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investment services

At the beginning of the year, markets were oversold. Since then they have bounced back vigorously, by more than we expected. We have been selling into strength based on the following:

1. The two main factors which have improved are:
   a. Led by the Federal Reserve monetary conditions appear to have softened and interest rates have fallen.
   b. Fiscal stimulus has caused the Chinese economy to recover.

2. Valuations, especially in the US, are stretched.

3. Sentiment is overbought.

4. Earnings estimates look much too high, leading to disappointments.

5. We are concerned that bond prices are too high, and that bond yields may move back up again.

Overall, we think a lot of good news is reflected in current prices.

Comment and Outlook

At the beginning of the year, markets were oversold. Since then they have bounced back vigorously, by more than we expected. Certain factors have improved, notably the stance of the Federal Reserve in the US has changed from hawkish to a position where markets are now discounting at least one interest rate cut this year. At the same time, economies, notably China's, appear to be improving.

After the run up, we are more cautious, and have been selling again. Sentiment is very optimistic, valuations- particularly in the US- are very stretched, and earnings estimates seem too high. Within equity markets we continue to like Eastern Europe, and we have added to parts of Asia. Peripheral Europe also offers opportunities.

Cash and Bonds

Monetary authorities throughout the world have been indicating a softer approach, with indications from Central Bankers from Canada to New Zealand suggesting that they are more likely to reduce rates than raise them. Nowhere has this volte-face been more significant than in the US, where the authorities, having previously provided a hawkish approach, suddenly-in the face of the equity sell off of the fourth quarter- changed their stance to one where markets are expecting a rate cut instead of the previously indicated succession of hikes. This change in policy is the main factor providing support for equities.

Other markets look unattractive, with real rates very low or negative (and often negative in nominal terms as is the case in Germany, Japan and Switzerland). Overall, bonds are less attractive than they have been for some time.

Currencies

There has been no change in our view on currencies. We continue to be concerned about the Euro (and sterling), but like the Japanese yen and US dollar. The yen should benefit from risk aversion and act as a safe haven in times of financial market sell offs. The main reason for our positive stance on the US dollar is its relatively strong growth, and higher interest rates. Japan benefits from low inflation and low monetary expansion.

We also like the Asian currencies such as the Singapore dollar, Malaysian ringgit and Thai baht-they appear undervalued and should benefit from strong growth, low inflation and positive interest rates. The recent weakness of the Turkish lira and Argentinian peso is ominous: both currencies were weak in the second half of 2018, ahead of the sell offs in financial markets.

Equities

After a very strong beginning to the year, equities are looking overbought and, particularly in the US, overvalued. We have begun to take some profits as we feel much of the (unanticipated) good news on interest rates is behind us, and earnings estimates look too high. We are not expecting another sharp sell off as occurred in the fourth quarter, but we feel it is appropriate to reduce equity exposure. The most attractive areas appear to be in emerging markets, particularly Eastern Europe, and Asia.

Greater China and Hong Kong

The Chinese economy, helped by fiscal and monetary stimulus, appears to be recovering, shrugging off the downturn in trade caused by the trade war with the US. This pick up has been led by domestic sectors, particularly consumption, following income tax and VAT reductions. This pivot towards domestic growth has also helped the all-important property markets, with construction showing signs of bottoming. Helped by easing credit conditions, this has led to a strong rebound in share prices, particularly in the mainland.

The outlook for China has improved, particularly its domestic sectors, but prices to a certain extent reflect that. Any resolution of the trade dispute with the US will provide a further boost, but we are not anticipating a speedy resolution. We also continue to like the opportunities in outbound Chinese tourism and have hotel and casino stocks in the rest of Asia.

Rest of Asia

In the remainder of Asia, statistics have been distorted by Chinese New Year, and the disruption to trade caused by the dispute between the US and China. Valuations look good and the softening of monetary conditions has helped property. Generally we have therefore concentrated on domestic, non-manufacturing sectors in Asia. We like Singapore, Korea and Thailand. Singapore is supported by low interest rates whilst Korea, despite a slowdown in growth, benefits from very low valuations. This is particularly the case in the (relatively) high-yielding conglomerates which the Fund owns. In Thailand, the recent election-albeit deeply flawed-looks likely to produce a (pro-military) result which will continue to provide some fiscal stimulus to support growth. Foreigners have been selling Thailand, but local purchases have been strong-again we have been owning beneficiaries of domestic demand.

