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PRIVATE & CONFIDENTIAL Quarterly Investment Bulletin

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General Economic Overview – Quarter 2 2018

The global economy continues to move forward at a steady pace with no immediate threat of recession on the horizon, but equally no real step forward on growth rates. The brakes have been put on this quarter because of the threat of trade wars, in the main between the US and China but also in Europe as the US seeks to battle with all the major trading blocks. Markets started to reflect this towards the end of the quarter as concerns have grown about the effects a potential trade war would have on the Chinese economy.

There are investors who doubt that global GDP numbers can move upwards from here, effectively meaning that global growth has peaked, but this has been countered somewhat by strong US economic data showing expansion allied to lower unemployment numbers. Tax cuts are beginning to have a positive effect but have yet to come through in any meaningful way in inflation numbers. Trade wars and tariff increases will undoubtedly put pressure on these statistics, but for the time being the US continues to pull the globe along with it. Perhaps the irony now is that investors are looking to China to provide stability in a market of uncertainty. China has started to shift slightly – loosening some monetary policy conditions by cutting the reserve requirement ratio for commercial banks which may, if we see capital flight, feed through into a weaker currency. A currency war on top of a trade war would not be good for the global economy.

Arguably this is the biggest threat to global growth in the near term but there are other economic concerns which need to be evaluated. Politically the Italian elections saw a long negotiation before a coalition was formed and even now the political uncertainty still exists as the coalition includes the populist Five Star movement. Globally there are other political hot spots such as Colombia and Mexico which have both recently had elections, and even Germany where migrant issues may threaten the coalition.

Government and consumer debt are also at extended levels particularly in the US where consumer debt is higher than before the financial crisis. In the US the issuance of government debt to support tax cuts will be extensive which has to have longer term repercussions on the economy if inflation stays at such subdued levels. Although the consumer has not faced significant inflation they have also not seen wage rises and so have extended credit facilities to purchase goods. The majority of car sales in the West are now based on some form of lease for example. This may have peaked in some areas such as the UK where uncertainty is threatening consumer spending.

On a broader basis global economic growth continues to be positive, estimated to be around 4%, although in areas of uncertainty such as the UK it has fallen – natural fears over Brexit have eaten into consumer and corporate confidence. This has also had an effect in Europe where it has combined with the uncertainty over future action by the ECB in the reduction of QE and bond buying programmes after years of unconditional support. Some of the peripheral economies such as Greece and Turkey are still very fragile in economic terms.

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Equity Markets Overview

The second quarter of 2018 has at least seen some confidence return to global stock markets with most delivering positive returns at the end of the quarter. There are however some interesting anomalies to consider in the current economic climate. Markets have performed very well since 2009 but many observers have noted that valuations have continued to be extremely high in an environment where volatility is increasing and geopolitical tensions intensifying. This combination should in theory cause greater jitters in financial markets but the MSCI Index is up over 10% over the last twelve months. Interestingly, similar concerns were being shown in 2015 when Yale Professor Robert Schiller noted that market values in certain areas looked to be in a bubble – the US S&P index has risen 34% since then. More recently we have seen that the number of bearish comments has reduced significantly, which suggests complacency might be a factor in investor behaviour after such a long positive period. This could be evidenced in the contradictory behaviour we have seen from some managers – the June 2018 Bank of America Merrill Lynch Survey of asset managers showed that equity investors had returned to being overweight in US equity, and globally the most crowded trades of all were in US and Asian tech shares. Is this the beginning of the so-called melt up prior to the end of this stock market growth phase? It is not possible to predict such an event but there are many investors who have increased cash and defensive holdings based on the view that markets are expensive with a correction due.

Most markets are still in positive territory this year, with the main exception being emerging markets which have sold off a little based on the stronger dollar, and not helped by recent negative returns from India and China A shares. The structural changes made in emerging markets have yet to isolate them from the movements in the US dollar hence the negative reaction.

