QUARTERLY MARKET OVERVIEW – OCTOBER 2017

"Investing is simple, but not easy" – Warren Buffett

In this quarterly update I want to explore factors which could change the way we think about the future.

Globally there are many things to consider; these include:

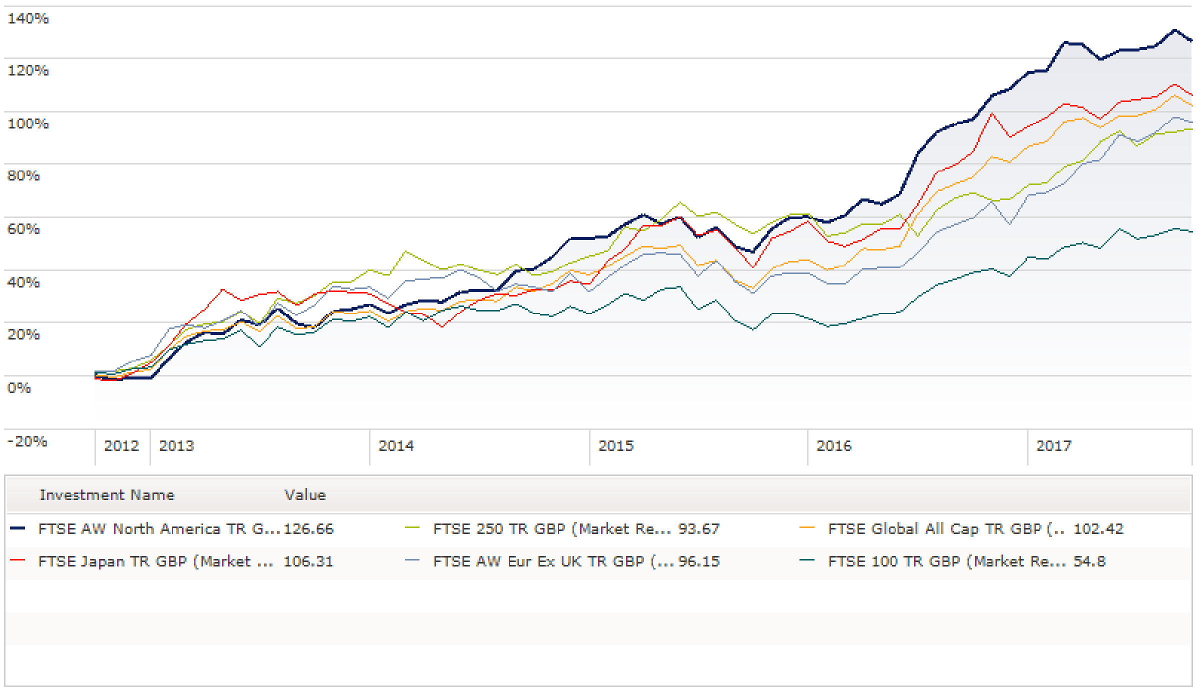
1. Has QE worked? What will happen as the US starts to reverse QE and when will others follow?
2. What impact does Brexit have on the UK, Europe, and the global economy?
3. Are investors missing opportunities in emerging markets?
4. Is North Korea developing a nuclear weapon for war, or to force countries to trade with them?
5. What will Trump do next?
6. Is the demise of Toys R Us a reflection of a changing world?
7. What is the impact of an aging population, and how does this change the long-term outlook?

This is far from exhaustive but it does show that there are many different aspects affecting markets. I believe Warren Buffett summed it up well: "investing is simple, but not easy".

George Ladds
George Ladds, Director, October 2017

DEVELOPED MARKETS

Five year returns 1 October 2012 – 30 September 2017



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.*

There are three factors I want to consider; longevity, destructive influences and monetary policy, and their impact on markets.

Longevity is a challenge particularly in developed economies; in the 1930's on average people spent 16 years in education and 44 years in work in the UK, life expectancy was to age 60. Providing a state pension and a health service for complex health issues was not a problem. Today life expectancy is age 80, with (on average) people spending 13 years plus in retirement, and this is expected to grow.

The over 85's represents the fastest growing segment in the UK population. And just one final statistic: 6 out of 10 over 65's will need care.