The elections in Indonesia have seen Jokowi re-elected, which was probably the best result. However, equity valuations seem stretched, as they are in the Philippines also. Malaysia has lagged, but the economy is suffering following the replacement of Najib by Mahatir last year. Exporters have been hurt by the slowdown in trade, and fiscal policy has been stifled by the need to clear up the mess left by Najib-a clean-up which has been slowing down the disbursement of funds for infrastructure projects as allegations of corruption are investigated. Malaysia is becoming relatively more attractive as it lags, but we are not yet inclined to purchase.

Japan

Japan trailed in the first quarter as exports to China fell and wages fell slightly. The second quarter will see a longer period of holidays than usual, as the new Emperor is crowned, ushering in the Reiwa era. This is also likely to crimp GNP growth, by reducing (as a one-off holiday) the number of working days. Earnings revisions have been weak, but Japan equities are being supported by accommodative monetary policy, with the long-term bond rate target being reduced to zero. We have reduced Japanese exposure slightly, but continue to like it for its defensive characteristics and low level of valuations, supported by low interest rates.

US

We continue to be surprised by how well the US share market has performed. Whilst the softening of the Federal Reserve's stance has helped greatly, the rise to new highs has seen limited breadth, with the market driven back up by the usual suspects from the highly rated technology sector. We did not expect such a swift rally. The US economy is performing more strongly than other developed markets, but it is unclear how sustainable this is: the tax cuts and fiscal stimulus of 2018 will have to be paid for at some stage as Federal deficits look unsustainable at almost 4% in a strong economy with full employment. Rising inflation-with wages bottoming, shelter (rents) up and oil prices rising suggest that interest rates should pick up. Finally, without tax cuts, earnings growth looks likely to slow this year as well. With valuations still high, and the likelihood of a political regime emerging under the Democrats which is likely to be less favourable to business, we think a lot of good news is reflected in current US prices.

Europe

Europe's economy, led by Germany and the auto industry, has been faltering. The auto industry suffered from falling demand, particularly in China; global trade has been weak; and the problems of Turkey also impacted European exports. The weakness of the banking system, particularly in Germany and Italy has exacerbated this. A flat yield curve and negative bond rates have hampered banks' ability to make money, particularly as demand for borrowing has been weak. The political background has been troubling too, with the rise of populist parties worrying and leading to fragmented legislatures with weak coalition governments.

Against this must be set the fact that European stock markets are cheap, with dividend yields much higher than the non-existent interest rates. Although our European exposure has been reduced, we still like Italy, Belgium and the Iberian Peninsula. In the latter, conditions are improving from very depressed conditions and we are seeing rising industrial production and increased loan growth. The election results giving the Spanish socialists PSOE a victory, but without a majority, are concerning, particularly with the emergence of the Far-Right Vox. However, we would expect economic policies to remain broadly social democratic, and not to interrupt the current recovery. Italy's coalition government is also fractious, and the Italian economy (and banking system) is far more fragile than Spain's, but there remain excellent companies in the country, and the valuations of Italian shares are the cheapest in Europe.

Elsewhere in Europe, the German economy appears to be faltering (and may need more fiscal stimulus) and we have avoided it. Irish stocks appear cheap, but we are reluctant to invest due to fears about Brexit. On the UK the economy is suffering, as investment decisions are delayed or diverted elsewhere, a process that will continue as a final decision is delayed. We continue to avoid UK stocks. We are not sure what the outcome will be but as Matt from the 'Daily Telegraph' puts it:

Eastern Europe

Growth in Eastern Europe will slow this year (from high levels) but will still be robust, despite the anaemic growth in Western Europe. Valuations remain low, with all three markets mentioned trading close to or below book value, decent yields and PEs of 11 or below. Romania, which has recovered from its sell off before Christmas when taxes on energy and banks were increased sharply. Details of these tax measures are still being worked out, but both Russia and Romania have been helped by the rise in oil prices. Poland is being helped by the fiscal stimulus ahead of the election later this year.

Conclusion

Markets, helped by indications that monetary policy will be loose, have done better than we expected. However, we think that a lot of the good news is reflected in current prices. As a result, we have been recently taking some profits.

30/4/19