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Keeping you informed matters

Annual Investment Review

January 2019

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Outlook

Leading economic indicators suggest that growth is easing across much of the developed world, particularly in Europe and the UK, but the global economy is still expanding healthily. Brexit and political winds across the developed world are increasing risks, however it is premature to call the end of the present expansion.

The IMF recently reduced their forecast for 2019 growth by 0.2% to 3.7% from 3.9%. This is still a robust outlook for the world economy and it is associated with continued stable and low inflation. As Quantitative Easing (QE) ends, there is some evidence that real wage growth, which is picking up, can step in to support future demand.

From a cyclical perspective, lead indicators do suggest that growth is easing across much of the developed world particularly in Europe and the UK. Yet the global PMI (Purchasing Manager's Index), is still trending at around 53, well into expansion territory. In our view, it is premature to call the end of the present expansion and the recent slowdown will probably stay the hands of Central Bankers. Interest rate rises will continue to be slow and measured.

At first glance the US economy is still booming. The most recent US composite PMI reading was 55 and pointing higher. US consumer confidence, as surveyed by the Conference Board, is at 5 year highs, jobless claims are at decade lows and housing starts, though slightly softer than their pre-crisis peak, have trebled from their post-crisis lows.

Nonetheless, we have probably seen "peak" growth in this cycle for developed economies.

Elsewhere, growth is likely to be accelerating; in Mexico, Brazil, India and Indonesia. China is the notable exception with annualised growth rates decelerating toward 6% from 7% in 2017 and 2018.

Due to the scale of China's industrialisation, the underlying growth rate of the economy will gradually converge with the West to nearer 3% than 10% but then, of course, the economy is many multiples larger than it was only a decade ago. China will continue to be a major contributor to world growth.

There is still a lot of debate about the merits of QE but essentially when the Bank Rate – the cost of short term borrowing - gets close to zero, the Bank (Bank of England, Federal Reserve et al) cannot provide stimulus to the economy by cutting interest rates. QE expands the quantity of money in the economy as opposed to its price.

The point of the policy was to deal with a clear absence of demand in the economy in the aftermath of the Global Financial Crisis of 2008. Inflation rates collapsed as demand for new goods and services contracted in the face of a "depression" style shock to the system.

QE was introduced as a financial bridge across the chasm of a potential depression to avoid a re-run of the 1930s.

It was always a temporary policy and it should be no surprise to market participants that the policy is now being wound down.

The Federal Reserve has deployed $4.2 trillion dollars of QE (roughly 25% of US GDP) and is now reducing the scale of its balance sheet by some $50 billion per month. The Bank of England and ECB have stopped their programmes but are not yet reducing their balance sheets.

This means that monetary conditions have tightened but only very marginally. As US interest rates have climbed, the US Federal Reserve is now in a position where it could revert to the traditional policy lever of interest rate setting to stimulate or cool the US economy. The US is well ahead of the UK and Europe in terms of recovery and growth and this marginal tightening has yet to begin in these regions.

The US and China have descended into a full blown trade war which has dented confidence, hurt supply chains and raised costs to consumers. If the world is retreating to a less open trading system, costs and frictions will continue to rise and will be a drag on global growth.

The financial impact of the trade war will be small. The WTO estimates the value of world trade at $42 trillion. Trump is applying tariffs to $500 billion of that trade which is the extent of the US bilateral trade deficit with China.

Ironically, it will be US consumers, steel users and farmers who feel the costs. A great deal of US value added is manufactured in China which then counts as an "import" when, for example, a newly minted iPhone X is returned to the US for final sale.

China is a low-cost manufacturer because the Chinese enjoy a lower standard of living than US citizens which is precisely why US corporates want to manufacture there.

The US does have legitimate trade issues with China particularly with respect to the theft of IP – Intellectual Property Rights and Forced Technology Transfer but applying punitive tariffs does not impact these problems.

