QUARTERLY MARKET OVERVIEW – OCTOBER 2014

"….although returns will be lower, investors are still being rewarded for taking risk………"

Comparing the world to 2008 / 2009 we see a very different picture. Many analysts believe the world economy is on track for a continued modest recovery; however some economies are much stronger than others. The UK and US are expected to raise interest rates from historic lows to around 0.75% (in the UK) and 1.5% (in the US) by the end of 2015.

In Emerging Markets and Asia we are seeing much needed reforms in India, China and Indonesia with hopes of changes in Brazil should a reformist government be elected. Frontier economies like Algeria and Romania are shining lights posting positive economic news.

But with this backdrop there remains risk in the Eurozone; deflation is a worry as is an escalation of the Russian / Ukrainian crisis. In the UK, the Scottish vote may impact on investment and growth in Scotland as investors remain worried that the calls for independence have not gone away, the election has the possibility of a hung parliament and there are concerns around the UK leaving the EU.

Globally, concerns around the Middle East and ISIS remain on the table and the impact this could have on neighbouring states. Unrest in Hong Kong has made markets nervous; Beijing cannot be seen to give into the protestors in a significant way as this could be a catalyst for change on the mainland.

Performance across the markets for the first six months of 2014 ebbed and flowed ending slightly up at the end of June. July and August and into September all produced positive numbers however they pegged back as concerns rose over the Middle East and unrest in Hong Kong.

In this update we will highlight some of the key macro themes.

CASH

Five year returns 1 October 2009 – 30 September 2014

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.*

For some time economic analysts have stated that investors must be more flexible in their search for income, and to achieve this they should consider taking on more risk.

It is expected that the UK will raise rates first; increasing rates to around 0.75% by the end of 2015, and up to 1.72% by the end of 2016. Banks will use the money to strengthen their books and therefore investors are unlikely to see immediate benefits of these rate rises.

Fixed income assets are sensitive to interest rate movements and as rates rise, asset values will fall. Effectively although the income may be good the capital will start shrinking. There is a belief that risk assets (i.e. equities) remain the best long term option for income and capital growth.

Looking at cash the average one year account is paying 1.70%, inflation is currently 1.72% meaning the returns are flat.

Some of the Challenger Banks like Virgin Money are offering up to 2.80% for Cash ISAs but the rates are considerably lower than the peaks of the nineties and before the financial crash in 2008.

Cash has traditionally been used as a safe source of income with some capital growth. Any income is now minimal with no scope for capital growth.

Rate increases will correct the imbalance but clearly the rates will not rise quickly and therefore income investors need to be more flexible in their search for income.

THE MARKETS

Below we will look around the globe and provide an overview of the key messages coming out from fund managers.

USA

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The news from the US is good and it remains the strongest region this year.

QE is set to come to an end in October and it expected that interest rates will rise next year. The labour market figures are positive and below the long term average which would normally trigger a rate rise. However, the participation rate is falling – this is people looking for work and a falling rate indicates potentially hidden unemployment. Additionally, wage growth is slow and this needs to pick up.

Real income of the median household is 8% lower than it was on the eve of the financial crises and it has not improved since the Mid-1990s. A positive shift will be important to a rate increase.

Consumer confidence took an unexpected downward turn, there were no obvious reasons for this and it could simply have been concerns over the Middle East.

The housing market is another indicator and this has disappointed. Individuals are not taking the first steps onto the housing ladder. Rent is higher than mortgages. The consensus is that students coming out of college are carrying greater debt and unwilling to add to that.

Going forward there are many positives in the US particularly around oil and gas production.

Oil production is expected to be at the same level as Saudi Arabia and Russia by 2017; self-sufficiency is very much on the cards over the next few years. Gas production is seeing chemical plants return to the US; it is also bringing down fertiliser prices which can be produced cheaper than importing from China.

With this is mind it is expected that the UK will raise rates first and the US will follow shortly after. In the US it is expected rates will rise quicker rising to 1.5% by the end of 2015 and 2.15% by the end of 2016. The US market can soak up higher rate rises because individuals are not sitting as much short term debt as the UK. Individuals in the US have 30 year fixed rate mortgages so any increase will not impact on the payments they making.

In summary the US continues to pull away from recessionary lows of 2008 / 2009 with the end of QE in October and likely interest rate rises in 2015. Oil and gas production will play a significant part in the future growth of the economy but there remains risks. US involvement in the Middle East crisis may well have damped consumer confidence and eyes will be on the next set of data around this. The housing market does play a part in growth and encouraging people onto the ladder will be key as will an upward participation rate and wage growth.

EUROPE & UK

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The UK did suffer from the uncertainty over the Scottish referendum, in the end the margin on the 'no' vote was greater than many expected. However, there remains a risk around the result of this referendum.

Many analysts refer to the Quebec referendum and fear that Scotland could suffer from a lack of investment and growth as investors turn their back on the country because of the potential uncertainty. The proposed new leader has not ruled out another referendum and this hasn't helped in dampening those fears.

