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Keeping you informed matters

Economic review

July 2018

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Outlook

You might be forgiven when looking at the headlines for thinking that the world economy was in deep trouble. Much of the rather unpleasant rhetoric surrounding Brexit, European, Trump, and Chinese politics obscures the fact that currently the world economy is doing rather well.

In fact, it is something of a paradox that just as the world economy is shaking free of the vestiges of the global financial crisis, political populism is putting that recovery at risk in a multitude of ways. Most obviously to us in the UK, Brexit is already negatively impacting investment. Businesses are deferring or relocating investment often to the European mainland.

The Italians have dealt a serious blow to European unity by electing a coalition of the Far-Right and the anti-establishment Five Star Movement founded by the Italian comedian Beppe Grillo.

Donald Trump is quite literally tearing apart the institutions that have governed international relations since the 1950s. Russia and, more importantly, China are becoming increasingly assertive on the world stage placing at risk the US sponsored Pacific-Asian political settlement that has kept Japan firmly in the "Western" group of developed nations since the war.

So, it comes as something of a surprise when the OECD in their May 2018 assessment of the global economy upgraded their outlook for global growth to 3.9% in 2019.

The composition of this growth has changed somewhat. The OECD sees slightly slower growth in China, US and the UK offset by stronger activity in the South-East Asian and Indian subcontinent. Nonetheless, expectations are robust. Now let's consider productivity.

As Paul Krugman, Emeritus Professor of Economics & International Affairs at Princeton University stated, "Productivity isn't everything but in the long run it is almost everything. A country's ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker." Many commentators regard the Information Technology revolution as a second Industrial Revolution. If that is true then possibly the most astonishing aspect of the technological changes we experience every day is the decline in productivity evident across the developed world since the impact of IT first began to be felt.

This decline in productivity means that economies are smaller and less wealthy than they should be. In the case of the UK, the decline in productivity seen since the financial crisis is estimated to be equivalent to some 15% of GDP. In cash terms that equates to about £300bn. In other words, a great many schools and hospitals.

On the other hand, a trend reversal in productivity would point to very material upside in output, wages and profits. Unsurprisingly, the only economy where we find real, albeit modest evidence, of a trend change is in the US.

There is a clear disconnect between a constant barrage of negative newsflow and the underlying momentum in global economic growth. The dilemma facing all investors over the coming years as we move from the loose monetary policy conditions brought about by the events of 2008 towards a more normalised environment.

For this reason, we don't want to paint too positive a picture of the outlook. Nonetheless, underneath the surface tension, the capacity of liberal, capitalist, free-market economies to reinvent themselves and recover simply continues. As Hayek pointed out decades ago, the road to serfdom resides in central planning not in free markets.

Global growth seems entrenched and indeed, is accelerating. Investors cannot be complacent; risks abound. Rising protectionism will tend to lower growth and raise inflation. However, equities look underpinned by solid growth with upside potential if, as is tentatively the case, productivity begins to improve.

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Key facts about the world

United Kingdom

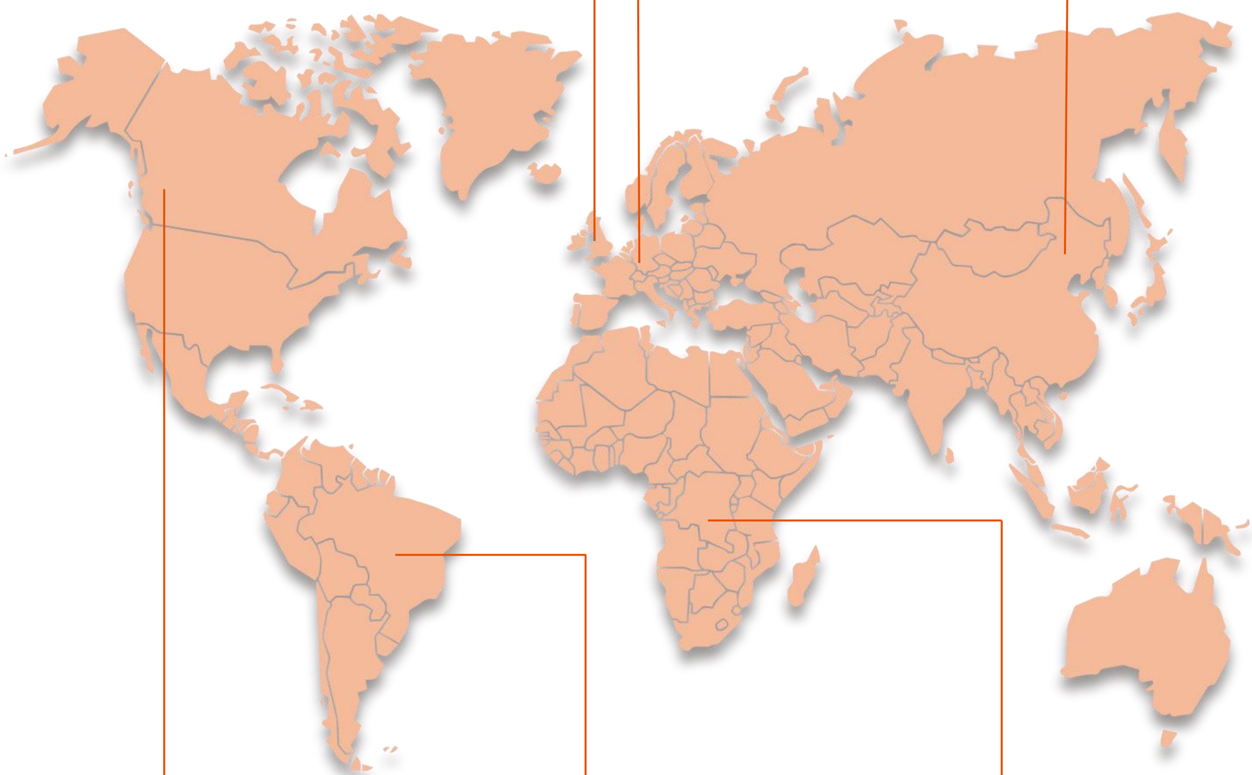
- UK growth bounced back as service sector expanded
- Sterling has remained volatile against the US$ and Euro as Brexit talks have ebbed and flowed

