Telford Mann
Pensions & Investments


# Market Outlook
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Financial Planners
Chartered


**There is no doubt that the emerging markets of Asia, Eastern Europe and Latin America have done well over the last 12 months with most regions gaining 25% or more. Despite these gains we feel that the upward surge is far from over. In fact, it may still be in its infancy. We believe there are a number of reasons to suggest that we can expect more from this sector in the coming years.**

Whilst developed markets are experiencing a growth slowdown, emerging markets are in a long-term expansion phase. Developed markets such as the UK, USA and Europe are forecasted to grow by around 2% or less in 2018, whereas emerging markets are projected to hit 4.5% growth next year. The BRIC nations (Brazil, Russia, India, and China) create 22% of global GDP, a figure that continues to climb. According to the International Monetary Fund (IMF), an expected 80% of total world GDP growth will come from emerging markets over the next five years.

India and China's portion of world GDP has grown by six times since 1970, whereas the G7 nations' share of world trade has declined from 50% to 30% during the same period.

Consumption is a primary driver of economies and you may be surprised to learn that the IMF reports that close to 85% of consumption growth is thanks to emerging markets.

This economic growth, when compared to the traditional developed markets, creates a solid case for long-term investment in emerging markets.

Emerging markets equity valuations are also very persuasive. From a price perspective, when compared to American S&P 500 stocks, emerging markets stocks trade at roughly a 25% discount. This makes emerging markets equities much better value for long-term investors.

While the Trump administration may (or may not) throw a spanner into the global trade picture, emerging markets are responsible for over 50% of developed markets' trade. As long as emerging markets policies remain the same, it's possible that they will become even bigger winners as developed markets play less of a role in trade, as trade between emerging markets economies expands.

Emerging markets are no longer just about commodities. In the early 2000s, energy and material stocks made up 30-40% of global emerging market capitalisation. This large proportion of commodities created tremendous volatility in these markets. However, more recently a change has taken place.

That weighting has dropped dramatically, with only 15% of emerging markets capitalisation now dependent on materials and energy. A strong rise in emerging markets consumerism has turned the focus to financials, consumer staples, industrials and IT. Less volatility means smoother equity markets, which attract big investors that in turn help support those equity markets.

Demographics have an important role to play in the emerging markets growth story. Approximately 80% of the world's population, 5 ½ billion people, reside in the emerging markets. Overall, emerging markets citizens are younger than the populations of the developed nations. This younger demographic combined with rapidly increasing wealth leads to greater consumption and, with it, economic growth. This economic growth is reflected in average annual projected rates of nearly 8% for India, 6% for China, and close to 4% in Colombia over the next three years. Comparing these numbers to the paltry 2% expected in the United States, creates a compelling case for emerging markets investments.

Finally, our own central banks, i.e. the Bank of England, Federal Reserve in the USA and European Central Bank have a part to play in the emerging markets equation. Accommodative monetary policy from the developed nations' central banks has kept interest rates ultra-low. These low levels have in turn lifted demand for higher yielding emerging markets stocks.

Following the United States' lead, several emerging markets central banks are in the midst of a monetary easing (interest rate lowering) campaign to bolster economic growth. It also helps that a stronger U.S. dollar increases the price of U.S. exports while decreasing the cost of foreign goods. This dynamic acts to lower U.S. earnings while improving earnings overseas.

Whilst the argument for continued growth in the emerging markets is compelling, it would be foolish to expect the path of that growth to be smoothly upwards. Undoubtedly we can expect upsets and volatility along the path to growth. However, for those who are prepared take a 3 to 5 year view, emerging markets investments should be a core component of a well-balanced portfolio.

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|---|---|---|---|
| Fixed Interest | ▲ | US Equity | ▲ |
| Absolute Return | ▼ | European Equity | ▲ |
| Property | ▲ | Asian Equity | ▲ |
| UK Equity | ▲ | Emerging Markets | ▲ |
| Global Equity | ▼ | Commodities | ▼ |

Up ▲ Down ▼ Same ▶

2017 has been something of a directionless market. There has been plenty of speculation, but very little of that conjecture has come to fruition or manifested itself in market reality. In those conditions, changing investments for change's sake rarely seems right. Following more recent analysis, we feel now is the time to make some adjustments and as we will explain in this update, we see accepting geopolitical threats as the biggest challenge facing global stock markets. 2017 has seen markets tested by such threats and we now feel more confident in how markets will react again to such challenges in the future.