This is a challenge across the developed world. There are visible strains beginning to build; there is less tax to provide for the needs of an aging population and in particular health care. Many of the complex health needs were arguably present, but longevity has meant that previously they were less visible, which is now no longer the case. Combine this with a need to provide an income for a longer period in retirement, and consider that in the UK there are over 1 million over 65s now working to supplement their pension income, and you have a ticking time bomb.

In terms of the stock market we would argue this has a self-perpetuating impact. Throughout our working lives we will likely invest in the stock market which drives demand; 30 years (or even only 10 years) ago, at retirement we would use the money we had invested in the market to buy a guaranteed income (annuity) and put the tax-free cash into a savings/cash account. Effectively, we pulled money out of the market producing a natural supply and demand cycle.

Today, there is lower demand for annuities and higher demand to stay invested, which means the natural flow of supply and demand is starting to be impacted; providing some inflation to prices. The longer we live the greater the potential impact. It is also worth adding, there are greater risks relating to the need for income to last longer and in particular provide for future health care.

In the US we saw Toys R Us file for bankruptcy, this seems to be a reflection of a wider trend towards destructive influences. It is a blog I want to explore in more detail but let's take Amazon; they started supplying Books and CDs, today they cover TV, music, cloud storage etc. There is very little that Amazon does not provide and this has an impact on many businesses. With their latest smart devices, you have to question how long the likes of Netflix and Spotify can last.

The big question is how do you value a business like Amazon; their Web Services (cloud) are possibly more valuable than any other part of their business. When economists talk about the markets being expensive or above average this is based on the past. We would argue that new technology means that valuations moving forward will be different, especially when considering companies like Amazon.

But are all new businesses worth the premium? Tesla for example, is a pioneer in electric cars but the challenges with electric cars are numerous. Of course, they are better for the environment but the reality is that to mine lithium is highly destructive; disposing of lithium is not easy and one crucial factor is that if all cars became electric, how would the national power grid cope with the increased demand? You would need more power stations to supply the electricity needed. Crucially with a business like Tesla the question is why would you buy a Tesla and not a VW or Toyota; there is no creative difference. Perhaps, a better investment is the technology that is used across these companies. However, the main point is that similar to Amazon these changes are destructive, not only to other businesses but also in how we value the stock market.

Turning to monetary policy. There will be debates for years to come as to whether QE worked. The reality is that in the US the Fed have never dug an oil well, they didn't develop a new business and it is things like this that build an economy not QE. Much of the money created boosted bank reserves but was never loaned out. The US Federal Reserve will start unwinding their $4.5 trillion balance sheet this month. It will start slowly with an initial $10 billion of Treasuries and mortgage backed securities being allowed to run off per month. However, this will step up by $10 billion every three months until it reaches $50 billion per month.

But whilst the Fed has started this process, other central banks are lagging behind. The Bank of Japan and European Central Bank are still fully engaged in the process. There is an expectation that the ECB will step down its asset purchases next year.

In terms of interest rates, we now expect the US to raise rates to circa 2.75%; putting this into perspective, in 2012 the "new normal" was expected to be 4.25%. It has come down a fair amount since then. But what about the UK?

The Bank of England has been nicknamed the "unreliable boyfriend"; logic and data would suggest the economy is fragile at the moment and there is enormous uncertainty with Brexit. The latest comments from Jean Claude Junker about David Davis are not promising. However, the Bank of England has now hinted strongly that rates will rise in November.

We are not alone in our view that the Bank of England might be wrong when it comes to interest rates. The UK economy did bounce post-Brexit but we think this was caught up in a global bounce, and where many developed economies are likely to grow by 2% to 3% the UK is stuck around 1% and could easily dip into recession.

For many consumers the squeeze is already present with below-inflation wage increases, and household budgets coming under pressure with rises in the cost of food and fuel. Although an initial rate increase will be small it will have an impact; the UK housing market is already wobbling and there is no fix for this. There have been a number of factors which have worked against the housing market and a raise in rates will add to this.

A move by the Bank of England will simply make things worse. For most of us our wealth is tied up in the home we own; if the value of that goes down we naturally feel poorer and there is evidence that this impacts how we feel about state of the economy. We are already seeing small signs of strain with a slowdown in car sales. What may seem obvious to us perhaps shows a disconnect between the Bank of England and real people; the general view is that they have backed themselves into a corner and they have no choice but to raise rates. Obviously, they could delay but this could impact the markets faith in the Bank of England and ultimately damage the already fragile value of sterling.

