Telford Mann
Pensions & Investments

Market Outlook

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Financial Planners
Chartered

> "A pessimist sees the difficult in every opportunity; an optimist sees the opportunity in every difficulty."
>
> Winston Churchill

Having had to spend the last 3 ½ years listening to me droning on about Brexit during meetings, I'm sure many of my clients are celebrating the fact that we are now at the beginning of the end of Brexit. Although the UK will leave the EU on the 31st January 2020, there remains the thorny problem of negotiating a trade agreement with the EU. Boris Johnson is hoping to achieve this before the 31st December 2020 and indeed he has pledged to do so in his manifesto. Critics are already saying that this is impossible and point to the fact that it took Canada 5 years to do the same. The Prime Minister, an ardent admirer of Winston Churchill, will therefore need to harness Churchillian levels of optimism if he is going to achieve the same feat in 12 months. However, I wonder if another quote from Churchill is appropriate here; **"To improve is to change, so to be perfect is to have changed often".** Knowing that he has the comfort of an 80 seat majority, Boris Johnson no longer has to rely upon the DUP or the ERG to win support for his policies. Perhaps this means that whilst we will see the same brutal approach that was so successful in negotiating the withdrawal agreement, i.e. sticking to the deadline come what may, but with the trade deal much softened in terms of the ultimate outcome as regards our future arrangements with the EU. This would allow him to keep his promise of leaving the EU, but doing so in a way that avoids damage to trade for UK businesses. Time will tell of course, but for now I'm with Winston in the Optimists camp.

Later in this edition of Market Outlook we will be examining the resurgence of "Value Investing" over "Growth Investing" and so before we do so, it will be helpful to explain what the different strategies are and how they work. In simple terms Growth Investing is a strategy that says there are some companies that just keep on growing year after year and it doesn't matter how expensive their shares are, because they keep getting bigger and making more money and so you should keep buying their shares. Amazon is a good example of a growth stock. At the moment the Price Earnings (PE) ratio for Amazon is 77. This means that you have to pay 77 times what they earn in income each year to buy their shares. In other words, Amazon shares are very expensive, but the strategy ignores this and relies on Amazon making bigger and bigger profits each year. By contrast Value Investing is about investing in companies which are basically sound, but for some reason their share price is lower than it should be, i.e. their shares are good value. For example, Tesco PLC used to be the darling of the UK stock market. It made bigger and bigger

profits each year and was perhaps the Amazon of its time with its share price peaking at nearly £5 per share back in 2007. However, in January 2016 the accounting scandal broke and their shares crashed to £1.42 per share. Although the publicity was damaging and resulted in several senior people being fired and taken to court, the underlying business was basically sound. Tesco enjoys a 30% market share and its next biggest rivals are Sainsburys and ASDA who each have a 15% share. What Tesco needed to do was reorganise and steady the ship and it did this by hiring Dave Lewis who spent the next few years turning the company around. Tesco's current share price is back at £2.50 per share and so if you invested back in January 2016 when the share price fell to £1.42, you would have enjoyed a 76% return on your investment over 4 years. This is a good example of Value investing and as we will discuss later in this report, there are encouraging signs that it is coming back into vogue after many years of dominance by Growth stocks.

The fallout from the Woodford scandal continues to reverberate around the investment management world. We suspect that this is an issue that our regulator, the FCA will be focussing on during 2020 and we wouldn't be surprised if there are more funds that run in to trouble in the coming months. Investment liquidity is a key discussion point during our conversations with fund managers, but we are confident that the funds we manage in our client portfolios have sufficient liquidity to manage redemptions as required.

