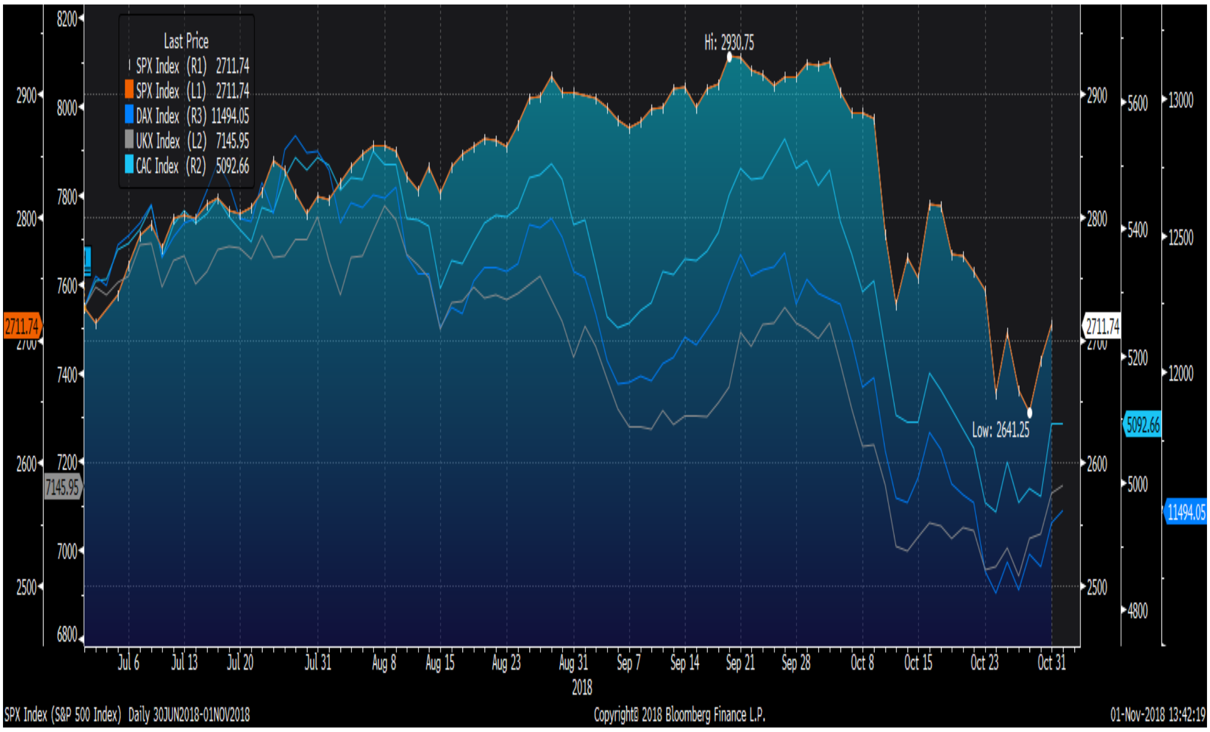
Market Review

In mid-June of this year the MPL investment team acted to take some profits in the portfolios, in the process reducing exposure to US equity markets, at the same time increasing holdings of cash, property, corporate bonds and infrastructure across client accounts. Subsequently, the third quarter of 2018 (to the end of September), was characterised by US markets unusually pushing on to new highs, very much against the trend in the UK and Continental European countries, notably France and Germany.

**US S&P 500 Index vs. FTSE 100; the DAX 30 (Germany): and CAC 40 (France)**
**July 2018 to Present**




Source: Bloomberg

The US market performance was a result of corporate profits there continuing to rise in the second quarter (increasing 16.1% year-on-year to June 2018, the largest year-on-year increase in six years), boosted by the Trump Administration's fiscal stimuli in the form of tax cuts filtering through to company bottom lines as enhanced profitability.

Strong US economic growth per se also played a part, with the US Commerce Department revising upward its estimate of how much real US Gross Domestic Product grew in the second quarter, to an annualised rate of 4.2% from an earlier estimate of 4.1%.

This backdrop supported robust second quarter earnings results from numerous companies in the US, helping to propel the S&P500 Index upwards and leaving investors with an encouraging outlook for the remainder of 2018, although it could be argued that this Index became a little over-extended as a result.

*Cautionary forward Guidance*

In our last letter to you, we alluded to the prospect that if and when forward (earnings) guidance provided by companies when reporting quarterly earnings became somewhat less bullish, then volatility would return with company valuations adjusting as a result.

