Arrow Financial Services

SQUARE MILE

INVESTMENT SERVICES

Market and Portfolio Update

The year has started well for global markets with the FTSE All Share and the US S&P 500 indices climbing by 4% and by 5% respectively and reaching new highs over the quarter. We are pleased to report that your portfolio has continued to make steady progress over the period, building upon the strong gains generated last year. The degree of strength in markets is perhaps a little surprising given the apparent wealth of uncertainties overhanging the world economy, although this would not be the first time that markets have climbed such a 'wall of worry'.

There have been a number of notable events over the quarter. Theresa May has triggered Article 50, commencing the process of the UK's withdrawal from the European Union and quite possibly prompting a further Scottish referendum. This will be a lengthy journey into the unknown though it is difficult to imagine that the process will provide any good news for the UK economy in the near term. Donald Trump has started his presidency in an aggressive manner as he attempts to enact his manifesto promises. So far, he has issued a flurry of executive orders, some of which have damaged international relations and his first major policy attempt, to repeal Obamacare, has been rebuffed by Congress. Elsewhere, the Dutch election demonstrated that the tide of popularism has not fully infiltrated the EU electorate, well at least not in Holland. The next major test will be the French Presidential election. The nationalist Marine Le Pen is not expected to win but if she did, it would have profound consequences for Europe. Just in case, we continue to avoid direct exposure to Europe in the portfolio.

Markets continue to make progress

There are several reasons for the positive progress by financial markets but virtually all of them deserve some degree of qualification. The economic outlook across the globe has improved with the key economic blocs now growing in unison. Whilst this could trigger a self sustaining growth cycle, we would stress that these rates of growth seem likely to remain lower than their pre-crisis level. Although company profits are expected to pick up strongly this year, financial analysts are usually optimistic at the beginning of the year, only to pull in their forecasts once reality sets in. This year, we think that there are good reasons why these initial forecasts might be met but it should be remembered that this comes on the back of a fallow period; the previous two years has seen little in the way of profits growth. Confidence is also improving, particularly in the critical US economy, and this should buoy consumer spending. However, the reasons for this confidence probably arises from hopes that President Trump will improve the lot of the average American and the continued strength of Wall Street spreading a feel-good factor. Both factors are very open to reversal and the ramifications would be felt in the portfolio.

Turning to the bond market, prices have stabilised so far in 2017 and in the case of UK gilts even risen a little, following on from the weak latter half of last year. Frankly, this puzzles us a little, as it suggests that growth will moderate and/or inflation will fall; neither of which is happening. Current yields are close to all time lows and gilts are highly likely to generate losses in real terms for investors. The current pause in bond markets is at odds with what equity markets are implying and reminds us that the global economy remains a long way from full health.

The portfolio is fairly cautiously positioned at present. We have no exposure to the outrageously expensive gilt market and the positions in fixed income that we do have are heavily skewed towards defensive short dated paper. These securities are close to their maturity date and as a result should be little affected if yields rise as we expect. We also have more cash in the portfolio than we would normally have but we see little point in committing capital to expensive long dated fixed income instruments that offer little in the way of yield yet are open to capital losses over the short and medium term. Positions in equities have been the main drivers of performance over recent months and over the last quarter returns from emerging markets have been particularly strong, up 10%. Our positions here have helped to offset some of our more cautious positioning elsewhere. We still believe that emerging markets offer attractive opportunities thanks to their reasonable valuations and decent growth opportunities.

We have made a few changes to the portfolio over the quarter. We have taken a little profit from some of the equity positions, though for most portfolios this involves paring down exposure by around 2%. We have also sold the Henderson UK Property fund. Property yields appear reasonably attractive when compared to gilts but if gilt yields rise as we expect, this valuation support would quickly crumble.

Equity markets have made impressive progress over the last 12 months and indeed since 2009 when the current bull run commenced. We intimated in last quarter's report that we were not entirely comfortable with the degree of optimism that is now filtering through into markets. We suspect that Trump will not be so omnipotent and while the global economy is not doing badly, it is not doing that well either. Another concern is that US interest rates are clearly on the rise and experience tells us that markets only absorb a handful of these before taking fright. Gains in markets have lifted valuations, which are now becoming increasingly vulnerable to either economic or political disappointments. However, markets have strong momentum behind them, which is capable of propelling them higher in the short term. We are happy to run with this for the moment, though given the risks outlined above, we will be looking for opportunities to reduce equity exposure further in order to lock in some of the gains.

Looking to reduce equity exposure to lock in gains

Economic review

	GDP Latest Growth Rate %	GDP 2017 Economist %	CPI Latest %	CPI Year Ago Economist %	Unemployment rate %	Current Account Balance % GDP	Budget Balance % GDP 2017
UK	1.9	1.6	2.3	0.3	4.7	-4.4	-4.0
US	2.0	2.3	2.7	1.0	4.7	-2.8	-3.5
Euro Area	1.7	1.6	1.5	0.0	9.5	2.9	-1.6
Japan	1.6	1.1	0.2	0.2	2.8	3.6	-5.3
China	6.8	6.5	0.8	2.3	4.0	2.0	-4.1

Markets review

	3 Month	1 Year	3 Year	5 Year
Equity (Local Currency)				
FTSE All Share	4.0%	22.0%	24.9%	58.7%
FTSE Small Cap (ex IT)	5.8%	19.7%	28.3%	117.2%
S&P 500	5.9%	16.4%	31.9%	80.8%
TSE TOPIX	0.6%	14.7%	33.7%	96.2%
MSCI EUROPE ex UK	6.9%	17.6%	22.2%	69.1%
MSCI EM (EMERGING MARKETS)	7.8%	15.1%	17.8%	28.1%
MSCI AC ASIA PACIFIC ex JAPAN	9.1%	17.8%	20.1%	42.1%
MSCI WORLD	5.4%	17.2%	27.5%	72.8%
Fixed Interest				
FTSE British Government All Stocks	1.6%	6.6%	25.4%	28.6%
FTSE British Government Linked All Stocks	1.9%	19.9%	44.6%	53.3%
The BofA ML BBB Euro Non Sovereign Hedge GBP	0.7%	4.4%	14.0%	36.9%
The BofA ML BB B Global High Yield Hedge GBP	2.4%	13.0%	16.2%	41.2%
Property				
IPD UK All Property	2.6%	2.7%	38.3%	59.7%
Currency				
Euros in GB	0.2%	7.9%	3.5%	2.6%
Japanese Yen in GB	3.4%	15.9%	23.2%	-5.6%
Swiss Francs in GB	0.3%	10.0%	17.7%	15.4%
US Dollars in GB	-1.2%	14.9%	33.3%	27.8%
All Returns are shown in Local Currency Terms				Source FE