Asset Allocation – At A Glance

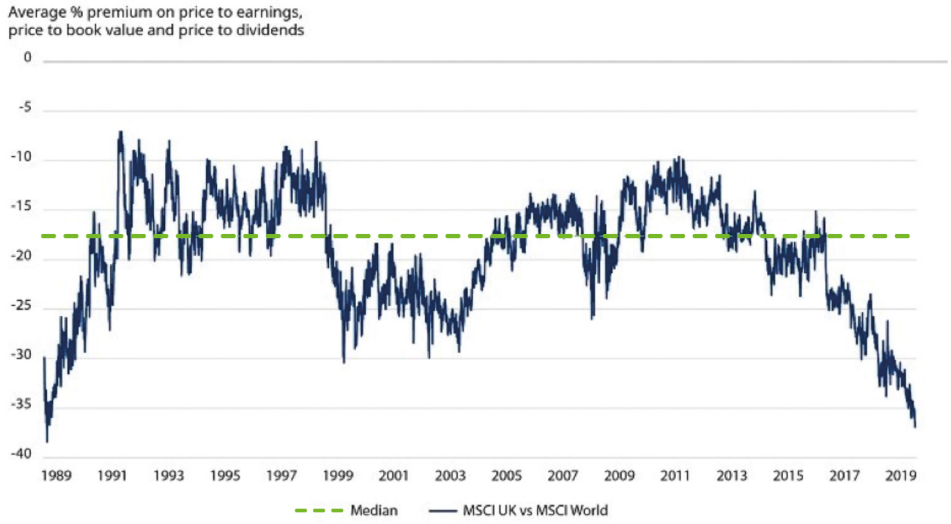
Fixed Income	▲
Property	▬
Absolute Return	▬
UK Equity	▲
US Equity	▬
European Equity	▬
Asian Pacific Equity	▬
Emerging Market Equity	▬
Commodities	▬
Global Equity	▼

With the result of the UK General Election now bringing some clarity to proceedings, we have taken the opportunity to make changes to the portfolios.

Whatever one's political leanings, Boris Johnson's victory has brought some certainty and stability to investment markets. Whether or not one agrees with his policies or approach, the UK has been stumbling through a period of inertia for too long and this result at least provides clarity on policy and likely economic approach.

We have been outside of the herd with our significant weighting to UK equities over the past couple of years. We have topped this up at regular intervals and at times this has hurt performance relative to chasing the US market, but we must invest with a clear strategy, because if we simply chase returns without a strong thesis and it goes wrong, we have no strong conviction nor explanation for our clients.

The chart below is not new, but remains true, UK equities continue to trade at a 35% discount to their global peers. The green dotted line is the historic average discount, 17% and so to be trading twice below that is anomalous.



Source: Morgan Stanley, Schroders, as at 6 December 2019. CS2283

The UK has remained the most unloved stock market globally for the past three years. Our previous inability to resolve Brexit or maintain a strong Government has led to investors staying away. Those global investors are poised to return to the UK, but have so far refused to do so for as long as it was impossible to predict what the future held.

The chart below shows how highly valued UK growth stocks are compared to UK value stocks, with the green line again representing the average valuation premium ascribed to growth stocks.

Source: Schroders, Thomson Reuters Datastream, data from 27 September 2013 to 27 August 2019. CS2242

Some of the key value stocks in the UK are housebuilders and banks. These stocks were the chief beneficiary in the immediate aftermath of Boris' victory with their share prices hitting double digit rises at points throughout Friday 13th December. The flip away from growth stocks to value stocks can be sudden and we saw this in September 2019 when value stocks caught the market by surprise for a fortnight. They pulled back again as uncertainty returned with the calling of the General Election, but it is the sort of market shift that if you are not invested during the period, you can miss out on significant returns.

The return to value stocks being in favour is something we have referred to numerous times in recent months and years, but the reality is that the trigger for sentiment and momentum shifting back in favour of value stocks can be something both significant and innocuous, but the one thing that is not in doubt is that growth stocks in the UK are trading at very high levels and we believe neither sustainably nor well positioned for any future economic downturn or fiscal/inflationary change. Value stocks have historically been a much better buffer against these economic factors than growth stocks and with the purported £20 billion investment into infrastructure under Boris Johnson, more regional projects and a boost to both commercial and domestic spending, banks and housebuilders are likely to be longer term beneficiaries.

Our UK equity funds hold these assets as well as a broad selection of UK domestic stocks. The General Election saw Sterling strengthen against both the Dollar and the Euro, which is good for UK domestic stocks and generally worse for stocks on the UK FTSE100 index who generate most of their earnings abroad. For example, the Pharmaceutical company, GSK, have 86% of their

earnings coming from overseas and so a 10% rise in the value of Sterling means an 8.6% fall in revenue for them. As it happens the differential immediately after the election wasn't as wide as many predicted it could be, but this may well have been in part due to increased optimism surrounding US/China trade relations on the same day, but longer term we would expect smaller, UK domestic stocks to be the major winners of improved market conditions in the UK.

