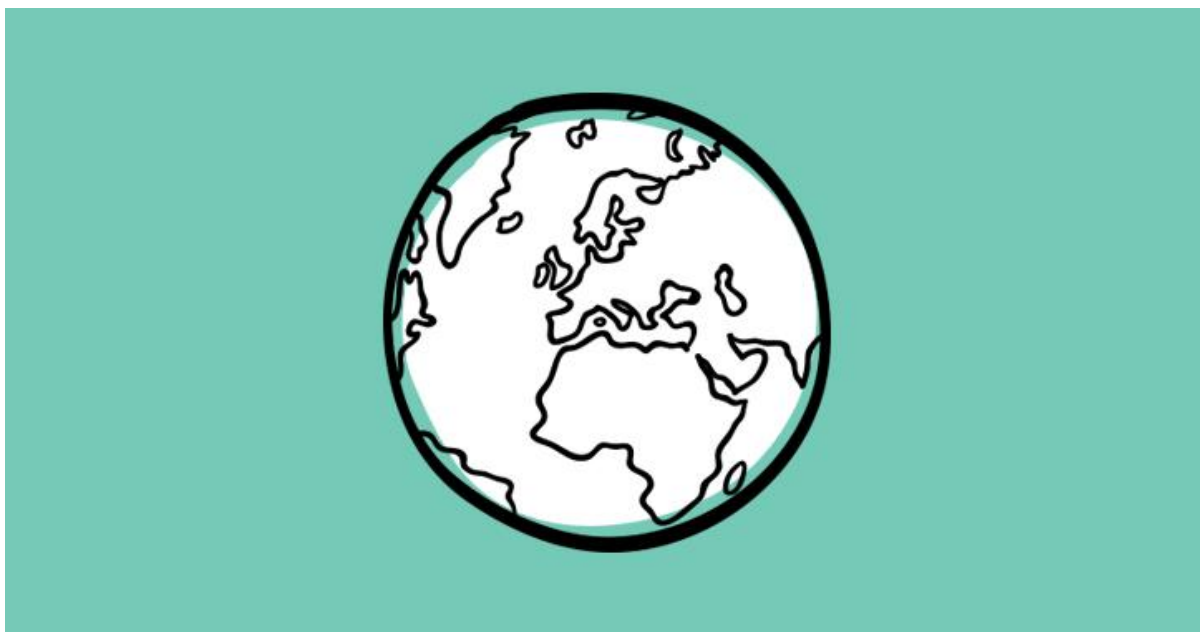


## QUARTERLY MARKET OVERVIEW – OCTOBER 2016



*“Practical men who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back.”*  
– John Maynard Keynes

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When we wrote the last quarterly update the vote to leave the EU was uppermost in our minds. With the fallout it was easy to forget that we are all part of a global economy. The speed of change in the UK post vote has been significant and shouldn't be underestimated.

Cameron came to power in 2015 with a mandate to hold office until 2020; no-one expected a Conservative majority and therefore it was unlikely the EU referendum would happen. However, with a majority Cameron moved quickly; believing the support was with him. Most people including those in Europe didn't envisage the final outcome. Within days of the vote Cameron was gone, and markets were expecting significant instability over the coming months.

What happened was the reverse; within six weeks a new leader was in place who swept in a new cabinet. Added to this political shuffle were vast economic changes.

The Bank of England cut interest rates in August and have indicated that rates may fall further (although this may put them at odds with the Government). This provides confidence to the UK consumer and should deter people from hoarding cash. An additional factor was the “collapse” in sterling which benefits exports, tourism and overseas investment; in this area we are starting to see mergers between companies and more of this should follow.

Most importantly the UK is part of a global economy. The quote by John Keynes may seem extreme but there is some truth in this. Whenever I speak to economists they often refer to the past; we often hear quoted “the last time we saw something similar was in 1930...”

