Arrow Financial Services

SQUARE MILE
INVESTMENT SERVICES

Market and Portfolio Update

Stockmarkets continued to glide higher over the fourth quarter, to provide investors once again with a generous double digit gain over the year. The FTSE All Share returned 13% and the world index, up by a similar amount, was led higher by the emerging markets which gained 25%. These are impressive results, especially in relation to the near zero return offered by cash and the 1.8% generated by the UK government bond market. One notable feature of equity markets over 2017 has been the absence of volatility. The last meaningful 10% correction occurred almost two years ago, since then any market wobbles have been minor and short lived. We caution that this is most unusual and markets are unlikely to be so calm over 2018.

The global economy is performing solidly and growth has been better than many had expected. This encouraging backdrop has lifted corporate profitability, which has helped support the jump in equity markets over the year. One of the few economies to disappoint has been the UK, where growth has been held back by cost increases caused by the Brexit induced devaluation of sterling in 2016.

We are mindful of the specific political risks faced by the UK. It is encouraging that some progress has been made in the Brexit negotiations, however, this is only a small step. We still have little idea what the end deal will look like nor, more importantly, do we know how it will impact the economy. We also need to keep a careful eye on the stability of the Government. We cannot ignore the rising popularity of the Labour Party and its left wing policies. The arrival of Jeremy Corbyn, or one of his acolytes, into power would have profound implications for UK investors. We are keeping our exposure to UK risk assets at significantly lower levels than normal as a result. In contrast, we have increased exposure to European equities The Eurozone still has structural issues to contend with. However, for the moment its economy is picking up speed nicely and political risks in the region have lessened somewhat.

> 2018 could be another buoyant year for investors

We have an inkling that the recent encouraging economic trend and market performance may continue. Confidence is gradually building and the memories of the 2008/9 banking collapse are becoming increasingly distant. There is much liquidity sloshing around in the system, created by record low global interest rates and quantitative easing programmes. It is true that rates are on the rise in the US and the Federal Reserve's QE programme is being gradually reversed. However, near zero interest rates and QE programmes are still operational in Europe and Japan. (The Bank of England's move to lift rates by 0.25% will have little impact on the global stage). This is beginning to influence risk appetites and we suspect that 'animal spirits' may be reviving. Consumer and business confidence is climbing and, more importantly for financial markets, investor confidence is mounting also. Over 2017, we observed speculative demand increase for assets such as art, bitcoin and new share issues in the Far East. If this persists, the fervour could spread to equity markets of more developed nations. 2018 could be another buoyant year for investors.

However, this is only an inkling. Our forward looking antenna is never particularly reliable and innovations such as QE further interfere with our radar. One thing that we can be certain about is that valuations in markets remain expensive. These range from an unreasonably priced government bond market to a merely dear equity market. This means that while we are optimistic for the coming year, we remain cautiously positioned in equity markets and entirely absent from the UK government bond market. As a consequence, we hold more cash than is normal in the portfolio. Any return to a more normal valuation range will prove painful for investors, particularly if this coincides with an economic slowdown. We remain vigilant for signs that risks of this are developing and we can shift the portfolios to a more defensive posture if necessary. Investor sentiment can turn very quickly and this is not the moment to be bold, especially at a time when others are becoming increasingly more so.

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	1.7	1.5	3.5	1.2	4.3	-4.0	-3.0
US	2.3	2.2	2.2	1.7	4.1	-2.5	-3.5
Euro Area	2.6	2.2	1.5	0.6	8.8	3.1	-1.3
Japan	2.1	1.5	0.5	0.5	2.7	3.5	-4.4
China	6.8	6.8	1.7	2.3	4.0	1.3	-4.3

As at 31st December 2017

Source FE Analytics and Square Mile

Markets review

	3 Month %	1 Year %	3 Year %	5 Year %
Equity (Local Currency)				
FTSE All Share	5.0	13.1	33.3	63.0
FTSE Small Cap (ex IT)	2.7	15.6	47.0	105.8
S&P 500	6.5	21.1	35.7	101.7
TSE TOPIX	8.7	22.2	37.4	134.0
MSCI EUROPE ex UK	-0.1	13.6	25.9	65.2
MSCI EM (EMERGING MARKETS)	5.7	30.6	35.0	46.8
MSCI AC ASIA PACIFIC ex JAPAN	6.4	30.2	34.1	57.2
MSCI WORLD	5.3	18.5	31.8	86.6
Fixed Interest (GBP)				
FTSE Actuaries UK Gilts All Stocks	2.0	1.8	12.7	23.3
FTSE Actuaries UK Index Linked All Stocks	3.5	2.3	26.0	50.7
The BofA ML BBB Euro Non Sovereign Hedge GBP	1.0	4.3	11.5	30.0
The BofA ML BB B Global High Yield Hedge GBP	0.4	6.6	20.1	32.4
Property				
IPD UK All Property *	3.0	11.0	30.2	70.5
Currency				
Euros in GB	0.8	4.0	14.4	9.5
Japanese Yen in GB	-0.9	-5.4	22.7	-7.8
Swiss Francs in GB	-1.5	-4.7	17.5	12.9
US Dollars in GB	-0.8	-8.7	15.3	20.2
All Returns are shown in Local Currency Terms unless otherwise stated				Source FE Analytics and Square Mile

As at 31st December 2017

* Data to 30th November 2017

Performance figures are calculated with net income (dividends) reinvested