The JO Hambro fund which we increased allocation to in June 2019 and the Marlborough UK Multi Cap Income funds both have significant weightings to UK mid and small cap companies. These companies are also prime targets for takeovers, much more so than the mega cap FTSE 100 stocks, and so there is the potential for a double upside from these stocks. At a recent meeting we held with James Lowen, joint manager of the JO Hambro UK Equity fund, James highlighted how overseas investors were poised and willing to reinvest into the UK in the right conditions, i.e. those we are now experiencing and so one can expect upward flows from here.

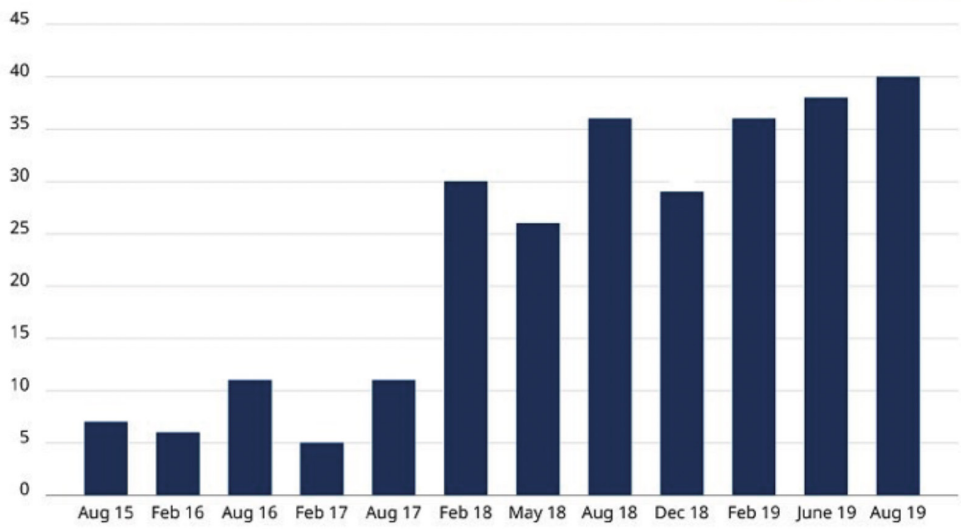
A key message though in relation to our mid and smaller company holdings, is that they have complete liquidity. There are no stocks which cannot be sold on demand if need be, and there are limitations on how much of each asset can be held at any one time, so as to avoid any concerns over returning monies to investors whenever requested. The same cannot be said of all UK equity funds in the market. Neil Woodford may have taken the headlines recently, but we expect others to follow suit and there are rumours about managers who are desperately trying to sell chunks of their portfolio to avoid being caught out with illiquid, unlisted stocks in the same way.

In June 2019 we sold out of the Jupiter UK Smaller Companies fund, following the departure of its star manager, James Zimmerman, and it is worth noting that since that time, the Marlborough Multi Cap Income fund and the JO Hambro fund have outperformed Jupiter by just under 5.5% and 7.5% respectively.

With the expectation of a bounce in UK equity value stocks, we have increased our UK equity weightings equally across our existing UK funds. We are certainly not saying that the Boris Bounce will continue in a one way upward trajectory, but we do think there is plenty of undervaluation in the UK equity market in the near term. If we do leave the European Union on the 31st January 2020, we would then expect a period of potential nervousness as the reality of arranging trade agreements in a 12 month period hits home. Whilst the eventual goal is now clear, how we get there remains uncertain and so we are also ready to reduce our weighting as and if we see those uncertainties start to unsettle markets.

