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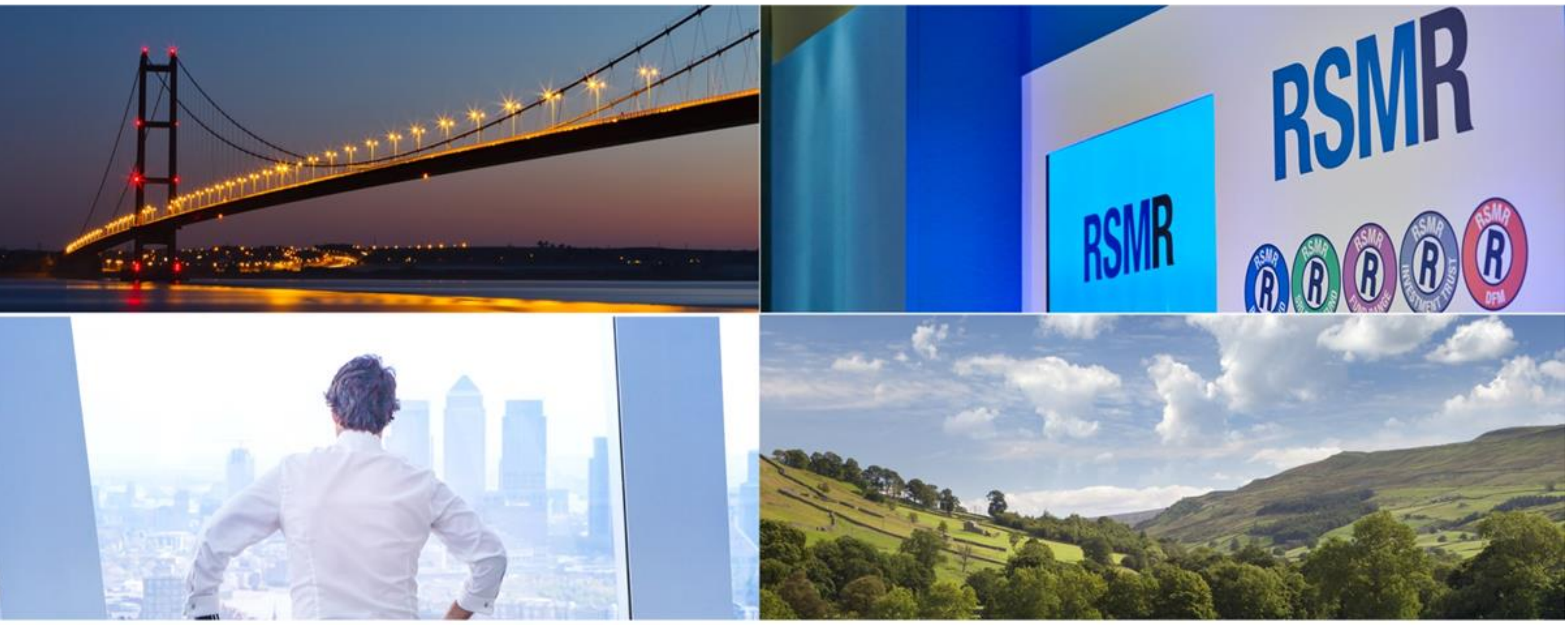

PRIVATE & CONFIDENTIAL

Quarterly Investment Bulletin

April 2019

General Economic Overview – Quarter 1 2019

In what might be described as an unexpected turn around, the negativity of investors was reversed in the first quarter of 2019, as we saw a very positive start to the year for markets. It is probably even more surprising if we look back at the reasons for the negative market movements in 2018 – a slowing economic backdrop, particularly in China, trade wars, political fragility and weak European data – all of which were still in place as we entered 2019. Markets had dropped some way in 2018 with nearly all asset classes reacting to the negativity with the exception of some government debt and property. One of the key concerns for investors was that the US Fed had indicated that its proposed path of interest rate rises would continue into 2019. This began to rattle investor's confidence as global growth did look to be weakening, resulting in the falls we saw in markets. Wind the clock forward to quarter one 2019 and we saw the Fed seemingly go back on its word and become more dovish in its tones, allowing investors to feel confident about a more pragmatic approach. This was not the only factor, but it is believed to have helped markets in this quarter

