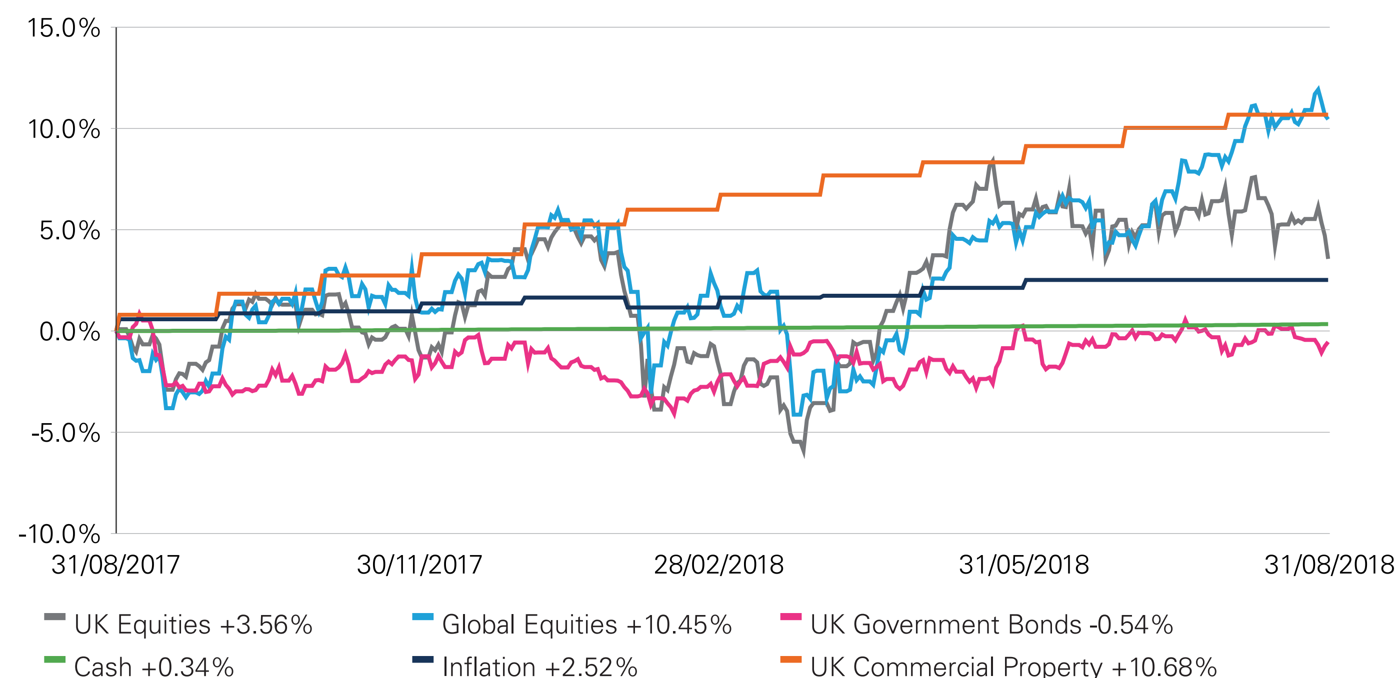
CCLA INVESTMENT MANAGEMENT LTD
MARKET REPORT AUGUST 2018

CCLA

Headlines

- Global equities gave mixed returns. Currency factors were an important contributor
- Domestic fixed interest sector returns were modestly positive
- Property values overall continued to edge forwards
- Sterling had a poor month and weakened against Dollar, Euro and Yen

Investment market returns over the past year



Source: CCLA

Market Review

Trading volumes continued to reflect the impact on activity of the peak holiday season. In thin and less liquid markets volatility tends to increase and during August this was particularly evident in the emerging market sectors. Positive influences on sentiment came from the corporate reporting season where good levels of sales growth had resulted in strong profit improvements. The global equity market gave a return to a sterling - based investor of 1.68%, an improvement which took the return so far in 2018 to 7.72% and to 10.45% for the past 12 months. Regional performances were mixed. The US was the strongest performer, with a return of 4.18%, Japan too moved ahead; this time by 1.03%. In contrast, values in Europe faltered by -1.29% and they fell back too in Asia, by -0.22%. The UK was a poor performer, giving a return of -2.76% after particular weakness in the final week of the month. The total return from the UK for 2018 to date is now only just positive, at 0.16%. Over the past year the gain is 3.56%. Within Europe only a minority of markets moved ahead. Ireland, +4.08%, was the best performer. Greece, Austria and Italy were all down by more than 5%. In Asia, gains were more numerous but similarly modest. Thailand headed the list with a gain of 3.51%, Pakistan weakened most, -4.17%.

The domestic fixed interest sector again traded sideways with a modest late gain pushing returns positive. Values were unmoved by good news on the government's funding position as the impact was offset by Brexit concerns.