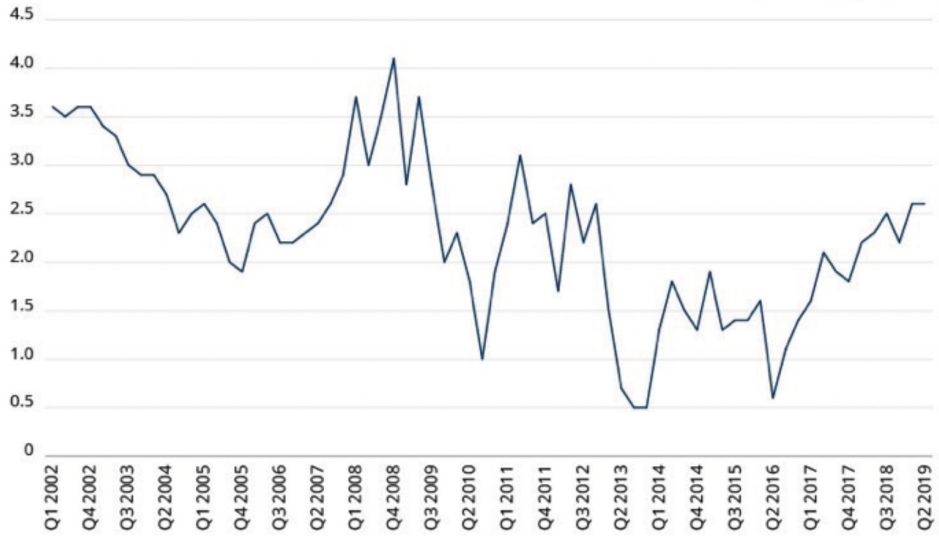
How the UK General Election and the now seemingly inexorable shift to Brexit on the 31st January 2020 affects European equities remains to be seen. We have been reticent to buy European equity funds due to continued concerns over the risks abounding in Italy and a more uncertain outlook in Germany, where they entered recessionary territory earlier this year. That said, a resolution of Brexit will provide greater certainty for the Eurozone, however, if the economy doesn't pick up, Christine Lagarde, President of the European Central Bank (ECB) has very little in the way of levers she can pull from a monetary policy perspective to stave off further recession. Her predecessor Mario Draghi used all of those up with his "whatever it takes" approach. Lagarde's only option will be to coerce the component countries within the Eurozone to introduce fiscal stimulus, but with rising populism across the Eurozone, herding individual countries to take collective fiscal action will not be easy. Another factor to consider longer term is that politically, keeping the Eurozone together is likely to become harder, once the UK leaves, given that the core liberal European nations will become further outnumbered by less like-minded nations. Leaving aside the concerns outlined above, on a pure investment basis, the Eurozone is looking more appealing and certainly if we do look to trim our UK equity exposure at some point during 2020, Europe is an area that we will look closely at. There are positive signs in the region, economic metrics have turned positive and are leading the US for the first time in many years. European equities are experiencing better earnings revisions than the US having reached a 2½ year high and Chinese PMI new orders are at a 9 year high.

The chart below shows that European companies are spending more now that at any point in the last 4 years.



Source: UBS. As at September 2019; survey covers Germany, France, Italy and Spain. CS2236

Tying into this, European wages are rising and indicative of increased consumer spending in the months ahead.



Source: Thomson Reuters, as at 30 June 2019. CS2236

The region holds ultra-cheap valuations at the moment and is relatively unloved by investors so if the improved sentiment continues to be supported by upwardly moving economic data, there would seem to be enough good news to outweigh the negatives and justify reinvestment in the coming months.

From a property perspective, we have been unaffected by the liquidity issues which have yet again struck the sector. We predict this news in virtually every update which we write, but like lemmings to the edge, investors continue to forget the problems the property sector has suffered in recent times. M&G are the latest to recently announce a closure of their fund to redemptions. Aberdeen Standard Life then joined the bad news story and so two of the behemoth property funds in the UK are struggling to return capital to investors.

In large part M&G's struggles stem from their high allocation to retail property. We can all see when we walk down the High Street, the problems with empty units, high rates/rents and a lack of quality tenants. Property portfolio managers have been more aware of this than most and so to end up with a portfolio too far skewed towards these assets is only going to lead to problems.

BMO and Kames represent the majority of our Property allocation and whilst these funds may occasionally adjust their pricing structure in times of uncertainty, they haven't ever closed the doors to redemptions on the funds we own. Adjusting the pricing structure in itself is not great, but to explain why that happens, if investors are stuck in property funds where they cannot access their capital, they tend to then draw their monies from alternative funds and in the case of property, those funds which have managed their portfolios better tend to suffer as a consequence of providing capital to unhappy investors who are trapped in investments elsewhere.