Our expectation is that Trump, much like the North American Free Trade Agreement (NAFTA) "renegotiation," will agree a policy stance with Xi Jinping, China's President, that allows him to tweet success in his trade negotiation with China.

The House of Commons has rejected Theresa May's withdrawal agreement. A no-deal exit, though damaging, does not look implausible. However, a more likely outcome will be some form of her agreement being passed by parliament before the deadline.

The British economy is enjoying wage growth and low unemployment although the darker side to that phenomenon is reported labour shortages. House price growth has stalled and Britain still runs a very large trade deficit.

Without rehashing all the arguments again, it is the case that, on the government's own figures, there is no form of Brexit that does not deliver a smaller economy than it otherwise would be had Brexit not taken place.

Tariff and non-tariff barriers will raise the cost and frictions surrounding trade, inflation is likely to rise forcing the Bank to raise interest rates with stagflationary conditions a plausible outcome.

From an investment perspective, Sterling is likely to remain weak (although susceptible to sharp moves depending on news flow). Domestic industries will have a smaller market to sell into with lower investment, the tax base will be smaller as net migration continues to fall but overseas earners and multi-nationals should provide some Brexit protection.

Markets are suffering from the combination of a "growth scare" coupled to erratic ideological politics on both sides of the Atlantic and indeed, the Pacific.

But take a step back and the future poses different risks – the risk of too much growth.

A recent OECD report found that on current, modest trends, world GDP is likely to be four times larger in 2060 than it is today. Industry, services and recycling are likely to be three times bigger than they are today. The global population is likely to reach 11.5 billion people from under 8 billion today; all staggering numbers.

Until recently, the concept of secular long-term stagnation had gained currency amongst economists but the reality may be the difficulty of handling excess growth rather than worrying about too little.

It is far too soon to suggest that the political risks which are dogging markets will be resolved quickly. Current volatility is likely to persist but it is worth remembering that cash returns to shareholders via dividends and share buybacks are at record highs.

Looking longer term, whether it is energy, water, bio-diversity, transport or agriculture, there is no shortage of opportunities for investors to fund profitable ways to ensure that the planet can meet the needs of its vast and growing population.

The coming period is likely to be more volatile for economies as all of the factors we have discussed above begin to work through the global financial system. This does not lead to a negative outlook however as many economies continue to exhibit solid fundamentals and authorities have the tools available to manage risks.