The promises made by the Westminster parties not only to Scotland but also England could damage UK growth prospects especially if there is a hung parliament in 2015. Additionally if the Conservatives come into power again it brings in the added risk of the UK leaving the EU. The markets are pricing all of this in but as different events come onto the table so the volatility will increase.

The question around when rates will rise dominates the UK. Unemployment has fallen quicker than most expected and now stands at the lowest level since 2008. Retail sales remain strong and increasing. However, real wages have fallen more in the UK than any other developed country since the crisis.

Additionally the housing boom is starting to show signs of slowing with the supply / demand position shifting towards over supply. This is likely to be driven by two factors, firstly elevated house prices and more stringent lending.

The challenge for the policy committee is getting the trade-off right between starting to normalise rates or waiting for more certainty in the strength of the economy. The reality seems to be small increases early next year up to around 0.75% by the end of 2015 and 1.72% by 2016. The rates in the UK are unlikely to go up as quickly as the US because short term household debt is greater than the US and any large increases in rates could slow down the growth in the economy.

Looking at sectors, the two unloved and relatively cheap sectors are banks and basic resources (food and drug retail, homebuilders, insurance, oil and gas). Protest fears in Hong Kong have weighed heavily on banks with exposure in Asia. There remain concerns over the domestic banking sector, even though much progress has been made, especially around the amount of interest only mortgages and shrinking margins going forward.

The food retail sector faces a shake up and the accounting scandal at Tesco unnerved the market with concerns that more is to come. On the flipside sectors like Technology, Chemicals and Financial Services, Food and Beverage have much higher valuations.

In summary parts of the UK economy are fairly valued others remain with depressed valuations. Unemployment continues to fall but wage growth isn't coming through. A slowdown in housing is good but the economy wouldn't want to see a 'crash' in the housing market. The risks around the Scottish referendum and the devolving of more powers to Scotland and England are real as are the risks around political uncertainty and the potential to leave Europe.

Europe remains challenging – the German manufacturing PMI data was negative which raised concerns that Europe's largest economy could be dragged into recession. Announcements from a number of European companies on profit warnings have also indicated concerns about the fragility of the Eurozone.

Although there have been concerns over deflation, these concerns have been lessened because much of this was driven by falling energy and food prices. However there are signs that domestic and manufacturing prices are pulling down inflation and this is a concern to policy makers. If this trend continues then action will be needed.

The challenge is to get earnings growth coming through. Banks need to lend more and corporates need to want to take on more debt to expand. However, banks are reducing debt and not lending as much. Equally corporates are not taking on the debt. There are good reasons for this and in many cases it is regional.

In Italy corporates may be unwilling to take on new projects and therefore debt because of the broader macro picture, for example bureaucracy and unfavourable employment laws. Any changes need to come within economies as well as the wider Eurozone and that might be more difficult to achieve.

In summary, Europe faces many challenges and the risk of deflation should not be underestimated. France and Italy are showing signs of significant slowdown and Germany has posted worrying news. The fall in inflation is across sectors and this is a worrying sign. Some form of QE may help but clearly individual economies need to make their economies more business friendly for companies to want to expand. As the UK and US continue to grow the difference between the economies will start to show and it is expected that interest rates will remain low in Europe for some time to come.

ASIAN, FRONTIER AND EMERGING MARKETS

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Valuations across Emerging Markets and Asia remain cheap and the different regions are unloved. We have seen stronger returns in 2014 however these have pegged back in the last quarter.

There is an argument to consider the wider picture when looking at Emerging Markets and Asia. The taper tantrums exposed the vulnerability of Brazil, Russia, India, Indonesia and South Africa.

India and Indonesia are two standout economies since last year. The election of a reformist government in India has been seen positively by markets although there is an acknowledgement that patience is needed. Action has been taken to reduce the deficit and focus is on creating an environment that is friendlier to foreign investors, effectively getting rid of red tape and barriers to entry. Investment in health, infrastructure and education is also helping the economy.

India's economy expanded at its fastest pace for nearly two years in 2014.

Indonesia has also seen a new government which has a focus on change with a drive to boost investor sentiment in the area. Like India it has taken steps to reduce its deficit.

China is also making steps in the right direction to move the economy towards domestic consumption. How they respond to unrest in Hong Kong is crucial, to back down could have a negative impact on mainland China as people demand more reforms, to stand firm well the consequences are unknown.

On the flip side Russia is closer to recession than most would admit as oil prices fall and squeeze government budgets. According to sources Russia needs oil to trade around $100 per barrel mark to keep it head above water. Additional pressures include trade sanctions and uncertainty around the Ukraine. In Brazil eyes are focused on the election, if the existing party is replaced then the new government is seen as reformist which the market is likely to respond well to.