We have increased our European equity allocation. European stock markets rallied in late 2016 and some funds produced stellar returns. We deliberately chose not to increase our allocation at that time. The 2016 rally was based on quite a linear argument, that of European banks recovering from their all-time lows and becoming investible again. For a period, this argument worked and those funds placing all their hopes on this outcome did very well, but to our mind we felt the European recovery needed to be based on more than just financials. The start of 2017 saw a pause in European markets as Dutch and then German elections took place, but with populism seemingly under more control and European companies now consistently growing their earnings, the rationale for a sustained, broad European rally seems more achievable. The Italian election next year is likely to present more challenges, but ultimately the control in Europe remains relatively stable. Despite her electoral problems, Angela Merkel and Mario Draghi are seemingly as unified as they have ever been.

We have included the Marlborough European Multi Cap and Invesco Perpetual European Equity Income funds in our portfolios to complement our existing holdings as well as increasing our allocation to the Edentree Amity European fund. The Marlborough fund in particular invests quite differently to the Threadneedle European Select fund. As the name suggests, Marlborough invests across all types of company; large, mid and small thus diversifying our European weighting. The managers at Marlborough have been quietly building top ranking performance utilising Marlborough's proven expertise in finding smaller companies to invest in which other larger funds don't research and therefore miss.

We have reduced our commodities allocation. In the wake of the US election and the Brexit vote, we increased our Gold and Natural Resources weightings, but we have now sold our gold allocation and reduced

our resources holdings. The gold price has been trading within a tight range for the past year. When global concerns heighten, gold continues to rally, but if we believe we have already experienced many of the potential political upheavals, the prospect for gold contributing positively to portfolios reduces.

Oil on the other hand has been quite the opposite, rallying consistently since June. The oil price reached a two year high last week as OPEC signalled a 9 month extension to their output reduction deal, essentially limiting the amount of oil which can be traded by 1.8 million barrels per day. The net effect of this is the creation of a floor price in the oil market to try and stave off the troughs the oil market has experienced in recent years and boost the price of oil by way of reduced supply. Currency still impacts the price of oil, particularly with regard to US trade data which if less positive than anticipated can see the oil price retrench, but with global economies looking to increase consumption from a reduced supply pool, the prospect for oil and more industrial resources seems more attractive than the gold market.

We have increased our weighting to Asia and the Emerging Markets and reduced some of our global allocation, which is heavily US biased. The Infrastructure fund had performed well, but was more volatile than we felt reasonable and whilst we don't anticipate a slowdown in the US, we feel that Asia and the Emerging Markets may be in the relatively early stages of a bull market.

The Asia and Emerging Market theme will be nothing new to longstanding investors of ours, but we did reduce our allocation to these markets quite heavily in the wake of the Trump election. One thing that has characterised the Trump regime thus far is the lack of action he has been able to take in the wake of his rhetoric. Having recently completed his tour of Asia, Trump's previously threatened US protectionism and trade reduction with the region has yet to come to fruition. Of greater concern is his social media spat with North Korea, how far the world has come from the days of face to face diplomacy, now reduced to 140 characters on Twitter. Asian markets have performed strongly, but again we deliberately held back from reinvesting until we saw how markets reacted to some of the more extreme verbal exchanges between the USA and North Korea. When tensions have heightened markets took a short sharp move downwards over a couple of days, followed by a similarly short sharp rally back to where they started and beyond.

According to Threadneedle's research, on average, Asian/Emerging Markets tend to rise 230% in bull markets. Since Jan 2016, some markets have seen a rally of 60% indicating that there is plenty more room for growth. Earnings data is the strongest for 7 years and expectations are consistently being revised upwards. In many western markets expectations tend to be over-estimated and end up being marked down. We have included the Jupiter Global Emerging Markets, Invesco Perpetual Asian and Threadneedle Greater China fund to increase the exposure in our portfolios.