Sticking with the UK briefly we have seen companies like Astra, Provident Financial, AA, Dixons, Pearson announce profit warnings. One profit warning seems to be okay but further profit warnings can see a collapse in share prices and even dividend cuts (see Provident Financial for evidence). It is fair to say we remain pessimistic about the UK even without even mentioning the political uncertainty we face.

Having a look across the developed economies, Japan remains of interest. A snap election is a shrewd move whilst the opposition seems non-existent. There are positives signs; both equities and residential property are below their 1989 highs and it has been through a protracted period of stress and false starts. To get things moving it has become one of the most indebted countries. And we shouldn't ignore the problems of an aging population.

But is there a turnaround happening; the big change was the Corporate Governance Code in 2015. We are starting to see a focus on profitability, independent directorships and we expect dividend pay-outs to increase. Generally, the outlook seems positive. One thing to consider (and rumours are dangerous), there are suggestions that Abe is ill and needs the election to enable a successor to be appointed. If this is true then everything could change.

We touched on monetary policy in the US. There are several factors which seem to be missed by economists. Currently there is around $3 trillion of cash held offshore. We expect tax changes to enable this money to come back. When this was last done 75% of cash came back to the US. We don't expect it to come back at this level but even a small amount will make a significant difference.

Secondly technology is having an impact especially in areas which many are ignoring for example media, financials and the shale industry. We expect that more manufacturing industries will embrace technology and this will be another boost to the economy. The third area is millennials; by 2020 this is expected to be half of the US working population. Where many have rented this has now shifted to buying.

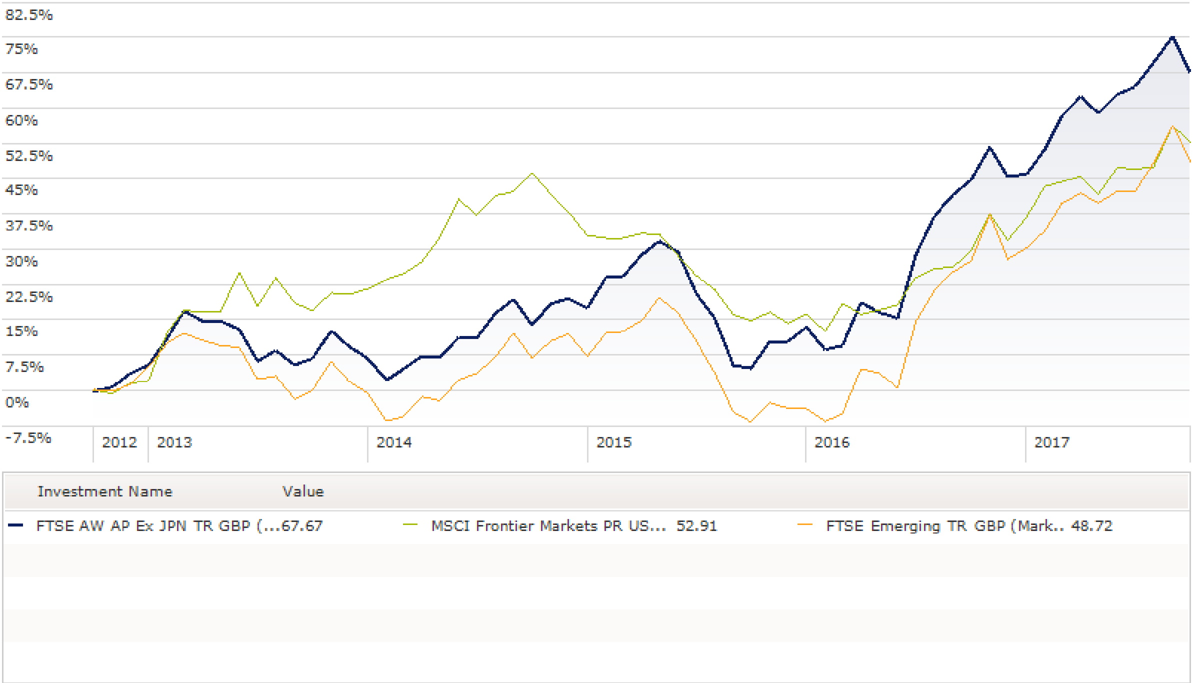
Away from the US and turning to Europe, there are challenges but corporates are posting strong earnings growth. Political concerns have slowed although Italy is one to watch. The German election may slow momentum to strengthen the eurozone. The key in Germany is how the coalition is built and we are monitoring this.

