WATTERSON
FINANCIAL PLANNING

Market Update

April | 2018

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Following an exceptionally tranquil 2017, financial markets have returned to a more typical fickle trading pattern. Equity markets started the year positively but weakness in bond markets then triggered widespread falls in share prices. This led to an uncomfortable 5 week period from mid January when prices of both shares and bonds fell. Government bond prices eventually stabilised and subsequently recovered their losses by the quarter end. This rally provided some support for equity markets though prices slipped once again as President Trump imposed new trade tariffs. Over the first quarter, the FTSE All Share index and MSCI World index fell by 6.7% and 4.5% respectively.

Typically, when equity markets fall, bond prices climb. This has been the pervading pattern over the last 40 years and it has helpfully allowed investors to smooth out some of the equity market volatility. A mix of holdings containing bonds and equities are sometimes referred as 'balanced portfolios' as a result. However, there can be periods when equities and bonds fall at the same time. We believe that the risks of this happening are significant. After years of quantitative easing and central bank buying, bond prices are extraordinarily expensive and current prices need to fall a considerable way to bring them towards more normal valuation levels. Any revival in inflation would make this an even more painful process. The experience at the beginning of this year represents only a taster of how unpleasant this might feel. Our exposure to bond markets is limited and this obliges us to hold more cash than we would normally choose to hold in the portfolios. However, during conditions such as those experienced over the first quarter, cash becomes the only way to moderate risk effectively. We do hold several corporate bond funds in the portfolio, selected because they are typically very defensive and stable. However, prices of even these stalwarts are vulnerable if an economic downturn causes an increase in repayment risk. This requires us to tread a very narrow path.

> Some of our optimism has waned

The technology sector performed very strongly last year and interestingly held up well during the early stages of the recent sell off. In contrast, traditionally, defensive parts of the equity market suffered badly. Defensive sectors such as real estate, utilities and infrastructure are not typically reliant on economic growth and tend to be more resilient during uncertain times. Not so on this occasion. We like shares that are typically more resilient during weaker markets and we are pleased that our positions in funds, such as LF Lindsell Train UK Equity and Fundsmith Equity, alongside our exposure to the insurance industry through the Polar Capital Global Insurance fund, held up relatively well. The portfolio was also helped by a significant exposure to technology shares gained via the position in the Vanguard US Equity Index Tracker fund.

Trump's introduction of trade tariffs is not a great surprise but is no less a disappointment. We had hoped that wiser counsel from his advisers might have held sway, but Trump has stuck to his own instincts. He is continually juggling his team and appears to be increasingly tilting it towards those who have a similar mindset as his own. The economic impact of Trump's announced tariffs will be limited but if other nations retaliate and the situation escalates, it could easily have a material impact on trade flows. This would be unhelpful for share prices. We have also been disquieted by the selection of John Bolton as Trump's national security adviser. Bolton's hawkish approach may bring a new dynamic to US relations with the likes of Russia and Iran. This could have consequences for the oil price, which has already risen from \$50 to \$70 over the last year. We are mindful that our recent switch from active funds to a passive index tracker in the UK will increase the portfolios exposure to the energy sector, which may prove useful if oil prices surge.

There is still much to be positive about. Global growth is strong and corporate profits are swelling. Financial markets are still awash with liquidity and there is much demand for investment opportunities. However, at the margin, trends have deteriorated a little and despite the recent price falls, few markets can be considered cheap. Our attitude through much of last year could have been described as cautiously optimistic. Events so far this year have caused some of this optimism to wane, yet have done nothing to soften our caution. While we are not happy to have suffered losses over the quarter, we are pleased that our portfolios held up relatively well as the headline indices suffered material falls. Financial markets rarely move in a straight line and our current investment strategy revolves around not being too greedy in capturing any upside and aiming to be more resilient during more difficult markets.

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