LONDON WALL PARTNERS

INDEPENDENT FINANCIAL ADVICE

INVESTMENT MARKETS COMMENTARY
TO 30 JUNE 2019

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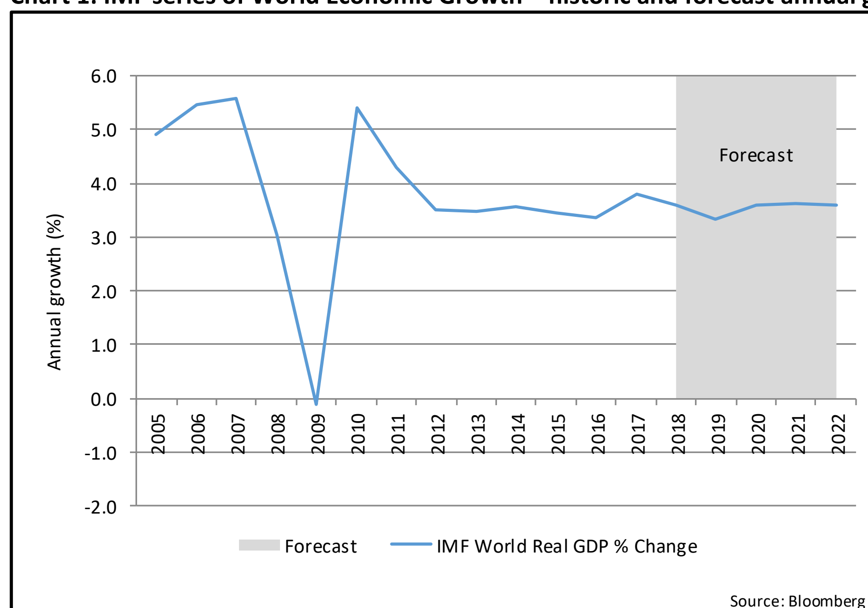
1. Investment markets commentary to 30 June 2019

Financial markets have delivered strong returns for investors so far in 2019, reversing the weakness in share prices seen in the final months of 2018. Bond markets have been reacting positively to subdued inflation and declining economic growth forecasts and stock markets have been supported by lower interest rates. There have been several reasons GDP expectations have been reduced, most notably the adverse impact of the trade war between the US and China; in addition, Brexit uncertainties and ongoing difficulties for the European car industry, as consumers seemingly turn against diesel, have damaged confidence. Despite these issues, both we and economic forecasters expect this prolonged business cycle to continue; Chart 1 below shows the historic annual growth rate of the world economy since 2005, together with the International Monetary Fund's ("IMF") forecasts for the next four years.

Chart 1: IMF series of World Economic Growth – historic and forecast annual growth rates.



It appears likely that markets and businesses will have to learn to live with trade skirmishes while President Trump remains in the White House. Recent pronouncements may have renewed hope that a deal can be reached with China, but his successful use of the threat of higher tariffs to persuade Mexico to tighten its border security is only likely to encourage him to use similar tactics elsewhere. Trump appears to have an issue with European luxury car manufacturers, so it wouldn't be a surprise if the EU becomes a focus for the next trade spat; this seems especially likely as he seems eager to get involved in Brexit negotiations which will start in earnest at the end of July, when the UK has a new Prime Minister.

For the first two years after the Brexit referendum vote in 2016, the UK economy appeared to shrug off the uncertainties surrounding the UK's future trading relationship with the EU, but in 2019 the situation has begun to deteriorate. This, together with the uneasiness caused by the change in Prime Minister, has been noted by the currency markets and sterling has weakened, as shown in Chart 2 below. The decline in the pound has boosted the return from overseas investments but this could reverse should a resolution on Brexit be achieved before the next proposed departure date of 31 October 2019.

Chart 2: Trade-weighted sterling exchange rate since 2015.

Summary of global market performance

Table 1 shows that, during the twelve months to 30 June 2019, company shares (measured by the FTSE All-World Index) returned 6.5% in local currencies, and 10.1% in sterling. UK Government bonds and UK index-linked gilts rose 5.3% and 6.9%, respectively, while US Treasuries returned 7.3% in local currency and 11.3% in sterling. UK commercial property gained 3.8%.

Table 1: Six and twelve month market returns.

