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Keeping you informed matters

Economic review

July 2017

Outlook

Previously we noted that the risks to the outlook seemed to be more political than economic. Ironically, the UK election was not part of our thinking, and we now find ourselves in an environment where the economic picture for the UK is at odds with the rest of the world.

The most recent lead economic indicators point to “stable” or even accelerating growth momentum across the world economy. This perspective is supported by the most recent Purchasing Manager Index surveys which give us a much more granular view of what businesses are doing and more importantly, spending.

Wages are now the key issue: developments here hold the key to future growth. Does low productivity result in low wages or does low wage growth generate low productivity? Whichever one is true, this link is key to future prosperity. In the decade since the crisis in 2008, both have flatlined.

The statistics tell an important story. In the period from 2008-2015, wage growth fell in virtually every major economy relative to the period 2000-2008. Only in France, Germany and Japan have real wages increased and the only meaningful acceleration has been in Germany where wage growth has risen from 0.25% per annum in the period to 2008 to 1.19% per annum in the period 2008-2015.

The biggest surprise of all is the shocking performance of the United Kingdom. In the period 2000-08, British workers saw a real annual increase in wages of 1.65% per annum. In the period to 2015 they saw a decline of 0.73% per annum. In 2015 real wages in the UK were 5% lower than they were in 2008.

This is not just academic because these trends have a real economic impact. From an investment standpoint, it is much easier to make successful investments in high wage, expanding economies than in stagnant, low-wage, declining economies. Raising wages and productivity is therefore the key challenge facing policymakers. A return to pre-crisis trends would translate into higher incomes, higher spending, stable inflation and sustainable profitability.

Britain is a special case, an outlier that raises genuine worries for investors in the relatively near-term if policy decisions entrench and fail to reverse some of the negative trends of the last few years.

As noted, wage growth and productivity is key. In or out of the EU, Single Market or Customs Union, Britain needs to address these twin issues. Weak productivity is by no means confined to Britain but the ramifications of Brexit amplify the consequences.

The decline in the value of Sterling means that the UK is importing inflation. The Bank of England will tolerate what it sees as a temporary overshoot but it will not tolerate a permanent rise in inflation or inflation expectations.

The decline in UK real wages has until recently been offset by a combination of lower interest rates and higher indebtedness, which is to say, lower saving. The UK consumer is amongst the most highly indebted in the world.

There are two problems here; first, even if it wanted to, the Bank of England cannot lower interest rates to cheapen borrowing or stimulate spending since rates are already close to zero.

Second, if UK inflation does pick up because of sterling weakness, then the Bank will want to raise rates. However, the UK consumer is not well placed to handle a rise in interest rates. Since average savings have never been lower, real disposable incomes could be squeezed even more than they already have been, by a combination of higher inflation, higher interest rates and lower sterling. All this at a time when Brexit negotiations are putting Britain’s key trading relations at risk.

Whilst the global picture is encouraging, a deep look inside the UK economy makes it hard to escape the sense that, relative to the rest of the world, storm clouds are gathering. The economic and political pictures remain intertwined.

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Key facts about the world

United Kingdom

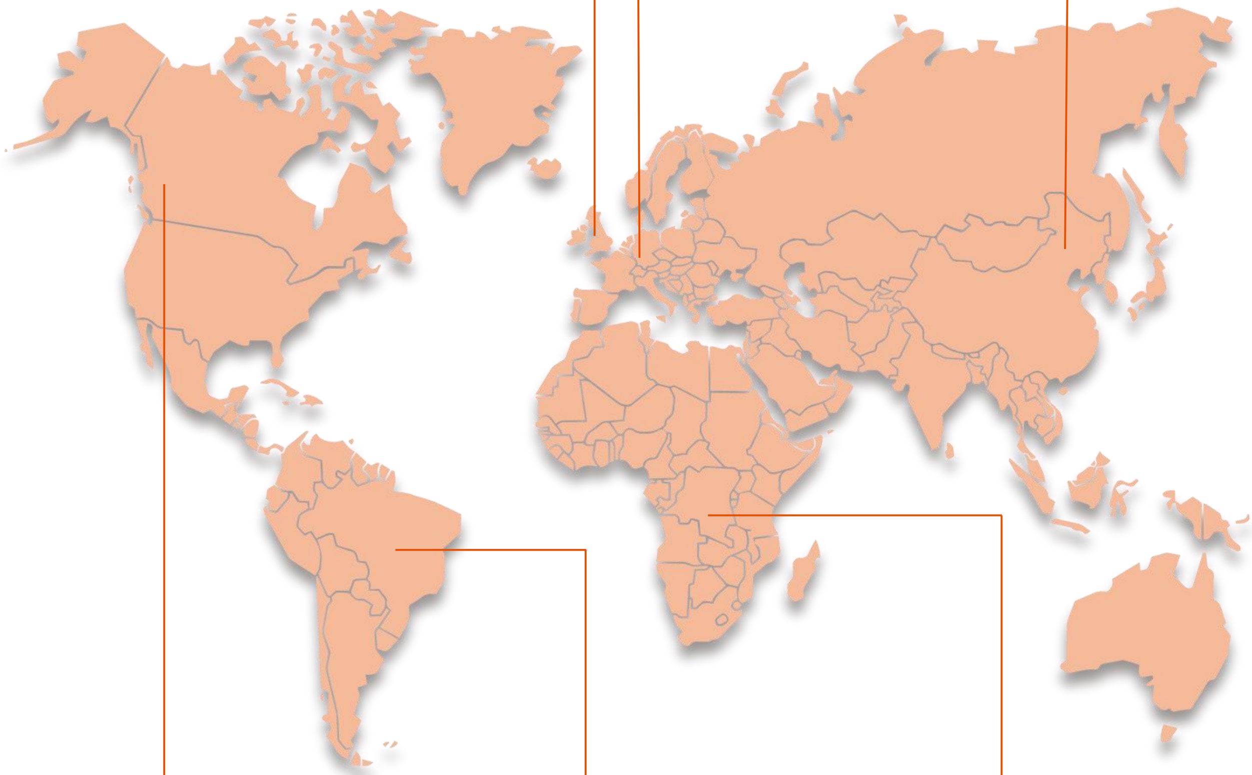
- UK snap election resulted in hung parliament
- UK economic picture has weakened
- Brexit may result in lower investment into the UK

