thesis

asset management

# Thesis Market Commentary

March 2018

*Under a system of perfectly free commerce, each country naturally devotes its capital and labour to such employments as are most beneficial to each... By increasing the general mass of productions, it diffuses general benefit, and binds together, by one common tie of interest and intercourse, the universal society of nations throughout the civilized world.*
*– David Ricardo, The Principles of Political Economy and Taxation (1821)*

President Trump's recent announcement of a new 25% tariff on imports of steel to the United States and 10% on certain aluminium products has led to speculation that the world may be on the verge of a trade war.

Trade is generally a good thing. Without it we would all be struggling in the style of The Good Life to be self-sufficient and produce everything we need to consume. With trade we can focus on doing a job we are good at, and buy the other things we need from others who are comparatively better at producing them.

Allowing everyone in the economy to specialise in something that they are good at makes the overall output of the economy larger. For example, I could knit myself a jumper, but it would take me a long time. On the other hand, if I spent that same amount of time analysing investments, something I am more qualified and experienced in, I could earn enough to buy a jumper and have money left over to spend on other things. That extra money is not just a benefit to me; it also enriches the producers of the goods or services I buy. By specialising we increase the income of the economy as a whole. The same is true internationally. Because of its financial service expertise, Britain is better off overall by exporting investment management services to the rest of the world, and importing jumpers. One could argue similarly that America is better off by exporting Hollywood films, large jet aircraft and so on, and importing steel from countries that can produce it more cheaply.

Of course the issue for politicians is that the people who previously forged steel in America are made worse off by this course of action. (Unless they retrain as film producers or aeronautical engineers and move to the west coast, which is costly and disruptive.) Even though the country as a whole is better off by free trade, the benefit is not spread evenly. President Trump has made the decision to make the US economy a little smaller in order to help certain industries. The risk is that other countries follow suit, and the cumulative effect is that the world economy becomes a lot smaller.

## What effect does this have on investments?

Recent developments in India have exemplified the benefits of freer trade to investors. Last year a common Goods and Services Tax (GST) was introduced throughout the country, but prior to this every state levied its own indirect taxes and excise duties. There were checkpoints on the borders between states where lorries faced long queues waiting for shipments of goods to be checked and the correct taxes paid. As a result, companies tended to have warehouses and factories in multiple states to minimise the impact of the delays. Now that the checkpoints have gone, firms can reduce their overheads by consolidating their operations. These lower costs mean that the companies can make greater profits, which has been beneficial to the Indian holdings within the emerging market funds in our portfolios.

It is difficult to make generalisations when choosing investments however. We live in a highly globalised world, which brings with it great complexity in terms of trading patterns. On the scale of an individual company we need to understand the dynamics of the products it sells. How mobile is the good or service which is being produced? Bulky or heavy but low value items such as bricks may not be economical to transport over very long distances. Many services can only be consumed where they are produced, for example haircuts. What is the company's production cost relative to other producers worldwide once transport costs are taken into account? What are the barriers to entry of the industry? For example the costs of starting a new window cleaning business will be much lower than for starting a new investment business, because of the need to comply with much greater regulation in the latter case. Are there economies of scale or network effects? Technology companies cluster in Silicon Valley partly because of the high concentration of suitably skilled staff. All of these factors contribute to our assessment of an equity.

CONTINUED ON P2

## Capitalising on trade pessimism

Most governments understand the benefits that trade brings, and will not want to retaliate against the new US restrictions in a fashion that risks an all-out trade war where countries raise tariffs and other barriers significantly. We therefore think that the risk to portfolios from trade restrictions is small.

Negativity can provide opportunities however. We are currently optimistic about the UK equity market, feeling that it has been held back by uncertainty since the Brexit referendum in a way which does not accurately reflect the prospect of many companies. In the long run politicians and their decisions do not drive markets. Portfolio returns are fuelled to a much greater extent by choosing well-managed companies with strong fundamentals and buying them when they are trading at cheap levels relative to the rest of the market. Despite possible changes in trade patterns we are therefore maintaining a substantial weighting to UK equities, including several relatively unloved companies which we think are trading too cheaply.

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## News and views

| Indices | Value as at 28/02/2018 | % Change on month | % Change year to date | % Change on 12 months |
|---|---|---|---|---|
| FTSE 100 Share | 7231.91 | -4.00% | -5.93% | -0.43% |
| FTSE All Share | 3981.61 | -3.77% | -5.69% | 0.71% |
| S&P 500 | 2713.83 | -3.89% | 1.50% | 14.82% |
| Dow Jones | 25029.20 | -4.28% | 1.25% | 20.26% |
| Euro Stoxx 50 EUR | 3438.96 | -4.72% | -1.86% | 3.60% |
| Nikkei 225 | 22068.24 | -4.46% | -3.06% | 15.43% |
| MSCI Emerging Markets | 1195.19 | -4.73% | 3.17% | 27.64% |
| UK Treasury 4.25% 2027 | 124.90 | -0.06% | -2.87% | -4.89% |
| Sterling/US$ | 1.38 | -2.81% | 1.93% | 11.02% |
| Sterling/Euro | 1.13 | -1.16% | 0.37% | -3.53% |

*Source: Bloomberg*

Equity markets suffered a sharp correction at the beginning of February, but as the month progressed, markets regained their poise and refocused their attention on the continued strong corporate and economic data. The spike in volatility, which was compounded by forced selling by some investors of complex passive 'inverse volatility' products, was sparked by rising yields and investor concerns over rising inflation that suggested a quicker path to normalised interest rates. Higher interest rates by themselves are not a disaster, but if we experience a broader tightening of financial market conditions, including a stronger dollar and wider credit spreads, volatility could reset to more normal (higher) levels.