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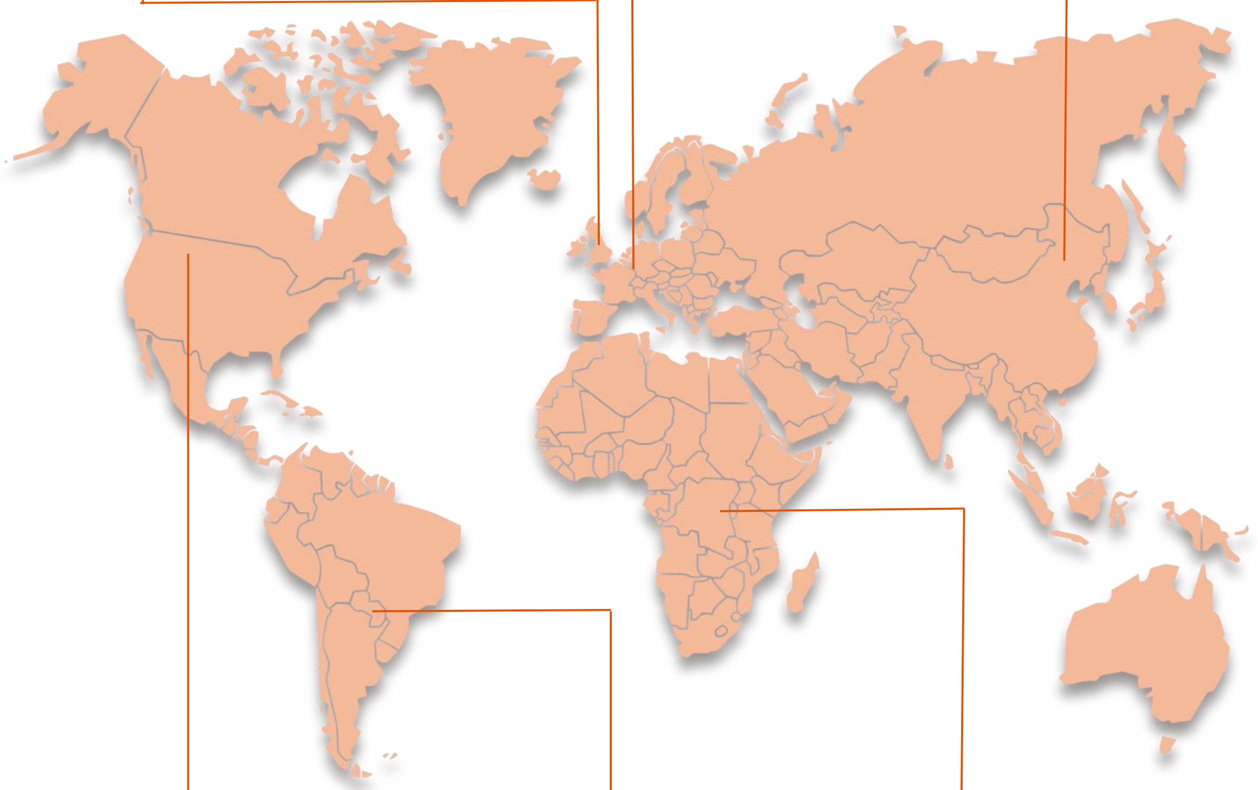
Key facts about the world

United Kingdom
- Brexit continues to drive sentiment and the political agenda
- Economic growth has actually held up well
- The possibility of a change in government has increased

Europe
- Germany's economy is nearing recession
- The Italian government is testing the EU's resolve on budget deficits
- French political situation is deteriorating with the Yellow Vest movement

Asia
- The Chinese economy has slowed more than expected
- The Indian reform program has slowed as the Congress Party has won seats at recent elections
- Japanese inflation remains stubbornly weak despite the government's best efforts



North America
- The Federal Reserve continues to raise interest rates
- The political landscape has altered since the mid-term elections
- President Trump is becoming more isolated

South America
- Brazil elected a new President with a large majority
- Mexico agreed an updated NAFTA agreement with the US

Africa
- The Egyptian economy has strengthened with growing GDP and falling unemployment
- South Africa's economy emerged from a recession during the second half of 2018