As the third quarter earnings season began in earnest in early October, some concerns surfaced regarding the impact on US company revenues and earnings of certain factors, namely the Trump Administration's combative trade policy, together with a waning impetus of the US tax cuts mentioned earlier, and the perceived upward trend in US interest rates.

Third quarter guidance provided by companies such as Caterpillar and 3M highlighted such issues as higher raw material (input) costs, as well as the difficulties the strong US Dollar is causing to emerging market economies where these companies conduct significant business. As closely watched bellwethers of the US equity market, these companies are tied to the fortunes of the US economy and thus are seen as indicating the current state of and projections for economic growth there.

In their third quarter earnings calls, cautionary forward guidance from management teams at both companies pointed to pressure on existing (profit) margins, making it clear that Trump's tariffs and the so-called trade wars with China are two of the biggest overhangs for their respective sectors.

In short, the imposition of further tariffs could result in pressures on profit margins exceeding levels previously anticipated by management teams at these companies. This could negatively impact revenues and ultimately earnings growth within corporate USA as a whole. As we analyse the anticipated future earnings streams of companies in order to estimate the present value of those companies, guidance thus far received has caused market participants to adjust company valuations broadly across all US equity markets.

The old adage, "if the US catches a cold, everybody else sneezes", remains very much true. This forward guidance resulted in US equity indices selling off in October as forward valuation expectations adjusted, with revenue guidance from all companies reporting being closely scrutinised, with many overseas indices following and tracking lower.

In the current investment climate, these falls have been exacerbated by extensive positions in passive securities being held by 'index investors'. As markets rise and fall, so the machines and their algorithms (controlling programmes) responsible for ensuring that index-tracking Exchange Traded Funds (which replicate all the holdings within the index they track) are in line with the current level of the index, indiscriminately buy on the up-side and sell on the down-side.

We note that during the global equity market pullback that occurred between February and March of this year, some of the biggest companies in the US and indeed elsewhere in the world did not participate in that sell off. In this latest sell-off however, companies in the US Technology sector did participate due to the valuations of these companies having in some instances reached over-extended levels.

These factors contributed to the levels of volatility seen across global equity markets in October (and indeed made for a deeper correction than that between February and March), as the global outlook for revenue growth, earnings, and ultimately valuations adjusted. Yet we note that US corporations are on track to repurchase in excess of $1 trillion worth of stock for calendar 2018 – this provides a significant stabilising influence within the equity market.

Asset Allocation

Amid the global equity market correction in mid-October, the MPL investment team took a tactical opportunity to reinitiate the former overweight positions in the Technology, Biotechnology, US Equity Income, and growth sectors. Ahead of Brexit, we also tactically increased portfolio exposure to the UK equity markets via the FTSE-100 and FTSE-250 exchange traded funds, these achieved by reducing cash, corporate bond and infrastructure positions to facilitate this change.

Despite October's turmoil in the US, we still believe that the secular bull market (a market driven by forces that could remain in place for many years) is still intact. Whilst corrections (classified as a fall of 10% or more) are always possible within a secular bull market, we believe that we are still in an overall upward trend as we approach 2019. Consumers in the USA are in a relatively strong position as we approach Thanksgiving later this month, with joblessness at record lows, wages rising and confidence high, which will make interesting reading for fourth quarter earnings results due in January.

Factors that would change this view in the interim include the prospect of a recession in the United States brought on by interest rates there being increased too rapidly. As briefly touched upon in previous investment letters, whilst economic indicators such as the yield curve of the US bond market, and Leading Economic Indicators such as the Purchasing Managers Indices do not presently indicate an impending problem there, we nevertheless have to tread carefully over the next year as the US bond markets are close to signalling that rates expectations may rise to a level detrimental to the equity markets.

However, the correction already seen in equity markets has brought valuations of forward earnings streams back to more realistic levels both in the US and here in the UK, which bodes well for these tactical positions over the next quarter. Brexit meanwhile remains a huge factor behind the overall underweight exposure that we have to the UK markets at present, with the performance of the FTSE-100 continuing to be driven by currency (principally the US Dollar to Sterling exchange rate) and investor sentiment regarding Brexit and the negotiating progress towards this.

In short, were there to be a hard Brexit this would drive Sterling lower significantly - to the benefit of larger UK companies which earn the bulk of their revenue in US Dollars, and would then translate those Dollars into a weaker Sterling. In the event of a softer Brexit, the level of uncertainty surrounding the outcome of the Brexit deal would be reduced; this could lead to a general rally in UK equity markets, the valuations of which have been depressed by this ongoing uncertainty, which in turn has led to overseas ownership levels of the UK markets being markedly low.