The reality is that post 2008 everything is new economically, and I would argue that this is uncharted territory. This is not a bad thing. We have just come out of a period of perhaps 30 years of rapid technological change, the likes of which we have never seen. We would expect slower growth, the price of goods to come down and then factor in low interest rates and QE.

Everything is now different; economists will try to apply past models because that is what they know best but the reality is that the old ways are very unlikely to allow us to map out what might happen in the future.

Two interesting statistics to consider:

1. Since the Lehman Crisis there have been 667 interest rate cuts by global banks (source BoAML August 2016). In the UK, interest rates have been at historic lows since 2009 and have in reality been falling since July 2007
2. Data from Citi in June 2016 showed that there are 40 armed conflicts in 27 locations, the highest in a decade, and that more elections and governments have collapsed in the last 3 years in major economies than in the previous decade

The BREXIT vote was just one global economic risk that we knew about but there are others including the US elections, China, global conflicts and global monetary policy.

One of the key elements to investing is diversification. The BREXIT vote showed that those who have a globally diversified portfolio actually did well because of the weakness in sterling. It also shows that things happen in different countries/sectors and you can never predict where the one best place to be is but having a strategy incorporating all areas of the global market can and does deliver positive long term returns.

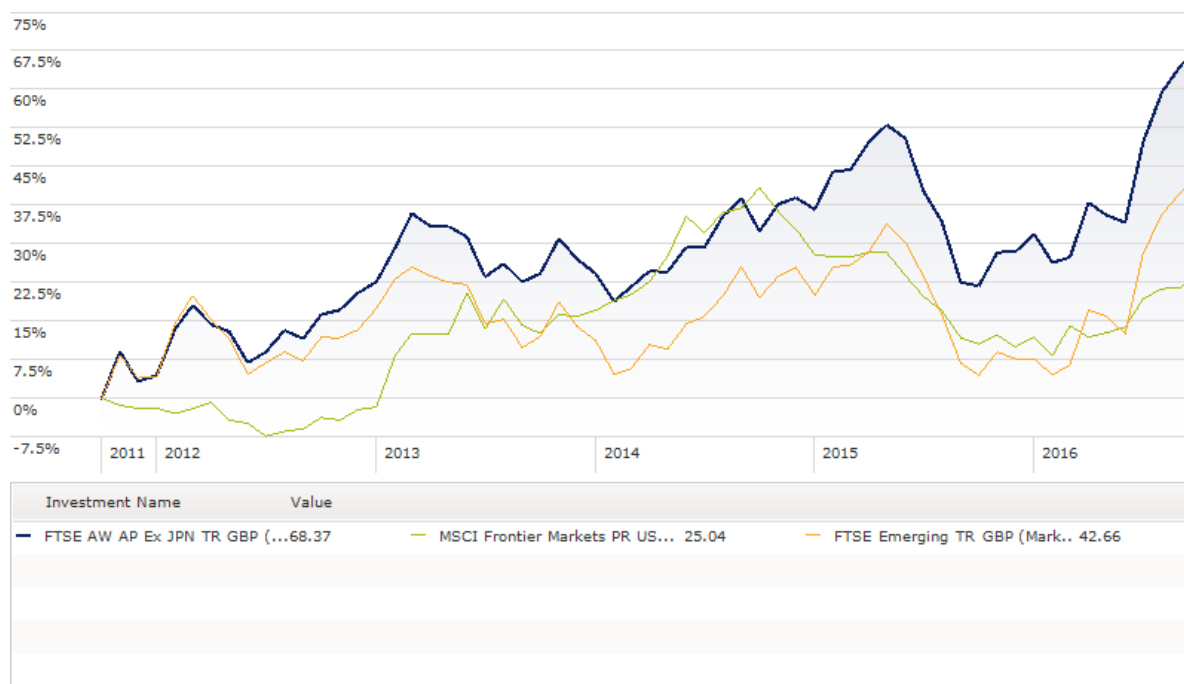
In this update we want to look at some of the bright spots and the challenges for investors.

