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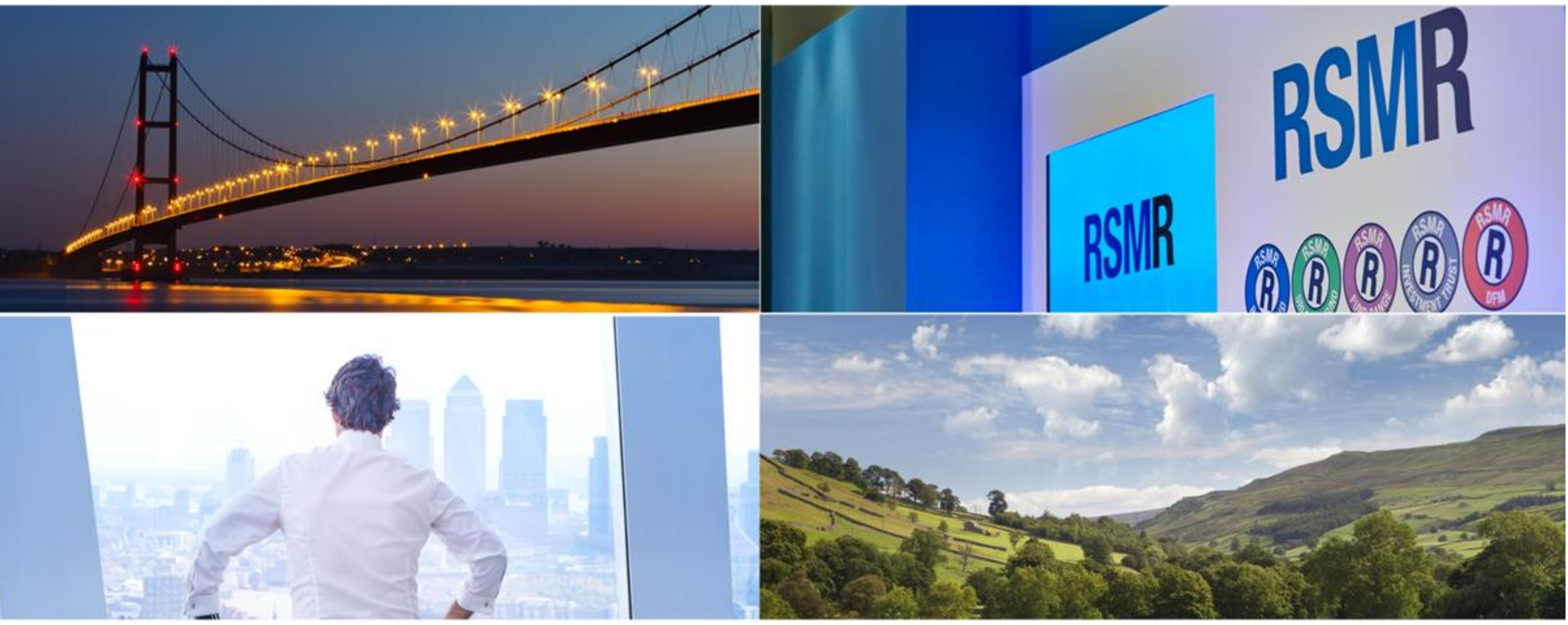

PRIVATE & CONFIDENTIAL

Quarterly Investment Bulletin

April 2018

General Economic Overview – Quarter 1 2018

What a difference a quarter can make! The global economy was in strong shape entering 2018 and there have been no significant changes to fundamentals that suggest the pace of growth or its current trajectory are changing, and yet we have seen a very different reaction in markets. There are definite trends that have now cemented themselves into investor considerations for the future, notably the pace of disruptive technologies and the reduction in central bank support, both very different in their effects but both very significant for future planning.

The first quarter of the year started very differently to the final quarter of 2017 with markets initially responding strongly to positive global growth predictions, but then correcting quite quickly on the back of some marginal but unexpected wage inflation data from the US. This probably indicates that we are more likely to see greater volatility in markets in 2018, rather than any short term fundamental growth trend reversals, and may well be part of the general move to normalisation of global monetary policy and a healthy resetting of markets. We can perhaps think of this as deferred from 2017 when fewer rates rises occurred, acting as a restraint for volatility and yields. Already this year we have seen more forecast rate rises and inflation fears as well as trade tariff threats which have caused volatility to increase.

