions to bank shareholders.

Figure 1. S&P Financials vs S&P Technology



Source: S&P

After a first quarter in which economic expectations were exceeded there was some disappointment as economic growth failed to live up to high expectations. Equity market earnings have been generally positive however there has been a wide dispersion of returns between sectors.

Towards the end of Q2, the tone of central bank comments changed and as we look forward, markets are likely to be concerned about a change of policy. The Federal Reserve raised rates in June and is expected to do so again in December. Their next stage in withdrawing the post financial crisis support will be to see a balance sheet reduction. Federal Reserve Chair, Janet Yellen has indicated that she wants this to be as dull as watching paint dry. They have been successful in avoiding disruption to asset prices with the last three rate rises. Recent comments from some Federal Reserve members suggest that asset prices may be somewhat overextended. Similarly in Europe better economic data means that the European Central Bank (ECB) will be looking to scale back its support in the coming months.

The Bank of England Monetary Policy Committee did not move rates but this was on a split vote. Governor Carney has indicated the markets should be prepared for rates to go up if the economy is strong enough. However the rise in UK inflation can be seen as Brexit related and with real wages falling and uncertainty about Brexit persisting, we believe they will err on the side of caution and keep rates on hold this year.

After a period of strong performance for equity markets some caution may be warranted in the face of central bank actions, but in the longer run we expect equity markets to remain well supported.

Fixed income

The first quarter was marked by an improving global backdrop as survey data indicated a broad based pickup in economic activity. As we entered the second quarter, some of these indicators were not able to sustain the strong momentum. The confidence boost following the election of Donald Trump waned as his ability to execute policy appeared increasingly impaired. The firing of FBI director Comey and his subsequent testimony to the Senate has eroded some of the president's political capital but its longer term effects are unlikely to be known for some time.

The economic data from the United States was more of a mixed bag this quarter and kept investors questioning whether the lofty growth expectations baked into markets could be met. Nonetheless, the US Federal Reserve continued on its policy normalisation path with interest rates increased by an additional 0.25% in June which had been widely expected. The combination of these effects pushed short dated US Treasury yields higher over the quarter versus longer maturity debt where yields trended lower.

Political risks faded over the quarter but the power of politics to surprise has in no way diminished.

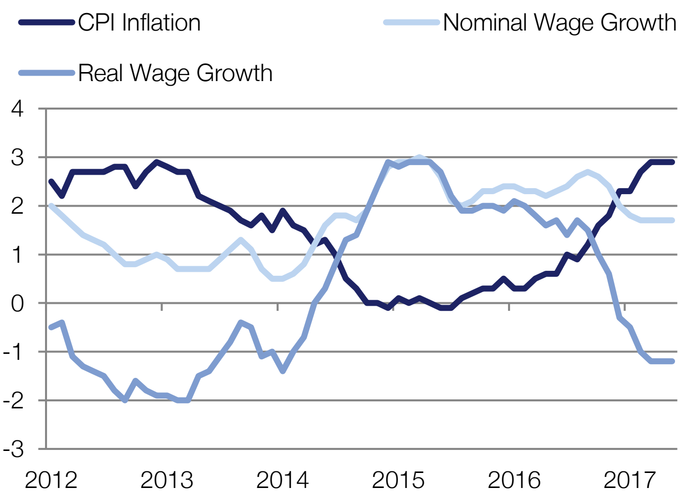
The all-important French election was seen as key to the Eurozone stability with the far right National Front leader, Marine Le Pen, pledging a "Frexit" vote if she got elected. In the first round of the Presidential election, most of the established parties were rejected with Le Pen and newcomer Emmanuel Macron receiving the highest number of votes. The majority of the polls predicted a 20-point lead for Macron in the second round so markets rallied in relief. The newly elected President is well known for his Europhile views so bond markets reacted quickly to price out the euro breakup premium that investors had previously demanded. This was particularly evident in French government bonds where the additional yield premium to its German counterparts fell from five year high levels back to ranges experienced over recent years. The UK was the unexpected political surprise in the quarter whereby a snap election was hastily announced and then concluded with a hung parliament. The impact was limited on the fixed income market as changes to fiscal policy are likely to be even more contentious.