*George Ladds*

George Ladds, Director, October 2016

## EMERGING, ASIA AND FRONTIER MARKETS

Five year returns 1 October 2011 – 30 September 2016



**Special note to graph:** You should note that past performance is not a reliable indicator of future returns and the value of your investments can fall as well as rise. The total return reflects performance without sales charges or the effects of taxation, but is adjusted to reflect all on-going fund expenses and assumes reinvestment of dividends and capital gains. If adjusted for sales charges and the effects of taxation, the performance quoted would be reduced.

It is very hard not to write about these markets without mentioning China; so I will not disappoint!!!

Before focusing on China it is worth looking at the markets in their entirety with a particular focus on emerging economies. For a long time, these markets have been unloved by investors however we are starting to see this reverse. It is worth adding that not a lot has changed; the fundamentals remain but it seems perceptions have altered.

Growth in emerging economies continues to outpace that of developed markets. IMF forecasts show GDP Growth of 1.8% for advanced economies whereas for emerging and developing economies this is between 4.1 and 4.6%.

There is also significant change across the economies; these are no longer just commodity-based but also benefit from sectors like information technology and services. We are also seeing structural change especially in Latin America; Brazil is seeing political reforms and in Peru the new president is more business friendly. Turning to Argentina we are seeing action to tackle their debt problems.

Away from Latin America, in India we are starting to see reform with the passing of the National Bankruptcy Law and Goods and Services Tax Bill. There has also been a relaxation of foreign direct investment rules to stimulate growth.

Across the regions the stabilisation of the US dollar has helped, as it has reduced the risk of default on US denominated debt. When economies are struggling it is hard to repay especially if the dollar is strong. There are risks with interest rates rising but this is likely to be slow and most economies have been able to prepare for this.

Turning to China there are challenges – oversupply in housing, excess capacity and slowing manufacturing as well as debt issues. But there is growth in consumption driven by rising wages, with an expanding service sector, new infrastructure initiatives and the opening up of domestic equity markets which is a big step forward.

The big unknown is the debt in China and depending on who you talk to will dictate your view. There has been a rapid rise in debt particularly within the corporate sector. The fear is that China won't be able to avoid a banking crisis. The impact of this will be to slow growth and ultimately impact the global economy. But there are several factors which may allay these fears.

China enjoys a high rate of national savings. The level of debt a country can sustain depends significantly on the share of domestic savings in GDP. Japan is in a similar position. Secondly, the debt built up is almost entirely domestic currency. Local companies have been paying down foreign currency debt since 2014 and it now only accounts for 5% of domestic debt. In contrast other emerging economies have 4 times this level of debt. It is also worth adding that China is also a large net creditor to the rest of the world.

