Danske Bank

*Wealth Management*

# Investment Commentary

31 March 2017

The last three months have been generally positive for investors and the publication of the latest Organisation for Economic Co-operation and Development (OECD) Interim Economic Outlook in March provided further confirmation of the ongoing improvement in economic sentiment. Global GDP growth is projected to pick up modestly to around 3.5 per cent in 2017 from just under 3 per cent in 2016. Confidence has improved but consumption, investment, trade and productivity are far from strong and political risks still remain, especially in Europe.

The US Federal Reserve raised US interest rates by 0.25 per cent to 1 per cent during its March 2017 meeting. The decision came in line with market expectations as the labour market strengthened and economic activity continued to expand. Interest rate forecasts point to another two rate hikes this year, the same as in the December projection.

US equities have been driven to new highs despite some ongoing valuation concerns. Earnings growth is back in positive territory, with the first quarter coming to an end, companies will start releasing their latest results and outlooks in the middle of April. According to estimates from FACTSET (a research provider), companies in the S&P 500 are expected to report an earnings increase of 9.1 per cent from a year ago. If this is correct it would be the best quarter of growth in more than five years and reinforces our current overweight position in US equities.

The Trump administration hasn't been able to get its legislative agenda off the ground so far. Plans to repeal and replace Obamacare have stalled, which led to fears about whether Trump will be able to get tax reforms, roll back of financial regulations and infrastructure spending plans through Congress and this means earnings estimates could be too high. However, if Trump and the Republicans can get tax reforms through Congress, especially one which allows US companies to repatriate cash sitting overseas and bring it back to the US at a low rate, this could encourage US companies to spend more in the US, hire more workers, build more factories and repurchase some of their own stock, boosting their earnings per share.

Over nine months after the UK's historic vote to leave the European Union the Government has started formal proceedings to leave the bloc by triggering Article 50. We now await two years of negotiations until the deadline date of 29th March 2019. However, setting aside the politics, the initial economic forecasts are looking positive; the Bank of England has painted a brighter outlook for the UK economy in 2017, with faster growth, lower unemployment and a more modest rise in inflation. The Bank predicts that the economy will grow by 2 per cent in 2017. UK manufacturers are also more optimistic about their business situation and exporting prospects, while reporting strong growth in domestic orders over the previous quarter.

UK equities have recovered well; companies that earn in US dollars and convert back to pound sterling have seen a 15 to 20 per cent uplift from the weak pound and the commodity rebound also helped corporate profits and boosted their share price. However, Brexit negotiations will cast a shadow over activity for some time to come and costs will increase as prices adjust to the weaker currency. We have to expect further volatility in the UK market as how the UK will exit Europe is resolved.

The EU has weathered the potential storm of the Dutch elections, with the winning VVD party more Euro friendly; a potential further country splitting from the group has been averted. However, Europe has a packed political agenda this year, with French and German elections scheduled and possible Italian elections also on the horizon. If we look beyond the political risk, the underlying economic data looks in a more robust state, export orders have jumped as the currency has weakened and household consumption and fixed investment were the main drivers of GDP growth. Europe offers the best recovery potential in the year ahead. European equities are likely to catch up with the region's economic recovery and corporate earnings, which have declined for 5 years, could grow by as much as 12 per cent in 2017.

Japan continues to battle through its structural issue of an ageing, shrinking population, yet inflation is starting to appear again in the economy and a weaker Yen has seen an upsurge in the purchase of Japanese equities. The ongoing quantitative easing programme has also meant that approximately GBP 43 billion of Japanese Exchange Traded Funds will be purchased, coupled with approximately the same value of corporate buy backs which should see a rise in the Japanese equity index in 2017. Interest rate rises in the US are also beneficial to Japan, as the currency divergence between a strengthening US dollar and weakening Japanese Yen will help to bolster Japanese exports.

Emerging markets have suffered from a strengthening dollar. Countries and companies have both borrowed heavily in US dollars so the cost of servicing and refinancing this debt increases. With the US possibly rising interest rates two or three more times this year, emerging markets look to have to contend with a stronger dollar for longer. It's not all bad news though, in terms of social mobility and demographics, the region continues to offer long term growth opportunities.

We continue to see limited potential for attractive returns from UK government bonds, as they have fallen by 1.9 per cent over the last six months. Overall a well diversified mix of bond types across global markets can act as a type of "insurance" within a portfolio, and help smooth returns over the longer term.

Strategic Bond and Emerging Market Sovereign bond funds are two of our favoured fixed income investments and work well for investors seeking income in the current low interest rate environment. They both offer decent risk-adjusted returns as long as the global economy avoids a recession.

There is no question that 2016 turned out a lot better than expected and considering the unforeseen results of the UK's EU referendum and the US election of an outside candidate as President, investment returns were very positive. Currency has been the main story of the last few months and will continue to ffect companies' earnings in 2017. We see potential risks in the near future, both on the political and economic front. As US interest rates diverge from both the UK and Europe, there will be opportunities and issues as the global economy has to operate with a further strengthening dollar.

**James Norman – Portfolio Manager, Investment Centre**