ALBERT E SHARP

INVESTMENT MANAGEMENT & STOCKBROKING

MARKET COMMENTARY

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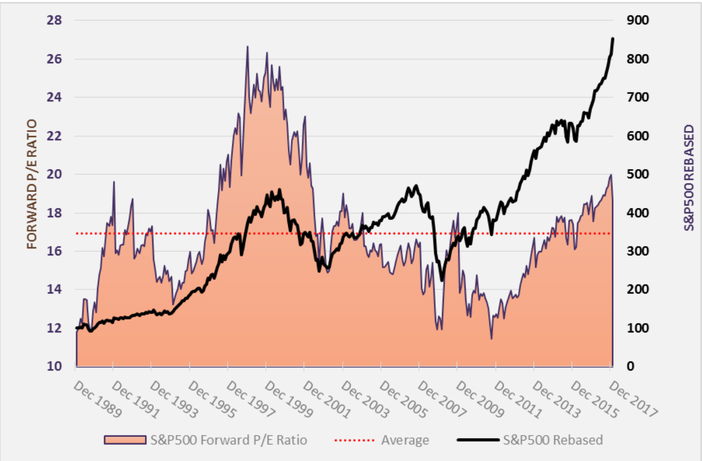
Where Do We Go Now?

With many equity markets ending the year on a high, 2017 proved to be another vintage year for most investors. This was one of the rare periods in which global growth was synchronised across all the major regions. In the US, the Dow Jones notched up a new all-time high in every month bar April. This was helped by a very strong technology sector which saw Amazon increase its market capitalisation by almost £200 billion, or 40 times the current size of Marks & Spencer. The UK lagged somewhat in the large cap space, although small and mid-caps fared well, with some of our favourite funds returning over 30%. Europe continued to recover, producing some good numbers and UK investors received an additional boost from a stronger euro. However, other currency movements hindered returns as sterling recovered against the dollar and yen. Holding funds with hedged currency classes helped to offset this drag. Emerging markets and Asia had an excellent year, helped by firmer commodity prices, growing demand from the developed world and a relatively benign political environment, give or take North Korean tensions.

Elsewhere, gold had a strong finish to the year as did oil, with prices now back to levels last seen in 2014. On reflection, bitcoin was probably the 'asset' that got most media attention over the year having opened at $952 and closed at $14,310, giving lucky punters a fifteen-fold return. In case you missed it, our thoughts on the subject are laid out in last month's commentary; spoiler alert, the title was *All Hope And No Judgement*.

This month we assess each major asset class and provide an outlook, but first a few words on the key themes that form our world view and answer some pertinent questions that we are currently receiving from clients.

First and foremost: **is the US stockmarket showing signs of being in a bubble?** Short answer, no. Valuations are high relative to history but it doesn't mean that the conclusion is sell. As shown in the forward P/E chart below, using the same metric at the end of 1997 and concluding that equities are too expensive would have implied missing out on a 60% return in the following two years.



Quite apart from the valuations, the mood is not comparable with that in 1999 or 2007/8. To be fair, we are seeing over-exuberance in pockets of the market such as in the cryptocurrencies and some of the Chinese stocks, but these are isolated areas.

As it stands, we argue that the current level and valuation of the S&P500 is justified by the scale of the tax cuts and incentives promised by the Trump administration. Companies with huge overseas cash balances (approaching $250 billion in Apple's case) can now repatriate this to the US with a much lower tax bill. This could lead to higher dividends, greater investment, pay increases and or acquisitions. We expect to see all of the above and it is undeniably good for the S&P500. If we see share buybacks then the P/E ratio immediately falls and all of a sudden the valuations look less stretched – indeed in the absence of further share price rises it may well make them look cheap.

We have consistently said over the last few years that the policy of low interest rates, combined with low inflation levels would be positive for equities and so it has proved. The extended period of this bull market is due to the incredibly shallow trajectory of global growth post the extraordinary impact of the financial crisis.

The chart on page 3 bears this out to a degree. Since 1955 it has taken, on average, ten and a half years for US earnings to double and the chart shows that this has occurred four times since then. It is now ten and a half years since the last doubling point, yet earnings are up only 33%. At the current rate it will be sometime in 2022, another four years from now that the next milestone is reached. The point to be made is that by historical standards, profit growth still has a huge amount of catching up to do and if profits are growing this is generally good for equities.

