Arrow Financial Services

SQUARE MILE

INVESTMENT SERVICES

Market Update

Following the excitement and uncertainty created by the Referendum in June, markets enjoyed a very calm summer and the price of many financial assets were bid higher. The UK economy since then has behaved well. The initial shock of the vote had caused a number of forward looking economic indicators to suddenly drop but as the weeks passed business confidence has recovered somewhat as it has become apparent that the economy has continued to grow. The new Prime Minister has underlined the government's intention to exit the EU although policy so far has got no further than "Brexit means Brexit". To use the words of Michael O'Leary, the Ryanair boss, it is 'clear as mud' as to what this will actually entail. Such uncertainty makes it very difficult for many companies to plan ahead and business investment, an important component in driving GDP growth, will suffer as a result. The Japanese have been quick to highlight that their companies employ 140,000 workers in the UK, and many of these positions are reliant on access to the European market. Theresa May's announcement at the end of the quarter that Article 50 will be triggered by March at least provides some clarity on the time frame of the formal process but it will take years to finalise the details.

In response to the expected slow down, both the Chancellor and the Bank of England have announced plans to stimulate the economy. Philip Hammond, the new Chancellor, has pushed back plans to balance the government's books by 2020 and we expect a pick up in spending to be announced in the Autumn Statement. Monetary conditions have also been eased by the Bank of England, which cut base rates by a quarter of a percent and implemented further measures to increase bank lending. While there is perhaps never an ideal moment to execute an exit from the EU, at least our key trading partners are doing well as the EU economies are enjoying a period of cyclical uplift.

A good quarter for markets

Yields on bond markets have been making new lows for a number of years but the moves in UK government bonds (sometimes referred to as gilts) this year have been nothing short of extraordinary. Gilts are now set to provide yields of less than 1% over the next ten years; this is the lowest level since the industrial revolution began 250 years ago and indeed since records began. This fall in gilt yields has generated some very strong capital gains. So far this year, gilts are up 14% which is ahead of the UK stockmarket itself up 12%. From here, it is difficult to envisage gilts returning much, in either capital or income terms.

Stockmarkets have been very strong over the period. Typically, there are two possible drivers of any outsized market return. These are either from increased optimism about the outlook of profits growth, or a revaluation of the existing stream of company profits. Analysts forecasts for profits are bullish next year and factor double digit gains from the major markets. However it is not unusual for analysts to be optimistic and for the forecasts to be reined in as the year progresses. This has certainly been the case in a number of recent years. Profits should receive a boost from the recovery in oil companies revenues, nevertheless, double digit growth rates strike us as being be rather too hopeful given the challenges faced by the developed economies. We believe that it is more probable that the recent stockmarket move represents a shift upwards in the valuation of profits streams. The fact that the value of government bonds has shifted higher the same way helps support this view.

The distinction is important. We are becoming increasingly inured to cash yields running at record lows and bond yields similarly have fallen well below any previous low. Why shouldn't equity yields fall as well? Perhaps they should and we have been suspecting that they might for some time. However, equity markets tend to be far more volatile than bond markets. We believe there is a strong case for equity markets to be more expensively valued than they have been through history. However, they are likely to be skittish during this period of adjustment whilst investors become accustomed to the new norm, if this is what it is. Markets have been making tentative steps to revaluing equities over the last few years, though there is a sense of complacency over the recent surge. There are plenty of factors that could rock this stability including Brexit developments, the US elections or the path of US interest rates to name but a few.

Portfolio Positioning

This has led to a considerable number of changes to the equities in the portfolios:

- in the immediate aftermath of the Brexit vote, reduced the exposure to the European and Japanese stockmarkets in favour of international businesses and increased exposure to the emerging markets;
- towards the end of September, reduced UK exposure in favour of more globally focused companies through taking a position in the Fundsmith Equity fund; and
- for higher risk clients, reduced equity exposure a little on the basis that this seems a timely moment to take some profits.,

There have also been some major changes to the fixed income component of your portfolios:

- sold entirely the portfolios' gilt exposure;
- sold corporate bond funds which contain significant sensitivity to long term interest rates;
- retained some positions in corporate bond funds but only where the interest rate sensitivity is low, typically in funds focused on holding bonds that are nearing maturity; and
- introduced a position in the Monument Bond fund, which follows a strategy of investing in mortgages and other secure loans which are tied to short term interest rates. Yields from these types of strategy are of course low but they are higher than cash and the risks to capital are modest.

Outlook

These moves have significantly increased the cash held across the portfolios and the removal of the gilt exposure does remove what has been a useful counterbalance. Gilts typically rally when stockmarkets fall. While cash can act to stabilise the portfolio's performance, we are currently seeking alternative assets that could have a more effective role in offsetting some of the risks in holding equities.

We live in interesting times. Bond yields have reached unprecedented levels and equity valuations may be in the process of departing from historical norms. If equities do continue to revalue higher it will help to lift the capital value of your portfolio, however, we do not expect this to be a smooth journey. There is a possibility of a corporate profits surge, which would be terrific news, but we consider it to be unlikely. Our biggest concern is that bond yields rise. Although we have now largely eliminated exposure to bonds, valuations of equities are likely to suffer if the bond market takes a turn for the worst. If not, we can see the recent gains being sustained and possibly even extended. As ever, we shall keep a close eye on developments as they unfold.

> Taking profits in gilts and some equities

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