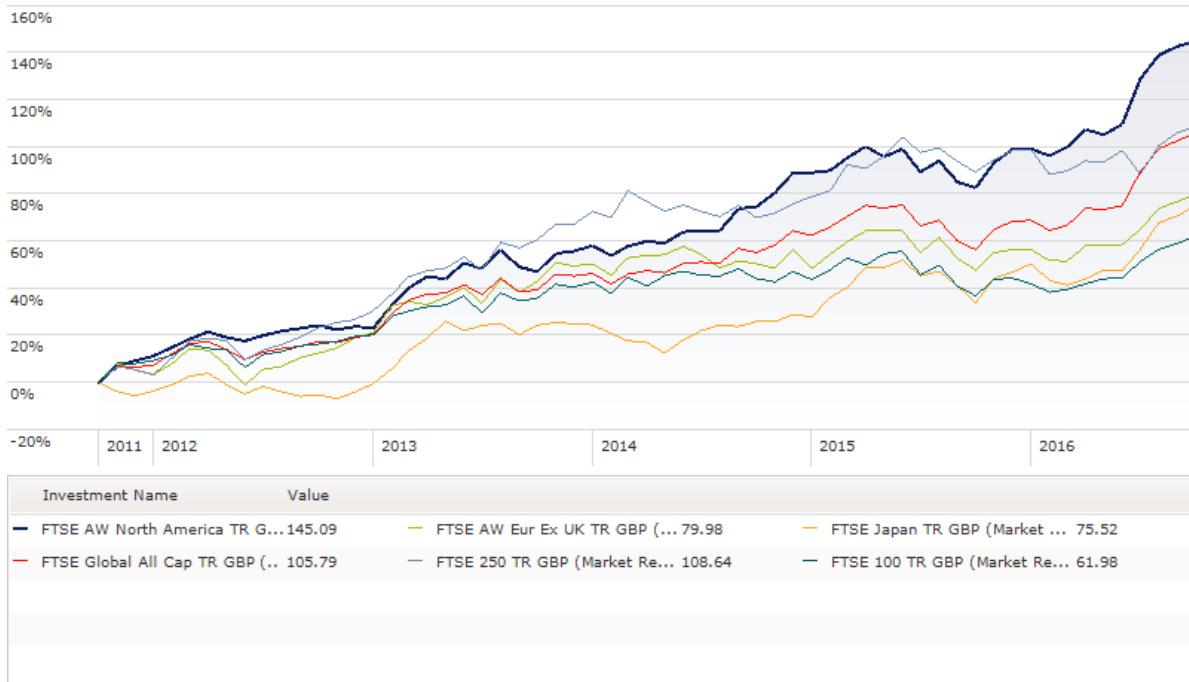
And finally Chinese banks capital reserve ratios are currently 17% with loans plus off balance sheet assets roughly equal to deposits.

The argument here is that what we can't see may cause bigger problems and that could be the case, but equally on the surface there appears to be many positives to offset this.

In summary China will always be the dominant player but it shouldn't overshadow the positives coming from many economies. Reform in India, Brazil and Peru are just some of the economies making positive steps.

**DEVELOPED MARKETS**

Five year returns 1 October 2011 – 30 September 2016



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What would happen if Trump won?

It seemed inconceivable that Trump would become the Republican candidate and yet he did, and many seem to think it is inconceivable that he could become President but...history shows the unthinkable can happen!

From an outsider it would seem that a Trump victory wouldn't be good for the US but the reality is that neither candidate is particularly market friendly. With Clinton there is a little more knowledge about what she might do and it is likely that her policies would remain largely the same as Obama. With Trump he is seen as more of an economic wildcard and he has already indicated he wouldn't reappoint Yellen. From a market view it is clear that they favour Clinton.

It's interesting to see that Trump can say almost anything and there appears to be no impact on how people view him, the latest seems to be his admission of tax avoidance. And yet where there are rumours of body doubles and secret illnesses for Clinton the reverse happens. The views will ebb and flow in the coming months; at the moment market indicators are showing the chance of a Clinton victory between 69 and 80%.

Some things to watch because I like statistics! Based on history if the stock market is up in the three months leading up to the election then it is likely the incumbent party will end up in power. If there

are losses, then the reverse is true. And here is the evidence, in the 22 presidential elections since 1928, 14 were preceded by gains in the three months prior. In 12 of those 14 instances, the incumbent (or the incumbent party) won the White House. In seven of eight elections preceded by three months of stock market losses, incumbents were sent packing. Exceptions to this correlation occurred in 1956, 1968 and 1980.

This raises the question as to which party is better for markets and this becomes a little murkier. In the two years following an election, Standard & Poor's 500-stock index gained:

- 16.9%, on average, when one party controls the White House and both houses of Congress;
- 15.6% when one party controls both houses of Congress and the other party owns the White House;
- and just 5.5% when the House and Senate are divided.

But a divided Congress doesn't always lead to sub-par returns. In the two-year periods following the 2008 and 2012 elections, the S&P 500 rose 19% and 42%, respectively.