In terms of China, President Xi Jinping has just announced his latest 5 year plan and he appears intent on a more stable, lower growth strategy for the next five years. This may result in lower GDP figures and a perception of reduced strength, but this is in fact part of his strategy to manage the credit situation in China and produce more realistic and achievable growth returns. An important factor in China is the continued move from the "old" China to the "new" China. Across virtually all measures, the impact of the "new" China (e.g. technology) on the economy now outweighs the "old" economy (e.g. corrupt state owned enterprises). To give an example of just how important China is to the world and the potential power of the

"new" economy, you need to consider demographics. China is not just as an importer of commodities for infrastructure development, Chinese millennials numbered 416 million in 2014 versus US millennials of 87 million. The average annual income of a Chinese millennial was $5,932 versus their US counterpart on $43,995 . With this differential there is no wonder that the "new" China is based on entrepreneurship, innovation and technology. There is undoubted risk associated with Asia, China and the Emerging World, but relative to unloved, mature bull markets in the developed world, the Emerging world bull market seems to be gathering momentum.

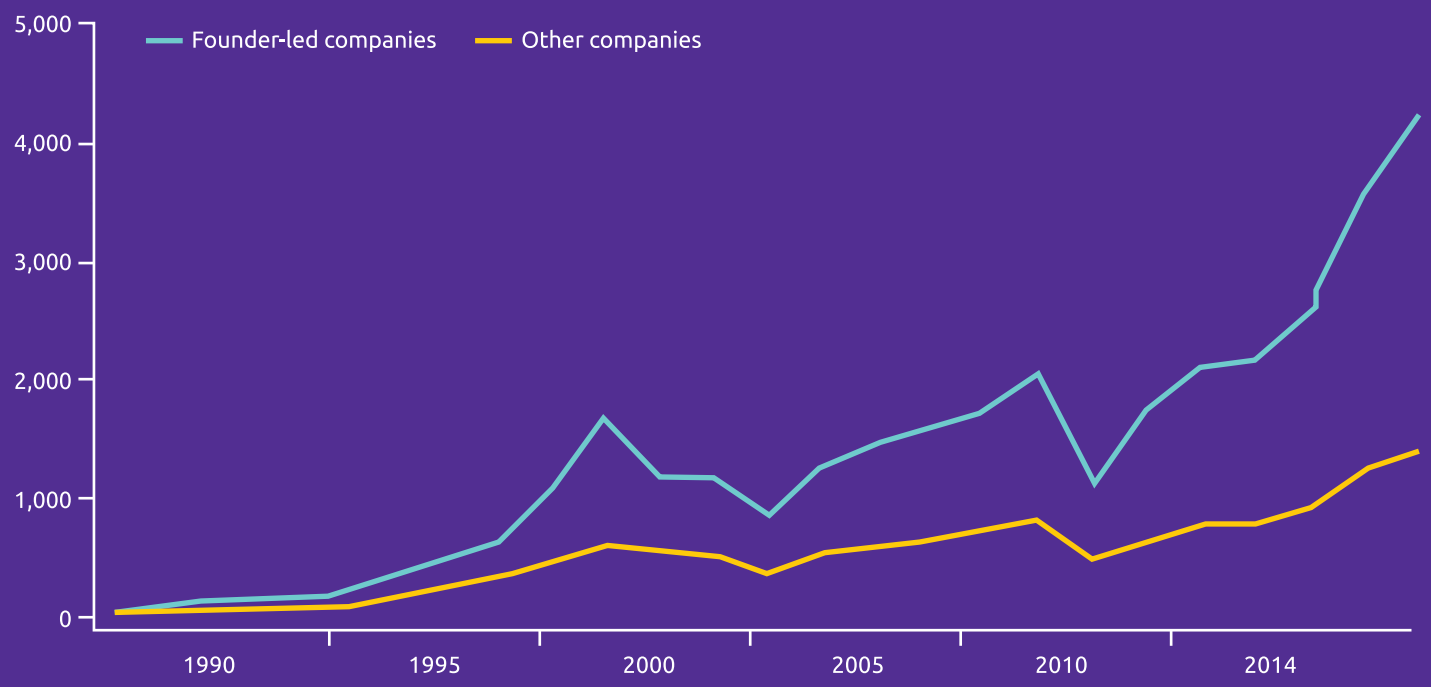
We have increased our weighting to the UK by way of the Jupiter UK Smaller Companies, JO Hambro UK Equity Income and Unicorn UK Ethical Income funds across our portfolios. The Unicorn fund is interesting in the sense that very few new ethical funds are launched these days, but Unicorn launched the Ethical Income fund last year to mirror the set up and performance of their traditional UK Income fund, a fund we used to own across our portfolios before it grew too big in size. The Ethical Income fund focuses on smaller companies, a theme we have built on with the Jupiter UK Smaller Companies fund, and adopts the MSCI negative screening policy for investment. Examples of zero tolerance sectors which the fund cannot invest in are tobacco, gambling, animal testing and genetic engineering. The fund has returned just under 19% for a year with a yield of over 4%, so a true diversifier in our ethical portfolios.

