Arrow Financial Services

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INVESTMENT SERVICES

Market and Portfolio Update

The final quarter of 2016 was an eventful one rounding off an eventful year. The FTSE 100 closed the year within a whisker of its all time high and many international markets are also testing new highs. The pound has been under pressure ever since the referendum in June which has resulted in spectacular gains for positions in global equities. Over the last 12 months, the FTSE All Share index is up by 17% and the MSCI World index has surged by 28% in sterling terms. Even the British government bond market generated a 10% return despite gilts falling away from the peak reached in the late summer. These are the strongest gains recorded by financial markets since 2009 and appear enormous when compared to the miserly returns available from cash, and at a time when UK inflation is little over 1%.

The portfolios have made steady gains over the quarter. Our conservative approach to managing savings has meant that we have not attempted to fully capture the bountiful returns of the wider market, nevertheless, the portfolios have generated the sort of returns over the year that might have seemed fanciful at the beginning of 2016.

For the first time since the financial crisis in 2008, the global economy has benefited from synchronised growth across the main economic blocks that are North America, Europe and China. Even a perennial laggard, the Japanese economy, grew a little over the year. The rate of growth is slow when compared to pre 2008, with few nations other than China managing a growth rate in excess of 2%. However, the fact that the major economies are now in sync with each other has elevated hopes that a self-feeding growth cycle has been established. The last eight years have been marked by continued attempts from the world's central banks to keep the economy moving through record low interest rates and by huge injections of liquidity via quantitative easing.

Steady gains over the quarter

The surprise success of Donald Trump in the US elections has also fuelled the optimism. It is difficult to be precise about what his policies will entail, for many of them seem to have been designed on the hoof during the election campaign. What they will certainly represent is a radical change to those that have been in place since the 2008 crisis. On paper, whilst cuts in taxation, deregulation and boosting infrastructure spending sound attractive, moves to curtail international free trade are less welcome. Trump has promised much to secure the votes that he needed. It will be interesting to see how he concentrates his activity during the early part of his term.

The combination of improved growth outlook and the US election result has put fixed income markets under pressure. During the summer bond yields touched levels that were very hard to justify. Indeed, governments were being paid to borrow in many parts of Europe and in Japan. Our decision at that time to realign our fixed income exposure and to sell out of gilts completely have so far proven to be well timed and side stepped the 3.5% loss recorded by gilts in the final quarter. We believe some of the political and economic events over recent months have lifted inflation risks and this is something we need to keep an eye on.

Of less help has been our caution in stock markets and our bias towards quality businesses with well-established franchises and strong balance sheets. While the value of these companies has risen, we could have made more gains by focusing on more volatile businesses such as energy and mining firms. We believe these industries are too risky given the uncertainties so don't plan to chase these stocks now but we plan to make changes to the portfolio to invest in areas which could benefit from higher interest rates such as financials.

The improvement in the outlook is encouraging but this is not to say that the risks have gone away. Firstly, and perhaps most importantly we cannot be sure that the global economy is back to full health. If the economy stumbles again, financial markets are likely to give back some of the recent gains. There are other areas of risk as well. The Brexit referendum and US election result demonstrate a growing popular discontent with the political status quo. Already, voters around the developed markets are looking for a new direction. In Europe, protest voters are shifting their allegiances towards nationalist politicians. Markets seem to be ignoring the implications of this (or more likely, their reaction is being masked by the European Central Bank's latest expansion in its QE programme). We do not consider it likely that a significant Eurozone member will seek to leave, but if it happened it would create an almighty political ruckus and turmoil in European markets. We are about to sell the portfolio's remaining position in Europe, the BlackRock Continental European Income fund. Hopefully this change will turn out to be unnecessary but as we saw last year, our precautionary switch out of UK smaller companies proved its worth following the Brexit vote.

We also have concerns about the UK and have been following the Brexit debates with interest. Whilst European politicians have much potential to lose from the Brexit process, they are showing uncharacteristic unanimity in several crucial areas, including the vexing issue of free movement of people. This escalates the risk of a 'hard' Brexit which could be bruising for the economy. After the quarter end, we have taken advantage of the strong year end markets to reduce UK equity weightings and reinvest overseas.

2016 was an exciting year for investors. Much has changed and as a result, we have undertaken more changes to the portfolio's composition than we would usually make. Markets can still make further headway but the pace of the gains are unlikely to be as rapid as we have experienced in 2016. At a time when confidence and greed reappears in financial markets, it often pays to be cautious. Although we don't have any sense of foreboding, heightened economic optimism can often lay the seeds for darker clouds. While we are optimistic for the outlook, this is not a time to be too greedy.

Improvement in the outlook is encouraging