The point in all of this is that whether we have a Trump or Clinton victory, eyes will be on who controls the houses of Congress. The reality is that there might be volatility with the build up to the election but long term things will carry on. The US is in good shape, interest rates are likely to rise and at the moment there are no signs of a recession. Any new President is not likely to want to upset a growing (albeit slowly) economy.

Turning to Europe there are two specific areas of interest (excluding BREXIT). The Italian Referendum is significant. Renzi has staked his political reputation on winning the referendum which would streamline parliament and the electoral system. Importantly these changes will bring financial stability. Most would assume that he would be certain to win this, but it appears the momentum is with the opposition parties.

The significance of these changes shouldn't be underestimated. The upper house currently has the power to bring down a government. This has meant that since World War 2 there have been 63 governments, none of which has lasted the full five-year term. This stifles growth and therefore anything that reverses this has to be an improvement but it seems the Italians do not agree. Renzi has said he will resign if he loses the vote; and the implications are far reaching. Firstly, the government could collapse, triggering an election. Secondly and more importantly the 5 Star Movement Party is gaining popularity and they could take power. If this happens then the next step is a referendum on whether to stay in the EU, with a vote to leave having potential to start the total break-up of the EU.

Turning to Germany the banking system is in trouble. The US Department of Justice has placed a fine on Deutsche Bank of \$14 billion and there are question marks on whether it can pay the fine. Merkel has said that she won't step in to prop up the bank. This is an interesting point because the bank employs 50,000 people and 56% of shareholders are German or German institutions. To not step in would have a massive impact on pension funds, insurance companies and private investors. The ripple across the banking system in Germany and Europe could be massive. Some argue this could bring down the euro.

We don't know the outcome but it's possible the fine could be reduced or there could be some bail out, but whilst there is uncertainty it makes the markets nervous.

Europe also faces challenges with Elections and extremist parties (such as National Front (France) or AfD (Germany)). In Germany it is likely they will take votes in the Elections but Merkel will remain to form a coalition party. In France the feeling is that Le Pen will get through to the second round but fail to win at that stage. If Le Pen did win, one of her first moves would likely be to call for in / out referendum on the EU.

The next twelve months in Europe are definitely something to watch. Austerity has hurt many people and we have seen a collapse in GDP in countries like Greece, as well as high youth unemployment in Spain and Italy. Like the UK, people are tired of reforms which seem to be going nowhere and this is driving populist parties; but there are signs that some things are changing. Although credit has been pumped into the system it is only this year that there has been demand from corporates and individuals, and this could be significant in kick starting a revival in Europe.

Turning to the UK; a change in government, falling sterling and a drop in interest rates have all been positive. Speaking to a fund manager recently they indicated that the UK could do very well over the next three years. During this time, we will remain part of Europe and enjoy all the elements that come with that. A weak sterling is positive for exports and we have seen evidence of investment in the UK through mergers etc. The cut in interest rates hurts those with cash, however for many the cut is effectively more money in their pocket. Cheaper loans should encourage people to spend which in turn helps the economy.

It is worth adding that interest rates could fall to 0.1% and that most do not expect rates to rise at least until 2021. My personal take is that it could be 2026 before rates rise, the reason is that assuming we invoke Article 50 in 2017, it is two years from there that we leave the EU. Certainly nothing will happen until the Bank of England see that is "safe" to raise rates. My view is that assuming a smooth exit then two years (i.e. 2021) will be too soon to make that judgement. Hence my view is that it could be up to 2026 before rates rise. Although the government seem keen to raise rates as quickly as possible!

The speed of change in the government has been really positive and will inject life where perhaps Cameron and Osborne were running low on ideas. Despite all the positives (spin) from the press about how well the UK is doing, it is worth remembering that we haven't left the EU yet which many seem to have forgotten. If we can build momentum over the next three years this will be helpful but there are challenges and these shouldn't be underestimated.