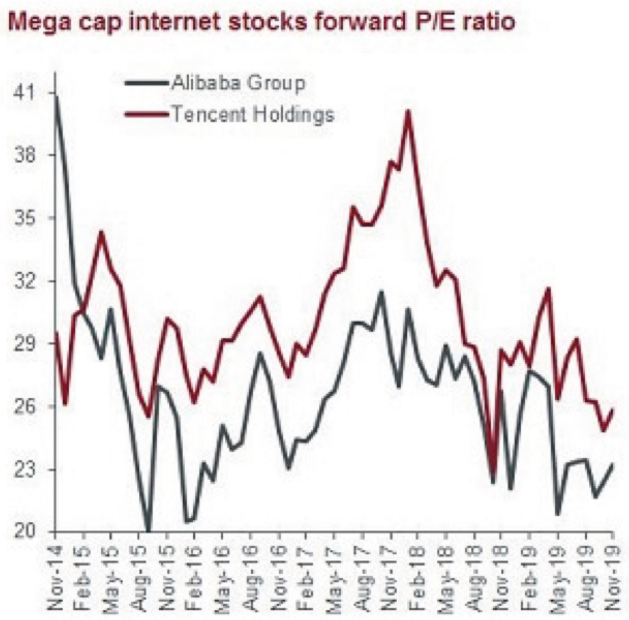
We have decided to switch our allocation from the L&G UK Property fund. This fund has around 24% in cash, so liquidity hasn't been an issue and is one of the reasons why we have used this fund over the years, but there is an opportunity to benefit from a potential uptick in valuation on the BMO and Kames funds should they adjust their pricing back up, typically by around 5%. For taking no greater risk and accessing funds with a proven track record across many of these volatile periods for Property, we can potentially increase investor's valuations.

In terms of China, we are maintaining our Chinese and broader Asian allocation. Japan is a favoured market for some of the fund houses at the moment, but we remain unconvinced that this time will be different for Japan despite all signals suggesting the market should be outperforming. In spite of the US/China trade wars, China has been a strong performer in our portfolios in 2019. We are seeing a thawing in relations between the two sides at the moment, but how the US use the unrest in Hong Kong over 2020 is unknown and may serve to further stir up relations if China deem Trump to be interfering.

China is increasingly sourcing its products from Asia rather than the US and companies such as Samsung are core beneficiaries of this strategy. As part of its "Made in China 2025" strategy, China aims to manufacture higher value products and services than it can import from elsewhere. In South East Asia, 150 million people buy online. E-commerce was worth around $5.5 billion in 2015 and is projected to be worth $150 billion by 2025. When looking at our holdings, technology companies form high allocations within the funds, Alibaba and Tencent being some of the biggest weightings.

Equally, healthcare expenditure is expected to generate 9-10% pa growth in the future. Seeing a doctor in China is no mean feat given the waiting lists and demographic demands. Ping An are one of China's leading healthcare insurers and they have just launched an online platform whereby patients can seek and receive professional medical advice online, thus easing pressure on China's medical system.

Despite these technology and healthcare stocks being so established in the China market, there remains value within them and as can be seen from the chart below, both Alibaba and Tencent are currently trading below their five year average valuations, suggesting there remains plenty of scope for recovery within them.



Source: Bloomberg, Janus Henderson Investors as at 26 November 2019.

One thing we perhaps forget sometimes is that China remains an under-invested region globally and that even with a mega cap company such as Alibaba, potential within the stock remains relatively untapped.

A similar technology theme applies in the US. Whilst the US has yet again been one of the world's leading stock markets, economic manufacturing data has taken a downward turn. There is increasing pressure on the services sector and it wouldn't take much for unemployment contagion to set in. That being the case, technology stocks remain attractively priced relative to broader sectors of the US economy, being cognisant of the potential impact Democrat Presidential candidate Elizabeth Warren could have on the sector if she were to win and implement measures to end the monopoly of big tech companies.