This gives us the opportunity to look at why we are in our current economic position and what this may mean for returns in the future. The recession following the GFC was not a severe form of a standard business cycle recession, which typically would result from monetary tightening post inflation, but rather a financially driven or balance sheet recession which reflected the aftermath of a badly over-leveraged global economy where imbalances had built up over a number of years. Recoveries from this type of recession are typically slow, hesitant and more drawn out, taking many years, even up to a decade before economic growth normalises. This has certainly been the case in the developed world since 2009. Technically both Europe and Japan had double dip recessions in 2012 and 2015 respectively. Even during what is likely to be the longest running period of US economic expansion, (the record by number of months looks likely to be broken in 2018) there have been negative year on year quarters of growth. Eventually economic growth has started to improve as the balance sheets of governments, corporates and individuals repair and recovery becomes more sustainable. The cyclical upturn is showing strong signs of reverting to a more normal pattern, with economies finally responding to the exceptional monetary policies of Central Banks (Zirp, QE and negative rates), together with varying degrees of fiscal stimulus, or at least an easing of austerity measures by governments worldwide.

The key question which is likely to determine the extent and pattern of returns is whether the upturn can continue for an extended period at an improving but still relatively modest pace with limited inflationary pressures, constrained by disinflationary secular forces, or whether it will assume a greater degree of normality as economies finally shake off the after-effects of the GFC. The pattern of returns in markets this year does suggest a more normal environment should ensue but what can be accepted as normal by markets remains to be seen.

Equity Markets Overview

The start of 2018 in markets saw much the same pattern as 2017 with investors more confident about global growth and supporting stock markets around the globe. This changed in mid-February as a number of fears began to take over. The sudden leap in volatility seemed to be more sentiment driven than based on any enduring information trends – the small increase in US wage data was enough to stoke fears amongst investors causing a spike in volatility numbers as recorded by the CBOE Vix index.

The economic fundamentals had not changed with most forward-looking analysis such as industry PMIs being above 50 which indicates continued confidence in economic growth. The blip was, for some investors, a sign that there would be an increase in the levels of volatility on a more consistent basis in 2018 after a very benign 2017. March saw more volatility as investors had concerns that trade wars between the US and China would cause markets to fall further around the globe, and issues over technology stocks in the US. Most markets ended March in the red for the first time in two years. The weakest have been those which have lagged others for other reasons such as the UK (Brexit) and India (political issues). As we move further into 2018 we will see whether this is an ongoing trend or whether the pattern of 2017 will be resumed.

UK

The UK has followed global trends in the last quarter with the main stock market falling, along with most others around the globe, as uncertainty has taken hold regarding the current level of global growth. The UK is in a different position to many western markets in that it is having to deal with its exit from the European Union at the same time as facing broader global economic uncertainty. Recent political rhetoric around Brexit has been more positive as we have moved onto trade discussions. The economy continues to struggle on the consumer side with a number of retailers closing down due to the shift in behaviour towards on line purchases – retail sales in February saw a stronger pick up than expected but the overall trend for the high street remains negative.

Large UK listed stocks were the worst place to invest in the first quarter as volatile trading sent developed market equities lower. The UK benchmark index was the worst performing index down more than 8%, whilst the largest quoted equities were buffeted by a rising pound and deep pessimism towards UK assets amongst institutional investors.

Economist opinions differ on the 2018 outlook with some being more positive, depending on how the EU negotiations progress. Any improved certainty would definitely help companies firm up investment plans for the UK, which is a core factor in improving productivity and efficiencies for a competitive global environment. One underlying positive for the UK economy is that European expansion is gaining pace and Europe is the UK's largest trading partner.

US

The US economic growth momentum continues to forge ahead, with employment data and industry PMI figures supporting improving growth. Add to this new tax incentives and there appears to be many positives for the world's leading economy. There are some clouds on the horizon such as the political uncertainty surrounding the Trump regime, and concerns over trade wars with China although this has calmed towards the end of the quarter.

Despite strong economic data markets have reacted to more marginal data with greater volatility. The somewhat unusual trigger for the biggest single day point loss for the Dow Jones Industrial Index was centred on a positive upside surprise for U.S. wage data. While indicators of the real economy getting better might be viewed as positive, the prospect of inflation rising made the market think about life after QE and maybe life in a higher interest rate world. The U.S. Federal Reserve has, as predicted, started to talk about the upside risks to inflation, but we still believe that, all else remaining equal, the deflationary factors will mute the rise in prices over the next phase of this cycle, versus previous economic cycles.