Whilst the issues outlined above remain the key focus for investors, over the longer-term there are some other risks which do not significantly influence the short term global growth picture. One of these is how late in the cycle it is, and what any eventual downturn will be like. Both Brexit and Italy (which has the potential to impact on other European banks) are areas of concern. In Europe meaningful reform remains problematic as populism but not anti-euro sentiment continues to attract support. In the US politics remain unstable, the Mueller report into president Trump's election activity was inconclusive in certain areas leaving more investigation to take place. Estimates suggest the US government shutdown took away 0.13% of growth for each week that it lasted. Markets are also suffering from the disruption of mechanised trading and other quant strategies including risk parity which heighten volatility. Trump's erratic behaviour is also not good for market stability – the US is no longer the globally stable force that it once was. Notwithstanding this the main focus for investors should be on the economic cycle and the outlook for growth.

China is undoubtedly slowing and is keen to get a trade deal with the US. A slowdown in China is not great for the US economy – US manufacturing has been hit by steel tariffs which have increased production costs and reduced margins – so there may be an interim deal which would allow the market to rally further. More positively the market concerns towards the end of 2018 over recession and Central Bank policy normalisation have abated and there is now more optimism on the trade front.

With the Fed on hold, markets are likely to see more stability in the first half on 2019 than the second half of 2018. A favourable US / China trade outcome, even if it involves kicking the can down the road, can allow equities to rally further. Outside of a messy Brexit with the UK crashing out on WTO trading rules sterling assets have scope to rally, although Brexit has already caused significant short-term damage to the UK economy. Some of last year's underperforming areas such as Asia, emerging markets, and mid and small caps have scope to lead a rally in the first half of 2019.

Equity Markets

The global economy can be seen to be slowing with growth predictions from the IMF reducing and recent PMI surveys suggesting a global contraction, or at least in Europe and China. The Citygroup Economic Surprise Index which measures whether individual pieces of economic data have underperformed or outperformed forecasts now sits at its lowest level since 2013. That said, 2019 has seen a more positive reaction from markets following the dramatic falls in late 2018. As is often the case, we saw an over-reaction in markets to negative information and investors quickly saw opportunities arise from falling valuations. The numbers from quarter one 2019 indicate a positive environment with global equity markets on average up over 8%. Many managers are more positive in their language, despite the economic headwinds. We are more cautious about markets in general but recognise that global growth is still positive and led by an expanding US economy. Although we appear to be late in the economic cycle it does not follow that a recession will ensue, as recent data from JP Morgan points out nine out of the last twenty global slowdowns have not been followed by recession. Markets are of course unpredictable and could tread water or gradually move up during 2019, rather than enter a period of negative returns as experienced in 2018. Volatility is certainly more apparent and will likely form an increasing part of our experience of investing as we move away from quantitative easing.

UK

The IMF forecast for growth of the UK economy has recently been downgraded for 2019 to 1.2% based on a number of factors related to the effects of leaving the European Union. The recent delays have already affected the inward investment in the UK economy by companies, with the UK now at the bottom of the pile for investment levels in the developed economies. A number of managers are positive on UK equities however as valuations are lower than for some time ahead of any solution to Brexit. In this environment we would expect GDP growth of 1.0% to 1.5% this year, modestly below trend, supported by higher government spending and consumer spending in line with real income growth of about 1.5%. We see core CPI inflation stable at or close to the 2% target as import price pressures have now faded and domestic price pressures remain subdued. Ultimately the key to UK economic expansion is the resolution of the Brexit issues which continue to affect normal trading and investment expectations.

US

The threat of trade disruption has not been as painful in the US as it has been seen to be globally. The US has a stronger domestic economy and a more independent economic framework. The US has been growing strongly enough for the central bank to raise rates over the last two years and although the predicted rises in in 2019 were one of the reasons for the sell off in the final quarter, the Fed has listened to the global economy and softened its approach since the beginning of the year. President Trump remains an unpredictable factor in this but his policy making period has now been restricted by the mid-term elections last year. Although there are many positives from US data, such as employment and consumer confidence data, there are some negative signs that should be monitored closely. The effects of the tax cuts in 2018 are reducing and there is increasing unease in the housing market as well as wage demands starting to creep up. There is some belief that a stronger inflationary environment in the US may well be a benefit for the economy and that the Fed may be more relaxed about the rate increasing above the 2% target. The US is the leading economy on the planet, and therefore is the one to be watched in terms of trends, although we are moving more closely to a point where the Chinese economy shares this role.