Do not read into this that we are blind as to what could go wrong and we deal with these points below. It is that for now, there is no real data that dents our positive stance on equities. We worry that other investors may be showing signs of complacency but our analysis and conclusions have to be evidence-based, and gut feeling is not helpful in answering the pressing questions of today.

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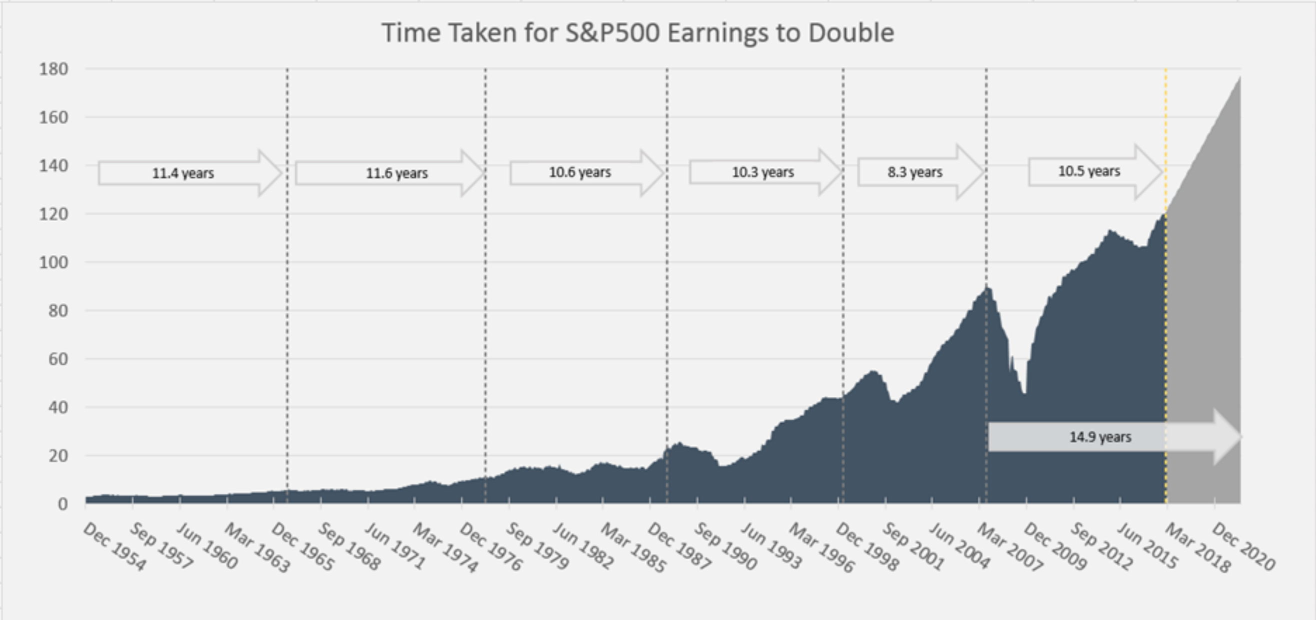

Source: Bloomberg ®, Albert E Sharp

Is Brexit bad for UK equities? Maybe, but it is dangerous to generalise. There are some companies that will be immune to any outcome no matter how extreme. Nevertheless, it does appear that international investors have been shunning the UK and it is difficult to see this mood shifting anytime soon. As a result, valuations look relatively cheap, potentially creating longer-term opportunities.

If interest rates go up, is this bad for bonds? This all depends on the speed of rate hikes and how expectations change. At present the consensus is for the US to hike three times in 2018, ending the year at 2%. In the UK, arguably held back by Brexit, it will be well into 2019 before even 1% is reached. If this pans out the impact will be fairly benign for bond prices. However if it suddenly emerges that economies are hotting up and rate rises are brought forward this would be bad news for fixed income investors. Higher wage growth could be a reason, and with tight labour markets, especially in the US, this eventuality cannot be ruled out. In fact this is our number one fear for the financial markets. Government bond yields are still at extremely low levels historically and in some cases still negative; in an extreme scenario there is the potential for a crash. In which case this would spill over into equity markets. Central bankers know this very well and it will take real skill to tread the tightrope and avoid what could be a damaging policy mistake, but it could be well into 2019 until this test is faced.