The US market has been led upwards by the technology sector and until March this sector had remained robust in the face of market falls. The FAANG stocks had proved a magnet for investors with the mix of disruptive technology and wide economic moats, but recent government scrutiny in the US and Europe, and issues around data controls have meant an end of quarter fall off for these stocks. In contrast the more defensive bond substitute stocks have made gains with utility stocks outperforming. This may be temporary, or could be a more considered perspective of a bull market in its final phase.

Europe

The message from Europe is one of growing strength as the broader set of economies continue to build on positive growth in 2017. There are distractions – Brexit being the most obvious, but also in more stable core economies, for example in France where President Macron is aiming to curb union power, something his predecessors have failed to do. There will undoubtedly be disruption in France over the coming months as the battle lines are drawn, and public services will be affected, particularly the indebted French railway service SNCF.

In Germany the picture has tended to be much rosier with the economy rebounding strongly from the financial crisis but recent worries over protectionism are making investors think again. Car makers and the chemical industry account for just under 30% of the Dax and are highly cyclical and vulnerable to an easing in the global economic upswing. By contrast banks and tech companies carry little weight accentuating the drag from the composition of the Dax. The German economy is closely linked to the health of the global market, particularly the car market where there are concerns about the sustainability of the current business model, which is still based on the internal combustion engine. That said, the recent political issues have been resolved with the new coalition treaty, the Eurozone is in a stronger position, and broad valuations still offer some upside to investors which is not so obvious in other stock markets around the globe.

Asia

Asian markets have continued to benefit from the regions stability, both in terms of a growing independent economic base and from a stronger debt to GDP ratio, and this starts to insulate them from moves in other currencies, particularly the dollar. The weakness in the dollar was still a strong benefit to Asian markets in 2017 and this has been maintained in the first quarter of 2018.

Until recently markets in Asia have been in an optimistic mood, enjoying the effects of improved economic growth on earnings prospects but not worrying about any associated exceptional inflationary risks. The combination of the global debt overhang, demographics and the lack of significant overheating pressures from China is likely to keep global inflation contained, which should mean that global interest rate rises will be moderate. This does not mean that nothing has changed. Volatility in markets is likely to increase from here, which may reduce global confidence and global earnings estimates. Asian equity markets do not appear overvalued but gains are likely to be lower and more volatile. As with the global markets, the performance of China holds significant sway in the mood of investors and, despite concerns in 2017 about a hard landing, the markets performed extremely well. Asian markets have not avoided the recent downturn but have definitely been more resilient.

China's equity market was supported by an upbeat Q4 corporate earnings season. Earnings expectations increased not only in the e-commerce and internet sectors, but also among industrial companies that are experiencing improved pricing power as a result of a reduction in excess capacity. China has seen long term political stability enshrined in law as Xi Jinping gained approval for the scrapping of the two term limit for holding the Presidential Office. The policy of emphasising the sustainability of growth ahead of the pace of growth and his supply side reforms all continue to support a balanced economy in China, and the region as a whole. The ambitious One Belt One Road (OBOR) drive for geo-economic integration also means the rest of Asia can rise with China, and new and stronger leaders across the region such as Modi in India and Indonesia's Joko Widodo can help integrate it further than ever before. The oil price continued to increase after supply concerns surfaced following the extension of production cuts by OPEC which helped all commodity exporting Asian and emerging market countries to recover.

These factors, in addition to the longer term demographic advantage the region has, mean that the shorter term economic issues in the West should not spoil the longer term trend for stronger Asian growth.

Japan

The Japanese market has suffered in the latest downturn but this is probably to be expected – the yen has seen some strength against other currencies, and the threat of global trade wars has affected their large global export led sectors, such as autos and consumer electronics. It is notable that even after the strong market appreciation of the last six years, the valuation of Japanese equities is 15x price/earnings, which is lower than its own history as well as other major markets such as the US. The biggest risk remains a return to a deflationary environment, but a more likely scenario is a mildly positive inflation figure below the government's 2% target.

