MARKET COMMENTARY

October 2017

Geo-political tensions dominate

Geo-political tensions dominated the quarter with rhetoric between the North Korean President Kim Jong Un and Donald Trump accelerating. This was combined with an historic policy move by the US Central Bank, major elections in Germany and a range of natural disasters causing widespread destruction. This should have been enough to unnerve markets, but ultimately investors remain confident believing that the economic environment continues to improve.

The tragic impact of several natural disasters across the Caribbean and US, took a terrible toll on human life, as well as prompting anxiety about their economic impact. Politically, these events allowed President Trump to reach a short-term deal with the Democrats, on the debt ceiling and provide additional spending to help the aid relief.

Escalation of political risk

Geo-political risk escalated as North Korea carried out several missile drills, prompting retaliation from South Korea and further warnings from the US. The latest missile launch followed the imposition of fresh sanctions by the United Nations Security Council. These sanctions include restricting oil imports, banning it from exporting textiles and ending new visas for North Koreans seeking to work abroad. To get Russia and China to agree to the measures, however, the limits on oil imports were watered down. Nevertheless, the sanctions are likely to have a major effect on the North Korean economy.

Unwinding of US stimulus

Much of the excitement about imminent US tax cuts, a new infrastructure investment cycle, and a broader Trump reflation trade faded following missteps from the Trump administration and greater appreciation of the legislative challenges involved. The US dollar was considerably weaker over the quarter reflecting a more measured outlook for US growth and inflation, benefiting Emerging Markets.

The US Federal Reserve (Fed) kept interest rates on hold but confirmed it would start reducing its stimulus programme next month. This double announcement was largely anticipated and the move to a normalisation should be considered a positive one. The Fed was however, more aggressive than expected on the timing of future rate rises and maintained its forecast of a further rate hike by the end of the year.

In terms of the stimulus reduction, originally the US started purchasing assets to support prices after the 2008 credit crisis. However, as the economic environment has improved, this process will be scaled down from October onwards, with a small amount being allowed to roll off the balance sheet each month, with the aim of reducing their asset holdings to $3 trillion by 2021. A slow and steady process should be a positive step in reducing their balance sheet but also increases the risk of a policy error if the rate of reversal is accelerated.

Political elections in Europe

The German Chancellor Angela Merkel secured her fourth term in office. This did not come as a surprise, of course, considering the strength of the German economy. However, the process of forming a coalition could be more challenging following the populist rise, and with the Social Democrats pledging to forge an opposition party.

But the clear winners of the German election were the right-wing AfD and the free-market FDP. Both parties more than doubled their share of the popular vote versus the last election, jumping over the 5 per cent threshold needed to secure representation in the next parliament. This complicates the formation of a new coalition government since none of those parties is close to the 50 per cent majority. In the longer-term, however, it could well increase the EU's reluctance to make many concessions for fear of putting more wind in the populists' sails.

Economically Europe is going from strength to strength with growth improving, inflation starting to rise and confidence building. Consequently, the euro appreciated strongly over the quarter, which has the potential to undermine the growth story, particularly as the European Central Bank (ECB) has highlighted that it may well start reducing its own stimulus in 2018.

The ECB is widely expected to begin winding down its purchases from January, following improvements in the Eurozone economy and amid fears that Eurozone central bankers will run out of assets to buy. The stronger euro has caused the ECB to revise downwards its inflation forecasts, whilst raising its growth assumptions. Eurozone inflation has been curbed by the stronger currency, which means that there is less pressure on the ECB to adopt higher interest rates.

Brexit rolls on

In the UK, Brexit negotiations continue to capture the headlines with disagreement over the terms of Britain's divorce bill. A conclusion to this financial settlement is needed before the difficult task of firming a political and economic exit structure can be achieved.

While global inflation remains relatively low, UK inflation rose to 2.9 per cent in August, above the Bank of England's target rate of 2 per cent. Naturally, interest rates would be raised from here but with the likelihood of it peaking as the effect of Brexit-induced sterling weakness falling out of the calculation, means it is a difficult decision for the Bank of England.

Raising interest rates now would also damage the financial outlook of the overly indebted UK consumer and would not be welcome at this stage from the midst of a withdrawal from Europe. To date, the consumer has repeatedly defied predictions following last year's Brexit vote, partly by running down savings or borrowing more. However, the consumer is starting to show signs of fatigue and spending is likely to slow from here.

The Goldilocks scenario

Growth is improving but not accelerating, while global inflation has risen at a slower pace despite a tight labour market. We firmly remain within the Goldilocks environment which continues to deliver reasonable growth and stable inflation. The question is whether inflation will continue to rise from here given the structural and technological changes in today's society.

From a risk perspective, geo-political tensions will continue to dominate headlines and markets will react accordingly in the short term. Economically, the challenge for central banks is how they unwind years of financial stimulus which has enhanced asset prices for almost a decade. As the global economy improves, central banks need to reduce this stimulus which could have negative consequences on specific assets. The need to implement this in a slow and orchestrated way is fundamentally key to financial stability.

Why invest in UK Equities

With all the uncertainty that Brexit creates, you might be forgiven for wondering why investment managers continue to invest your money in UK Equities.

It is important to understand the fact that a company is listed on the FTSE 100 does not necessarily suggest that it will suffer as a result of a downturn in the UK economy.