	% Total Return			
	Six months		Twelve months	
Index	local	£	local	£
FTSE All-World	16.1	16.4	6.5	10.1
FTSE All-Share (£)	13.0	13.0	0.6	0.6
S&P 500 ($)	18.2	18.3	9.8	13.9
FTSE Europe ex-UK	18.2	17.9	6.6	8.6
TOPIX (Y)	5.2	7.5	-8.2	-2.1
FTSE All-World Asia ex-Japan	12.2	12.1	2.2	4.8
FTSE Emerging Markets	11.0	12.0	4.5	8.3
FTSE UK Govt 5-15 years (£)	3.7	3.7	5.3	5.3
FTSE UK Govt I-L 5-15 years (£)	4.0	4.0	6.9	6.9
iBOXX £ Corp Bonds 5-15 years (£)	7.1	7.1	7.1	7.1
ICE US Treasury Index ($)	5.3	5.4	7.3	11.3
MSCI UK Monthly Property (£)	1.0	1.0	3.8	3.8
Gold Bullion ($)	10.8	10.9	13.1	17.3

Table 2 shows returns over the last three and five years. Company shares have generated the strongest returns in sterling terms over the longer term; the US stock market has performed particularly well, but the UK has lagged. UK commercial real estate, bonds and gold have also produced positive returns.

Table 2: Three and five year market returns.

	% Total Return			
	Three years		Five years	
Index	**local**	**£**	**local**	**£**
FTSE All-World	42.1	48.1	50.5	86.0
FTSE All-Share (£)	29.5	29.5	35.8	35.8
S&P 500 ($)	46.2	53.6	61.3	116.7
FTSE Europe ex-UK	36.0	44.0	36.8	53.8
TOPIX (Y)	33.1	33.1	36.6	72.6
FTSE All-World Asia ex-Japan	36.5	42.4	36.8	64.3
FTSE Emerging Markets	37.4	42.4	37.5	57.5
FTSE UK Govt 5-15 years (£)	5.7	5.7	25.9	25.9
FTSE UK Govt I-L 5-15 years (£)	13.2	13.2	28.2	28.2
iBOXX £ Corp Bonds 5-15 years (£)	15.5	15.5	33.4	33.4
ICE US Treasury Index ($)	4.1	9.3	13.9	53.0
MSCI UK Monthly Property (£)	21.0	21.0	54.3	54.3
Gold Bullion ($)	8.7	14.1	7.6	44.5

Notes:
1. Figures as at 30 June 2019.
2. All figures include income reinvested.
3. Local currency indicated in index name, for single country indices.
4. MSCI UK Monthly Property Index may be subject to retrospective revision.
5. Source: FE Analytics.

2. Outlook and approach

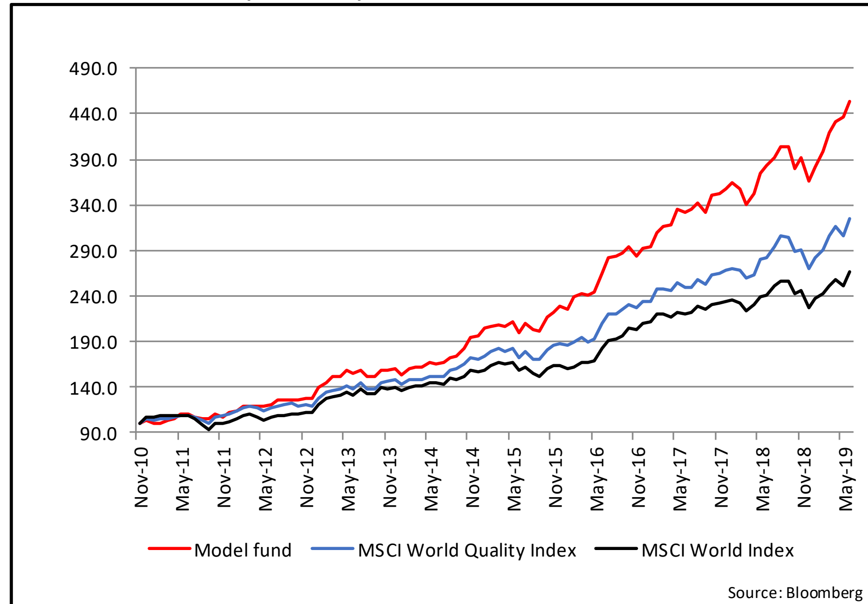
Given we continue to believe that the world economy is in a prolonged era of expansion, we have retained our recommended asset allocation; we still expect that investing in strong companies will prove rewarding for long-term investors and our strategy favours stocks in preference to bonds.