2018 in Charts

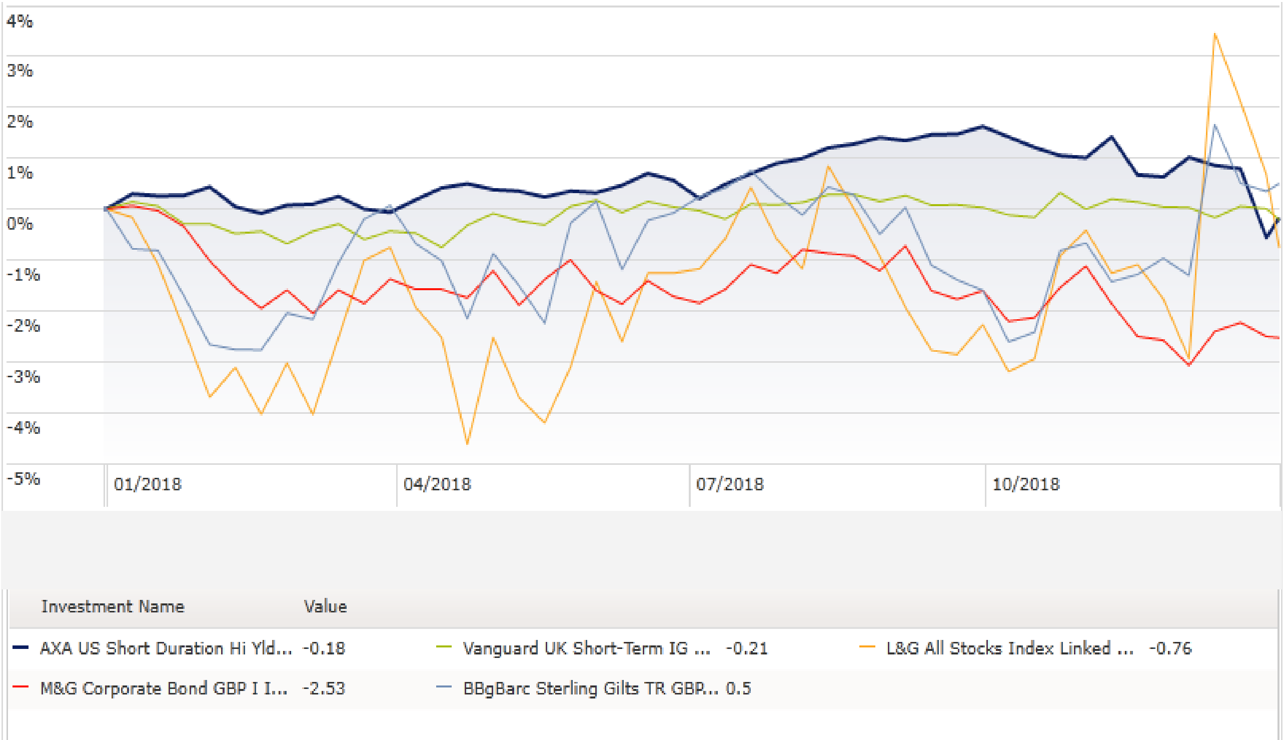
Major Market Movements in Local Currency (1 year)

Major Market Movements for Sterling Investors (1 year)

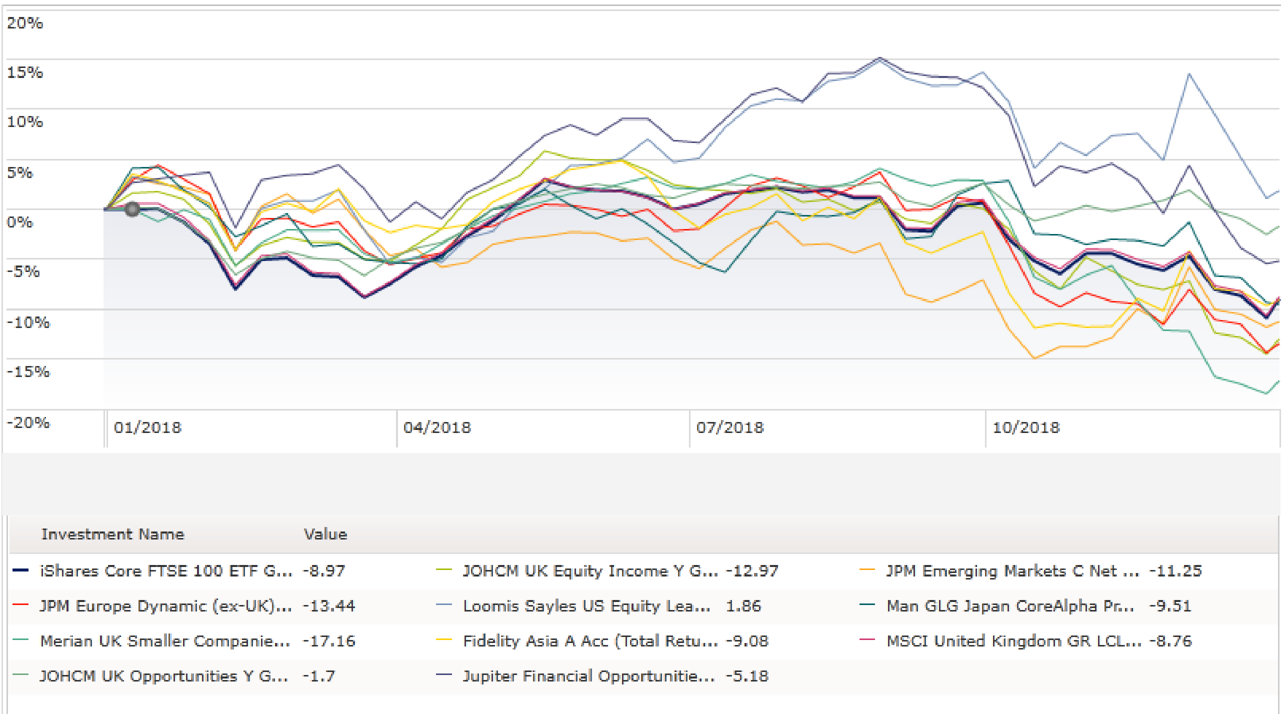
Source: Data from FE Analytics 2019 01/01/2018 – 31/12/2018