UK

There are a number of unique factors currently affecting the UK's potential for growth, notably the negotiations surrounding its departure from the European Union. The recent decision by the Bank of England to hold interest rates at current levels backs up the belief that growth and potential inflation is not yet strong enough to withstand further rate rises. Rates of growth have improved in the second quarter, but year on year data analysis from the British Chamber of Commerce has cut GDP forecasts to 1.3% from 1.4% for 2018 although Q2 growth is expected to be up on the Q1 figure of 0.1% to 0.4%. There are some sectors which have been disappointing, the manufacturing and construction sectors for example where higher oil prices have driven up input costs but have not fed into consumer process or earnings growth. One of the confusing features of western economies since the financial crisis is that rises in employment have not led to higher earnings growth - there may be more slack in the labour market than the BoE has anticipated historically.

There is still a case to support UK equities as the UK's twelve-month forward PE ratio relative to the MSCI World Index is in line with its 15-year average which suggests some discounting of an economic slowdown. Another measure is yield which is hovering around 4% and still showing some future potential. The UK stock market this quarter has done well relative to other global markets thanks to a strong rally in large cap stocks, in particular supported by energy names.

We have to be somewhat cautious about the potential for the UK economy in the short term given the

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negotiations for Brexit, with business investment likely to be compromised. Recent consumer data and the issues on the UK high street are symptoms of this uncertainty and this is negative for the economy. Longer term attractive valuation levels and greater certainty of Brexit outcomes may well see stronger support for the market.

US

The forecasts for US economic growth remain robust at around 4% thanks in part to a healthy level of confidence in both corporate US and the consumer. Political uncertainty has reduced as markets get more used to the actions of the President and his style of communication, but there may be issues ahead with his stance on trade deals and tariffs. The central worry for company executives and economists is not the short-term disruption of economic expansion, but the steady and relentless drag on corporate earnings and spending that takes place over a number of quarters. A survey in May showed that 95% of top chief executives saw foreign trade retaliation as a moderate to serious risk. Tariffs are a complex set of factors to evaluate for a business and the true effects may only be seen some 12-18 months down the line.

Markets have been mostly resilient to such factors this year as they have focused on the continuing rise of the technology stocks and an improvement in the energy sector as the oil price and commodity prices have recovered. The NASDAQ continues to be the best performing index buoyed by the FAANG stocks that continually seem to defy valuation extremes. Recent tax cuts are now beginning to filter down to the US consumer as a number of firms start to increase wages or pay higher dividends to investors. The tax cuts, combined with a strong economy, should see S&P 500 earnings boosted by at least 20% in 2018. As a result the market, which had been trading on a relatively high PE of around 20x has fallen back to around 17.5x which is much more in line with long-term averages (this is on a current, rather than cyclically adjusted basis). Trump's personality is now influencing both policy and people. The influence of trade hawks, such as Novarro, has led to more insular policy decisions. They have egged on the President's mercantilist policies, leading to the imposition of tariffs on many products imported into the States with no distinction between countries who are friends rather than foes of the United States.

The consequent effect of the US debt mountain should not be underestimated as US government debt issuance starts to increase. The Trump administration may well need Chinese support on this meaning a trade war might bite deeper than expected.

Europe

Europe has had a more difficult quarter. It has had to face uncertainty around Brexit and also the migrant crisis which is causing tension, particularly in Germany where the coalition is struggling to find common ground. On top of this, the Italian elections and the state of their economy has been both a short and longer-term concern. The tariff battles with the US administration continue to threaten the trading prospects between the two blocks - the threat to the automotive industry is a key concern for European leaders as the US is taking a closer look at this sector.

Inflation is lower than the ECB wants it to be and this, combined with the need to not disturb what is a fragile growth picture, we are likely to see the ECB withdraw stimulus very slowly as it reduces its QE spending. The ECB has to be very careful because the experience of debt accumulation is very different across Europe – Germany has a zero government budget, whilst Greece has a debt to GDP ratio of 173%.

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At the same time Eurozone reform is also on the agenda with the French Prime Minister aiming to get a European budget agreed for the first time. The valuation levels in Europe are now more attractive but there are also signs of increasing economic weakness that investors need to be aware of, such as the fall off in exports to Asia and the UK.