These challenges include how we actually leave the EU. Focusing on one big topic of discussion is passporting rights. If no agreement is reached this could have a significant impact on the UK economy. The Financial Services industry makes up 8% of the UK economy, 3.4% of British jobs and 10% of UK exports.

Another area of concern is car manufacturing. The industry contributes £12 billion to the UK economy and is the third largest manufacturing industry in the UK, surpassed only by food and metal products. 6% of the total manufacturing industry is employed in this sector, and 78% of cars built in UK factories are destined for other countries with the EU the biggest market. There could be an argument that the EU wouldn't be worried about this, but UK motor vehicle imports are higher than the exports and 85% of this comes from the EU.

Away from BREXIT and briefly just touching on Japan. The elections in July saw Abe strengthen his grip on power with an increased majority in the upper house to 60%. They also face challenges, for example wage growth remains weak and without rapid tax rises it is unlikely they will reach their

surplus target by 2021. Japan needed stability and a reformists government, which it now has but change will not happen overnight.

In summary, the US economy seems robust albeit reflecting a low growth global environment. The run up to the election will bring volatility to the market but whoever comes in will settle the markets and the focus will move to somewhere else. In Europe the rise of populist parties is something to watch; the feeling is that although they will have an impact it is unlikely certainly in France and Germany it will be strong enough to deliver a change in government. Italy's outcome is less certain so we will be keeping an eye on this.

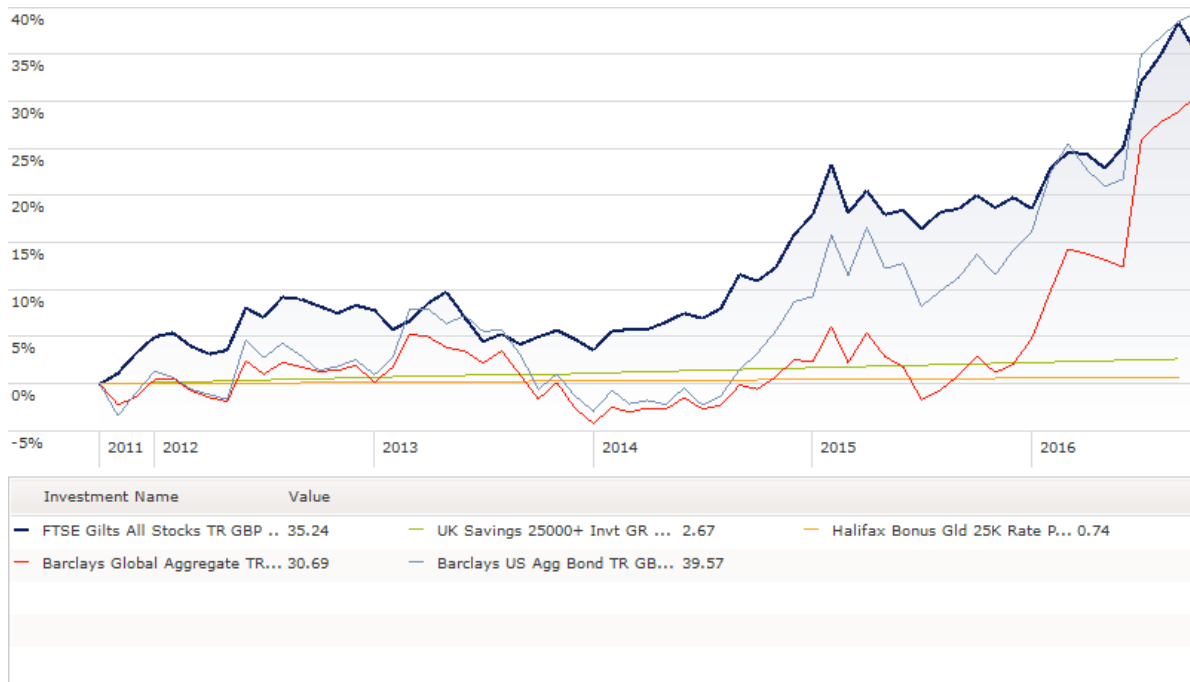
In the UK the signs are that until physical BREXIT the economy could do extremely well, however beyond that there are significant challenges and whatever we read in the papers might be best taken with a pinch of salt!