In Japan, the government confirmed Haruhiko Kuroda as the Bank of Japan's (BoJ) Governor for a further five years. The progress towards lifting inflation in Japan remains slow and Kuroda reaffirmed the need for 'powerful monetary easing' when he spoke in front of Parliament in February. It seems likely that the BoJ will keep its 0% yield target for ten-year government bonds in place in the near term and this is likely to weigh on global longer-term yields. The corporate governance story continues to develop and this increasingly looks structural in nature. While the pace of share buybacks by volume in 2017 lagged what we saw in 2016, the number of buyback cases hit a record high in 2017. The market is likely to reward companies with improving governance policies. Despite recent setbacks Japan still looks to be an area of value for investors assuming global economic growth continues to improve.

Emerging Markets

The return of strength in emerging market stock markets in 2017 was a boost for investors, particularly in China which was one of the best performing emerging markets last year as the stockmarket soared. This result probably surprised many investors who are more familiar with gloomy warnings about the country's slowing economy, overheating property market and rising debt levels. Investors do need to be careful how they view this as the improvement in valuations was quite tightly focused on the technology sector, as it was in the US. The MSCI China IT sector returned over 90% (in US dollars) and most of these gains can be attributed to just two stocks, Alibaba and Tencent. There are still some pockets of value in within the Chinese economy that can be exploited by investment managers, and the government is also making large strides in improving areas of the older economy. Tackling pollution is one of the government's priorities and as part of its environmental protection campaign, many of the most polluting projects have been closed. The government has also sought to reduce the amount of leverage in the financial system and has tightened regulations around shadow banking and clamped down on certain savings products.

China is a key factor in the growth of EM but the most vibrant economy at the moment is India. Since the appointment of Modi, India has seemingly gone from strength to strength and is seen as an increasing part of many EM managers asset allocation. Indian growth is running at 7.2% per annum and is the fastest growing economy in the world, yet this level may not be enough to satisfy the ever-growing population with 12 million Indians joining the workforce every year. India has some obvious opportunities to exploit with this growing population, but it does need to address the problems of public transport and infrastructure as well as its weak public-sector banking system and the lack of credit for company expansion.

Elsewhere the smaller but growing economies of South East Asia look to offer good structural growth opportunities. In Thailand, the economy is bottoming out with elections this year whilst in Indonesia, after a dull period of growth, consumer sentiment is beginning to improve. In the Philippines, there are hopes that the government will drive forward infrastructure projects and Malaysia, after the economic weakness caused by political instability, now seems to be improving.

We continue to believe that there are areas of value in EM but that there is a broader cautionary note for investors in both EM equity and debt as they need to consider the rising beta component of returns. Passive flows into EM debt comprised around 25% of flows into the asset class as of November 2017, and, whilst still below EM equity passive flows (60% of the total), this increasing share will likely push up the beta component of returns for the asset class. In a downturn, the largest constituents of the benchmark could be hit very hard if we start to see outflows from some of the large passive vehicles.

Fixed Interest

The fluctuating returns from fixed interest markets have continued to confuse investors through the first quarter of 2018. In a period of stronger economic growth and rising rates, many economists have predicted the end of the bond bull market, however recent falls in yields have failed to reproduce that in global debt markets. The longer-term prognosis for the asset class is broadly negative given global growth rates, but sentiment driven falls in equity market have seen investors move to safer haven assets driving yields back down again.

Markets have also focused on the change in leadership at the Fed with Jay Powell taking over from Janet Yellen. This has proved to be a non-event in terms of policy as the recent first meeting of the committee with him as chair suggested plans differed little from the previous regime. Four rate hikes in the US are possible this year which should result in a flattening yield curve given that the dot plot has shown an upshift or more hawkish stance in recent months. The ten year treasury yield has fallen in recent weeks after widening the gap to 0.78% from two year yields at the beginning of February - again indicating a flattening yield curve.

Spreads in general are tight across all market sectors suggesting that there is little room for this element of the market to deliver returns. In 2017 the rising yield environment gave corporate bond holders across the spectrum decent returns, in particular high yield holders who benefitted the most. There is far less scope for this in 2018.

There are also some interesting technical factors influencing fixed interest markets at the moment which may distort markets on a temporary basis leading to opportunities which at first may not seem obvious. A confluence of factors, including increased treasury bill issuance to fund the US deficit and repatriation of offshore assets by US companies, are contributing to higher rates in the US vs. other developed markets—and subsequently to the rising cost of hedging US dollars back to Japanese yen. The rising hedging cost is translating into a shift in preference among Japanese investors, away from the US, and into Europe. While it is difficult to quantify the scale of the flows precisely, the increased demand for European corporate bonds has the potential to offset reduced buying from the European Central Bank's corporate sector purchase programme. The government sector is also being impacted: year-to-date, France and Germany have each seen a significant increase in Japanese inflows as a percentage of their market size.