There remain some positives in that domestic demand has been improving, with the European Central Bank (ECB) reporting a notable pick-up in lending data. The domestic economy has further room for improvement, but there are other headwinds that are approaching such as higher oil prices and the recent depreciation in the euro which will reduce the purchasing power of households. This is unlikely to cause a major slowdown as strong employment growth should act as a support and, for the majority of member states, fiscal policy has shifted from tightening to a small loosening, with pressure growing for even more relaxation of budget stances.

Asia

Asian markets have been weaker in the second quarter from both an economic and market perspective as foreign trade disputes have escalated, led by the US administration. Most observers are watching China as it reacts to the new threats from the US but so far it has been a 'tit for tat' process. The Chinese have in fact been courting leading global company executives, meeting with them to get an understanding for the 'one belt one road' programme whilst offering a pragmatic approach to the new trade tariff battles. The other US-led influence is the dollar and as this has strengthened it has cast a shadow over Asia and emerging markets despite the fact that most economies are more financially sound than prior to the financial crisis.

In China growth is set to soften somewhat in 2018-19 as exports ease and investment slows, and the current account surplus is projected to stabilise. Infrastructure investment, a major growth driver in recent years, is projected to slow further amid tightening monetary conditions and a more rigorous approval process for local government investment. In early 2018, consumption strengthened on the back of rising real incomes and a low unemployment rate – e-commerce sales in particular have expanded very rapidly. Producer price inflation continued to moderate and consumer price inflation remains subdued. The monetary policy stance will remain neutral with a tightening bias, as mitigating financial risks has, appropriately, become a key policy priority. Shadow banking activities are increasingly being reined in due to the extension of the macro-prudential policy framework to cover such activities, and credit growth is slowing, whilst capital outflows moderated in early 2018 following a surge and the exchange rate has stabilised.

The market has de-rated on macro concerns, but the prospect for corporate earnings in the region, certainly on a selective basis, continues to be encouraging. For example, in China consumer franchises will continue to benefit from the upgrading of consumer appliances by the Chinese middle class. Many businesses within the Greater China and Asian region benefit from the secular growth theme of technology with the region housing leading global chip makers such as Samsung, together with strong automation and robotics businesses such as Keyence and Advantech. Some domestic sectors such as healthcare will continue to see a catch-up in spending which remains low as a percentage of GDP compared to developed markets. Growing prosperity in the region will fuel higher health spending.

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Over the next 10 years the world is likely to see an increase in both populism and protectionism which is negative for the Asian economies, especially as within Asia it is hard to avoid exporting businesses as these are often global leaders in terms of quality of franchise and competitiveness. Asia remains a competitive hub for this type of business. We should not be too negative however as the longer-term demographic advantage the region has, means that the shorter term economic problems created by trade issues and currency movements will be overcome.

Japan

The Japanese economy had better than expected first quarter growth which moved it away from falling into a technical recession, but annual growth is still at a subdued 1% level. Growth is projected to remain above 1%pa through 2019. Sustained growth above Japan's estimated potential rate is projected to underpin a gradual rise in inflation to nearly 1½ per cent (excluding the impact of the consumption tax hike). The New Economic Policy Package could lead to even faster growth, although its full benefits may take longer to be realised.

Growth was expected to rebound in Q2, but data for the quarter so far signals that the improvement could be limited. Consumer confidence fell in April as a historically-low unemployment rate is failing to translate into substantive wage gains. Despite tight labour market conditions, wage growth remains sluggish and began falling in real terms to about 2½ per cent, while the ratio of job openings to applicants has risen to its highest level since 1974. With the working-age population (15-64) declining at an annual rate of 1.1% since 2013, labour shortages are becoming more severe and a number of firms are cutting back services and operating hours to cope with labour shortages. The manufacturing PMI fell to a nine-month low in May due to soft demand pressures. On the flip side, a weak yen could boost exports, therefore spurring manufacturing activity.