Europe

- Populist government gained power in Italy
- German GDP forecast to grow at 2.2% by the IMF
- Slower economic growth and reduced deficits in France

Asia

- Contraction in the Japanese economy in 2018. Valuations of Japanese companies remain attractive
- Peace talks between North and South Korea could increase stability in the region



North America

- Record level of M&A activity and declining capital investment
- Risk of a trade war with China has increased global instability
- The US will continue to lead economic growth into 2019

South America

- Brazil's GDP forecast has been slashed for 2018
- Venezuela continues to suffer from hyperinflation
- Mexico votes in a populist left leaning candidate in a common narrative that is playing out globally

Africa

- Shrinking GDP growth rates in South Africa threaten to cause instability
- Trade war could affect commodity reliant countries on the continent
- Political fallout continues to dominate northern countries

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Q2 Performance Review

A rebound in equity markets and a temporarily stronger Pound drove returns

- US equities continued to be the best performing market
- UK equity exposure provided broad based positive returns
- Emerging Markets were adversely affected by rising interest rates in the US
- The Pound rallied strongly but has since fallen back
- Credit spreads have widened, leading to losses

The second quarter reversed the volatility seen earlier this year with equity markets rebounding strongly across the developed world. This rebound was not universal however with Emerging Markets not participating in the rally this quarter.

The performance of our strategies was driven by our exposure to UK equities, with 4 out of 5 of the best performing holdings being UK equity funds. Our holding in the iShares FTSE 100 ETF delivered 9.56%, followed closely by our exposure to the JOHCM UK Equity Income fund which returned just over 9%. The interesting point about the performance of the UK equity exposure was that it coincided with a strengthening Pound for the first time since the Brexit vote in 2016.

US equities continued to benefit from the growth exhibited by the technology sector and our holding in Loomis Sayles US Equity Leaders returned 11.75%. Its exposure to Microsoft, Amazon and other companies benefitting from the move to the networked world has led to the fund returning 20% more than the S&P 500 over the past three years, an impressive 87.62% in absolute terms.

Credit markets continued to suffer losses as investment banks have become less tolerant of holding exposures as interest rates rise in the US. Having said this, our holdings in this area, M&G Corporate Bond, Fidelity Moneybuilder Income and IP Corporate Bond provided near flat returns. The best performing fixed interest holding was the AXA US Short Duration holding which returned just under 1%.

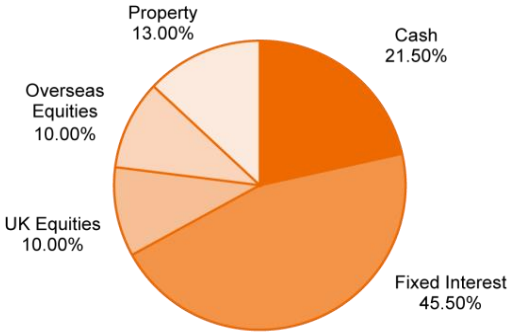
Our exposure to property has helped the strategies this year as equities have been volatile and fixed interest markets have adjusted to a higher interest rate environment globally. Returns from the SLI UK Real Estate Fund for example have been positive for each of the past six quarters, returning 6.95% for the year.