There are other pockets of value, for example emerging market debt which has generally been more volatile than its western counterparts but is now being seen as more stable given its looser link to the strength and weakness of the dollar. In recent months local currency debt has performed better than its hard currency counterpart which may be an opportunity for future investors to capitalise on a less US correlated asset class.

Fixed interest assets should not be dismissed because of the potential for monetary tightening as they can provide a safer haven than many other assets should stress re-emerge in global markets.

Property

Although the asset class has fallen out of favour in recent years there still remains a sensible reason to have an allocation in a diversified portfolio given its correlation to other asset classes. Whilst liquidity can be an issue at pressure points in open ended funds, if investors recognise the stability of the yield component and are prepared to take a longer-term view, then property can be an effective element in a portfolio.

The dire predictions by some market observers for the office sector in the aftermath of the Brexit vote – driven by concerns over Central London, which makes up 20% of the office sector – have failed to materialise. While capital values for Offices fell immediately after the referendum, those losses have now been recovered. The popularity of e-commerce has led to an increase in demand for well-located fulfilment centres and smaller distribution units and keen competition for this space has also led to an improvement in the lease terms landlords can expect to achieve. Within the Retail sector, secondary assets located in smaller towns look most compromised, as a vicious circle of weak tenant demand gives rise to vacancies, creating a less enticing shopping experience and results in further empty units as tenants leave.

The UK commercial property market remains stable but open-ended property funds contain more cash than previously, which is understandable given the events following the EU referendum. This liquidity issue did cause a problem and cannot be ignored but we are unlikely to see the same investor rush for the exit again soon, unless there is another significant Brexit / European-related issue, which would likely affect the London market the most. Market fundamentals remain reasonably good and the asset class still provides good diversification qualities. The area of distribution / logistics / warehouses is particularly popular at the moment given the demand for last mile delivery, same day delivery, click and collect etc.

The global REIT / property securities market is sensitive to interest rate movements and the global REIT space is dominated by US assets. A close eye will be required on interest rate rise expectations as further US rate rises are expected and not necessarily fully priced in currently.

Overall, the asset class still has a viable role within a diversified portfolio, especially in the low interest rate / bond yield environment investors currently face.

Summary

The themes of debt, demographics and disruption continue to dominate our thoughts as we move further into 2018. The so termed 'Goldilocks period' for investors where growth has been neither too hot nor too cold has potentially come to an end in early 2018, as investors have taken fright at data which last year would not have created as much concern. The more recent issues over global trade wars and protectionism did appear more fundamental but, for several reasons, we felt this would be resolved before it became a significant issue, and the countries involved seem to have taken sensible steps to avert the problems escalating.

There is clearly an increase in sensitivity currently – the falls in markets were probably mitigated somewhat by strong macro data. Data released over the month showed that for the fourth quarter of 2017 the annual pace of real GDP growth rose to 2.7% in the Eurozone, whilst in the US this growth was around 2.5%, and growth was broad-based across the regions. Growth looks set to continue at an above trend pace given that the composite Purchasing Managers' Index remains at an elevated level of 57.5 for February, despite moving lower from the previous month's figure of 58.8. The base case for continued global economic growth appears to be intact although this now has to sit alongside a more volatile set of global stock markets.

Despite these recent falls, valuations remain stretched in certain markets such as the US, and particularly in the technology sector. This is one aspect of the divergence between the returns of growth stocks compared to value stocks which have continued to struggle even in the more recent market sell offs. Longer term analysis such as the Schiller PE is also indicating that this current period in the economic cycle is looking long in the tooth, although it does not predict when, or if, it may end. At the same time we have the apparent certainty that this period of loose monetary policy is coming to the end in most western markets, moving from QE to QT, the most watched market outside of the US being Europe and the ECB. This tightening has to be managed carefully as global growth, whilst more robust, is subject to swings in sentiment.

A volatile first quarter might be behind us, but a challenging environment remains as investors assess trading risks and opportunities in equities and bonds over 2018.

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