2018 in Charts

Model Growth Returns Fixed Interest (1 year)



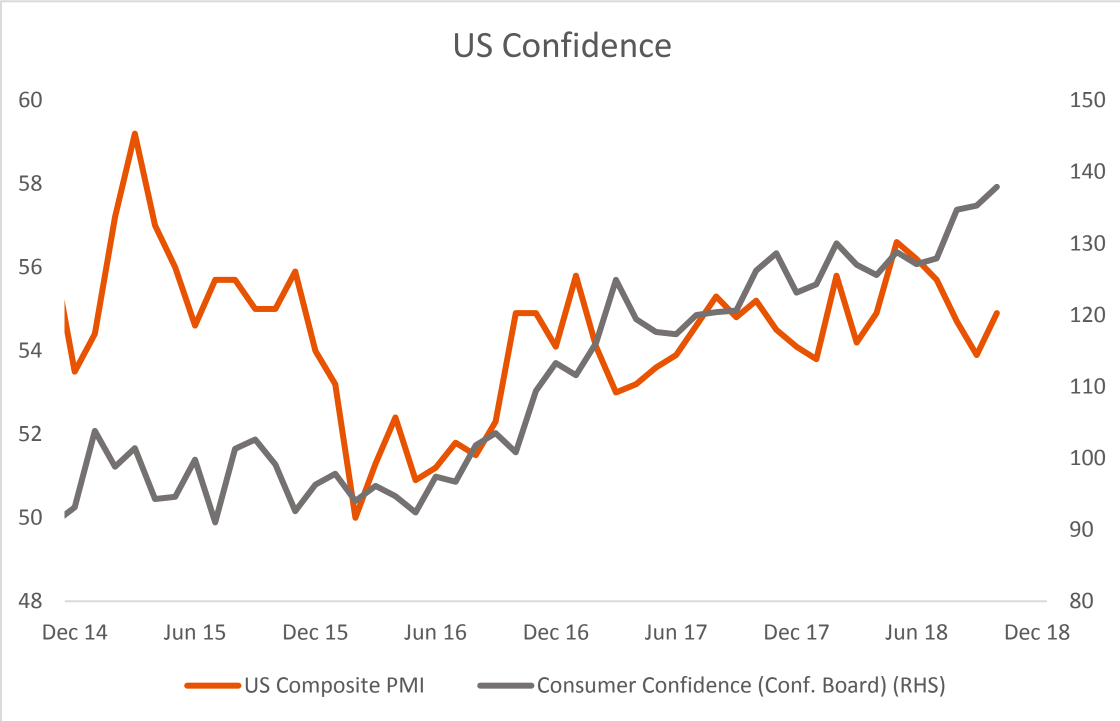
Model Growth Returns Equity (1 year)