Europe

- French political scene has stabilised
- Eurozone integration has been stepped up again
- Germany continues to benefit from a weak Euro at the expense of others

Asia

- China headline confidence readings at highest since May 2016
- The Indian growth outlook has slowed but still outpaces most global economies
- North Korea continues to stoke tensions in the region



North America

- The Federal Reserve is forecast to raise rates again and reduce QE
- US Oil production is leading to lower oil prices and lower inflation
- Political wrangling over Trump's policies

South America

- Another corruption scandal has erupted in Brazil
- Brazil, the largest economy, will fall back into recession again
- The Mexican Peso has rebounded strongly following Trump rhetoric

Africa

- South Africa has fallen into recession but this is expected to be short lived
- Nigeria, Africa's largest economy, has returned to growth
- Kenya is suffering from double digit inflation driven by drought

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Q2 Performance Review

Another positive quarter for returns

- Fund specific exposures drove returns rather than a broad market theme
- UK Smaller companies performed better than their larger counterparts again
- US exposure was mixed, with larger companies driving returns
- European equities performed strongly as economic conditions improved
- Asian exposure, including Japan, was hindered by weakening currencies against the Pound

The majority of holdings within the strategies provided positive returns, albeit with more variance this quarter.

A noticeable trend has been the strength of the Pound against the US$, rising over 4%. This has coincided with weakness of a similar magnitude against the Euro which has affected returns to UK investors markedly. For example, whilst the JPM Europe Dynamic fund rose 5.92% over the period, over half of its return was attributable to Euro strength rather than underlying equity moves. In the US on the other hand, the Loomis Sayles US Equity Leaders fund rise of 4.83%, was nearly halved by the currency movements. This is a factor that will remain a key driver of returns over the coming year.

Within equities, returns were driven by our choice of fund rather than any broader market theme. Our active UK equity funds, JO Hambro, Old Mutual and Woodford, comfortably outperformed the UK equity market as their focus on company cashflows was rewarded by the marketplace.

There was significantly more divergence in the returns generated and volatility exhibited by the lower risk assets in the strategies. The index linked bond exposure in portfolios fell towards the end of the quarter as bond yields rose around the world. The corporate bond exposure in portfolios, M&G and AXA US Short Duration High Yield, both provided positive returns in this environment.

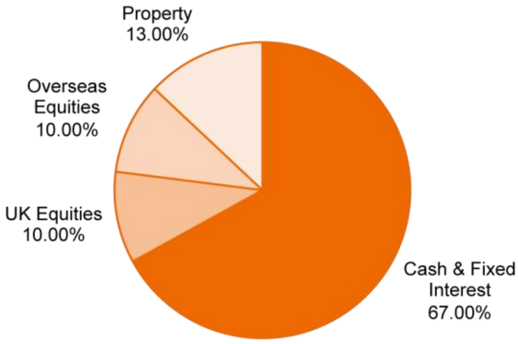
Cash weightings in our strategies remain elevated as we manage the more volatile environment driven by the Brexit timeline, US interest rate cycle and increased political tensions globally. As we stated previously, managing the risks in our strategies is as vital as the potential for returns. Following many years of low, near zero, interest rates, it appears only prudent to be patient whilst interest rates begin to rise and liquidity is withdrawn from the financial system.