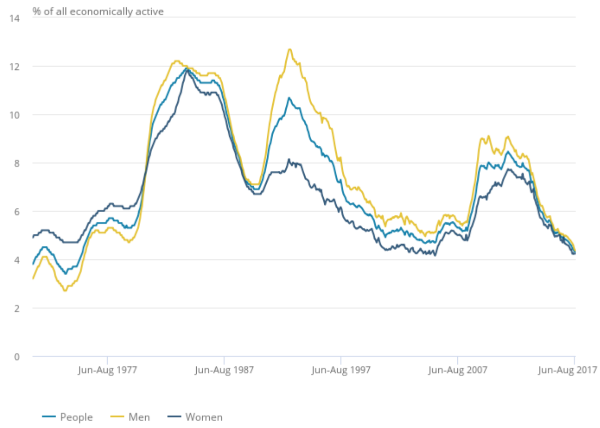
Many international companies choose to list on the FTSE 100 in order to derive the benefits associated with listing on a major stock exchange. One of which being demonstrable evidence *(to investors)* of their compliance with the requisite standards of corporate governance and accounting.

Expanding that point a little further, the overwhelming majority of profits attributable to FTSE 100 companies are actually derived from outside of the UK - so much so that the FTSE100 index is not generally considered to be particularly representative of the wider UK economy.

Of course the high proportion of profits sourced from outside the UK, combined with the significant devaluation of sterling relative to USD and Euro has benefitted investors with FTSE 100 exposure following the 2016 EU referendum.

The fact that the UK economy faces significant Brexit related uncertainty is beyond doubt. Yet we must set some context. The UK is one of the World's largest economies and is likely to remain so. There is also some good news amongst the bad. The ONS Labour market survey, for example, reports a continuing improvement in unemployment numbers.

Figure 11: UK unemployment rates (aged 16 and over), seasonally adjusted
January to March 1971 to June to August 2017



Source: Labour Force Survey, Office for National Statistics

Of course it would be remiss not to acknowledge that a more complex picture sits behind the chart above. Indeed those of you with children in their early twenties will perhaps be all too aware of the very real hardships faced by those who are subject to increasingly flexible working practices. (*Unpaid internships, zero hour contracts and the gig economy to name a few).*

Notwithstanding this, the UK has rarely seen better employment numbers, indeed some economists maintain that with unemployment of circa 4% we are about as close to *'full structural employment'* as we are likely to achieve.

Thus I come to a comparatively simple but nonetheless, valid reason when attempting to explain why investment managers continue to recommend some exposure to UK Equities:

'Things are rarely as good as optimists might hope but nor are they likely to be as bad as pessimists might fear.'

Conclusion

As we have said so many times before in our investment commentaries, there is real and present risk to investing.

Yet without risk, there is no return and without return, we cannot reasonably expect to contain the impact of inflation upon the real value of your wealth, as it continues to creep back into global economies.

Our primary control against investment risk is a well-diversified portfolio, aligned to a long term outlook. The corner stone of any investment strategy is understanding the risk that you are *'willing and able'* to take. Of course your *'investment term'* will fundamentally impact your ability to take investment risk. The shorter your investment horizon, the greater the risks presented by market volatility.

If you would like to discuss your investment portfolio(s), please do not hesitate to contact your usual financial planner.

Recommended changes to our portfolios

We will be recommending a number of changes to our model portfolios over the next quarter.

Our recommendations will be specific to your particular risk level(s) but are likely to include some minor tweaks to our recommended asset allocations and a few changes to our recommended investment funds. As usual, our portfolio fact sheets will cover any recommended changes in detail.

One of the most important parts of investing is ensuring that your investments are managed in line with your *'willingness and ability'* to take investment risk. In simple terms this means we must consider both how you *'feel'* about investment risk *(i.e. the risk of your investment falling in value)* and how the realisation of an investment loss might *'impact'* your goals & objectives, and importantly, your standard of living. Willingness *(how your feel)* is by its nature more subjective, whereas ability *(it's impact)* is objective, requiring consideration of hard facts such as *'assets & liabilities'* and *'income & expenditure.'*

As part of this round of portfolio recommendations I have asked your Financial Planner to make contact with you to arrange to meet with you in order to review your portfolio risk level before implementing our latest recommendations.

This information only applies to investors in our Model Portfolio Service.

Disclaimer

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Investment Association Sector Returns

Sector	3 Month %	6 Month %	1 Year %	3 Years %	5 Years %
Cash & Near Cash					
Money Facts 90 Day Notice Account (£10K)	0.13	0.25	0.53	2.05	3.80
IA Money Market	0.03	0.04	0.14	0.42	0.74
UK Fixed Interest					
IA Sterling Corporate Bond	0.29	1.21	0.61	16.08	27.09
IA Sterling High Yield Bond	1.53	3.55	7.38	14.59	30.69
IA Sterling Strategic Bond	0.79	2.13	3.27	13.09	25.43
IA UK Gilts	-0.60	-2.11	-5.60	17.62	18.96
Commercial Property					
IA Property	0.50	2.21	3.48	25.76	45.30
UK Equities					
IA UK All Companies	2.13	4.83	13.65	29.44	68.09
IA UK Equity Income	1.17	3.65	10.59	27.54	66.07
IA UK Smaller Companies	5.38	12.22	25.00	50.56	111.24
International Equities					
IA Asia Pacific Excluding Japan	1.99	4.67	15.65	45.75	66.96
IA Europe Excluding UK	2.83	9.33	21.88	49.48	97.81
IA European Smaller Companies	4.93	13.42	23.78	72.44	127.11
IA Global	1.53	3.03	14.92	42.99	83.22
IA Global Equity Income	0.76	1.45	12.32	36.24	73.81
IA Global Emerging Markets	3.99	5.72	17.42	37.17	43.94
IA Japan	2.05	4.26	13.34	56.47	105.89
IA North America	0.72	-0.15	14.64	53.24	113.68

Important Notes:

- Source: Financial Express Analytics
- Bid to bid pricing
- Total return basis
- Returns shown in local currency (Sterling)
- Time period ends at end of last quarter (30/09/2017)