A tight labour market, the Bank of Japan's (BoJ) ultra-loose monetary policy and renewed fiscal support are shoring up economic growth this year but higher energy prices and weaker export growth will reduce the contribution of the external sector to overall growth. The main downside risk is an increase in geopolitical tensions, which would lead to an appreciation of the yen. Government debt relative to GDP is the highest ever recorded in the OECD area, which poses serious risks. Achieving fiscal sustainability requires a detailed consolidation programme that includes measures to control spending in the face of rapid ageing.

Emerging Markets

Emerging markets were one of the few areas that had a negative second quarter. There are a number of reasons but the main ones were related to the strength of the dollar, issues over trade between China and the US, and geopolitical uncertainty.

Emerging market assets have seen a sharp reversal in the second quarter with economic problems in Argentina and Turkey, a slowdown in Brazil following the truck drivers' strike, the prospect of a left-wing President in Mexico, fears over the Indian electoral cycle and curbs on fixed asset investment in China, together with the macro negative of a resurgent dollar, all of which have provided the perfect storm for this region. The introduction of tariffs and fears of a global trade war have impacted on Asia, which has particularly strong manufacturing hubs dependent on export driven growth. The fact that Asian

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economies which are more export orientated have performed better than other EM assets reflects the fact that these countries do not have significant current account problems. Current account deficit countries have historically suffered the most during global liquidity scares, with the last significant event occurring during the Fed taper tantrum in 2013. A rising dollar following an unexpected tightening in US monetary policy, or a change in expectations of future rate rises, tends to be bad for all risk assets, but especially emerging markets.

Latin American markets are certainly more nervous about the US regime as they go through a period of political change with a number of elections – Columbia and Mexico have just had theirs and Brazil has elections in October. Higher US rates and a stronger dollar do affect these economies more than most; a clear example is Argentina which has just signed a \$50bn IMF package and now walks a financial tightrope. Elsewhere it is striking that tighter finances and soft commodity process have not produced the balance of payment crisis of the past.

In today's world, avoiding emerging market companies which have significant FX mismatches could be an important way to avoid serious losses if the US currency continues to strengthen. Countries at most risk from a strong US currency are those with current account deficits, with some of these also vulnerable to a rising oil price. Within Asia both Indonesia and India have seen currency weakness in the second quarter.

At times of US currency strength, it is typically north Asian countries such as China, Taiwan, Korea and Singapore that perform the best.

India has struggled so far in 2018 as growth has failed to rebound quickly from the shock caused by both de-monetisation and the imposition of a nationwide GST the equivalent of VAT. These have both been disruptive in the short-term, although the effects of de-monetisation have now passed through.

Within the emerging world some companies borrow what they believe is more cheaply in US\$ debt. This has been behind the weakness in some EM corporate debt and there is no doubt at the individual company level some businesses may suffer financial stress. To avoid this it is important to rely on sound analysis by fund managers operating in this space as this is a micro rather than top down factor weighing on corporate profitability.

Fixed Interest

The conundrum for many asset allocators and defensive investors is how best to position portfolios for the various scenarios which may play out in the fixed interest market in this current environment. This is what investors have been debating for well over two years as they have anticipated a rising interest rate environment. The returns from bonds have continued to surprise as losses have been limited – in western markets this rising rate trend can be seen more obviously, but even in India recent rate rises have been activated by the central bank. The rate of increase has been small and well telegraphed by central banks, leading investors to remain sanguine and not, as some had feared, rushing to cash or alternatives to avoid the end of the so termed bond bubble. Sense suggests that a fall in rates at this point looks unlikely so there is no benefit from hanging onto medium and long dated assets particularly in the government bond sector. In fact, supply looks set to increase if, as we expect, the US starts to fund its tax cuts and the ECB reduces its bond buying programme. At the same time however, we have been in a long period of global growth which some believe has to come to an end, despite the strength of the US economy, in which case

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holding secure assets like government debt continues to make sense. If, as many economists predict, we do get further rate rises in western economies then government and investment grade credit holders may well see capital losses but if rates only reach 2-3% then investors may well continue to prefer to hold these assets for their defensive characteristics – the picture remains confused.

