FOR PROFESSIONAL ADVISERS ONLY

Market Update

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SQUARE MILE
INVESTMENT SERVICES

Financial markets rebounded over the first quarter, recovering a large part of the losses suffered during the final quarter of last year. The FTSE All Share index closed the quarter up by 9.4% and similar returns were generated by other global stockmarkets. Remarkably, the returns from the gilt market were also high. At the beginning of the year, the total fixed return for investing £100 in a 10 year gilt bond was a pitiful £13, if held for the full term. Already this year, such an investment has generated over £3. Therefore, over the next 9 ¾ years, the bond will provide a further, paltry, £10 gain. If the price of these gilt bonds is correct, it informs us much about the future path of interest rates and hints at dreary growth prospects for the economy. A similar picture is also forming in the other major developed economies such as Europe and the US.

Whilst climbing asset prices always provide a warm feeling for investors, the reasons behind the recent price jump are not so cheery and reflects the moderating economic growth outlook. The correction in asset prices in the final quarter of last year began when markets started to recognise that the lacklustre outlook will ultimately impact profits growth. What has changed this quarter is that central banks around the world have begun to acknowledge this in their management of short term interest rates, thus triggering markets to rally.

The most powerful global central bank is the Federal Reserve, America's equivalent to the Bank of England. The Federal Reserve had previously been on course to gradually lift interest rates from the abnormally low levels that have prevailed over the last decade. It now looks likely that the US economy will not be able to support interest rates much above where they currently lie. At 2.5%, rates are currently less than half the level that they were before the crisis. Interest rates in the UK and Europe are well below this level and unlikely to be lifted significantly higher without risk of pushing economies into recession. The poor interest rate outlook has made the already low yielding government bond market appear more attractive. This has resulted in a jump in values of gilt bonds, which in turn has increased the attractiveness of other financial assets such as stockmarkets.

A strong quarter for financial markets

In effect, returns from tomorrow have been brought forward to today. This means the future returns from cash, bonds and equities will be lower. This perhaps is an inevitable consequence of our ageing populations and a heavily indebted economic system. On the other side of the pond, President Trump's attempt to re-energise the US economy through higher spending and tax cuts appears to be falling short of expectations. Efforts to increase growth in the European economies also seem to have had little success.

We have no wish to appear despondent on the outlook, indeed we are not. Instead, we continue to warn clients that future returns will be low, and the news over the last few months has caused us to ratchet these expectations down once again. Returns over the last few years have been boosted by several of these revaluation events. There may be further episodes to come, which would enhance short term returns but cause a further reduction in long term expectations. Economies will continue to grow, but at a lower pace than we have experienced through much of our lives.

As is usual, the best long term returns are likely to come from risk assets such as equities and these we believe will be able to deliver returns well ahead of inflation. This is not something that can be said for returns from cash and bonds, where the purchasing power of money placed into these vehicles seems certain to diminish. We, as your investment manager, can help offset the prospect for lower returns by focusing on funds that are run by talented managers who can generate better than average returns. We can also boost returns by minimising costs. Unfortunately good investment funds do come at a price, though perversely the very worst funds are often the most expensive. Square Mile employ a large and very experienced team which seeks out the most attractive and best value investment funds for your benefit. Our costs of doing this are kept deliberately low by spreading them across a wide client base.

We are making a few changes to the portfolio. Following the retirement of the lead manager, we are switching the position from the Schroder Tokyo fund into alternative but very well run Japanese funds. For more cautious portfolios, we also making changes to the absolute return fund holdings and enlarged the exposure with the introduction of a new fund. The last 18 months have been difficult for absolute return strategies but we believe that conditions are improving for them and that this should allow the managers to generate worthwhile returns.

With the benefit of hindsight, we may have missed an opportunity at the beginning of the year to buy equities at cheaper prices. We mentioned in our report at the end of December that prices were closing in on levels where we would become buyers. Frustratingly, markets rallied before these were reached. What we take from this experience is how sensitive valuations are to declines in long term interest rate expectations and that central banks are ready to lower rate expectations to support fragile economies. While this remains the case, equity valuations are unlikely to fall to bargain levels. Next time we shall have to factor this into our buying trigger.

However, this sensitivity to interest rates does highlight a potential risk. Inflation over recent years has been very modest and this has allowed central banks to lower rates to support growth. If price increases become material and widespread, central banks will be forced to lift rates, possibly rapidly. This would have very unpleasant consequences for financial markets. Fortunately, we don't see this as a likely outcome but the threat means that we are unlikely to become aggressively positioned

A reduction in growth and interest rate expectations

in the portfolios, especially at a time when valuations are not cheap. Our central expectation is that markets will remain volatile but gradually advance over time with the best, though most volatile, returns coming from equities.

One matter that we have not mentioned is Brexit. At the time of writing, this remains unresolved. Predicting the political outcome of this process is impossible and our investment strategy on UK equities reflects this. Even once the political decision has been taken, the economic consequences will be very uncertain. However, in time these uncertainties will diminish and eventually clear. Talented fund managers should be able to identify companies that will benefit from this changing landscape and profit from these opportunities. We are alert to this and poised to act once the political course of action has been clarified.

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