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asset management

Thesis Market Commentary

February 2018

Tales from the City

The end of 2017 saw markets rise with the 'Santa Rally', which continued enthusiastically into the New Year, with the US S&P 500 reaching an all-time high on 26 January. The UK market followed a similar trend, but peaked slightly earlier as Brexit fears and political issues stalled the market's march earlier than in the US.

No market can continue to rise smoothly forever in an environment of low volatility. In the UK we are now back to levels seen last September, whilst the US has only given up a month's gains. At the time of writing, this is hardly a disaster, but markets have once again made the headlines, causing a few to be unsettled by big movements and increasing volatility. It seems some have quickly forgotten how good things have actually been and that a pullback was clearly inevitable.

Despite still being a global market these days, the UK currently has its own peculiar issues, more of which we will touch upon later, but in the US it is largely the growing evidence of rising inflation and increasing likelihood of rising interest rates that has caused the recent retreat. The US continues to grow steadily in terms of GDP, the latest inflation data is still well within the Fed's target and the move on rates is also not unexpected. However, there is no denying that the US stockmarket is clearly expensive on a cyclically adjusted price earnings (known as CAPE) of 32.4x – trading at almost twice its long term average of 16.8x.

Comparatively, the UK is like a New Year half-price sale! On a cyclically adjusted price earnings basis it trades on 15.7x, versus its long term average of 16.9x. This quite staggering difference paints an interesting picture for asset allocators to ponder. There are possibly several reasons for this, such as Brexit, currency concerns, some recent high profile company issues (Carillion and Capita) and the ongoing pension deficits at a few of the UK's largest listed companies (BAE and BT).

Whilst no one can predict the future, valuations are a significant tool in helping investors forecast where the best returns are likely to be made and on this basis the UK looks quite compelling. With US companies about to benefit from tax breaks and looking at potential homes for their capital, 'UK plc' looks an attractive earnings enhancing opportunity. Therefore, increased merger and acquisition activity looks very likely, which could sustain market upward momentum. Opportunity and a contrarian stance often go in hand in hand.

Whilst this current long running bull market will cease at some stage, we have yet to witness some of the behaviours that are often seen just prior to the crunch. Bitcoin may have hit the headlines, but cryptocurrency influence is at best a minority diversion at present to global stockmarkets.

We continue to worry about some valuations, are trying to be sanguine about politics, which can often be irrelevant for investors and whilst still adopting a pretty cautious stance, we carry on finding interesting opportunities for our clients for the longer term.

MiFID II

Turning to regulatory matters in the City there has also been a great deal happening this year. MiFID II came into force on 3 January – this is neither an obscure Welsh hamlet nor a sequel to John Wyndham's epic 'The Day of the Triffids'. However, this new piece of EU legislation has fundamentally changed the way our services are now offered, through the enhanced disclosure of fees and charges and the provision of investment research.

It is worth just reminding clients of some of the key changes again, as it has been a frequent topic of conversation recently. Most notably, the reporting requirements have been increased to quarterly, from half yearly, with an intermediate notification should markets fall by 10% or more. Whilst these are important short term flags, it should still not change the fundamental reasons for investing over the medium to longer term and these factors should still be kept firmly in mind.

Increased transparency requirements about fees and charges have also come into play. Whilst this is an inherently good thing which Thesis supports wholeheartedly, it would be fair to say the industry is currently struggling to interpret all the requirements needed, which are not as clear cut as one would ideally like. At Thesis we have erred on the side of caution, when looking at

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how we show projected costs to new and existing clients alike. One area which is worth flagging, is the need to effectively show the cost of actually transacting a trade – for example if a stock can be bought for 10p (the offer price) and sold at 9p (the bid price), the cost of actually transacting is therefore 1p. Now imagine multiplying this calculation over a year, for many deals, across many types of assets and markets using multiple assumptions and one can truly understand the complexity of the new rules. A good analogy for this is like factoring in the precise cost of fuel to be used when driving to the supermarket as part of your weekly shop!

MiFID II has also impacted the provision of 'free' investment research by sellside analysts at banks and brokers to asset managers, which in turn would utilise them to place trades. EU regulators were concerned that the old system meant equity and fixed-income trading costs were passed on to asset managers' trades and were inflated to include the cost of providing reports. Going forward, Thesis has taken the strategic decision to pay for all research, rather than pass on cost to clients. Our internal analysts have always scrutinised the value of all research received and will continue to do so in the 'new world'. Whilst more and more trading continues to be done electronically anyway, these changes are quite possibly the biggest shake up to the City since 'Big Bang' in 1986. There is no doubting that banks and brokers will clearly have to adapt fast and tailor their services accordingly, meanwhile some fears remain that small and medium-sized companies will now receive far less attention, which would be bad news for capital raising and stockmarkets generally. One also has to question whether in a 'google world' where much information is now free, what the longer term consequences will be and what business models will thrive and survive in the future...