We believe the Eurozone will be impacted by any deal over Brexit. Ultimately all this posturing by Junker and Davis is not helpful and we believe that it may be corporates that break any deadlock for their own self-interest. Having said all of that, we believe Europe is in a much stronger position than the UK.

In summary, longevity, destructive influences and monetary policies will have an impact on everything we do and how we view the market. Of all the main developed economies the UK is certainly the most fragile and the Bank of England’s latest move seems foolish. The US is moving to a more normalised world (whatever that is) but there are still some great opportunities. Europe seems “free” from political uncertainty for the time being and mixed with positive economic data should be strong moving forward. We expect Abe to win the election but if the rumours are correct, then we have to ask what impact this might have in the not too distant future.

EMERGING, ASIA AND FRONTIER MARKETS

Five year returns 1 October 2012 – 30 September 2017



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.*

I want to start by looking at North Korea; there are real concerns over the development of a Nuclear warhead, the question is, is he mad or is he shrewd?

Of course, the same could be said of another political leader! One interesting thought on this; what if this is about trade, the ultimate bargaining tool is a Nuclear warhead. Unless he is mad he knows ultimately no-one will win by firing a weapon of mass destruction, but it can bring people to the table and that could massively change the economy particularly if sanctions can be lifted and trade starts to flow.

In terms of emerging markets there is still a view of old industries and exporters of cheap goods. But this is changing with highly innovative technology from hardware to software to various forms of e-commerce and entertainment.

When we talk about disruptors, some of technology driving change is coming from emerging markets and Asia. Autonomous driving is a good example where many producers of components and the infrastructure to make it a reality is located in emerging economies especially Asia. These are companies developing sensors, cameras etc. I also recently read that one popular mobile phone (I guess Apple) has 80% of its components made in emerging markets. When we consider electric cars, there are no points for guessing who are the leaders in battery technology.

Where many developed economies are struggling with an aging population the reverse is true in many emerging economies. Internet presence is massive compared to developed economies and many young people are shunning bricks and mortar shops to buy goods online. The new middle class is very different to that of developed economies.

China's "internet plus" strategy aims to increase digitalization across the economy, and increase the presence of internet based businesses globally. But it is not just China.

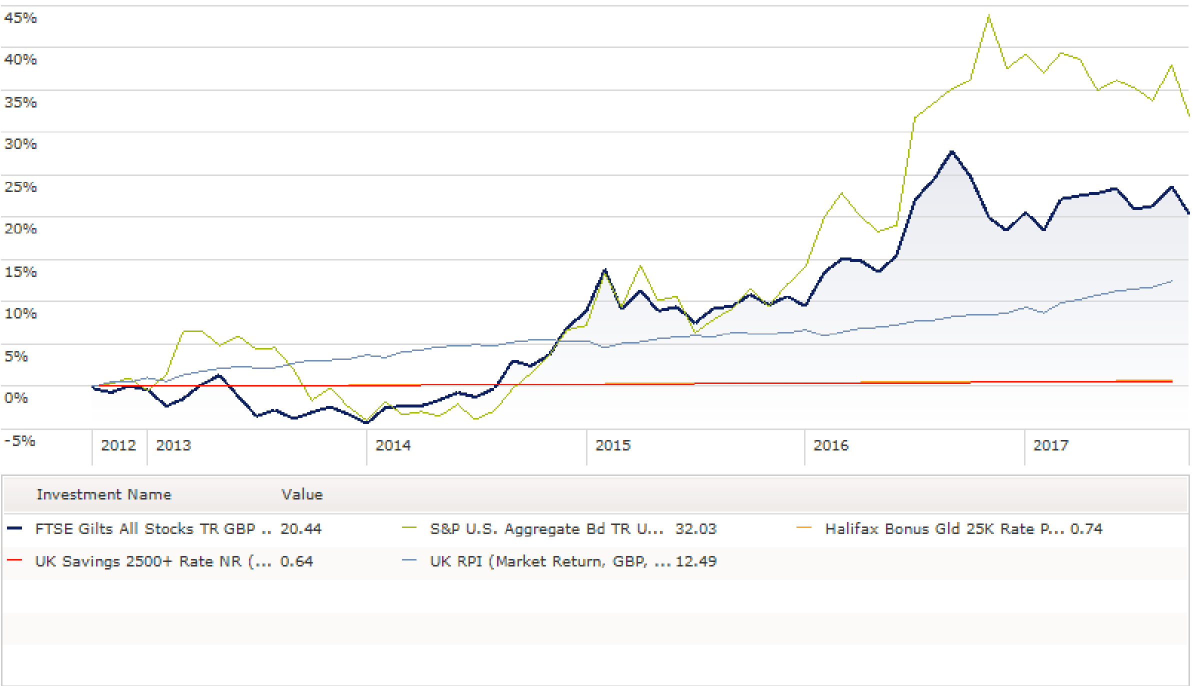
Research recently showed that a 1% increase in internet penetration in Indonesia would significantly increase jobs through the creation of new industries and working patterns. It is through this development that more disruptive developments come and this impacts all of us.

