

## *December 2017 Portfolio Review*

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So goodbye 2017 and welcome to 2018! Last year economies fared very well although it didn't feel quite so good in the UK: equities went up and bonds didn't have the bad year that growth can bring. A year ago, Donald Trump's victory in the US presidential election convinced many investors that inflation was finally due to stage a recovery, as the new administration in Washington would enact an aggressive programme of tax cuts, infrastructure spending and protectionist trade policies.

Such policies should have encouraged consumer prices to rise, by buttressing economic growth and raising the cost of imports. In anticipation of these effects, there was weakness in the price of bonds, the value of whose fixed payments is eroded by inflation, and a surge in so-called 'value' stocks that are seen as cheap and likely to outperform in such environments.

But inflation in advanced economies struggled to spring to life, largely due to a dearth of wage growth, partly as a result of the Trump administration's failure to register achievements in nearly all of these areas. Without a sustained increase in salaries, which could then be used to buy more goods and services, we are unlikely to see a persistent rise in inflation.

The risk of deflation – or falling prices – did recede this year, however, as global economic growth picked up, appearing increasingly synchronised across countries and regions.

Much like this year, we believe that the outlook for markets in 2018 will hinge on inflation. This, in turn will hinge on wages and productivity improvements in which can translate into pay rises.

There were a number of announcements in the UK Budget on steps to boost productivity. Taken together, they might have an impact over the medium to long term; none of them was particularly impressive, though.

The US, where a major tax overhaul is working its way through Congress, presents a stronger case for optimism. If provisions within the bill that increase the deductibility of capital investments remain in the final legislation, these may spur further spending on assets with a long life, which can boost productivity. This could also lift US economic growth by 0.2-0.5% over a decade.

While we continue to monitor the situation in the US closely, our central case remains that the world economy will not see runaway inflation in 2018. Against this backdrop, central bankers, who are tasked with maintaining price stability, can continue to remove stimulus measures at a leisurely pace.

The biggest risk to markets remains valuations, we believe, which are at or near record high levels and everything going so smoothly has led many to suspect it's the calm before the storm. This is understandable; post-war economic cycle lengths have averaged about six years while investment returns have tended to see flat-to-bad years follow a couple of good and vice versa. But cycles don't die of old age. Without some dynamic causing a downward shift, it's reasonable to expect that the global

economy will continue to move forward even as the current cycle enters its tenth year. So, what could bring the party to an end?

In our view, the two factors that could cause a slowdown in 2018 are a fall in consumer confidence and the continued effects of quantitative tightening (QT). If the former happens, it is likely to be in those regions where wage growth is low, consumers have already expanded their debt and – such as in the US and the UK – traditional businesses face yet more pressure from tech-based competition.

The rise in employment this year has brought a large number of people's spending power up. But as we hit "full" employment, the rate of employee growth slows. At this stage, one would expect wages to rise more quickly. But so far, in most regions, it hasn't happened to any extent. In our discussions with many analysts, we would characterise the consensus view on wage growth acceleration as "it hasn't happened yet but it will". But could structural issues in certain economies (such as Brexit in the UK and labour market issues in the US) be a constraining influence?

Consumer confidence in the US could be bolstered by the effects of President Trump's tax cut, and UK consumers could well beat the markets' low expectations, perhaps if Brexit uncertainties continue to clear up. Whatever the case, we are likely to see a divergence of growth rates across the globe, compared to the synchronised rates of 2017.

As for QT, the huge amounts of liquidity provided (by QE) since the financial crisis, has buoyed assets across all classes and underpinned global activity by keeping the financial system healthy. It's natural, therefore, that its unwinding might have the reverse effect, particularly in those areas most 'propped up' by the incredibly loose financial conditions. Residential property could be a prime example of this next year. The US Fed has already begun unwinding their asset purchases, and all else being equal they plan to speed this up next year. But, in our view, the more significant factor will be when the ECB and BoJ begin their own QT. The latter two central banks have collectively injected far more money into the global economy than the Fed over the past five years and, even if it's marginal, their tightening will likely have a bigger impact.

ECB members have already begun "forward guidance" on tightening toward the end of next year. This halting of asset purchases will be priced by markets well in advance. This may mean a tightening of general financial conditions. However, because ECB liquidity has flowed substantially into US assets, it would be as likely to affect the US, where financial conditions have been loosening despite the Fed's policy moves. We would therefore expect increased bouts of volatility, a distinct change from 2017.

How will the year play out? Well while business cycles don't die of old age, they tend to be heavily correlated with confidence levels – particularly in investment terms. Towards the end of the cycle, markets become exuberant and tend to approach the 'overheating' stage. That is, one can often tell when a crash is about to occur by the fact that everyone becomes massively overconfident. One of the striking things to note this time around, however, is that, despite equities trading at all-time highs with a year of strong synchronised growth behind us, markets appear to lack almost all confidence, with investors extremely worried about valuation levels rather than celebrating them. This tentativeness could make any sudden crash unlikely. It's possible that, with growth having moved sluggishly

upwards since the financial crisis, when the unwinding of this particular cycle comes it will be similarly sluggish.

## Monthly Portfolios Report

The close of 2017's figures shows some significant gains to investors' over the 12-month period. Risk-takers fared best with the higher risk portfolios posting gross returns of between 11% and 15% but even the lower risk defensive portfolios averaged a respectable 5%. Ethical investors were also rewarded with gross returns exceeding 13%.

Amongst the indices which our reviews are conducted against, emerging markets played a very significant role, with the MSCI Emerging Market index showing a gross return of over 26% for the 12 months. In this area, the Alquity Indian Subcontinent fund, a new introduction in 2017, would have produced a gross return of 55% for 12 months. The next highest fund was the Baillie Gifford Japanese Smaller companies fund, a regular upper quartile performer, at 37%.

Within the domestic market, the steadfast Lindsell Train UK Equity fund was the 7th highest return producer, and a resurgence of the Unicorn UK Income fund in the second half of the year made both funds prime contributors to portfolios at over 20%.

The theory of a well diversified portfolio means we are wary if everything is performing well at the same time. This would suggest a lack of diversification and whilst it may lead to short term gratification, when tides turn, as they inevitably do, the reversal also generally applies to all funds. In our monthly reviews, we have kept a very close eye on the periodic 'under-performers' such as the H2O MultiReturns fund or the Premier Defensive growth funds. The former has at times also been mentioned as one of the month's top performers showing how different market conditions mean different relative performances.

At this stage, then, we continue to maintain all funds under close review monthly and will update as changes are deemed necessary.