While uncertainties provoked by Brexit and President Trump's trade battles may challenge corporate, consumer and investor confidence in the short term, the company share funds that form the foundation of your portfolio are focused on quality businesses, which should thrive despite such concerns. Our favoured funds have a negligible weighting in those automotive, agricultural, chemical and airline stocks which could suffer from a no-deal Brexit and / or higher trade tariffs, focusing instead on resilient industries such as personal care, consumer staples, software, healthcare and specialist industrial sectors.

The graph overleaf is a reminder of how this element of our strategy has fared over recent years. It compares the return of the World Index with the World Quality Index and one of our actively managed model funds which focuses on high quality companies. The World Quality Index aims to capture the performance of a broad number of quality growth companies by using a quantitative approach to identify companies with a high return on equity, stable annual earnings growth and low financial leverage.

Chart 3 shows that our model fund (red) has strongly outperformed the Quality Index (blue) since inception, and both have beaten the World Index (black) by a considerable margin; we expect this to continue in the years ahead.

Chart 3: Performance of a model portfolio fund (red line), the World Quality Index (blue line) and the World Index (black line) since 2010.



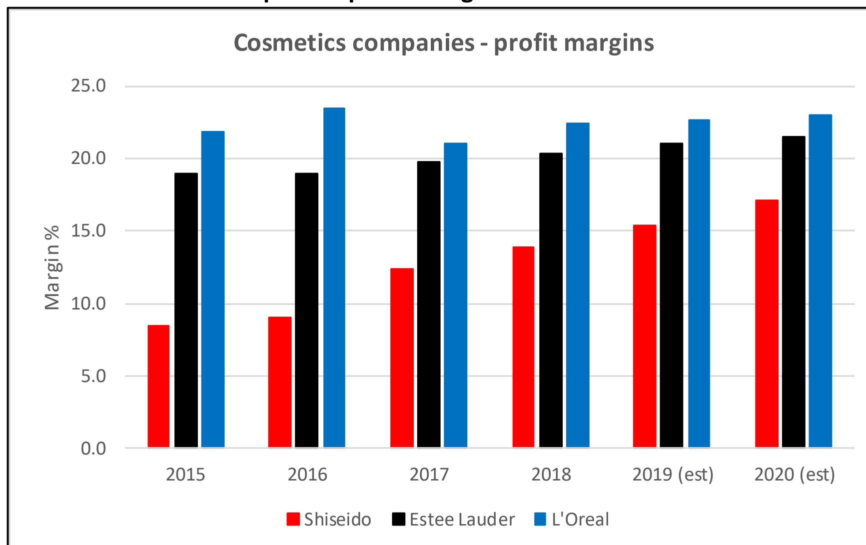
(for the purposes of this graph, we selected the model quality-focused fund with the longest track record of the three such funds we recommend; these funds have different portfolios, but similar returns over comparable timescales).

The majority of our recommended company share and real assets allocations are to funds which invest globally, seeking to hold the most attractive investments irrespective of where they are listed. In addition, we continue to recommend funds which are focused on Japan and on Asia; while some of our global funds have holdings in these markets, their overall allocations are relatively modest.

There are several reasons that we advocate a dedicated allocation to Japan. First, many Japanese companies have first-class products, but don't currently generate comparable levels of profitability to their Western peers; this has been recognised by the Japanese government and their corporate governance initiatives are focused on raising the returns of Japanese businesses. Secondly, Japanese companies are world leaders in a number of fast-growing sectors, such as robotics and factory automation, and thirdly the Japanese stock market offers attractive diversifying characteristics for portfolios. The first of these points is illustrated in the chart overleaf; this shows the historic and prospective profits margins of three leading global cosmetics companies.

Chart 4 shows that (i) L'Oreal's margins (blue) are expected to remain the highest over the six-year period, (ii) Estee Lauder's margins (black) should gradually increase towards the standards set by L'Oreal, and (iii) margins at Japan's Shiseido (red) are catching up rapidly. Shiseido's improving performance is no accident. In 2014 the company appointed a new chief executive, and his prior experience at Kraft and Coca-Cola has helped him to improve corporate performance by confronting historical cultural issues and increasing spending on branding and advertising. As Shiseido's profit margins improve, the increasing cash flow will permit yet more to be spent on marketing.

