March 2018 Portfolio Review

During the last quarter of 2017, investors enjoyed what could be referred to as a 'melt-up' in stock markets during January. Global growth had picked up markedly into the year end, and the expectation was that this would continue for most of 2018, boosted by US corporate tax cuts. The investment community was caught between trying to rationalise the increasingly lofty valuations with the growth outlook and warning that the ever-higher highs were pushing stock markets into dangerous 'bubble territory'.

The first quarter of 2018 has seen these rises brought to an end by concerns that an overheating economy would push inflation, and therefore interest rates, more quickly than anticipated. Interestingly, slowing economic momentum after the first sell-off round, swiftly led to the recent second round. It is ironic that the second wave was on the back of the slowing, rather than overheating economic conditions.

In the meantime, central banks demonstrated that they were not inclined to overreact to inflation edging back towards more normal levels of around 2%. This, together with the moderation in the pace of growth, led to the much-watched longer term US bond yields ending the quarter well below the 3% watershed – the level which some had feared would cause bond markets to start misfiring and upsetting financial markets more broadly.

However the partial recovery from recent falls indicates that stock markets still have legs, given global growth rates remain healthy. The challenge of the coming quarter will be to foresee market reaction to the changing (but broadly normalising) environment. Macro-economic data flow over the coming weeks will be as important as the Q1 corporate earnings reports, which start to come out towards the end of April. Economic growth momentum no longer poses a particular threat but growth remains strong enough to warrant expectations of gradually rising interest rates and bond yields. This in turn should prevent valuations from running away, as the competition of fixed interest bond yields returns.

However, more difficult to assess is the likely impact of the end of abundantly cheap capital. After a decade of ultra-low cost of capital, we must expect that it has, in instances, been allocated less efficiently than can be expected when it is scarcer. We therefore cannot be entirely sure how the corporate sector will cope under the higher burden of interest payments – though economic growth should soften the impact. We should expect more defaults in companies who were either kept afloat by cheap credit for longer than their underperforming businesses would have normally survived. This will bring back memories (and fears) of the credit crunch, but defaults from underperforming firms have always been part of a functioning economy which, by its nature, reallocates scarce resources to the most beneficial use available.

The risk of a serious trade dispute has been ever present since President Trump's election 17 months ago, but until now this has been a phony war. Over the last week, this risk has however crystallised

with the USA provisionally imposing import tariffs on 1300 Chinese items (such as aerospace and car parts, medical equipment and machine tools) building on the initial tariffs on steel and aluminium imposed last week. This is retaliation against China's tariff imposition on $3bn of goods such as meat and fruit.

Asia has prospered by acting as the 'workshop of the world' over recent decades supported by global trade liberalisation, and this rupture with the past has made some investors nervous. This concern is understandable given the dominance of Asian exporters. The World Trade Organisation has warned that global economic growth could fall 'quickly' if Washington and Beijing were to continue to push ahead with trade tariffs. US Treasury Secretary Steve Mnuchin's comments about being 'cautiously optimistic' that China will reach a deal to avoid tariffs, the White House trade advisor, Peter Navarro said that the Trump administration is 'actively' involved in talks with China to resolve the recent trade tensions between the two nations. In addition, Chinese Premier Li suggested that negotiations would continue, to ensure that both US and Chinese firms retain access to each other's economies. Markets were initially encouraged by the comments from both the US and China. However, China's subsequent confirmation of 25% tariffs on some US goods has made markets uneasy.

US equities remained volatile recording their biggest one-day rise since August 2015 before falling as technology stocks suffered another sell-off. The NYSE FANG+ Index includes ten of the world's largest global technology companies. The five largest US technology and internet companies account for more than 14% of the S&P 500 index while the technology sector accounts for 27% of the S&P index, making it the largest sector component. Since hitting a peak in mid-March 2018, the NYSE FANG+ index has fallen 15%. This has been caused by data and privacy issues, as well as safety issues relating to driverless car testing. President Trump has also launched an attack on Amazon saying it pays little or no taxes and is putting thousands of retailers out of business.

International Trade Secretary Liam Fox said the UK hopes to have 40 trade arrangements with 70 countries in place by the end of the Brexit transition period in 2020. He said he hoped to 'roll over' the existing arrangements with the EU agreements and that all those countries had been spoken to and had agreed they would like that outcome.

Portfolios

In a reasonably turbulent month, 'genuine' diversification was again key to tempering portfolio volatility. The higher risk growth portfolios, which hold the greater exposure to overseas assets, stemmed falls to within 1.5% whilst some of the major indices (MSCI World and S&P500) were down by as much as 4.2% and 5.9% respectively.

'Genuine' diversification refers partly to the spread across the major asset classes of cash, property, equities and fixed interest, but more importantly to the way exposure is achieved between differently correlated assets and investment classes, often achieved through a less traditional use of long only strategies.

Again, the Natixis Multi-Returns fund led portfolio positive returns, capitalising on sterling's gains against other major currencies. The fund posted a gross return of +2.3% over the month.

The second highest performance came from the Atlantic House Defined Returns portfolio generating +1.43% for the month, again from diversified exposure to major market indices through autocalls, giving some security against equity market volatility.

Given the poor performance of the US and Emerging markets, coupled with the uptick in sterling it is not a surprise to see portfolios dipping a little over March. Over 12 months all portfolios remain in positive territory with 1-year volatility for even the higher risk portfolios contained within approximately 2/3rds that of the major UK equity indices.