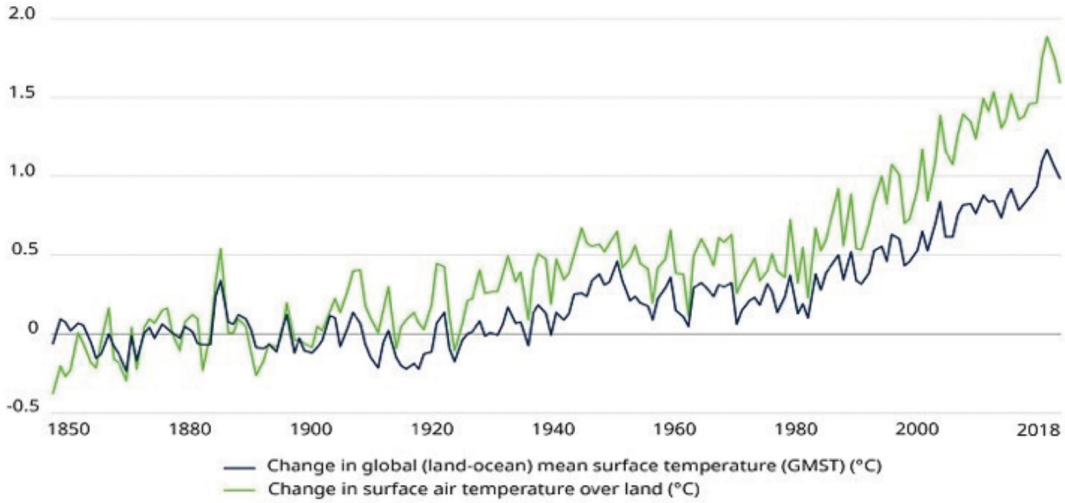
Dollar movements against Sterling are a key consideration for future returns. We saw a bounce in Sterling in the immediate aftermath of the UK General Election and most commentators predict that Sterling will rise against the Dollar to £1.35 from its current position of £1.31. It could go higher still than that, although with uncertainty over Brexit trade deals, £1.35 seems a more realistic expectation. With that in mind, to increase our UK equity allocation, we reduced our global equity allocation, by switching out of the Artemis Global Income, Schroder Global Equity Income, Janus Henderson Sustainable Global Equity and Liontrust Global Growth SF funds.

Our fixed income allocation has remained the same since we reintroduced Emerging Market Debt into our portfolios in late Summer 2019. Fixed income as a sector is largely challenged at the present time with concerns over liquidity, interest rates and inflation, but the Janus Henderson Fixed Interest Monthly Income fund has returned over 13% in 2019 to date. We hope the fund will return 5% per annum and so 2019 has been an exceptional year, but there is quite a difference between returns in the sector with an index tracking UK gilt fund producing 7% for the year and an index tracking corporate bond fund producing 8% for the year. This demonstrates the value and importance of specialist management in more unpredictable times.

We have recently had the Liontrust Sustainable Futures Corporate Bond manager to visit us to provide an update on their fund. At times the fund has underperformed due to its risk aversion. It is a true ethically minded fund allied with a discipline that won't participate in short term moves to boost returns or take on lower grade credit with higher yields to massage figures. For example, through 2019, they have avoided utilities and industrials due to political risk and sustainability concerns, but have been overweight insurers and housing associations, the latter of which benefit from waves of funding and support irrespective of issues affecting the wider property market.

It would be remiss to conclude this report without reference to sustainability and climate change. 2019 has been a year where Greta Thunberg and the future of the planet has been in sharp focus.

The chart below was released by the Intergovernmental Panel on Climate Change and highlights the change in temperature globally year on year since 1850, one can clearly see the rising trend irrespective of measures taken to date.



Source: Intergovernmental Panel on Climate Change (IPCC). CS2252

In 2020, the Paris Agreement comes into force and China's emission trading scheme is expected to become active in 2020 as well. In short, global pressures are coming to fruition to force change. Industries traditionally associated with alternative energy supplies will no longer be the major beneficiaries of the renewed focus on climate change. Those companies who are able to innovate and produce supplies or components that contribute towards the introduction of renewable energy will become some of the most valuable to be invested into and being invested in these areas early on in the process will see the greatest potential for returns longer term.

To give an example of electric cars, according to research by JPM, by 2020 China is expected to be responsible for 59% of global electric car sales. To support this demand, rapid battery costs are falling by 15-20% year on year under supply chain pressures. In turn traditional commodity demands will change dramatically. On the back solely of Chinese electric vehicle demands, global lithium demand is expected to rise to 20% by 2025, nickel demand will rise on the back of battery demands, aluminium and copper are the other major winners of electric vehicle production in the search for lighter, more efficient vehicles.

None of this is to say that traditional energy supplies are no longer relevant for many investors, in fact many utility companies may well see an upturn in valuation as a result of greater certainty over Brexit, but it is to point out that natural resources funds may no longer be the most direct way to access the commodity theme. Whilst ESG has been a deceptively popular theme in 2019, not many of the ESG badged products really do have sustainability at their heart and when we select funds for both our ethically biased or traditional strategies, we need to look beyond the fund name to the underlying approach where we are finally seeing a much quicker reward from investment into renewable energy products than we have at any time in the recent past, as targets and turnaround pressures force swifter change.

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