Chart 4: Cosmetics companies' profit margins.



Source: Bloomberg

We also recommend clients have an allocation to Asia and / or emerging markets, as increasing wealth and positive demographic trends should help drive strong consumer spending growth in these regions. One of the ways we monitor economic developments in these regions is to study BP's annual reviews of the global energy market, as they provide insights into economic development and consumption in emerging markets; their reports are also longer term in nature than those typically available from financial market analysts and are particularly appropriate for our investment time horizon. Another reason we look at BP's work is that it gives us insights into other important developments, such as climate change, and the likely electrification of the world's car fleet.

BP's 2019 reports confirm just how fast growing the Chinese and Indian economies are, and how important they will be to growth in the world economy. The table overleaf shows energy consumption in key economic regions and countries from 1997 and 2017 (the latest figures available), together with BP's projections for 2040.

Table 3 – Primary energy consumption (in million tonnes of oil equivalent (Mtoe)).

Area	*1995*	*2017*	*2040*
OECD	5,214	5,738	5,719
Non-OECD	3,351	7,773	12,147
US	2,070	2,235	2,223
EU	1,678	1,689	1,475
China	891	3,132	4,017
India	252	754	1,928

Source: BP Energy Outlook, 2019.

This data highlights that:

- Energy consumption in developed OECD countries is broadly stable, as energy efficiency programs offset the demand growth caused by economic expansion; energy consumption is expected to decline in the EU in the next twenty years.

- Energy consumption outside the OECD will increase by a multiple of 3.6 times from 1995 to 2040, as economies grow and consumers can afford to use more energy.

- Over the same time period, energy consumption in China is projected to increase by a multiple of 4.5 times and India by 7.7 times.

- Global greenhouse gas emissions will only be contained if material progress is made in China and India; it could be that pollution issues in these countries force governments to take decisive action.

In addition to studying the annual forecasts we also monitor how these numbers change over time; there are some encouraging signs on climate change as over the last five years BP has reduced its 2035 forecasts for coal consumption by over 1000 Mtoe p.a., primarily due to a change in fuel mix in China; they have also increased their forecasts for renewable generation in 2035 by nearly 1000 Mtoe.

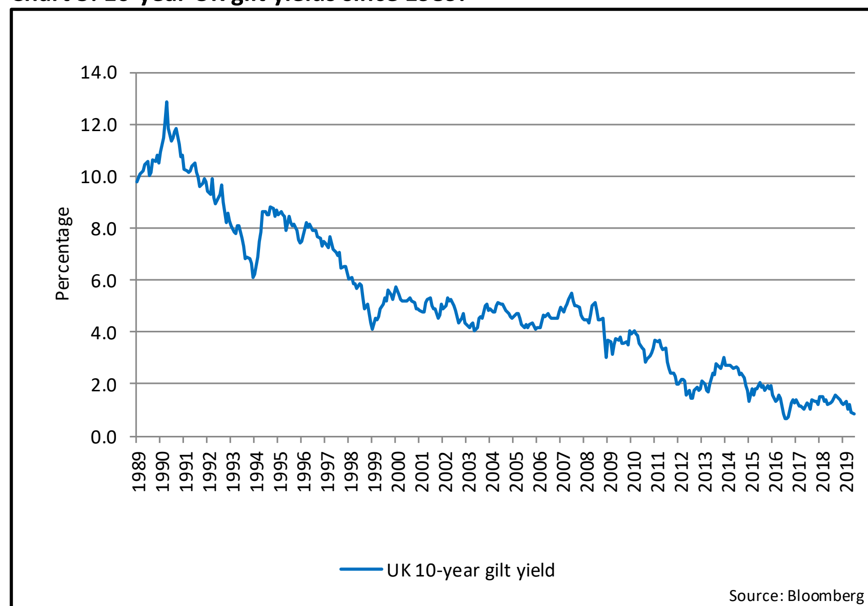
Our recommended funds should not be at risk from a more aggressive approach to reducing carbon emissions as they have a negligible allocation to fossil fuel producers; they also generally avoid the automotive, airline, cement, chemicals, mining and shipping industries, all of which are material emitters of carbon dioxide. However, we keep an eye on the matter to ensure the manager of our global listed infrastructure fund is continuing to assess appropriately the opportunities and threats for their investee companies, such as electricity transmission businesses.