Currently the fixed interest market seems to have good support in the form of central banks (ECB, Japan) and pension funds. There are limited defaults in higher yield assets and even emerging market debt is backed by stronger balance sheets in regions that were previously weaker. This does not mean there is a limited downside to holding these assets however – a stronger dollar has shown that emerging economies are still linked closely to its fluctuations despite having much stronger balance sheets. Debt issuance is on the increase both corporate and government as they seek to restructure longer term deals, secure cheap finance and undertake leveraged buyouts, whilst rates remain low. Almost half of US corporate debt issued this year has carried a higher risk rating of triple B plus, triple B or triple B minus with demand still high and the spread between triple A and triple B only 50 basis points. Liquidity in corporate credit is lower now than before the financial crisis with less market makers and trading desks operating.

It is also strange that in this backdrop the term premium (the calculation the US FED uses to calculate the extra compensation investors need to hold longer term assets) is currently zero – normally it would be positive at this point in the cycle. JP Morgan have calculated that the global yield curve has inverted for the first time since 2007.

There is clearly plenty to think about in this complex asset class and there are no clear-cut answers, other than that diversification as important as ever. Even with the potential for monetary tightening, some exposure to fixed interest can provide a safer haven than many other assets should stress re-emerge in global markets.

Property

Although the UK commercial property asset class has fallen out of favour in recent years there continue to be sensible reasons to have an allocation in a diversified portfolio given its diversification benefits and lack of correlation to other asset classes. Whilst liquidity in open-ended funds can be an issue at pressure points, 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 UK commercial property market remains stable but returns have moderated versus the previous few years. The potential outcomes of the Brexit negotiations and negative connotations for the London property market in particular are leading many UK fund managers to reduce or avoid central London property, although the market continues to be supported by strong overseas demand. 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 is pushing up prices. The retail sector continues to struggle with profit warnings and financial difficulties announced from a number of high street retailers, such as Mothercare, Carpetright, Toys R Us and John Lewis, as internet shopping continues to take market share, so fund managers need to be very selective in this area. 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 time, which

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will impact absolute returns.

The global REIT / property securities market is sensitive to interest rate movements and is dominated by US assets within the global REIT space, therefore the path and outlook for US interest rates and US economic growth will be important influences on future returns. The fixed income market is not pricing in the same interest rate path as the Federal Reserve has forecast, so there is the potential for a negative knock-on effect to property securities/REITs should markets need to re-price.

Summary

The second quarter of 2018 has seen much larger differences in the returns from asset classes and markets than has occurred in the last couple of years. A strengthening US\$, tightening monetary policy and widening geopolitical risks have driven the winners and losers in the first half of the year. Although there have not been any major setbacks in the second quarter and markets have for the most part seen positive returns, it feels like investors have not been buoyed by the news and are not very far from their weightings at the beginning of the year. There is commentary in the financial press that the level of uncertainty warrants a more defensive outlook and that investors have perhaps become complacent signalling a potential peak in markets. This is difficult to judge although in recent weeks we have seen more concerns over the escalation of trade wars with investors starting to pull out of areas like emerging market debt, whilst most major equity markets have so far been more sanguine about the prospects of this happening.

The outlook for global growth in 2018 remains relatively benign with most estimating it at around the 4% level. June saw the US Federal Reserve raise interest rates for the seventh time since 2015, and the following day the ECB announced that it would end its €2.4tn euro bond buying programme in December. Now only the Bank of Japan is persevering with its QE programme – the extraordinarily supportive monetary backdrop that has assisted financial assets globally is now coming under some degree of pressure. This in itself is enough to explain the higher levels of volatility in markets, although it also needs to be remembered that outside of the US interest rates are still well below what would historically have been considered to be neutral levels, and even in the States they are only heading to a ‘new neutral’ some way below previous peaks. A less benign global liquidity regime has seen outflows over the quarter from both equity and bond funds. Overall, by the end of the year global liquidity will begin to shrink for the first time since the financial crisis.

The second half of 2018 may provide us with more indication about how robust the global economy will be in the next 12 to 18 months but looming trade disputes look to be a focus for markets as we move through the rest of the year.

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