Economic data in the Eurozone continued to point to higher growth levels however core inflation showed little sign of improvement. The ECB seems more convinced that "transitional" factors are holding inflation down. This should be less of a deterrent to keep monetary policy unchanged. It removed the reference with regard to lower interest rates and most recently hinted that it would adjust monetary policy as the economy continues to recover. This was followed by references indicating more comfort to raise interest rates by the Bank of England (BoE). This sudden change of stance towards interest rate policy took investors by surprise. Government bond yields, which had been declining for most of the quarter, rose quickly in response to these messages. Subsequent commentary from the ECB suggested that the market has misinterpreted the message but investors viewed the near synchronised "hawkish shift" as a reason to reduce exposure to government debt.

The change in tone by the BoE is especially surprising considering the recent economic trends. The central bank appears concerned that consumers are stretching themselves too much which poses wider risks to the economy.

UK CPI has continued to trend upward as the effects of the weaker pound are being passed through to consumers. Inflation has now reached 2.9% with wages unable to keep up. This squeeze on real wages has soured consumer sentiment and the household savings ratio has fallen to its lowest in 50 years (Fig. 2). The consumer is the largest component of economic growth so their limited savings and declining real wages are likely to have a sizeable impact on growth. The manufacturing sector has been boosted by the falling currency but is unlikely to take the slack up from the consumer. Hence we remain skeptical about their willingness and ability to raise interest rates significantly, if at all.

Figure 2. Squeeze on UK consumers



Source: UK ONS

Corporate bonds were well supported over the quarter. The strong backdrop maintained in the face of a reduction in monthly asset purchases by the ECB and the completion of the BoE corporate purchase program. The rejection of far right French populism by the electorate further supported risk assets. As this risk to the Eurozone project faded, investors felt more comfortable owning debt across the whole Eurozone. Peripheral and French corporate bonds were the largest beneficiaries of this improving risk tone with financial sectors outperforming. The financial sector in the periphery saw some significant developments.

In Spain, Banco Popular saw material outflows prompting an intervention by the regulator. Subsequently some of the bank's subordinated bonds defaulted and the business was sold for a nominal sum to Santander. The ability to impose losses on Italian bank bond holders is much more challenging as retail investors hold a lot of this debt. This makes it a politically sensitive issue. Nevertheless, two smaller banks were forced to merge with Intesa whereby the government pushed to shield retail borrowers from the worst possible outcome. Hence we would emphasise that this is a complicated area of investment where one must examine the structuring of the debt closely when investing.

Equities

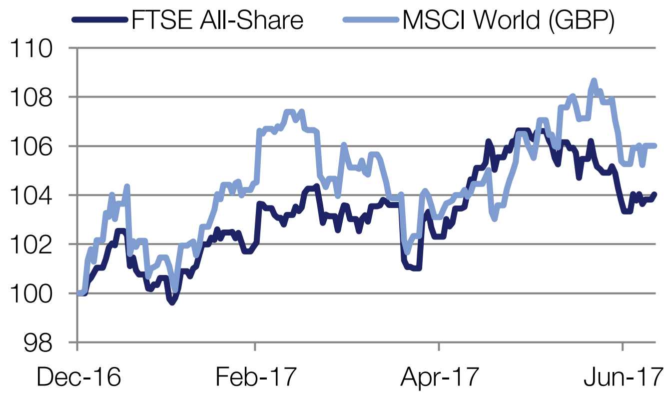
UK Equities

The outcome of the UK snap general election gave rise to a number of fresh questions about domestic and Brexit policies. Investors were also concerned about rising tensions in North Korea and the Middle East, and the confluence of events led to some profit-taking in the UK equity market in June, with the FTSE All-Share falling 2.7% over the month.

