Arrow Financial Services

SQUARE MILE
INVESTMENT SERVICES

# Market and Portfolio Update

Global stock markets have continued to make headway although their momentum waned towards the end of the quarter with markets finishing a little off their highs. Gilt prices were also strong for much of the quarter though prices closed slightly down following the comments made by Mark Carney suggesting that UK interest rates may soon have to be lifted. The portfolios made modest progress, building further on the decent gains made over the first quarter of the year.

Strangely, the main event of the quarter had little impact on financial markets. Theresa May's gamble on calling an early election backfired and following a disastrous campaign, she lost her majority in Parliament. At the time of writing, she remains in power with the help of the Irish DUP but it is hard to see how such a wafer-thin majority can be sustained for long. This is not what she was seeking as she begins the Brexit negotiations. Her weakened political state will undoubtedly soften her stance on a number of contentious issues and she will become more open to enact populist policies. Already we have seen a softening in the austerity measures in place and higher levels of borrowing appears an inevitable result. This cannot be good news for the bond market and nor can we ignore the implications of over 40% of the electorate voting for parties following hard left policies. We continue to be extremely cautiously invested in the already expensive UK bond market and favour having higher allocations towards international markets than would otherwise be the case. This, despite the additional risk that non-sterling exposure brings.

European markets breathed a sigh of relief that the European cycle of elections has not put any anti-euro party into power. We still have the German elections in September and Italy must hold an election within the next 12 months. We don't think either will prove to be too contentious for markets. The main parties in Germany are all pro-European, and while the anti-euro Five Star party may gain the largest share of Italian votes, markets are used to the nation's customary state of political turmoil. Towards the end of last year, we cut European exposure from the portfolios as it seemed sensible to avoid the risks that this cycle of elections brought. With the worst of the danger behind us, we are now looking for a suitable moment to re-establish exposure to European equities.

> The General Election had little impact on financial markets

Progress has also been made in clearing up the European banking system. Several banks in Spain and Italy have been closed. Some losses were passed on to investors though public money has been used to protect depositors and secured lenders. These banks have been limping along for some time and action is long overdue. Unfortunately, this typifies the slow pace of action by the authorities inside the Eurozone. There may well be further closures of crippled banks over the coming months and it is sensible to do this whilst economies are strong. Unfortunately, while this clears up some of the symptoms created by the structural imbalances, it does not solve the cause. The new French President, Emmanuel Macron, seems aware of this and talks of the need for further reforms. This has helped lift the euro exchange rate versus the dollar. In time, we expect some of this optimism to fade, which should allow a better opportunity to re-establish positions. In the nearer term, we are planning to lift exposure to Japanese shares, which look more favourably valued compared to other equity markets. We also plan to switch out of high yield bonds, issued by companies in Europe and North America, in favour of bonds issued by developing nations. This trade provides a decent pick up in yield with only a modest increase in risk.

There appears to be no shortage of potential risks that could derail markets. British domestic politics, Donald Trump, Eurozone imbalances, Russia, tensions in the Middle East, Brexit, North Korea, debt problems in China, corruption scandals in Brazil and India to name but a few. However, what concerns us the most is the valuation risk inherent in financial markets. By this we mean, the risk that markets fall from today's expensive valuations towards more normal levels.

We have mentioned on previous occasions that bond market valuations are at near to all time highs (the data here goes back centuries rather than mere decades) and equity markets are close or even a little beyond the typical valuation range seen over the last 100 years. With interest rates at such low levels, arguments can be made to justify this. However, we are conscious that interest rates are no longer being pushed lower and quantitative easing programmes are approaching their end or have already been completed. In the US, interest rates are being gradually lifted. If we see inflationary pressures return, central banks could be forced to lift interest rates much faster than markets expect which could act as a catalyst for prices of financial assets to fall. The good news is that there has been little sign of inflationary pressures. For one reason or another, wage rises have been very modest despite the relatively full employment rates. While this continues, corporate profits and the value of the portfolios could continue to grow higher as economies expand. However, we caution that a short term pull back in markets over the summer months is not unusual, especially following the sort of advance we have seen over the last year.

## Looking for opportunities to re-establish European equity exposure

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# To 30 June 2017

## 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 | 2.0 | 1.6 | 2.9 | 0.3 | 4.6 | -3.1 | -3.6 |
| US | 2.1 | 1.9 | 1.9 | 1.0 | 4.3 | -2.6 | -3.5 |
| Euro Area | 1.9 | 1.7 | 1.3 | 0.1 | 9.3 | 3.1 | -1.4 |
| Japan | 1.3 | 1.3 | 0.4 | -0.4 | 3.1 | 3.6 | -5.1 |
| China | 6.9 | 6.7 | 1.5 | 2.0 | 4.0 | 1.6 | -4.1 |

## Markets review

| | 3 Month | 1 Year | 3 Year | 5 Year |
|---|---|---|---|---|
| Equity (Local Currency) | | | | |
| FTSE All Share | 1.4% | 18.1% | 23.9% | 65.2% |
| FTSE Small Cap (ex IT) | 2.9% | 28.4% | 34.1% | 132.9% |
| S&P 500 | 2.9% | 17.2% | 29.2% | 91.7% |
| TSE TOPIX | 6.8% | 32.2% | 35.7% | 132.1% |
| MSCI EUROPE ex UK | 2.2% | 21.6% | 21.3% | 81.8% |
| MSCI EM (EMERGING MARKETS) | 6.6% | 21.8% | 19.4% | 44.1% |
| MSCI AC ASIA PACIFIC ex JAPAN | 6.4% | 23.4% | 22.3% | 59.2% |
| MSCI WORLD | 2.7% | 18.8% | 25.4% | 85.3% |
| Fixed Interest (GBP) | | | | |
| FTSE Actuaries UK Gilts All Stocks | -1.3% | -0.9% | 22.5% | 22.4% |
| FTSE Actuaries UK Index Linked All Stocks | -2.3% | 6.7% | 40.0% | 48.9% |
| The BofA ML BBB Euro Non Sovereign Hedge GBP | 1.0% | 3.3% | 12.1% | 39.6% |
| The BofA ML BB B Global High Yield Hedge GBP | 1.8% | 10.2% | 14.8% | 42.2% |
| Property | | | | |
| IPD UK All Property * | 2.4% | 4.2% | 35.5% | 62.7% |
| Currency | | | | |
| Euros in GB | 2.7% | 5.7% | 9.7% | 8.5% |
| Japanese Yen in GB | -4.5% | -6.0% | 18.7% | -14.3% |
| Swiss Francs in GB | 0.6% | 4.7% | 21.9% | 19.3% |
| US Dollars in GB | -3.7% | 2.9% | 31.6% | 20.8% |
| All Returns are shown in Local Currency Terms unless otherwise stated | | | | Source FE |

* Data to 31st May 2017