Cazenove Capital

January 2018

Market update

Better economic growth

World growth was modestly stronger in 2017 and the global economy is now growing at its fastest pace since 2011, with the upturn increasingly broad-based across countries globally. That's good news – although a world economy growing at 3.5% rather than 3.2% does not reflect a major change in the underlying theme: normal is not what we saw during the decade prior to the 'Great Recession'; normal is a much duller affair. Despite this positive economic growth in developed and emerging economies, we have seen poor growth in productivity. Although this has led to much greater job creation than expected in the US, Germany and the UK, for the average working person it has meant low real income growth. This year we would like to see a pick-up in productivity-enhancing capital investment. So, as 2018 begins, the activity picture remains strong; business is confident and leading indicators signal robust growth ahead.

Inflationary pressure rising

Although the growth picture is good, markets are likely to face two challenges. First, growth expectations are higher than a year ago, which increases the possibility of disappointments. Second, unlike in 2017, stronger growth is more likely to be accompanied by higher inflation and higher interest rates. Inflationary pressures are rising globally and we expect firms to respond to the recovery in growth by raising prices more aggressively in 2018, particularly in the US. UK inflation has already spiked higher, as sterling weakness increased import prices – this effect should disappear from the annual inflation rate and as such we expect inflation in the UK to soften, bucking the global trend.

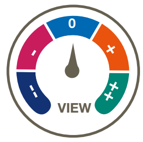
Levels of liquidity to slow

Rising inflation expectations globally will increase bond yields (and decrease bond prices), a move which could be exacerbated by the reduction of quantitative easing. The overall level of global liquidity is set to slow in 2018 and begin to contract in 2019. Although the US Federal Reserve began a gentle process of normalising monetary policy two years ago, it was clear that they were looking for reasons to delay the pace of interest rate increases. This reluctance to tighten has now largely disappeared. As a result, it is likely that faster growth in 2018 will be accompanied by three 0.25% interest rate rises in the US. The Bank of England has also started increasing rates, with the first rise of 0.25% in November 2017. We expect any further UK interest rate rises to be gradual, given the slowing trend in inflation and ongoing Brexit uncertainty, with the speed dependent on levels of wage inflation.

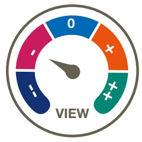
Implications for portfolios

For investment markets, this background of continued growth and a gentle cyclical upturn in inflation leads us to maintain a constructive view on equities. We continue to be underweight in bonds within portfolios, where we expect yields to be higher and prices to be lower in 12 months. We expect volatility to increase, in both bond and equity prices. Equity valuations are above their long term average levels, reflecting the expectation for above trend earnings growth. Indeed global earnings are expected to grow by a further 10% this year. As expectations have risen, so too has the risk of earnings disappointments, with profit warnings harshly punished by the market. We remain invested in equities to benefit from positive earnings growth, but are wary of the consensus position and may look to lower the overall risk of portfolios gradually as the year progresses. Alternative investments provide useful diversifiers, and where appropriate we hold property and infrastructure for income characteristics and absolute return to dampen volatility.

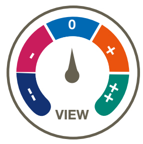
Current views



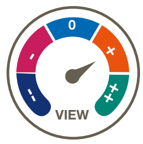
Equities



Bonds



Property



Absolute Return/Cash

Note: These diagrams are indicative of our asset allocation preferences.

Cazenove Charities is the largest investment manager of charitable assets in the UK. Supported by the investment resource at Schroders, the team of 25 charity specialists has a track record of generating strong risk adjusted returns with a commitment to responsible investing.

Important information

The opinions contained herein are those of the author and do not necessarily represent the house view. This document may include forward-looking statements that are based upon our current opinions, expectations and projections. We undertake no obligation to update or revise any forward-looking statements. Actual results could differ materially from those anticipated in the forward-looking statements. This document is intended to be for information purposes only. The material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. The material is not intended to provide, and should not be relied on for, accounting, legal or tax advice, or investment recommendations. Information herein is believed to be reliable but Cazenove Capital does not warrant its completeness or accuracy. No responsibility can be accepted for errors of fact or opinion. This does not exclude or restrict any duty or liability that Cazenove Capital has to its customers under the Financial Services and Markets Act 2000 (as amended from time to time) or any other regulatory system. Cazenove Capital is part of the Schroders Group and is a trading name of Schroder & Co. Limited 12 Moorgate, London, EC2R 6DA. Authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. For your security, communications may be taped and monitored.