Taking a 12 month view, we assess the individual asset classes below with a general observation that equities have further to run, fixed income could be mixed and property still looks reasonably valued.

UK Equities: Neutral

Even after hitting a new all-time high recently, the appetite for UK large caps is not huge. This is partly explained by the index's composition, not helped by a lack of out and out growth companies and less than 1% tech in the top 100.

There is a value argument that cannot be overlooked, but also a lack of catalysts. Mid and small caps look more interesting and better-positioned to benefit from a period of global growth. In a recent meeting with the **Mid Wynd** investment trust team, it emerged that they held no UK companies in the fund. It speaks volumes that this talented group with a global stock picking remit couldn't find one UK stock worth adding, despite being based here.

Our favourite funds include **UK Buffetology**, **Investec UK Alpha** and the **Henderson Smaller Companies** fund. Investment trusts trading at a discount to NAV can be found much more readily in this sub-sector and we regard this as a particularly fruitful hunting ground for both long and short-term and opportunities.

Europe ex-UK Equities: Positive

Having been out of Europe for several years we have now ventured back; acknowledging the improved political landscape and recognising that the valuation gap is simply too great. After a good run, we continue to see good value. There is a rich vein of European companies across the market cap spectrum which look increasingly capable of growing earnings at a healthy double digit clip in 2018 - regardless of how the political climate changes or what happens with Brexit.

In our model portfolios we added the **Artemis European Opportunities** fund and later in the year the **JPMorgan European Smaller Companies** fund. This is also an area where investment trusts can play an important part.

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US Equities: Positive

Having laid out much of the case for US stocks above, we would add that the one missing part of the bull market story so far is a noticeable surge in mergers and acquisitions. There were more deals in 2015 than last year however, due to the expected repatriation of cash, we anticipate this activity should increase. This could benefit the **Fidelity American Special Situations** fund whose value bias could pay off in such an environment. Mid and small caps feature heavily in our thinking here, having lagged the large caps somewhat over the last few years. We favour the **Artemis US Smaller Companies** fund and remain alert to closed-end opportunities.

Emerging Markets: Positive

A strong US economy is a helpful backdrop for emerging markets and as a result it is difficult not to be positive. Last year saw a return exceeding 25% in sterling terms, with many of our funds faring even better. That said, in 2018 there are several major elections looming across the region (including Russia, Mexico, Brazil, Thailand and Malaysia) which have the potential to cause disruption. If Trump and Brexit are anything to go by second guessing (a) the outcome and (b) the correct investment strategy based on (a) is a dangerous game to play; history has shown how economies in some emerging markets can get trashed almost overnight when placed in the wrong hands.

The **Templeton Emerging Markets Investment Trust (TEM)** has been one of our core holdings over the last few years. So-called frontier markets (e.g. Argentina, Bangladesh, Vietnam) continue to offer tremendous growth stories and we like funds that manage to gain this exposure. Active management in this area is critical and tracking funds risk missing out on some of these great untapped, expanding markets. Sadly, the recent resignation of fund manager Carlos Von Hardenburg means this fund is under review until we have assessed the new management team.

Asia ex-Japan: Positive

China straddles the emerging market and Asia categories and, given its sheer size, dominates both. The investment case for this region remains compelling. The structural growth of the middle class, urbanisation and the changing shift in demand towards consumer goods and services create incredibly powerful drivers; companies that can capitalise on these trends stand to gain significantly. One of the technical factors that could prove to be beneficial is the opening up of the A-shares market to overseas investors. There could be some hidden gems here and despite tales of shady corporate governance, shrewd managers should find this a rich source of fresh investment ideas.

The India recovery theme is set to stay around for the foreseeable future and as Prime Minister Modi continues to implement his reforms, the underlying potential is mouth-watering for investors. It pays to have specialist knowledge and again, the small cap area has been and will continue to be a source of stellar returns. Markets can be a volatile and we generally prefer to play India through broader Asian funds that have demonstrated a willingness to gain plenty of exposure.

Elsewhere, economic data in countries such as Vietnam and Laos are impressive but corporate governance still leaves a lot to be desired. Again, local knowledge is key and we favour teams that can demonstrate they are close to the action.