We also track the development of the electric car industry as one of our model funds has an investment in Tesla and its Chinese peer, Nio. Progress to date has been slow but increasing pressure from governments (such as the UK's proposal to achieve net zero carbon emissions by 2050) may yet speed up electrification. BP also note that the introduction of autonomous vehicles could adversely affect some industries; it is plausible that car ownership will cease if self-driving cars can be hailed on demand. Banks may suffer from lower demand for car loans and with the probable improvement in safety, the car insurance industry will be disrupted; our model funds have next to no allocation to banks or insurance.

3. Bonds and cash

We continue to be cautious about bonds. The asset class is likely to generate only modest performance as yields are low, and prospective returns are unlikely to match inflation over the medium and long term. The valuation argument against bonds also appears strong. Chart 5 below shows the yield on 10-year UK gilts since 1989; with yields near the bottom of their historic range, we think that bond markets remain poor value and prices could decline.

Chart 5: 10-year UK gilt yields since 1989.



We believe company shares, listed private equity and infrastructure and commercial real estate should deliver superior returns to bonds and currently bonds should only be held as insurance against unexpected adverse events; we continue to recommend clients should have the lowest bond allocation appropriate for their circumstances. We also recommend clients seek the highest quality insurance, i.e. government rather than corporate bonds. For clients who require bonds to provide portfolio protection, we currently advocate a mix of UK index-linked gilts and US Treasuries.

3.1. Index-linked bonds

Index-linked gilts should provide a low positive return if held to redemption, based on current inflation rates and forecasts. UK index-linked gilt redemption values and coupons are adjusted using the RPI measure of inflation and the Office for Budget Responsibility expects RPI to be c.1% per annum higher than the CPI measure of inflation, due to differences in the way the two series are calculated. The Government's target for CPI inflation is 2% p.a., implying that RPI could average c.3% p.a. With real yields on our recommended index-linked gilts close to -2.3% on average, the prospective return to maturity of these stocks would therefore be c.0.7% p.a.

Gilts are exempt from capital gains tax, so we recommend index-linked gilts with low coupons; these are more efficient for taxable accounts as a larger share of the return is earned in tax-free capital gains, rather than taxable income.

3.2. Conventional bonds

While index-linked gilts offer a modest degree of protection against an unexpected increase in inflation, conventional bonds should provide a defence against a recession; interest rates are usually cut in response to an economic downturn and this generally supports bond prices. We are currently advocating a minimal allocation to conventional bonds as yields and prospective returns are low and we are not expecting an imminent recession. Our preferred conventional bond market is in the US where Treasuries offer close to the highest yields of any G7 country and the highest quality insurance.

3.3. Cash

UK interest rates have been 0.75% since August 2018 and returns from cash are likely to remain below the Government's CPI inflation target of 2% p.a. for the foreseeable future. We recommend that long term investors remain fully invested, with cash weightings as low as practicable.

4. Real assets

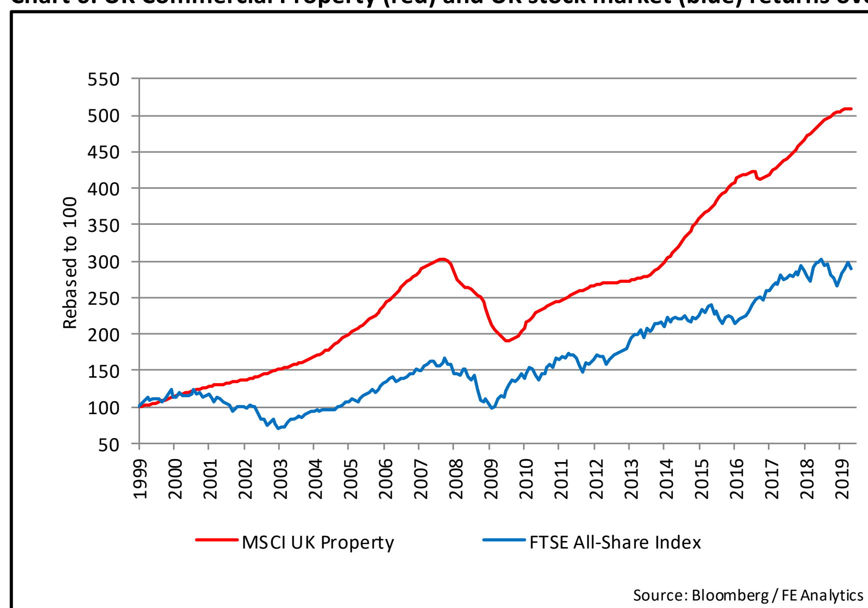
We continue to recommend allocations to commercial property and global listed infrastructure. We expect these real asset investments to outperform cash and bonds, to deliver attractive returns above inflation over the medium and long term and to provide appropriate portfolio diversification.

