Quarterly review

for the three months to 31 March 2017

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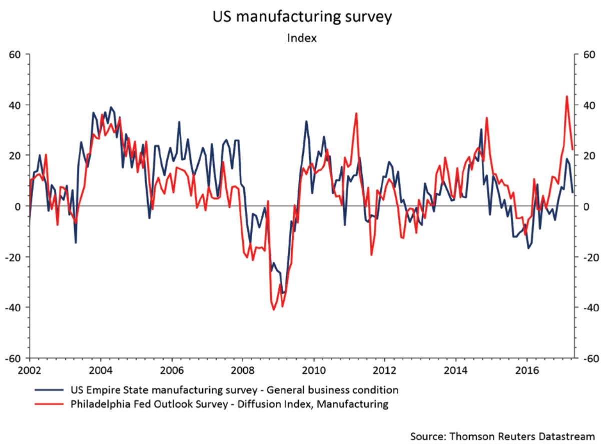
As expected, the Federal Reserve raised interest rates in March, the third such rise since December 2015. What was not expected were comments from Fed Open Market Committee members about the current policy of reinvesting principal payments received from maturing investments held on the Fed balance sheet. According to the meeting minutes, "most participants" thought it would be appropriate to change policy later this year to reduce the balance sheet's size as part of the gradual process of monetary policy normalisation. Fed policy will remain data-dependent and "predictable" but the reference to shrinking the balance sheet definitely struck a more hawkish note. In contrast to 2016, during which investors expected four rate rises but witnessed just one, 2017 could prove a year in which US rates rise faster more than anticipated.

US equities gained 4.81% in sterling over the first quarter of 2017 despite the headwind from tighter monetary policy but underperformed the 5.78% gain by global equities in sterling. US economic data remained strong: gross domestic product (GDP) strengthened in the second half of 2016 and consumer confidence and survey data were strong in early 2017. Manufacturing leading indicators shrugged off the impact of the strong dollar in 2016 on exports, rising sharply (see chart below).



GDP growth softened in early 2017 but this is consistent with the pattern of recent years, during which a weak first quarter has been followed by accelerating growth during subsequent quarters. US corporate earnings are expected to strengthen. The chart below shows actual and forecast earnings growth. Analysts' forecasts typically "lag" at major turning points but the correlation between forecast and actual earnings is clear and the recent pick-up in forecast earnings growth is encouraging.

High US equity valuations may, however, prove a headwind at a time when the Fed is tightening monetary policy. The chart below shows two measures of the price/earnings (p/e) ratio, a key valuation metric, for US equities. The historic p/e is shown in red; the cyclically-adjusted Shiller p/e, is in blue. The Shiller p/e, which some analysts favour over the historic p/e, is based on average rolling 10-year inflation-adjusted earnings. During the last 30 years, the Shiller p/e for US equities was higher than at the quarter end only during the dotcom bubble.

High valuations leave little room for disappointment in the event that Donald Trump fails to honour his election pledges to cut taxes and increase infrastructure spending. The failure to repeal Obamacare at the first attempt in March called into question his ability to secure funding and political support for a large-scale fiscal stimulus.

Political uncertainty extended beyond the US during the quarter. European electoral developments, Syria's

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civil war and tensions over North Korea also contributed to increased demand for defensive investments. Although risk aversion measures such as the Vix volatility index remained subdued, gold and the yen rose 6.94% and 3.43% respectively in sterling.

Global bonds gained 0.56% in sterling and sterling corporate bonds rose 1.86% as investors reassessed inflation prospects. US core consumer prices fell in March thanks to a 6.2% petrol price decline and some one-off factors, cutting annual core inflation to 2.0%. Oil prices fell 10.13% in sterling over the quarter as US output increased. The base effect of rising oil prices in early 2016 will soon drop out of the data and the modest increase in March's US non-farm payroll figure, the key employment measure, added to the more subdued short-term outlook for US inflation. This, however, is not expected to deter Fed officials from raising rates again in June. Over the longer term, near-full US employment and steadily growing global demand will fuel inflation.

In the UK, March's annual core inflation rate was 2.3% and annual average weekly earnings increased at the same rate. Sterling's fall has added to inflationary pressures resulting from near-full employment and recovering commodity prices. Sterling rose modestly against the dollar over the quarter and rose a further 3.46% in April following Theresa May's decision to call a general election to strengthen her hand at the Brexit negotiating table.

Equities in Asia excluding Japan and emerging markets rose 12.06% and 10.17% respectively in sterling as fears of US protectionism receded. In an April volte-face, Trump said China was not a currency manipulator. Indian equities gained 15.73% in sterling as the stockmarket recovered after last November's demonetisation of large-denomination banknotes. This clamped down on tax evasion but also adversely affected the money supply. A regional election success in March showed support for Narendra Modi's reformist policies was running high. A new general sales tax to supersede complex state-level arrangements should help India's corporate sector.

Equities in Europe excluding the UK outperformed, gaining 7.35% in sterling despite the uncertainty occasioned by elections this year in which anti-European Union candidates may make gains. Stronger economic data coupled with continued European central bank (ECB) monetary support reassured investors. The ECB is expected to maintain its asset purchase plan until December and preserve ultra-low interest rates until after its bond-buying programme ends.

The 4.02% sterling gain for Japanese equities was mostly driven by the yen's rise. The Bank of Japan (BoJ) is targeting near-zero yields for 10-year government bonds to weaken the currency and stimulate inflation but the yen's safe-haven attractions outweighed the impact of BoJ policy over the quarter. Japan's economy is benefiting from stronger domestic and overseas demand and rising corporate and consumer spending. At the quarter end, Japanese equities appeared modestly valued but vulnerable to yen-strength. In the short term, lack of clarity over Trump's plans for import duties has proved unhelpful because the US is Japan's largest export market.

Over the coming months, if inflation rises as expected, I believe equities will offer investors some protection in real terms while cheaper markets in Europe, emerging markets and Japan, where monetary policy is likely to remain accommodative, could make further gains. With US equity valuations high, the Fed tightening monetary policy more rapidly than expected remains a major risk. In this environment, sterling cash should prove more defensive for sterling investors than longer-dated bonds.

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