Property: Neutral to Positive

Last year was a mixed bag for the sector with the likes of Land Securities down, but specialist funds such as **TR Property** up nearly 40%. In the open-end UK commercial property sector, results were much better with most of the big funds showing returns approaching 10%. We see 2018 delivering more of the same. With interest rates expected to stay low and economic conditions set to remain generally positive the chances of double-digit returns look good. This is especially so for the **Aviva Property** fund that struggled in 2016 following Brexit. Having been forced to move to a bid pricing basis to stem outflows, there seems like a good chance that this will revert to an offer price basis, which would immediately boost the value for investors by around 5%.

Fixed Income: Negative

As discussed above, the threat of interest rates rising in the US and elsewhere in the world is not helpful for the asset class, especially if there is a risk that the market is underestimating the speed and magnitude of tightening. This has been our concern for some time and over the last 12 months and our underweight/zero expsoure to gilts and other government bonds proved to be the right call, with returns flat at best. Riskier high yield and emerging market debt generally fared well, as one might expect, but with risks not dissimilar to equities in some cases, comparison with government paper is not apples-for-apples.

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It is for this reason we prefer to play this asset class through funds that have a broad remit, maybe with the ability to use derivatives to hedge risk and a track record that demonstrates the ability to protect capital. These funds tend to fall into a catch-all 'strategic bond' category and we favour the **Artemis Strategic Bond**, **Jupiter Strategic Bond** and **Schroder Strategic Credit** funds.

In addition we have tended to play this area using absolute return funds that have bond-like risk and return profile. This strategy worked well in 2017 although returns around the 4% level ,though well ahead of cash, felt meagre given the big numbers from equities. Multi-asset funds play a part, but remain on watch. We particularly like vehicles that have a clear focus, with a clear message and a track record with minimal drawdown. Using a strict long/short equity remit, the **Janus Henderson UK Absolute Return** fund is a great example of a fund with a consistent strategy and a long history of success. The fact that the fund can short other funds should not be confused with the outright risky bets undertaken by some fund managers in this area.

Japan: Positive

When we talk to investors about why we like Japanese equities, the immediate pushback is nearly always the so-called demographic time-bomb. The statistics are indeed shocking. The fact that adult diapers have been outselling baby diapers since 2011 is not just due to the fact that the population is getting older, there are also fewer babies. Last year the number of births in Japan dropped below 1 million for the first time since records began in 1899. Extrapolate the numbers and the consequences are terrifying It doesn't necessarily follow that this is bad for share prices, but both individuals and the professionals unwittingly allow their investment decision to be influenced by these powerful, negative images.

We believe that there are more important structural factors at play. The central case relies upon the reforms introduced by Prime Minister Abe that deal with some of the key issues that have been neglected for over 20 years. The various stimulus packages have clearly helped, but it is the changes in government philosophy through promoting deregulation, entrepreneurship and a more flexible labour force that should prove to be a more powerful boost to the economy. As these shifts are seen to yield positive results, then the process can be self-sustaining and it is the cultural change that essentially is good for the economy and good for the stock market.

We nudged up our exposure to Japanese equites around this time last year on the view that the region looked relatively cheap and that President Abe's reform policies were working. On reflection we should have been more aggressive, with the Nikkei 225 enjoying a 19.1% return. We remain optimistic and a recent meeting with Richard Aston, fund manager of the Coupland Cardiff Japan Income & Growth trust confirmed many of our views.

Aston believes that the management culture within listed companies in Japan is changing for the better. For example, having been static for years dividend growth will now be amongst the highest in the world. Instead of hoarding cash and protecting the employees, a more shareholder-friendly attitude is developing. Also, some management teams are beginning to acknowledge that they have scope to raise prices. After years and years of deflation, this is a major breakthrough and if we start to see real evidence of action, expect to see share prices soar. Since the government is indirectly a major shareholder in many of the country's largest companies through an extensive ETF purchase program they will be a beneficiary and will be putting pressure on companies to make the move. Aston reasons that "there is still a culture of compliance and it is a matter of time before higher prices becomes the norm." These salient points are yet to be fully understood and as a result the region remains under-owned by many investors, but in time we expect this to change.