And finally just touching on the global economy both the WTO and IMF are concerned about slow growth and have downgraded their predictions for 2017. They have expressed concerns that there are deeper problems with the world economy, but the reality perhaps is as simple as we are in a new and uncharted place and history cannot tell us what the future holds.



## CASH

Five year returns 1 October 2011 – 30 September 2016



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With the cut in interest rates headlines bemoaned the impact on savers. It is true that one of the casualties of falling interest rates is cash savers. But the reality is that saving rates have been consistently falling decade by decade.

During the 1980s the average savings rate was 8.95%; during the 1990s it was 6.95%, and by the 2000s this had dropped to 4.40%. Since 2010 this has fallen further to 1.92%. (source swanlowpark.co.uk). Since the cut in rates in August, the average cash savings plan has fallen to 0.49% for an Easy Access Account and 1.69% for a Five Year Fixed Bond.

For some time, cash was seen as an income producing asset, but this is no longer the case and with inflation having the potential to rise then in real terms cash will be a negative returning asset.

Some have turned to fixed income (bonds) as the next level of risk. These are interest rate sensitive and falling rates have been beneficial. However, yields on government debt are zero and in some cases negative. Some fixed income managers are saying that investors moving forward are not going to be compensated for the heightened level of volatility in terms of the potential income and returns.

The next step up is equity income and it is possible to build a basket of global equity income funds which offer the potential for capital growth and growing dividends. Investing globally also provides protection against a weak sterling. As an example Asia Income Funds can pay over 4%, and European and some more specialist funds over 5%. So there are options to get income from investments but there needs to be an acceptance of risk.

If cash is being held as a safety net, then it is worth reviewing whether the levels of cash held are excessive. And if this is the case then is it worth considering investing this, particularly if it is not needed immediately.

In summary, whether rates go up in 2021 or 2026 cash is going nowhere fast, and in real terms with inflation it becomes a negative returning asset. Holding some cash is important but investors wanting income and growth will need to consider taking some risk to achieve this because cash is no longer king. The age of the high interest cash asset has well and truly passed.

## CONCLUSION

Markets have taken a fair beating this year especially in early quarter one and at the half year. Against all of this surprisingly the markets have been resilient, and those investors with a global spread of assets should have seen positive returns.

To some extent in hindsight a vote to leave was always going to happen, and in the short term, for the UK, this now looks positive. Beyond that is less certain but it is worth adding to the mix the challenges in Italy, Germany and France which should play out over the next twelve months.

There will be volatility in the markets in the time before the election in the US, and although the polls seem to hint to a Clinton victory this is far from certain. Whoever wins the thing to watch is who controls the house and senate.

Beyond that much of what we said in the first quarter remains – China, ISIS and Oil Prices will all have a potential impact on markets.

In reality we are seeing a return to ‘normal’ volatility but what we can’t look to the past to map out what the economic landscape may look like in 5 or 10 years. This is simply because we have never been here before.

We still believe in a world of low growth, low interest rates, increasing inflation and greater volatility it is probably fair to see that average returns of between 5% and 7% are the new normal.

**Source: Charts have been sourced from Morningstar. Other data sourced from Guardian, Hermes, Citi, Bank of America, Kiplinger.com, Templeton, BBC, FT.com, eu-facts.co.uk and M&G. Any reference to a fund or share is not a recommendation to buy or sell that asset. Past performance is no guide to future performance and investments can fall as well as rise.**

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