Europe

Whilst the UK is embroiled in internal and external Brexit negotiations, Europe also has its own regional issues to contend with. After signs of recovery in 2017/18 Europe is definitely slowing again and it is not just the obvious candidates that are stuttering this time, Germany is also showing weakening data with recently released figures showed it only narrowly avoided falling into recession in quarter four 2018. Many of the issues in Germany are related to manufacturing with January showing a surprise drop in industrial production, linked to the trade war issues between Europe, the US and China. Asian demand for German exports has dropped, particularly related to the auto market. The other major European economies have not escaped this, but they are less exposed. France has its own issues as President Macron tries to wrestle them away from restrictive employment contracts, whilst increasing the tax take. The smaller economies have only really recently started to recover and remain fragile with Italy the most problematic of these given its weak political environment and banking and borrowing problems. There are some bright spots however, with Ireland showing substantial economic growth and Spain also recovering well.

Asia

The mainstay of the Asian economic region is China, where growth expectations are between 5.5 and 6.5%, which is falling but still well above most other economic regions. There is confidence that fiscal and monetary stimulus will be in place after the meeting of the National People's Congress and that this will find some traction, especially if a trade deal between China and the US is completed. China itself is still seeing strong domestic consumption as, outside of auto sales where the ending of a tax incentive last year has distorted the numbers, retail sales growth is still running at around a 10% growth rate. The issues in China are probably causing investors to be more cautious than is necessary at this point but any signs of a likely US / China trade deal will ease investors' concerns. Inflation in China is under control with no need for central bank action at this point.

The strongest growing economy in the region is probably India, but elections are coming up and a clear majority for the incumbent Bharatiya Janata Party (BJP) under Modi seems less likely. That said, any new party or coalition is probably going to tread the same path as Modi, so there is less concern globally about any change.

Elsewhere fundamental structural and demographic advantages give the region some impetus and a stable or weakening dollar is a positive change.

Japan

Slowing economic growth affects Japan in the same way as many other countries and Japanese growth is expected to be around the 0.5-1% mark in 2019. Fiscal and monetary stimulus continues to support the economy as well as a robust labour market, which is likely to support domestic demand. With inflation still very low the Bank of Japan is unlikely to adjust rates in the short-term, driving savers towards more equity participation. Currency has been a strong influence on market perceptions for Japan and a stronger yen has not been helpful of late – the yen is seen as a safe haven currency in periods of stress and this was a factor in late 2018. Stock valuations are below historic trends so investors believe there are good opportunities longer term in Japanese stocks.

On the policy front, Japan continues to make progress in corporate governance, tourism and free trade, and has improving relationships with many countries. Shinzō Abe is likely to become Japan's longest-serving prime minister since the birth of the country's parliamentary system in the 1880s. This stability is in stark contrast to the problems besetting many other countries.

Emerging Markets

The dominant economy in Asia and emerging markets is slowing as is clearly being seen in the data emanating from China. The debate is whether this can be managed into a hard or soft landing. China is switching between being an export led economy to a consumer led economy, and this change has increased in urgency as trade wars have escalated. Historically, Beijing has injected stimulus into the economy, but they have also been managing a period of deleveraging, reducing the spread of shadow bank lending since 2017. There has been some movement recently to increase stimulus to the economy and it is hoped that this, plus the formation of a trade deal with the US, will prove to be enough to boost economic growth. The 2019 National People's Congress (NPC) concluded in March and China's government announced a series of targets and counter-cyclical macro policies to support domestic growth and employment.

Emerging markets are also going through a series of elections in 2019 including the very important Indian elections. If Modi were not be returned then it would have a short term negative effect on the region and emerging markets in general.

Elsewhere the conditions for growth remain strong with population growth and an expanding middle class increasing the power of the consumer. With over 140 million new middle class consumers entering the Chinese market alone each year there is huge scope for expansion in the region. Frontier markets are growing in momentum with Korea and Vietnam gaining investor interest as manufacturing hubs.

Fixed Interest

The recent so called 'pivot' from the Federal Reserve (a pause in interest rate rises) has been a positive sign for investors in general and signalled a period of stability in rate expectations, indeed some economic commentators think the next move from the Fed has an even chance of being downwards rather than upwards. This is a big shift from last year's positioning, and recent moves in the sovereign bond markets have seen yields fall. With this in mind the yield curve is likely to steepen, but it will perhaps take a little more time for us to see actual cuts in US rates. The recent inversion of the US yield curve, when longer term rates move lower than shorter term rates, is often cited as a precursor of recession, and has been a reasonably accurate predictor of this over time. It is possible for the outlook to become more positive if conditions improve, and this is helped by current rate stability, but we will need to also see stability in company earnings and profit margins.