Interestingly there is a very different attitude in many of these economies to do well. Research in 2013 showed that 2/3rds of people in the UK and the US thought their children would be worse off than them. Whereas in China 82% thought they would be better off and Brazil 79%. Other countries that felt their children would be better off included Chile, Malaysia, Venezuela, Indonesia, Philippines, Nigeria, Ghana and Kenya.

Of course, there are challenges facing these economies particularly fiscally and politically but this needs to be put against a younger more ambitious population and innovative technology. In summary, growth remains strong and we believe long term the story remains. North Korea is something to watch and it will be interesting to see if it plays out in the way we think (and hope).

CASH

Five year returns 1 October 2012 – 30 September 2017



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.*

I want to change the thinking around cash. Yes, it appears interest rates are going up even though we think this will be a dangerous move. The reality is that this is not going to suddenly deliver amazing rates of return for cash.

The way we view cash needs to change because of what we said at the start. We expect to live into our 80's, and those over 85 are the fastest growing segment of the UK population. The idea that at retirement we move everything to cash has gone. Our money has to work for us and it means taking some risk with our investments.

The reality is that if the timeline for investment is 15 years plus then investing in the market is not that risky. Money in retirement has to work for us whether to help provide an income, provide money for care or simply be used to pass onto our children.

As an example, if we had £100,000 invested in cash for the last ten years the **real value** (i.e. after inflation) would be £86,000 if we assumed inflation of 2% and interest of 1%. Invested in the market with a 5% return and 2% inflation would be £146,000 in real terms (again after inflation).

Of course, we all need to hold some cash for essentials but large sums of cash will simply be eroded over time by inflation. The counter argument is that cash is safe and stock markets are volatile. This is true. Markets will go up and down and we can never guess when this will happen. Timing the market is proven to be fruitless but what we do know is that when markets go down they will almost certainly go back up. If we look at 2001 within 2 years the markets were back up, in 2008 and 2011 it was within 12 months. With a 15 year plus time horizon this shouldn't be a concern.

However much we write about this, ultimately journalists and politicians need to endorse the message because people will not change their outlook unless this happens.

CONCLUSION

I think I am cautiously optimistic about the global economy. Coming to the realisation that to ignore the economists is a good thing. For them to judge the state of the market on past data seems baloney.

We can see opportunities in the US, unless of course Trump does something destructive! Away from the political concerns in Europe investors are focusing on the fundamentals which are positive. We remain optimistic about Emerging Markets and Asia which seem to be at the forefront of rapid technological change which will impact our lives.

The UK is a problem child and we feel strongly that the disconnect between politicians and the Bank of England will do harm. Raising of interest rates has the real potential to push the UK into recession and it would be no surprise if this happens over the next couple of years.

In summary, whatever we hear about the value of the markets it is worth factoring the impact of longevity, technology and economic policies because we think this paints a very different picture.

Source: Charts have been sourced from Morningstar. Other data sourced from BBC, Fidelity, Standard Life, BlackRock, Schroders, Neptune, Templeton, Hermes and JPMorgan. 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.