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Global Market Strategy – April 2018

- ***Volatility in full swing but bull market not over yet***

There was a sell-off in early February and then markets recovered. The last ten days of trading in March saw heavy selling. All of a sudden there is plenty to worry about: the threat of a new cold war; a trade war with China; Brexit; inflation; and now consumer privacy violation, leading to the likelihood of increased government regulation.

However, refreshingly, markets are healthy again. We needed a reality check. 2017's goldilocks scenario is over and we are back to the occasional cleansing that markets have to go through to stay healthy, flushing out over-exuberance and bringing a sense of balance. The US market now trades on 17 times forward earnings - expensive but not excessively so. Corporate earnings will grow 17% this year and there are some companies which are still very reasonably priced, but the big change is the high level of uncertainty, as reflected in the yield curve of both the UK and the US.

Many tech stocks, whose valuations have been serenely rising for the last decade, got clobbered during March. Facebook, is down 19% this last quarter; Apple is down 'just' 8%, and there are many in between. Amazon fell 9.6% and Netflix fell 8.5% just last week, yet the US tech-heavy Nasdaq still closed up 2% on the quarter. Despite the falls in March, tech is the one sector that is fundamentally sound far more so than any other.

Say good-bye now to passive investing. During the last five years you could buy an index fund in any sector and sit back. Now investors have to seek more discerning returns.

It is by no means certain that interest rates will rise as quickly as many commentators are expecting, viz three more rises in the US this year and one in the UK in the Autumn. Wage inflation is pitiful in the UK and only marginally better in the US, which does not bode well for retail, already suffering from the dominance of Amazon.

One company not suffering from the online behemoth is McDonald's, which seems to have found another niche. McD is a meeting place for the young, and since a new British brand manager took over in 2015, quickly to become the multi-millionaire CEO a year later, the chain has gone from strength to strength, promoting all-day breakfasts, good coffee and healthy menus. The share price was languishing around $90 when Stephen Easterbrook took the helm; it is now $159, having recently been above $170. In spite of its 2.5% dividend yield it trades on more than 22 times earnings, so it is expensive but its return on equity has constantly been above 30% over the last few years.

It is stories like this that investors have to search out - companies with what Warren Buffett calls 'stickability', ie likelihood of continual client loyalty and good margins. When the market sells off, it presents investors with buying opportunities but McDonalds is an example of having to pay top dollar for a quality stock. Few shares are on sale but Apple makes a case for itself: it trades on less than 15 times forward price earnings, has mid-thirties percentage return on equity, carries plenty of free cash and offers a 2% yield. The stock could however be jeopardised if a change in sentiment toward the technology sector is prolonged but Apple's valuation is in stark contrast to Amazon's. Amazon's share price of nearly $1500 means buying into 176 years of profitable future growth, and right now there is no dividend. True, analysts are expecting earnings to rise at a compound annual rate of 37% between 2017 and 2019 but a forward PE of 176 requires a faster rate of growth than that.

As we start a new quarter, several fund managers have come out with their prognostications for asset and geographical sector performance from now on to the end of the year. Consensus among them is that while equities will be volatile but trending gently higher, property is an unfavourable bet right now. For those who have a good yield, they can afford to ride the market; for those looking to enter, they are doing so at a time in the UK when the bubble is big.

The three areas for equity advances remain Europe, Asia and Japan, with China remaining key to the Asia-Pacific region. With President Xi being given a free and indeterminate reign beyond the usual 10 year limit, he should be able to drive through necessary reforms such as the opening up of the A-share market, more flexible exchange rates and development of a broader bond market. An extended Xi tenure also makes it more likely that the elephant in the room, China's debt problem, can be effectively managed. This is clearly recognised in Beijing as an important issue and sorting it out will be a multi-year project.

Against this backdrop, the ongoing consumption story with a growing middle class and opportunities in a wide range of sectors from airports to technology and financial services looks appealing.

China's increasing dominance of the region, while a geo-political threat, also has a silver lining. Asia Pacific is increasingly becoming an autonomous region which can shrug off Donald Trump's protectionism and still thrive in a less open world.

Elsewhere in Asia, the Indian story remains a long-term positive. The economy is overcoming some short-term hurdles such as the recent demonetisation measures and the harmonisation of taxes across the country. Companies held back on investment while these were pushed through, but GDP growth is strong and there is scope for significant infrastructure improvement.

On the currency front, Britain's currency is looking stronger despite the doom and gloom merchants. Many are preoccupied with concerns over Brexit but sterling has risen 13% against the US dollar since Donald Trump became President, helped no doubt by his repeated statements in favour of a weaker dollar. Chart analysis suggests current levels around $1.40 to the pound could bounce higher to the psychological $1.50 mark later this year, a move that could come sooner rather than later following the dollar's sustained fall through 91 on the US dollar futures index earlier this year. Despite its apparent support at 89, analysts predict a greater likelihood of a decline to 85 rather than a rally to 91. If the top of the range in US Treasuries is 2.80% rather than 3.20% for the 10 year, the $1.50 level could be breached comfortably.

Dollar index, 6 months to March 30th, 2018. Source: BIgcharts.com

Favoured investment plays:

Nil risk:	USD cash (in preference to Euro cash)
Cautious risk:	AAA Corporate
Balanced risk:	Managed / Multi-asset funds / Long-Short Absolute Return funds
Market risk:	UK**, European equity**
Adventurous risk:	**Japan, Asia, Germany,** US equity, UK/European/US smaller company sector
Speculative risk:	**Water, Technology, China, India, Other EM**

Disclosure:

Nicholas Chappell has the following personal investment exposure: Technology (including new energy, all US) 33%, Global Equity 18%, US smaller cos 2%, (Other) US equity 8%, Germany 5%, India 4%, (Other) Asia 13%, Pharmaceuticals 13%, China 4%

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