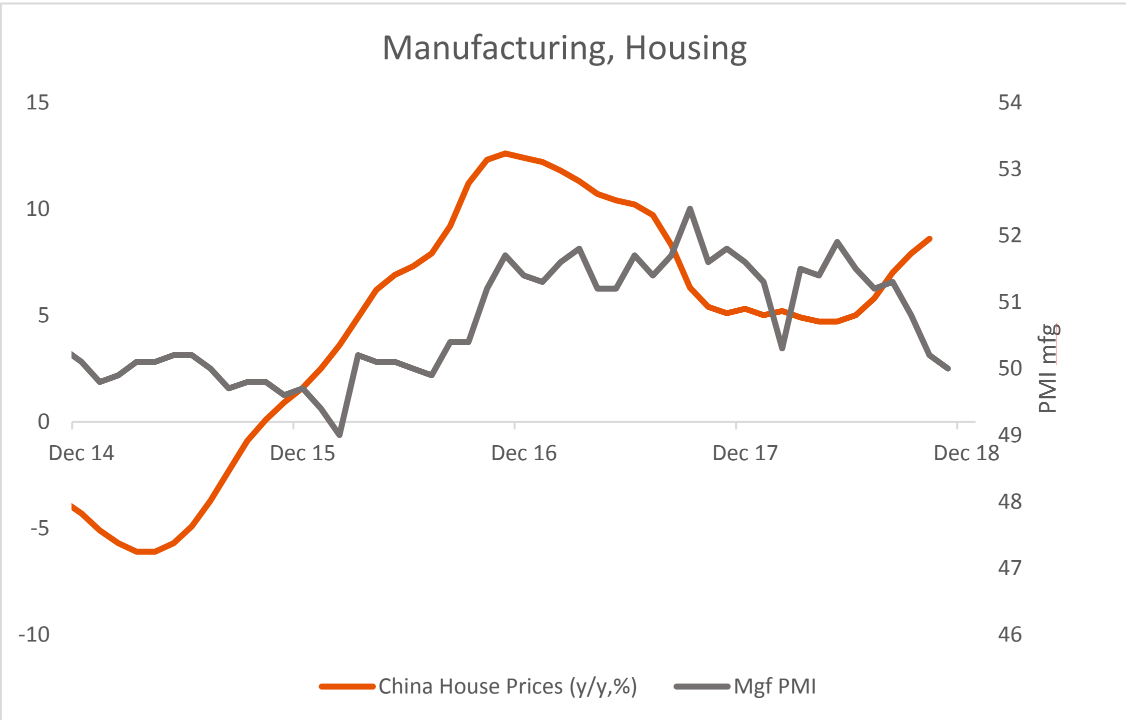
Source: Data from Morningstar January 2019

2018 in Charts

Global growth driven by a strong US economy



Offset by worries over the weakness in China



Source: Thomson Reuters, December 2018

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2018 performance review

A volatile year of two halves

- Equities fell for the first time since 2011
- US equity exposure helped returns and ended the year positive
- UK equity exposure benefited from our bias towards defensive companies
- The Pound was weak against most major currencies
- Fixed Interest exposure provided diversification when equity markets fell

Equity markets fell during 2018

One allocation that provided positive returns for example was the Loomis Sayles US Equity Leaders fund which returned 1.86% against a fall of 4.76% for the MSCI North America index. The performance of this holding was helped by its exposure to companies such as Amazon and Visa which have strong market leadership in their respective markets and continue to increase their penetration of those markets.

Within UK equities, defensive stocks performed strongly as investors began to worry that interest rate rises in the US would lead to slower economic growth in the future. Our holding in JO Hambro UK Opportunities fell marginally against the broader UK equity market fall of 8.76%. This was driven by the manager's focus on cashflows and high cash weighting during the year as they believed many sectors of the equity market remained expensive.