**UK**

Like all the world's leading stock markets, the UK was down in February led by tobacco and other perceived defensive sectors, such as utilities and telecoms – the so-called "bond proxies"– where investors often seek shelter. We have been rotating our UK equity portfolio away from such sectors, given the prospects for higher interest rates and instead favoured quality companies with wide moats that protect them from competition such as those in the specialty chemical or industrial sectors that should also continue to benefit from the global upswing in economic growth.

We are also watching economic data from the UK very closely for any signs of an improvement in corporate and consumer confidence. The domestic focused stocks are beginning to look cheap on a relative basis and may therefore offer up a good entry point if we start to see any sort of recovery in sentiment. In addition to this, we think we are likely to see a switch in earnings momentum away from the UK's overseas earners and towards its domestic earners as sterling continues to rebound.

The UK's Monetary Policy Committee (MPC) voted unanimously to maintain the Bank Rate at 0.5% and upped its GDP forecast for 2018 to +1.8%, better than many expected last year, but still subdued by historical standards. The MPC did however note that, should the economy evolve in line with its projections, the interest rate would need to be increased somewhat earlier and by a somewhat greater extent than previously anticipated in order to return inflation to the 2% target. The upshot of this was the market priced in a 70% probability that interest rates would be 0.25% higher following the May Bank of England meeting.

**US**

Some investors are concerned that the Federal Reserve (Fed) will raise its rate four times this year, rather than the projected three, fuelled by inflationary worries following the release of January's strong wage growth data (+2.9%) and concerns the recent tax cut package may add further stimulus

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into what is already a strongly growing economy. It is not unreasonable that investors focus on the rise in hourly wages as being a harbinger of future inflation, the easy and apparent conclusion, however, is not correct. The average hourly wage rate rose only because the hours worked fell more than the total wage bill. This is not to deny that average wages are trending higher. But, January's spike does not make a case for runaway inflation. We also think the Fed is unlikely to move rates higher abruptly because there are too many cases in the past where the consequences of sharp increases have created dire circumstances for the economy.

**Europe**

Despite the correction in financial markets, macroeconomic fundamentals supporting the European economy remain very strong. The European Commission revised up its economic growth forecasts, now expecting GDP growth of 2.3% in 2018 and 2.0% in 2019. We did however see some softer data points with the eurozone composite purchasing managers' index (PMI) dipping to 57.5 in February, retreating from the near 12-year high reached in January. Inflation also moderated to 1.2% in February from 1.3% in the previous month. Within equity markets, all sectors retreated in February. The best performing sectors were energy and information technology sector. Meanwhile, the healthcare and consumer goods sectors were the biggest detractors given their high sensitivity to a change in interest rates and bond-like characteristics.

**Emerging markets**

In the emerging market universe, EMEA outperformed although was still down, supported by South Africa (Zuma resigned as president) and Russia (currency movements), while Asia Pacific underperformed against Latin America, which again was helped by a relative outperformance from Brazil. Within Asia, North Asia markets underperformed ASEAN and everywhere outperformed India, which fell 6.7% (government introduced a long-term capital gains tax on stocks in its budget). China (down 6.4%) and Korea (down 6.3%) were also noticeably weak, especially during the early month sell down. Thailand took the honour of being the only Asia market to show a gain.

**Japan**

Economic data releases were generally weaker than those seen in recent months, but we feel some data points were influenced by a number of one-off factors such as the timing of Chinese New Year and also as a result of poor weather. We still expect Japan's GDP growth to remain firm at 1.0%–1.5% in 2018, with risks tilted to the upside. Fiscal policy is likely to remain supportive ahead of the planned value-added tax hike in 2019 and with unemployment below 3% and job growth accelerating, inflation should move up. January's core inflation data provided a positive surprise with 0.9% year-on-year ahead of consensus estimates of 0.8%. Third quarter corporate results season has thus far delivered more positive surprises than negative ones which have led to upward revisions to full year earnings guidance. We continue to believe that the valuation case for Japan still holds and that Japanese corporate earnings growth is likely to exceed global peers.

**Fixed income**

US Treasury yields continued to rise at a robust pace reaching an intra-month high of 2.95% as stronger than expected US economic data and signs of higher inflation led the market to start positioning for more US interest rate rises than had previously been thought necessary. The minutes of the Federal Reserve's January meeting were also a timely reminder that we are in the midst of a monetary tightening phase. UK 10-year gilt yields ended the month marginally lower at 1.50% against a backdrop of more hawkish comments from Bank of England Governor Mark Carney. European yields moved sideways, following January's upward move, with the 10-year Bund down slightly from 0.70% to 0.66%. Corporate bonds made negative total returns and underperformed government bonds with a slightly larger decline in investment grade than high yield.

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