An important aspect here is the currency and it is in Japan's interest to see their exchange rate devalue. This is broadly recognised by the policymakers and for this reason we believe that it is prudent to keep some exposure hedged, especially if one is taking a view beyond five years. Last year, the yen fell by 5.3% against sterling and an unhedged position would have reduced returns by a similar amount. However, exchange rates move due to countless market forces well beyond the control of politicians and at times has found itself acting as a safe haven, making it a difficult shorter-term call. Our vehicle of choice has been the **Neptune Japan Opportunities Fund** which naturally hedges currency and this returned an index-beating 26.9% last year. We also like the more aggressive **Legg Mason Japan Equity** fund, which notched up 36.1% and would have more had we bought a hedged class. We also like the **Coupland Cardiff Income & Growth Trust** and actively monitor the various investment trusts that offer discount opportunities.

Miscellaneous & Technology

There are several asset classes not captured by the categories above, that we have not mentioned and this is largely due to having no view. Our position on gold for example remains the same in that we have no sense of what is a fair value and for that reason cannot buy into a situation where we have no exit strategy. Bitcoin, falls into the same broad category. We are not saying the prices are going to fall, we simply have no basis for making any constructive investment case.

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In addition to and indeed in support of our upbeat outlook on equities is our positive view on the technology sector, a theme that has been consistent across our portfolios over the last few years. The area has had a strong run of late and any pullback feels a little overdue. We would use this as an opportunity to top up or initiate positions. The **Allianz Technology Trust** is our current fund of choice.

The table below summarises why we do *not* believe there is a bubble and indeed see scope for further gains to be made.

	2018 Sales Growth	2018 EPS Growth	2018 PER (x)
Coca Cola	-12%	6%	22.8
P&G	4%	9%	20.7
Mondelez	3%	12%	18.0
Average	*-2%*	*9%*	*20.5*

	2018 Sales Growth	2018 EPS Growth	2018 PER (x)
Facebook	34%	12%	22.4
Google	19%	17%	21.0
Apple	14%	21%	14.5
Average	*22%*	*17%*	*19.3*

Source: Bloomberg®

We have chosen Coca-Cola, Proctor & Gamble and Mondelez (Cadbury, ex-Kraft) as stable “blue chip” US companies, perceived to have quality brands, first rate management teams and a strong market position. Facebook, Google and Apple are comparable leaders and the table clearly shows that these tech giants not only have far superior top and bottom line growth rates, they are also cheaper in forward price/earnings ratio terms. This analysis doesn’t take into account the far stronger balance sheets in tech suggesting that the market has simply been too slow to recognise the difference. Consequently technology should be valued at a premium to the wider market and until we get to this point, we remain buyers.

So in conclusion, we believe that the momentum across the global economy, supported by expansive US economic policy will continue to be good for equities. The main concern is that investors are too dovish in their interest rate expectations and that surprise rate rises could not only spook the bond market but spill over into other asset classes. Inflation would be the likely spark, but at present the evidence suggests that it is not returning anytime soon. Pointing in the right direction, we continue to enjoy the fair winds and followings seas but remain watchful for signs of looming squalls.

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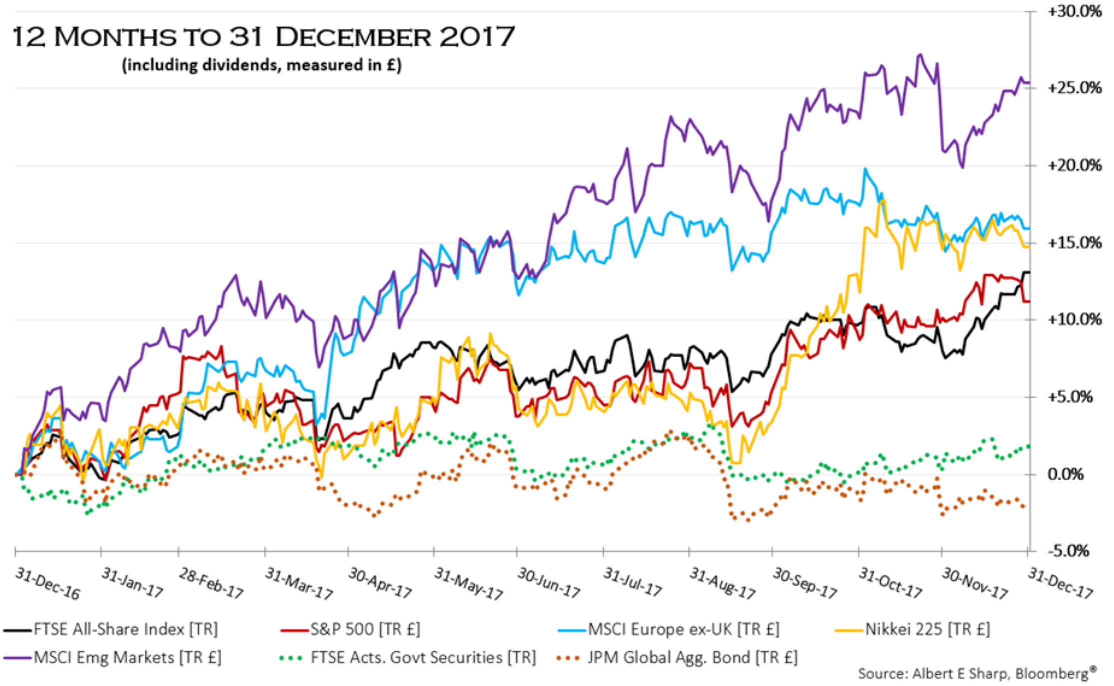
INDEX RETURNS