Within the UK equity area one fund that did not perform well was JO Hambro UK Equity Income. Having said this, the fund's holdings, in aggregate, now trade at a valuation that has not been seen since the depths of the 2008 financial crisis and is estimated to provide a dividend yield of 5.7% for the coming year which we see as positive.

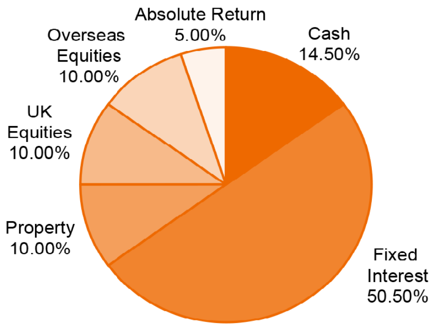
Our fixed interest exposure provided some diversification in the final quarter as equity markets fell and credit spreads widened, mitigating losses in our strategies. The L&G All Stocks Index Linked holding returned 1.55% during the last three months of the year whilst the Kames Ethical Corporate Bond fund, held within our Ethical strategies, was flat whilst the average fixed interest holding actually fell. Overall our relatively cautious positioning with higher cash weightings within the strategies during 2018 helped the overall position.

SECTOR	3 months	1 year to 31/12/18	1 year to 31/12/17	1 year to 31/12/16	1 year to 31/12/15	1 year to 31/12/14	5 years (annualised)
IA OE Property Other	5.38	3.70	7.08	8.59	5.58	13.08	7.51
IA OE UK Index Linked Gilts	1.96	-0.46	2.21	25.13	-1.34	18.66	8.31
IA OE £ Corporate Bond	-0.53	-2.20	5.24	9.69	0.22	10.63	4.59
IA OE £ High Yield	-4.13	-3.56	6.30	11.25	0.03	2.02	3.08
IA OE Global Emerging Markets	-4.97	-11.53	24.52	31.62	-9.23	3.43	6.36
IA OE Asia Pacific Excluding	-6.69	-9.81	25.29	26.00	-2.80	9.73	8.71
IA OE UK Equity Income	-10.90	-10.53	11.50	9.05	6.62	3.62	3.75
IA OE UK All Companies	-12.49	-11.15	14.05	11.04	5.01	0.86	3.57
IA OE North America	-12.71	-1.15	10.48	30.09	4.53	17.77	11.83
IA OE Europe Excluding UK	-12.92	-12.16	17.45	17.06	9.38	-0.94	5.52
IA OE Japan	-14.59	-11.32	17.79	23.55	16.21	0.43	8.54
IA OE UK Smaller Companies	-15.79	-11.79	27.13	8.52	14.92	-1.58	6.60

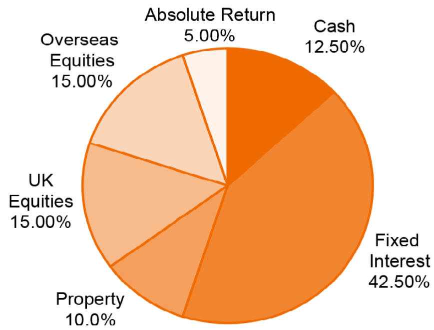
Source: Morningstar, bid-bid pricing, net income