Property values improved again, despite a mixed news background. The retail sector remained difficult. Surveys showed that, two years after closure, half of the BHS store portfolio remained empty. Homebase announced the closure of 42 stores and the intention to seek lower rents on 70 more. Houser of Fraser, now owned by Sports Direct, has apparently proposed cancelling rents on some stores entirely, instead providing owners only with a contribution to local costs. Events were more positive elsewhere in the sector. Demand for London offices continued to be strong and well balanced. The latest data showed that diplomatic purchases accounted for 10% of space requirements (the new Chinese embassy at Royal Mint Court), financial companies 17% and tech occupiers 15%. The void rate was just 5.6%. The headline deal was the sale by Goldman Sachs of its new headquarters building on Farringdon Street, for £1.2bn.

Economic Developments

Data releases suggested that the quarter to June was the 8th in succession where the global economic growth rate exceeded 3%, with manufacturing growing by about 3.5% and consumption about 3.8% higher. The sources of growth however seem to be narrowing, as the broad synchronised expansion evident in the later months of 2017 gives way to a phase where the global data is much more dependent on expansion in the US as momentum reduces elsewhere.

UK official interest rates were increased to 0.75% at the start of the month, the second increase in a year but also only the second since 2009. The rise, at a time of significant economic uncertainty, was justified by sticky inflation and concerns that growth, although modest, was still at a pace above the economy's long - term capacity. Economic growth for the second quarter emerged at 0.4%, in line with expectations and reflecting some recovery from the flat start to the year. A similar outturn is currently expected for quarter 3. The Bank of England has forecast growth of 1.5% for this year and 1.8% in 2019, although that assumes no Brexit related disruption. Interestingly, none of the recent growth data includes any significant contribution from net trade, despite the weakness of Sterling over the period. The unemployment rate fell slightly but not enough to influence the overall percentage. The improvement however was not the result of more in work, instead it was due to a reduced labour pool as the retirement rate slowed and the reservoir of foreign workers reduced. Inflation inched up to 2.5% after 3 months at 2.4%, the first increase since November. Manufacturing imports costs were 10.9% higher over the year, a reflection of a stronger oil price and Sterling's weakness. Core inflation should decline slightly over the remainder of the year probably to just below 2%, but the headline rate is likely to remain above 2%. Even so, with wage growth at 2.7% and edging higher, it looks as if the pressure on consumer expenditure will ease over the remainder of 2018. Government finances enjoyed a strong month in July. Income was £2bn greater than expenditure, taking total borrowings for the period April-July to £12.8bn, the lowest quarter since 2002 and compared with £21.3bn in 2017. There were a number of special factors in the data which mean that we can't simply extrapolate the current trend, but it is clear that the annual total will be sufficiently below start of year expectations to give the Chancellor some leeway for additional spending.

In the **US** Apple became the first company to gain a trillion dollar market capitalization. It joins a long list of US firsts including US Steel, first $1bn capitalisation, General Motors, first to $10bn, IBM, first to $100bn and Microsoft first to $500bn. Estimates of economic growth were increased to an annual rate of 4.2%, just over 1% for the quarter. The upgrade reflected higher estimates for investment and a stronger balance of trade as import values were revised lower. This is likely to be the strongest quarter for growth this cycle, coinciding with the peak in corporate earnings growth. Against this buoyant backcloth the Federal Reserve confirmed that interest rate increases were likely in September and again in December. The 'Fed' described its stance as moving from 'accommodative to neutral', on this basis the indicated increases in 2019 would move policy towards tightening. US government bond issuance fell in the quarter to $40bn compared with a huge $530bn in the period to April. The level of issuance early in the year, combined with higher interest rates and the shift from quantitative easing to quantitative tightening, gave a sharp and unexpected liquidity shock to markets, the echoes of which are still evident in the emerging economies today. There was positive trade news with the announcement of a deal with Mexico. It does look to be substantially symbolic, with little changed from what was in place before, but it is positive because it makes an extension or escalation of the dispute much less likely. It is also a helpful headline for the Republicans ahead of the mid-term elections.

Growth in **Europe** was less strong, at 0.4% or 1.5% on an annual basis. It compares with 0.7% for each quarter in 2017. The ECB described the position as one where the opportunities and risks were broadly balanced and so made no changes to current or proposed future policy.

Elsewhere, the focus has been on **emerging economies**, particularly Turkey and Argentina. What Turkey and Argentina have in common is a weak fundamental economic position, high debts, much of which is in foreign currency and a dependence on overseas capital inflows. Their approach to the crisis however has been completely different. Argentina has followed a textbook path of increased interest rates, spending cuts and an early appeal for aid from the IMF. Turkey has been less orthodox, demonstrating in particular a marked reluctance to increase rates despite sharply rising inflation. Interestingly and despite the differences of approach, the outcomes have been similar, as risk averse investors have withdrawn, putting sharp downward pressure on exchange rates. An environment of reducing liquidity in investment markets, as quantitative easing gives way to tightening increases the risk of squalls such as this.

Summary

We expect equity values to be supported by continued economic growth and by higher earnings. In contrast, bond yields offer poor prospective returns in almost all likely scenarios. Property returns are expected to remain positive overall although sub-sector risks are increasing.

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