SECTOR	3 months	1 year to 30/06/17	1 year to 30/06/16	1 year to 30/06/15	1 year to 30/06/14	1 year to 30/06/13	5 years (annualised)
IA UK Smaller Companies	6.56	36.60	-5.67	9.80	22.43	26.78	17.04
IA Europe Excluding UK	6.29	29.19	5.21	4.01	13.93	31.74	16.24
IA UK All Companies	2.64	22.43	-3.66	7.04	14.28	22.42	12.05
IA Asia Pacific Ex. Japan	2.63	28.57	5.98	8.98	3.36	14.19	11.88
IA UK Equity Income	2.48	19.38	-1.31	7.46	14.84	22.00	12.15
IA Japan	2.13	24.88	7.97	17.16	-1.62	25.39	14.27
IA £ High Yield	2.05	10.85	1.89	-0.12	11.77	12.61	7.26
IA Property	1.78	6.89	9.63	7.83	7.52	10.50	8.47
IA Global Emerging Markets	1.71	26.99	5.38	1.38	1.88	7.51	8.24
IA £ Corporate Bond	0.93	6.80	6.69	4.92	7.36	7.60	6.67
IA North America	-0.86	23.35	14.00	14.75	10.31	25.23	17.39
IA UK Index Linked Gilts	-2.48	6.84	15.32	12.88	2.91	3.19	8.11

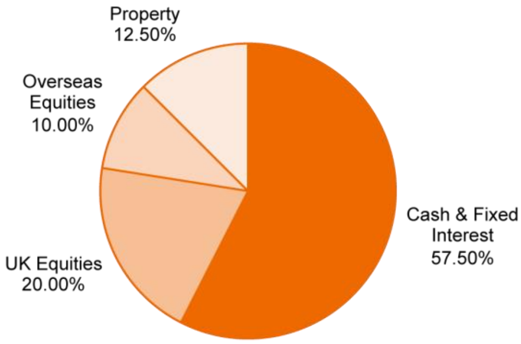
Source: Morningstar, bid-bid pricing, net income

The positioning of our strategies

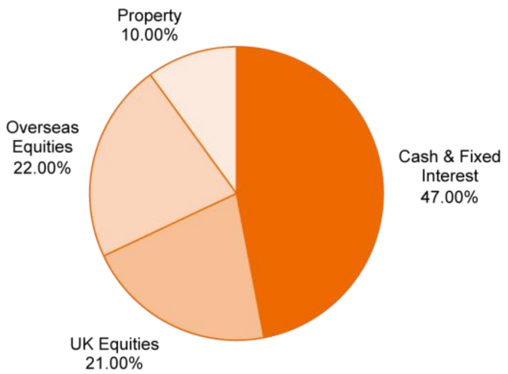
Very Conservative



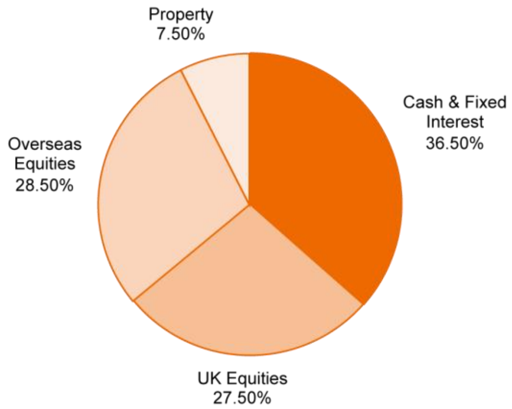
Conservative



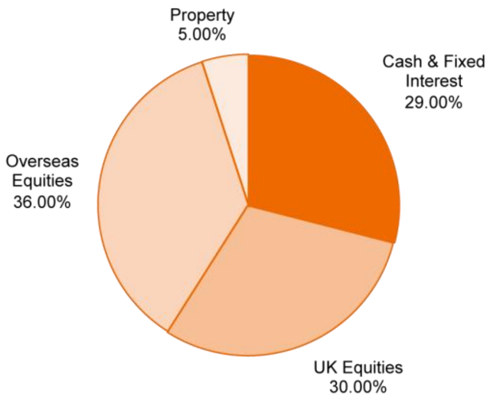
Cautious



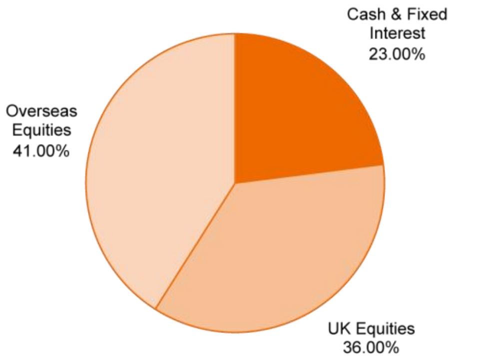
Balanced



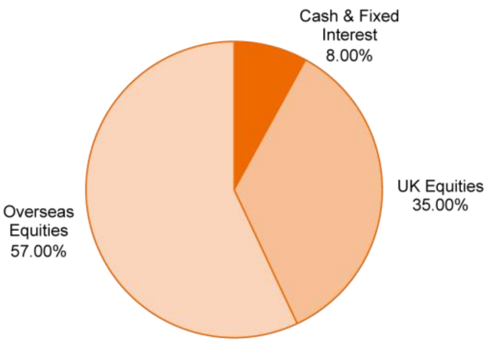
Growth



High Growth



Adventurous



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