SECTOR	3 months	1 year to 30/06/18	1 year to 30/06/17	1 year to 30/06/16	1 year to 30/06/15	1 year to 30/06/14	5 years (annualised)
IA OE North America	11.17	1.69	23.33	14.00	14.75	10.31	15.35
IA OE UK All Companies	9.02	0.21	22.43	-3.66	7.04	14.28	9.82
IA OE UK Small Companies	8.66	10.15	36.60	-5.67	9.80	22.43	16.13
IA OE UK Equity Income	8.28	-2.67	19.37	-1.31	7.46	14.84	9.21
IA OE Property	5.30	0.40	6.91	9.63	7.83	7.52	8.13
IA OE Europe Excluding UK	3.69	-0.58	29.16	5.21	4.01	13.93	10.99
IA OE Japan	3.57	9.24	24.88	7.97	17.16	-1.62	11.60
IA OE Asia Pacific Ex Japan	2.73	6.03	28.57	5.98	8.98	3.36	10.51
IA OE £ Corporate Bond	-0.17	1.10	6.79	6.69	4.92	7.36	5.56
IA OE £ High Yield	-0.39	1.57	10.85	1.89	-0.12	11.77	5.14
IA OE UK Index Linked Gilts	-0.54	3.26	6.80	15.32	12.88	2.91	8.10
IA OE Emerging Markets	-3.06	9.49	27.00	5.38	1.38	1.88	7.83

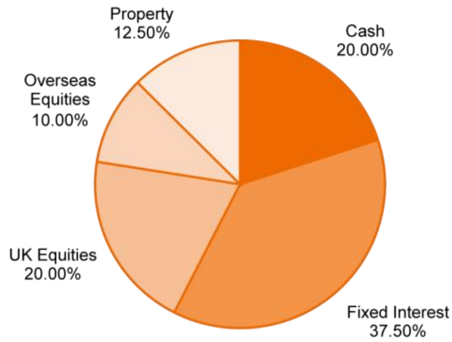
Source: Morningstar, bid-bid pricing. Net income reinvested. Past performance is not a reliable indicator of future results.

The positioning of our strategies

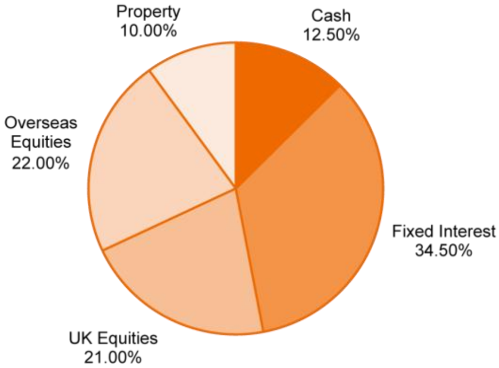
Very Conservative



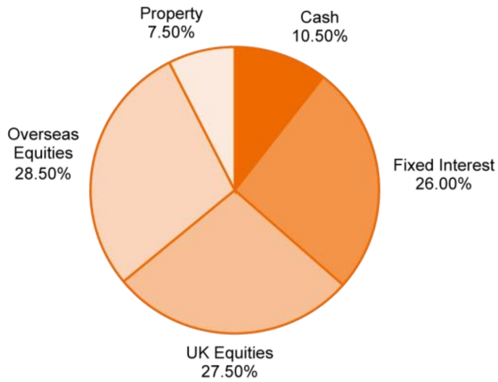
Conservative



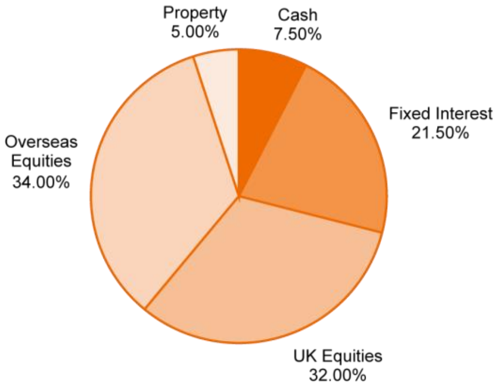
Cautious



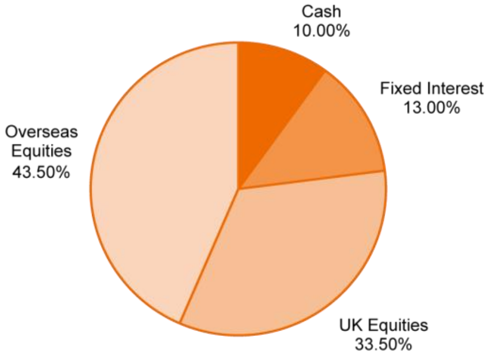
Balanced



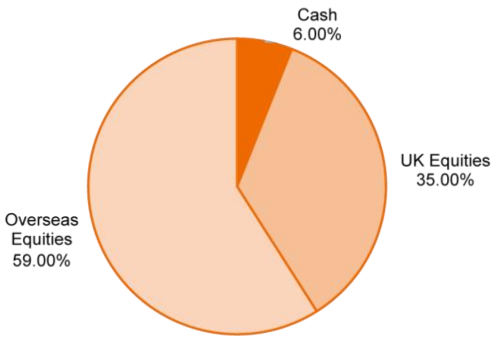
Growth



High Growth



Adventurous



Disclaimer

Opinions constitute our judgment as of this date and are subject to change without warning. The value of investments, and the income from them, can go down as well as up, and you may not recover the amount of your original investment. Past performance is not a reliable indicator of future results and forecasts are not a reliable indicator of future performance. Where an investment involves exposure to a foreign currency, changes in rates of exchange may cause the value of the investment, and the income from it, to go up or down. The information in this document is not intended as an offer or solicitation to buy or sell securities or any other investment, nor does it constitute a personal recommendation.

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