The positioning of our core strategies

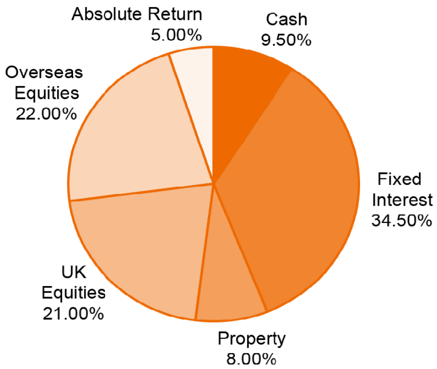
Very Conservative



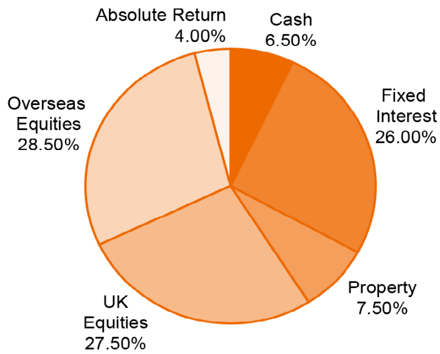
Conservative



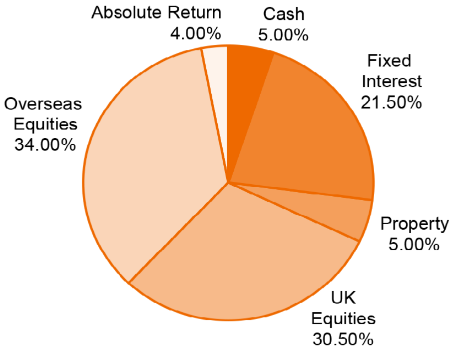
Cautious



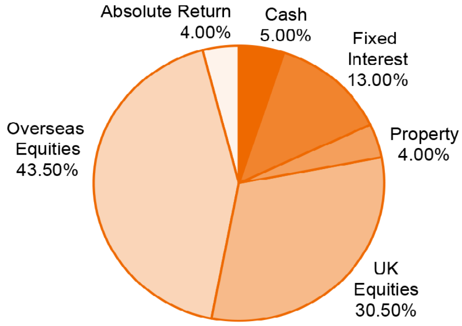
Balanced



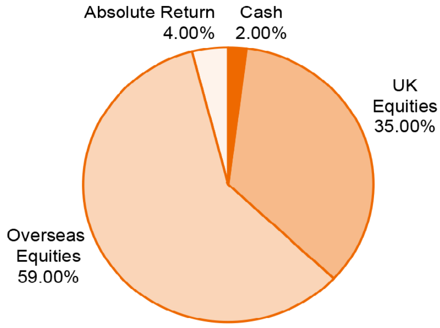
Growth



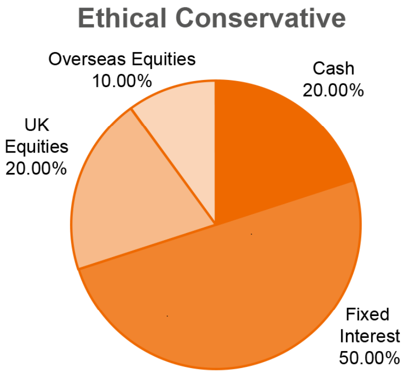
High Growth

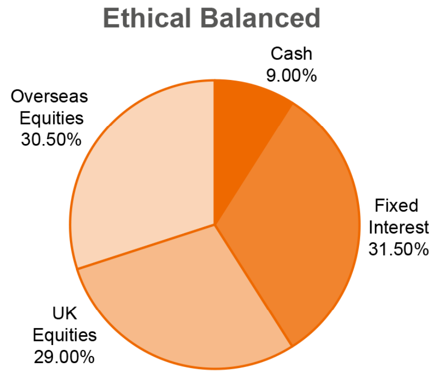


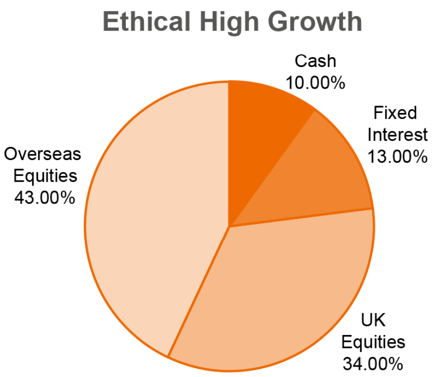
Adventurous



The positioning of our ethical strategies







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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