Source: The Independent, FT.com, JP Morgan Asset Management – Guide to Markets December 2017

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News and views

Faster economic growth, a departure from the previous assumption that inflation was unlikely to increase and signs of wages picking up, have all been important in challenging the complacency in the markets about low volatility lasting indefinitely. With central banks clearly on the exit path to reducing extraordinary accommodation and markets finally pricing in an increased chance of the Federal Reserve actually delivering three rate hikes in 2018, increased volatility was always likely at some stage. Large positions had been built up in betting on continued low volatility (eg in inverse-VIX products); when the volatility spike correction came, capitulation on low-volatility bets magnified the dynamics, triggering margin calls that forced investors to sell a wide range of asset to raise cash fast. As markets started to fall and momentum picked up, sell orders were triggered by algorithms which use advanced mathematical models to make high speed trading decisions. It is therefore worth pointing out that the extent of the recent moves in markets have been driven by technical factors, not fundamentals. Economic and corporate profitability remains sound and in the immediate period ahead, we see continued strong global activity.

Indices	Value as at 31/01/2018	% Change on month	% Change year to date	% Change on 12 months
FTSE 100 Share	7533.55	-2.01%	-2.01%	6.12%
FTSE All Share	4137.66	-1.99%	-1.99%	7.24%
S&P 500	2823.81	5.62%	5.62%	23.91%
Dow Jones	26149.39	5.79%	5.79%	31.64%
Euro Stoxx 50 EUR	3609.29	3.01%	3.01%	11.72%
Nikkei 225	23098.29	1.46%	1.46%	21.31%
MSCI Emerging Markets	1254.59	8.30%	8.30%	37.98%
UK Treasury 4.25% 2027	124.98	-2.81%	-2.81%	-1.79%
Sterling/US$	1.42	4.88%	4.88%	12.84%
Sterling/Euro	1.14	1.55%	1.55%	-1.94%

Source: Bloomberg

US

In what some dubbed a "melt-up" – the self-perpetuating rally that often precedes a sell-off – the gains in equities through January were impressive, with the S&P 500 entering its longest period without a correction of more than 5%.

The latest batch of economic data indicated that momentum remained strong into year-end. Growth of the US economy in the fourth quarter of 2017 has mainly been attributed to the consumer, whose spending at 3.8% grew at its quickest pace in 18 months in the run-up to Christmas. US gross domestic product grew at an annualised rate of 2.6%, which, though slower than predicted, suggested that underlying demand was strong, especially as consumer

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confidence was matched by optimism among businesses. Business investment in equipment grew at an 11.4% rate, the quickest since the third quarter of 2014 and picking up from the third-quarter's 10.8% pace. Spending on equipment is likely to be underpinned in 2018 by the corporate income tax cuts and recent gains in crude oil prices.

UK

The UK's major market indices missed out on the wider rally seen across global stock markets against a backdrop of rising commodity prices, strong global growth expectations and strengthening sterling which rose to its highest level against the US dollar since the EU referendum. Sterling was supported by expectations that the Bank of England could increase base rates faster than previously anticipated and while this shift benefited sentiment towards companies with significant domestic exposure, relative US dollar weakness weighed on the overseas earnings of the UK market's many multinational constituents. January was a heavy month for trading updates, which brought a number of profit warnings, including Capita, Debenhams, Dignity, Carpetright, Card Factory, Connect Group and Mothercare (none of which we own), amongst others. Equities also faced headwinds from large cap defensive areas of the market that were negatively impacted as gilt yields rose in line with a broad-based sell-off in bonds.

Eurozone

Eurozone equities posted gains amid a robust growth backdrop and accelerating economy, but the region's economic expansion has led to some suggestions that the European Central Bank (ECB) could soon end its ultra-loose monetary policy. Investors are therefore now closely watching the ECB's monetary policy language, awaiting any hints of future plans to withdraw stimulus. So far the Governing Council has committed to continue asset purchases until September and not begin raising rates until "well after" the asset purchase programme ends. The European earnings season is about to kick off and earnings expectations look relatively modest given the strength of the economic backdrop. Consensus expects earnings growth to be around 10% this year, which is lower than the 13% achieved last year. If those expectations are reached or exceeded we would expect further positive returns.

Japan

Initial indications show a continuation of the strong profit growth seen so far this fiscal year as Japanese companies benefit from domestic reflation and a stronger global environment. In terms of economic data, preliminary estimates for industrial production growth of 2.7% year-on-year were supportive, although consumer spending slipped slightly. In the job market, unemployment fell further, but the focus is now on this year's annual wage negotiations, with wage growth needed to support spending and help counter the effect of higher food prices.

Emerging markets

These were some of the best performing equity markets in January, heavily driven by emerging Asia. A number of factors are supportive of activity and stocks in emerging markets, including a weaker US dollar, stronger commodity demand and prices, and an expansion in global business investment.

Fixed income

Broad-based growth, expectations for higher inflation, and greater supply put upward pressure on developed market bond yields throughout the month. In the UK, rates rose on the back of better growth expectations and growing optimism around Brexit negotiations. In the US, rates moved higher as generally positive economic data pointed toward a rate hike in March and in the Eurozone, German bonds experienced a similar sell-off as a rise in core inflation pushed the 10-year bund yield higher.

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