Index	Region/Asset Class	31 Dec 2017	1 Month Change	1 Year Change	2 Year Change
UK 100	UK	7,687.8	+4.9%	+7.6%	+23.2%
UK Mid Cap	UK	572.6	+3.8%	+10.4%	+14.1%
UK Small Cap	UK	5,911.9	+2.4%	+14.9%	+27.6%
Dow Jones Ind Avg	USA	24,719.2	+1.8%	+25.1%	+41.9%
S&P 500 Index	USA	2,673.6	+1.0%	+19.4%	+30.8%
NASDAQ Comp.	USA	6,903.4	+0.4%	+28.2%	+37.9%
Nikkei 225	Japan	22,764.9	+0.2%	+19.1%	+19.6%
Euro Stoxx 50	Europe	3,504.0	-1.8%	+6.5%	+7.2%
CAC 40 Index	France	5,312.6	-1.1%	+9.3%	+14.6%
DAX Index	Germany	12,917.6	-0.8%	+12.5%	+20.2%
Milan Index	Italy	21,853.3	-2.3%	+13.6%	+2.0%
MSCI Emg Mkts (£)	Emg Mkts	575.8	+3.7%	+25.4%	+66.3%
IBOVESPA Index	Brazil	76,402.1	+6.2%	+26.9%	+76.2%
MICEX Index	Russia	2,109.7	+0.4%	-5.5%	+19.8%
S&P BSE SENSEX	India	34,056.8	+2.7%	+27.9%	+30.4%
Shanghai SE Comp.	China	3,307.2	-0.3%	+6.6%	-6.6%
Hang Seng	Hong Kong	29,919.2	+2.5%	+36.0%	+36.5%
UK All Property	UK Property	7,147.4	+1.2%	+6.9%	+8.4%
UK Conv Gilts	UK Gilts	3,589.1	+1.4%	+1.8%	+12.1%
UK Index linked Gilts	UK IL Gilts	4,908.9	+2.0%	+2.3%	+27.2%
JPM Glob Agg. Bond	Global Bonds	794.6	+0.4%	-2.2%	+19.2%
iBoxx Non-Gilt	UK Corp Bonds	340.4	+1.3%	+4.3%	+15.4%
WTI Crude	Oil	60.4	+5.3%	+12.5%	+63.1%
LMEX	Base Metals	3,418.9	+7.6%	+28.5%	+55.2%
Gold Spot $/oz	Commodities	1,303.05	+2.2%	+13.1%	+22.8%
S&P Agri & Livestock	Agriculture	753.84	-1.0%	-6.2%	-11.2%
£1 = US$	Currencies	1.35	-0.1%	+9.5%	-8.3%
£1 = €	Currencies	1.13	-0.9%	-4.0%	-17.0%
£1 = Yen	Currencies	152.23	+0.0%	+5.3%	-14.1%



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ALBERT E SHARP
INVESTMENT MANAGEMENT & STOCKBROKING
WWW.ALBERTESHARP.COM
7 Elm Court
Arden Street
Stratford Upon Avon
Warwickshire
CV37 7LN
☎ 01789 404000