In the UK, a soft Brexit could lead to the Bank of England raising rates later in the year, given such moves have been on hold recently. In Europe and Japan the chance of rates rising from their negative positioning is unlikely as economic prospects have declined. Investors are once again drawing comparisons between Europe and Japan, as the European Central Bank (ECB) appears to be struggling to normalise policy. The ECB has pushed back it's expected date for tightening monetary policy in its forward guidance and leading indicators of activity have been very weak in recent months. New orders, especially from the rest of the world, have fallen precipitously, and inventories have started to build. Weakness in external demand may be feeding into the domestic economy.

Given developed market rates are on hold for the time being, it seems most opportunities are in the areas of higher yield and emerging market debt. Corporate credit also seems to offer more opportunities given spreads have widened of late. The issues that face corporate debt holders are firstly, the increasingly crowded position in credit, and secondly concerns about credit market structure and liquidity which has not been tested since the financial crisis.

Property

UK commercial property market returns have continued to moderate compared to the previous few years. The ongoing Brexit uncertainty has led many investors to reduce or sell out of their property allocations, which has put pressure on capital values. A disorderly Brexit may have particularly negative connotations for the London property market and many UK fund managers are reducing or avoiding Central London property, although it has continued to be supported by overseas investors with relative currency moves being in their favour. The area of distribution / logistics / warehouses remains popular due to the demand for last mile delivery, same day delivery, click and collect etc. but this has pushed up purchase prices and driven down yields. The retail sector continues to struggle with profit warnings and financial difficulties announced by an increasing number of companies, as internet shopping continues to take market share, so fund managers need to be very selective. Liquidity levels within commercial property funds remain above average in many cases, which is a longer-term fall-out from the EU referendum result and the subsequent investor sentiment towards the asset class, and this may continue for some, particularly with the Brexit uncertainty, which will impact absolute returns. If fund managers can generate any returns in addition to the natural income this will be a very positive outcome.

The global REIT / property securities market is sensitive to interest rate movements and the global REIT space is dominated by US assets, so the path and outlook for US interest rates and US economic growth will be important influences on future returns. Global growth is slowing and the Federal Reserve has signalled a pause in interest rates, so the fixed income market is not currently pricing in any rate increases for 2019. This would be positive for the property securities market, but there is the possibility of an interest rate surprise which would have a negative knock-on effect to property securities/REITs should markets need to re-price. This is something to watch.

Summary

The improvement in market returns so far this year has been surprising, given that the issues that prompted last year's market falls are more or less still in place. The one change that seems to have had the greatest influence has been the 'Fed pivot' which re-routed US interest rate expectations from 2 or 3 upward moves in 2019 to none. At some stage the late cycle concerns will re-emerge as the US economy will undoubtedly slow this year. China is in a structural slowdown and, once its economy stabilises, it is unlikely to keep adding further policy stimulus as deleveraging remains a priority. China is still seeing strong domestic consumption (outside of auto sales where the ending of a tax incentive last year has distorted numbers).

There are also some issues which, whilst not too significant in the short term, will become increasingly important in the global growth picture. One of these is how late in the cycle we are and what the eventual downturn will be like, should it eventually arrive, and which assets should be held to best negotiate it. Funds designed to protect on the downside have struggled in the last twelve months and investors are losing patience. There may still be a few shorter-term opportunities – markets often overreact and this was seen last October when over a period of four weeks, markets went from believing in an inflationary boom to fearing recession. Very often the truth is somewhere in between – a more mundane and less newsy outcome.

For many managers it has become difficult to distinguish sentiment from fundamentals as so many asset classes correlated at the end of 2018. The process of selecting the best stocks has required managers to judge a company on its fundamental qualities including such things as cash flow return on capital, dividend policy and other technical factors. When markets move in unison it is very difficult for active managers to differentiate portfolios and market returns, but in an environment that is delivering increasing volatility, we believe there is greater scope for active managers to outperform. The key factor is for portfolios to diversify, and whilst this may sound like a broken record in these quarterly reviews, we stand by its importance, and the need to emphasise it when possible.

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