The Jupiter UK Smaller Companies fund is run by one of Jupiter's rising stars, James Zimmerman. There are quite polarised views on UK equities at present, with some simply looking at market levels and saying they are overvalued, whilst others see Brexit as something which is still some way in the distance with opportunities for domestic growth, particularly if the Government adopts a less austere approach to spending. Many funds in the UK Smaller Companies sector have been around for a while and are run in a quite traditional manner, the Jupiter fund is different in that the manager's starting point is filtering his stock universe down to those companies whose founders maintain a minimum of a 5% shareholding, but often more. This reduces his stock universe quite dramatically, but from his experience of working in the US, he found that companies whose owners are key stakeholders are often more trustworthy, open and forward thinking with regard to the valuation of the business, because it is their valuation at stake. The chart below demonstrates the outperformance of founder-managed businesses in the US.

He is quite different in his approach to geography as well which means that this fund has the capacity to preserve and grow capital whether the focus is on UK domestic names or companies with earnings from overseas, something which may help counteract the Brexit effect. Jupiter's advantage is that some of their selected stocks are largely ignored by the wider market, because they don't fit the "normal" investment criteria, but this leads the fund to offer something quite different to our existing UK holdings and supports our view that there is a growth story still in the UK, if the stockpicking is of a high enough standard.

We have sold all of our Absolute Return holdings. Absolute Return has done a job for us in the portfolios, but in a directionless market where market

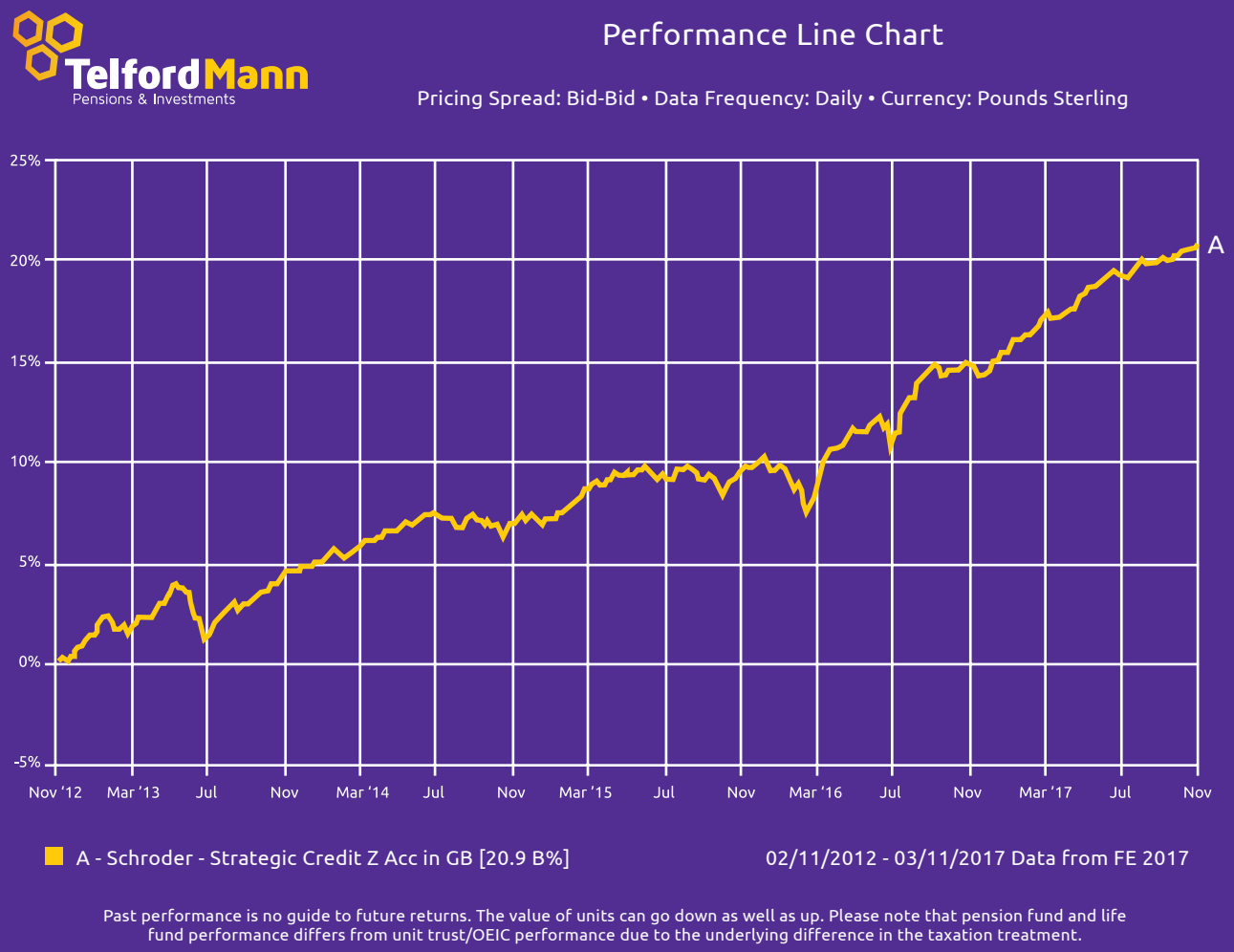
Based on an analysis of S&P 500 firms in 2014 – Indexed total shareholder return