4.1. UK commercial real estate

The UK commercial real estate market has continued to deliver positive absolute and real returns over the last year, despite challenges on the High Street. The growth in popularity of online shopping has led to numerous store closures, while logistics operators have continued to invest in additional warehouse capacity. Though retail properties have generally declined in value, the industrial sector has delivered strong capital gains; returns from offices have been close to the property market average. The year ahead is likely to see more of the same.

While UK commercial real estate returns have not matched those of stock markets over the last year, this is not the case over the long term, as shown in Chart 6 below:

Chart 6: UK Commercial Property (red) and UK stock market (blue) returns over the last 20 years.



UK commercial property is the main element of our recommended portfolios which could be vulnerable to a no-deal Brexit; should the UK's trading arrangements deteriorate materially as a result, the domestic economy will probably suffer, and thereby adversely impact occupier demand and rental growth. Conversely, however, should the resolution of the Brexit conundrum lead to improved corporate confidence and stronger sterling, UK commercial property would most likely deliver the strongest short term returns of our recommended assets. Looking further ahead, we remain confident that UK real estate will continue to provide attractive real returns; first, because initial income yields exceed inflation, and secondly because of the tight supply / demand balance in the office and industrial sectors.

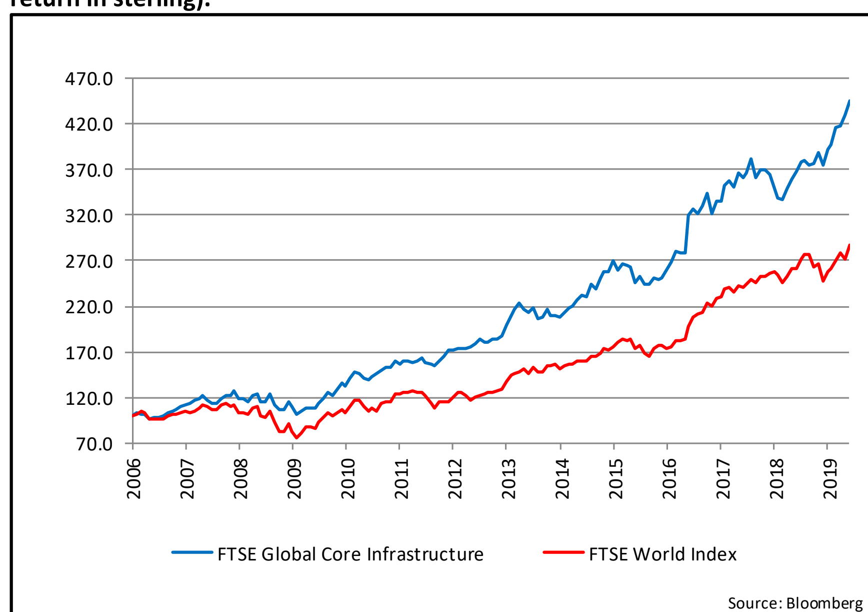
4.2. Infrastructure

Infrastructure companies operate long life assets such as ports, airports, gas, water and electric utilities, pipelines and tolls roads. Their profits are relatively unaffected by economic cycles and therefore infrastructure is usually regarded as a defensive asset class. Many infrastructure assets are insulated from inflation by regulation, concession terms or contracts that are explicitly linked to a relevant inflation rate.

Infrastructure assets generally have long lives and stable cash flows, which support their long-term value, especially as few have material maintenance requirements. Infrastructure companies also rarely have competitors and therefore can be subject to government regulation; we advocate taking a global approach to investing in listed infrastructure to diversify regulatory and political risk across different jurisdictions. The manager of the global listed infrastructure fund we recommend (which invests in some UK companies) will be monitoring developments at Westminster closely in the near term, as the current leadership of the Labour party has indicated they may seek to renationalise some UK utility companies should they form the next Government. With the European Convention on Human Rights requiring that fair compensation is paid when property is acquired by the state, investors should be protected, but the share prices of the relevant companies could be sensitive to developments in the short term.