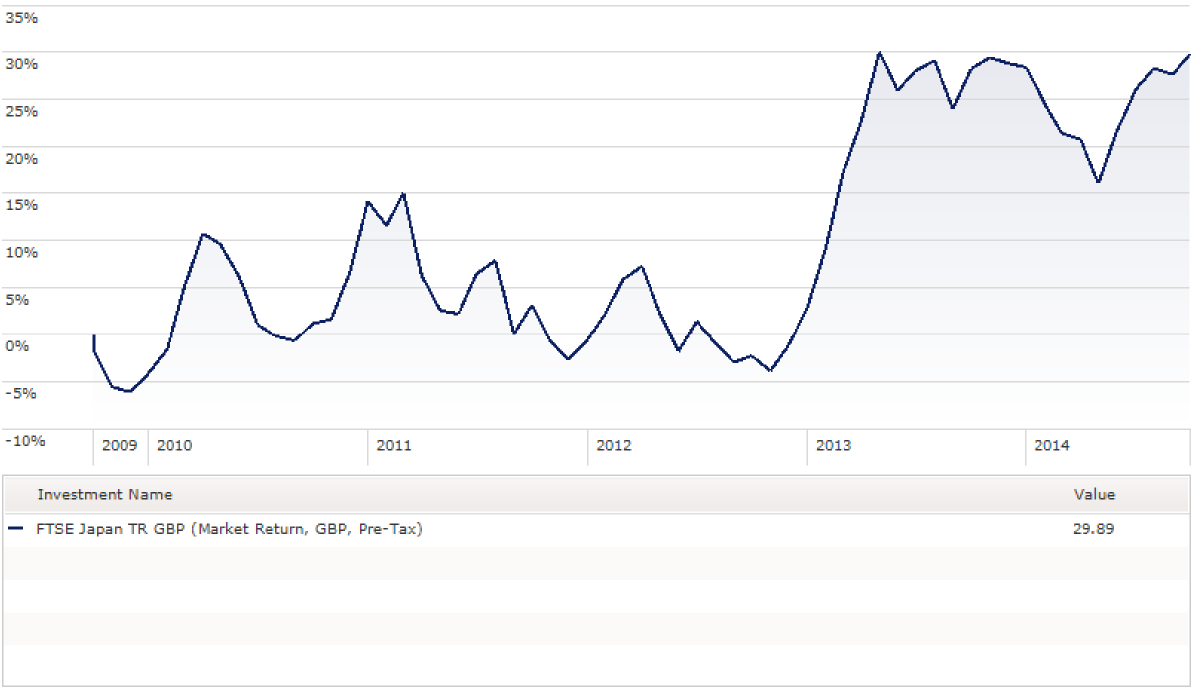
It is worth considering that as the US gets stronger, some economies will struggle especially commodity based economies like Brazil and other Latin American countries so Brazil has a lot to do.

Away from the obvious Algeria and Romania are two standout economies. Touching on Romania it weathered the sovereign debt crisis that hit the Eurozone as well as the more recent events in the Ukraine. GDP rose by 3.8% on a year by year basis making it one of the fastest growing economies in the EU. Interest rates and unemployment are low and disposable income is growing. The country is positioned well.

Although emerging markets and Asia appear cheap it does vary between economies and those that are good tend to be more expensive than those that are poor. In summary stock picking is how money will be made in the region with a careful eye on the macro impact.

JAPAN

<u>Five year returns 1 October 2009 – 30 September 2014</u>



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The three arrows of Abenomics have been fired….

The first two arrows targeted fiscal stimulus and monetary easing, and the third structural reforms.

Economic data has been volatile, with household spending falling in response to an increase in sales tax in April and the economy contracting by an annualised 7.1% in the second quarter of this year. Looking through the short-term volatilities however, the economy appears to be stabilising and recovering moderately.

Structural changes were never going to be achieved overnight.

Positives include inflation generated with prices on an upward trajectory, a lower yen, the biggest rise in wage figures since 1997 along with strong employment data, and signs of an improvement in business confidence.

Economic growth estimates are starting to move higher, with Goldman Sachs forecasting real GDP growth of 1.0% for the year and increasing to 1.5% through to 2017.

In summary patience is key but everything is moving in the right direction.

CONCLUSION

With the UK and US moving to raising interest rates and economies growing we are for the first time in several years starting to see a divergence between economies and their economic growth paths. The implications for investors are complicated and there are many challenges both in the UK, Europe as well as the Middle East, Russia and the Ukraine and Hong Kong.

There is a belief that although returns will be lower, investors are still being rewarded for taking risk although they will need to accept more volatility and therefore diversification is crucial going forward.

Income assets, especially cash, remain challenging and to achieve higher income may need additional risk. Globally Europe remains fragile and further stimulus is likely to be needed. Japan is progressing as are economies like China, India and Indonesia. Brazil is a place to watch as is Russia.

In summary indicators show lower returns for equities of between 5% and 8%, with more volatility. A number of economies are growing quicker than others. The global risks should be underestimated not should those closer to home.

Source: Charts have been sourced from Morningstar. Other data sourced from Barings, Schroders, Templeton, Threadneedle, Standard Life Investments and JP Morgan. 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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