The views expressed are those of the presenter at the time of preparation and may change in the future.
Source: Bain & Company, March 2016. www.hbr.org

movements are short and sharp, they struggle for returns and sometimes don't provide that volatility buffer they are designed to do. We believe that Fixed Interest offers more scope for returns in the coming months. This is quite a bold move on our part as Absolute Return represented the lowest risk element of the portfolios and it certainly doesn't represent a belief that markets can only go up from here. We have increased our Henderson Fixed Interest Monthly Income, Schroder Strategic Credit and Threadneedle Monthly Extra Income holdings.

In our lowest risk portfolios we have also added weightings to Rathbone Ethical Bond, Edentree Amity Sterling Bond and Schroder High Yield Opportunities. The Schroder Strategic Credit and Henderson funds are quite interesting in that both offer a yield of over 4%, but are relatively stable in their returns and their respective volatility levels are extremely low. The chart below demonstrates the stability of the Schroder fund over the last five years, consistently meeting its 4% per annum target return:




Past performance is no guide to future returns. The value of units can go down as well as up. Please note that pension fund and life fund performance differs from unit trust/OEIC performance due to the underlying difference in the taxation treatment.

The Threadneedle UK Social Bond is an addition worth noting. The fund is run on a not for profit basis in conjunction with The Big Issue to select holdings from a social universe of between 350-400 stocks. The fund charge is low and it is a Corporate Bond fund, a quite unloved Fixed Interest sector over the last 12 months. This fund is added on merit as it stands up on investment criteria, the fact that it is designed with a clear socially ethical mandate is a by-product. The fund is gaining traction and it is a surprise that there are so few funds such as this available. The fund's underlying holdings are recognisable names and so this isn't a fund investing in off the wall ideas, it is simply that any purchase has to meet the fund's positive social outcome criteria.

An example of this criteria is locality, so the fund manager may identify a positive social outcome sector to invest in, but then he will seek to invest in that sector in a location deemed deprived to make the optimum positive social impact.

Overall, these fund changes shift the emphasis of the portfolio to areas which have been unloved and lagging behind the US and UK larger company rally to areas of the developing world and Europe which have been less attractive to investors in recent times, all the while maintaining a focus on the overall risk of the portfolios by way of our Fixed Interest allocation which will help to stabilise our portfolios and provide a consistent yield should those perceived geopolitical threats emerge.

Source NBS, CEIC, Euromonitor, Goldman Sachs Global Investment Research May 2016

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