UK equities have underperformed their global peers this year. The MSCI AC World benchmark has returned 6% in sterling terms and the FTSE All-Share has returned 4% (Fig. 3). Specifically mid-cap stocks have underperformed the rest of the market. This was in part due to the UK election, which added to uncertainty for domestic earners, but it also reflected evidence that the UK consumer is feeling increasingly squeezed by the combination of rising prices and modest wage increases. Approximately 50% of earnings from FTSE 250 companies are generated domestically. Concerns on the relative health of the UK consumer were subsequently underlined by profit warnings from domestic retail stocks like Topps Tiles, AO World, and DFS. We have been concerned about such profit warnings for a while.

Our emphasis has been firmly placed on the safety and solidity of large multi-nationals with diversified earnings, and UK stocks that have safe and secure income streams.

Figure 3. UK equity market underperformance



Source: FTSE/MSCI

The global economy entered 2017 with the best growth momentum in some years and earlier this year, the global manufacturing PMI (or Purchasing Managers Index – a survey that assesses the health of order books, hiring trends etc) reached its highest level since 2011.

There was some ebbing in the 'pulse' of the global economy just before the start of the last quarter, but of late there has been a pick-up in survey data from the US and China. Global GDP estimates are rising again and there are renewed hopes that growth in the US will be boosted further by policy reform ahead of the all-important mid-term elections in 2018. A number of the UK companies that we favour will do well if global growth does improve and there will be an extra kicker if the US dollar begins to strengthen again.

On the back of post-Brexit vote currency weakness, dividend support has been solid with dividends from FTSE All Share Index constituents rising 13.4% in the first half of 2017. A further boost to dividends came from mining companies following the repair of their balance sheets. The broader picture was far more modest, however, and there were high profile dividend cuts from stocks such as TalkTalk Telecom, Cobham and Amec Foster Wheeler.

With ongoing threats, we continue to pick our way forwards with care.

International Equities

After three impressive quarters, the upward move in international equity indices continued further in Q2. In the US, the S&P 500 rose 2.7% whilst the CAC 40 in France rose 1.7% and the DAX in Germany 2.1%.

The impressive rise in technology shares continued although the technology-heavy Nasdaq index gave up half its quarter's gains in June to close +4.2% in Q2.

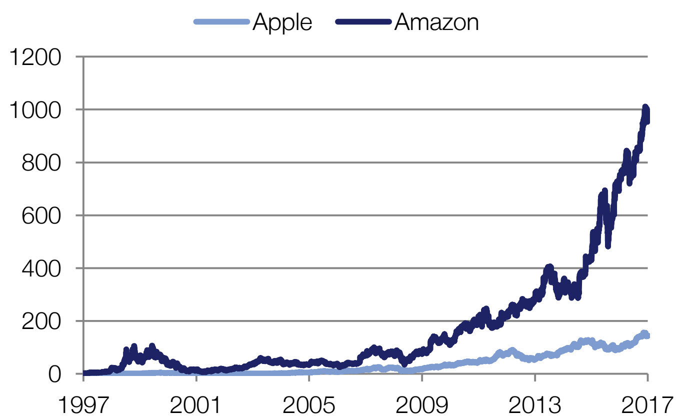
Global financials returned to leading markets whilst consumer staples stocks were not far behind. In the US, banks pushed on at the end of the quarter as the Federal Reserve signalled their rebuilding of capital was sufficient and hence freed up the banks to return 100% of 2017's generated capital to shareholders.

The big losers once again were energy stocks which followed a 5% fall in Q1 with another 5% fall in Q2 as the oil price continued to slide despite production cuts by OPEC nations being extended. US shale operators appear to be happy to take up the slack.

Healthcare stocks performed well, especially towards the end of the period when signs that the US government was going to clamp down on rising drug costs began to fade.

During the quarter we also saw two significant dates – the 10th anniversary since the launch of the iPhone and the 20th of Amazon going public. Apple is rightly lauded for producing the most successful ever consumer product, but it is easy not to realise the scale of Amazon's achievements. Revenues have gone from $16 million at the time of the IPO to $136 billion in 2016 (Fig. 4).

Figure 4. Apple vs Amazon share price



Source: Bloomberg

Compounding returns truly are the eighth wonder of the world. US equities are where we find most truly market-leading companies which we believe can compound away over the passage of time.