Listed infrastructure companies have delivered competitive returns over the long term as shown in Chart 7 below; since 2006 the FTSE Global Core Infrastructure index (blue) has outperformed the FTSE World index (red), and it also declined less during the GFC of 2008 / 2009.

Chart 7: FTSE Global Core Infrastructure index (blue) and World index (red) since 2006 (total return in sterling).



4.3. Gold

Gold gained 17.3% in sterling terms in the last twelve months. Over the last five years its increase of 44.5% in sterling terms has been lower than that of most major company share markets and property; the price had been relatively stable from 2014 until May 2019, but rose to over $1,400 an ounce during June 2019 in an apparent reaction to several incidents with oil tankers in the Middle East.

Some investors hold gold in the expectation that it should increase in value during times of stress in other financial markets. We prefer to recommend conventional and inflation-linked government bonds for portfolio protection, as they offer a guaranteed redemption value and an income, which gold does not. The gold price remains materially below its all-time high reached in 2011, during the European sovereign debt crisis, as shown in Chart 8 below.

Chart 8: Gold price (US$ per ounce) since 2010.

To discuss this note, or any other matter, please contact Nick Fletcher on 020 3696 6801, or any member of the London Wall Partners investment team on 020 3696 6805.

Appendix - Regulatory Information and Disclosures

Table 6 – Discrete twelve-month total returns in local currency.

	Return (%) for the 12 months to:				
Index	**30.06.19**	**30.06.18**	**30.06.17**	**30.06.16**	**30.06.15**
FTSE All-World	6.5	11.3	19.9	-2.7	8.8
FTSE All-Share (£)	0.6	9.0	18.1	2.2	2.6
S&P 500 ($)	9.8	13.7	17.2	3.3	6.8
FTSE Europe ex-UK	6.6	4.2	22.5	-8.4	9.8
TOPIX (Y)	-8.2	9.7	32.2	-22.0	31.6
FTSE All-World Asia ex-Japan	2.2	9.4	22.1	-7.3	8.2
FTSE Emerging Markets	4.5	10.7	18.7	-7.5	8.2
FTSE UK Govt 5-15 years (£)	5.3	0.8	-0.4	11.0	7.4
FTSE UK Govt I-L 5-15 years (£)	6.9	0.9	5.0	8.0	4.9
iBOXX £ Corp Bonds 5-15 years (£)	7.1	0.7	7.1	8.6	6.4
ICE US Treasury Index ($)	7.3	10.0	5.1	9.2	16.8
MSCI UK Monthly Property (£)	3.8	0.9	-4.8	11.1	-10.9
Gold Bullion ($)	13.1	11.3	19.9	-2.7	8.8

Table 7 – Discrete twelve-month total returns in sterling.

	Return (%) for the 12 months to:				
Index	**30.06.19**	**30.06.18**	**30.06.17**	**30.06.16**	**30.06.15**
FTSE All-World	10.1	9.4	23.0	14.0	10.2
FTSE All-Share (£)	0.6	9.0	18.1	2.2	2.6
S&P 500 ($)	13.9	11.9	20.6	21.5	16.1
FTSE Europe ex-UK	8.6	3.0	28.7	6.4	0.4
TOPIX (Y)	-2.1	9.5	24.2	9.5	18.4
FTSE All-World Asia ex-Japan	4.8	6.7	27.4	6.5	8.3
FTSE Emerging Markets	8.3	5.9	24.1	3.7	6.7
FTSE UK Govt 5-15 years (£)	5.3	0.8	-0.4	11.0	7.4
FTSE UK Govt I-L 5-15 years (£)	6.9	0.9	5.0	8.0	4.9
iBOXX £ Corp Bonds 5-15 years (£)	7.1	0.7	7.1	8.6	6.4
ICE US Treasury Index ($)	11.3	10.0	5.1	9.2	16.8
MSCI UK Monthly Property (£)	3.8	-0.8	-2.0	30.8	-3.2
Gold Bullion ($)	17.3	9.4	23.0	14.0	10.2

Notes:

1. All figures include income reinvested.
2. Local currency indicated in index name, for single country indices. The returns of non-sterling assets may increase or decrease as a result of currency fluctuations.
3. MSCI UK Monthly Property (previously called IPD) Index may be subject to retrospective revision.
4. Source: FE Analytics.

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