Alternative investments

Hedge Funds/Targeted Absolute Return

In contrast to the challenges of 2016, absolute return funds continued the positive trend established in Q1, with most strategies and managers now above their previous peaks. The best performing strategy within the absolute return universe continues to be event driven. In a low growth environment, companies have to innovate or consolidate and the premiums we are seeing in this current merger cycle are the highest since 2008. However, given at best fair equity market valuations and a strict regulatory environment, deal break risk has risen with a number of high-profile deals breaking down.

Many long/short equity managers are also having a much better time this year as the market pays attention to fundamentals again, creating better opportunities for stock pickers.

For most of the quarter, multi-asset funds continued a long run of benefitting from the positive performance of the asset classes in which many of them invest. This trend reversed in the last few days of the second quarter as bonds sold off although low to negative correlations helped mitigate losses of most multi-asset managers.

In spite of political uncertainties, asset class volatility remained low dampened by a decent earnings season and the US Federal Reserve's careful management of interest rate and balance sheet expectations. At one point in the quarter, volatility hit a decade low, making it difficult for many macro managers to make meaningful trading gains.

Looking ahead, with investor concern around valuation levels growing, absolute return strategies should continue to do well and attract assets. We continue to favour event driven and long/short equity strategies. The top-down environment for event driven has not changed and the return potential remains attractive. The stock dispersion within equity markets between style/sectors offers a wide opportunity set for long/short equity funds. Multi-asset funds will continue to be attractive, however, the reduction in return potential has to be factored in given our views for equities and interest rates.

Property/Infrastructure

Real estate and infrastructure assets continued to post positive returns for the second quarter continuing their strong performance from earlier in the year. However some of the gains in infrastructure were given back as bond yields rose.

The result of the UK snap general election is unlikely to provide a stable backdrop for UK real estate assets.

Whilst we remain cautious on UK commercial assets, the yield differential that exists between property and the bond market provides support for the asset class. We find the outlook for the residential sector equally opaque. The recent election campaign highlighted again the lack of supply of affordable housing. The government's help-to-buy scheme introduced in 2013 helped the UK economy recover. In summary, we believe that both sides of the UK real estate market are at a mature stage, suggesting potentially limited scope for capital growth. The attraction moving forward has to be based upon the income yield, recognising this itself could be vulnerable should conditions turn recessionary in response to political upheaval or any other factors.

European property continues to perform well in a global context. Yield compression is beginning to become a smaller component of capital growth as spreads tighten. Stronger demand and low levels of supply are supporting healthy income growth. Within Europe we continue to favour German residential, considering its attractive fundamentals. We see less attractiveness in the US REIT market, especially anything that involves investment in retail space which is really suffering in the face of changing consumer trends.

In the short term, infrastructure assets will continue to remain vulnerable if bond yields rise. However, on a longer term view the income generated by these assets remains attractive and should offer an inflation hedge that has a low correlation to equities.

Quarterly report contributed by:

Jonathan Marriott	Chief Investment Officer
Meena Lakshmanan	Head of Investment Solutions
James Follows	Head of UK Equities
Russell Harrop	Head of International Equities
Jeremy Sterngold	Head of Fixed Income

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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.

For further information please contact:
Esther Clark
T +44 (0)20 3207 8007
E esther.clark@lgtvestra.com

LGT Vestra LLP
14 Cornhill
London
EC3V 3NR

T +44 (0)20 3207 8000
F +44 (0)20 3207 8001
E info@lgtvestra.com
W www.lgtvestra.com

LGT Vestra US Ltd
14 Cornhill
London
EC3V 3NR

T +44 (0)20 3207 8000
F +44 (0)20 3207 8001
E info@lgtvestra-us.com
W www.lgtvestra-us.com

LGT Vestra (Jersey) Ltd
Charles Bisson House
30-32 New Street
St Helier
Jersey, JE2 3TE

T +44 (0)1534 786 400
F +44 (0)1534 786 499
E jersey@lgtvestra.com
W www.lgtvestra.com