INVESTMENT COMMENTARY

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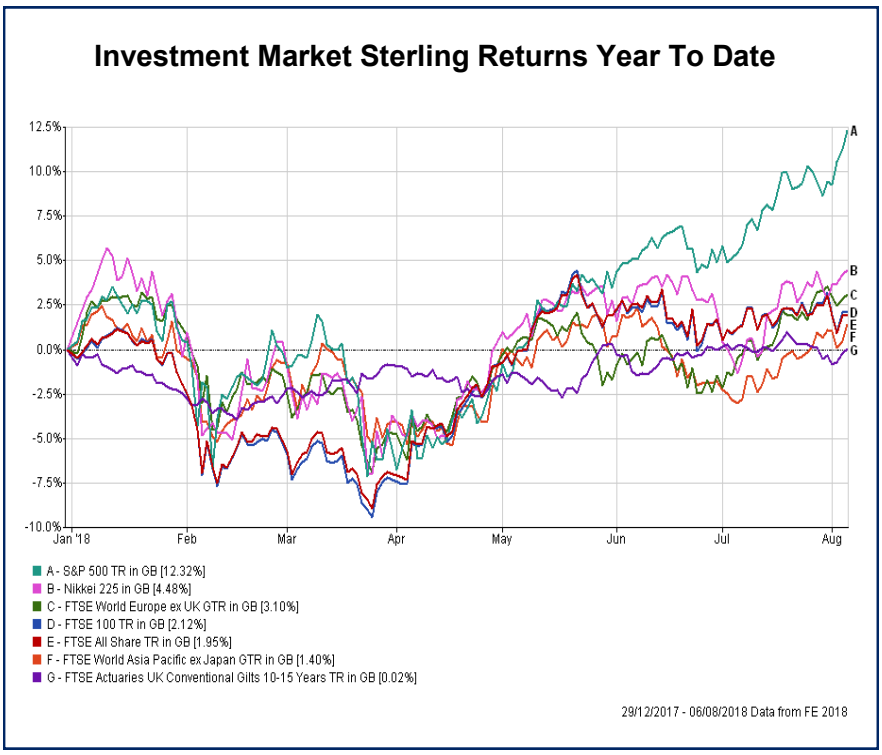
It is now over six months since equity markets fell sharply on the fear of larger and faster rises in US interest rates than projected. Investment markets are showing positive returns since the start of the year, despite these falls, with the US equity market accelerating upwards in particular. The US equity market appears to be taking tighter monetary policy and the escalation in trading tensions in its stride. President Trump's tax breaks are supportive of corporate profits. Conversely, the threat of trade wars is still weighing on sentiment in China and Asia Pacific markets in general, as well as in Europe. The major economies still continue to expand albeit at a slower pace. The US Federal Reserve (Fed) is leading the way by increasing interest rates, against a backdrop of a healthy US economy. The Bank of England (BoE) has recently increased rates for only the second time in ten years, whilst the European Central Bank (ECB) also continues to rein back its monetary stimulus. Only the Bank of Japan (BoJ) appears to be maintaining looser monetary policy, as low inflation still remains a challenge in that economy. As a general point, the price of copper (of which China consumes around half the global supply) has fallen 17% since June. The copper price can indicate softness in the global economy as it is used across a broad range of manufactured goods, particularly those involved in developing infrastructure. A falling price may also reflect increased supply.



UK

The BoE's Monetary Policy Committee (MPC) voted 9-0 to increase Bank Rate by 0.25% to 0.75%. The Q1 weak economic growth is seen as a blip due to the bad weather in February and March. Q2 Gross Domestic Product (GDP) grew by 0.4% from 0.2% in Q1 and is expected to stay at a similar level for the next two quarters. GDP growth of around 1.7% is expected for 2018. Inflation remains at 2.4% pa Mark Carney, the Governor of the Bank of England, commented that future rate increases would be "gradual" and "limited", with the shape of Brexit having a bearing on future moves. He predicts that interest rates should end up at between 2% and 3% to support UK economic growth in the longer term. Wage rises are expected to add to inflationary pressures as the jobs market remains tight. The MPC is now turning its focus to inflation control. Sterling has weakened recently as worries persist about the terms upon which UK/EU trade in goods and services will continue post-Brexit.

EUROPE

German industrial production fell in June by 0.9% which was worse than expected. Factory orders plunged by 4% in June too. German exports were flat in June, while imports rose by 1.2% to reach the highest monthly value since records began in 1950. The deterioration in EU/US trade relations is impacting on the EU's largest exporter. After what appear to have been constructive talks between President Trump and Jean-Claude Juncker, the President of the European Commission, it has yet to be seen if the US definitely steps back from further tariffs and perhaps reduces the current ones.

The ECB did not alter interest rates nor its asset purchase programme at its latest meeting. Mario Draghi, the President of the ECB, was relatively upbeat about the European economy pointing to a "solid and broad-based growth path". Rates could rise as early as June 2019 – previously September 2019 had been expected. Eurozone economic growth in Q2 was 0.3%, which was lower than predicted. Weaker manufacturing figures were common across the region. Unemployment in the eurozone has fallen to 8.3%, the lowest level since December 2008. Inflation was running at 2.1% pa in July, a slight increase from 2% pa in June. As oil price increases fall out of the figure, the inflation rate is likely to fall.

US

The US equity market is almost back to record highs of January 2018 (in US dollar terms) despite increasing interest rates, the threat of retaliatory tariffs by the Chinese and the re-imposition of sanctions on Iran after President Trump withdrew from the Obama-era nuclear agreement. US economic growth has risen at its fastest rate since 2014; Q2 growth is at 4.1% pa. Consumer spending increased by 4% and exports surged in order to beat newly introduced trade tariffs. Core inflation (excluding food and energy) is at 2%. Worryingly, housing investment is down 1.1% in Q2 (down 3.4% in Q1). At its August meeting, the Fed left interest rates unchanged at the range of 1.75%-2%, as largely expected. It commented that economic indicators are "strong". This was a change from the previous wording of "solid". Against this robust economic backdrop, two further rises are expected in 2018, probably in September and December. The shares of US mega-tech companies and the technology sector overall have experienced some weakness recently, as sales growth slowed for both Facebook ($120 billion was knocked of its value in one day) and Netflix. However, good revenue growth from Apple saw its value break the $1 trillion level and led to more positive sentiment towards the sector. The Q2 earnings season has generally been a good one for the more than three-quarters of S&P 500 companies that have reported so far.

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ASIA PACIFIC

With the threat of the US increasing existing trade tariffs from 10% to 25%, China has threatened counter-measures of imposing tariffs on $60bn of US imports. The Chinese stock market has been negatively impacted, as have the Asia Pacific region's equity markets as a whole. Currencies fell across the region as the US dollar strengthened. There is now a growing disparity between US and Chinese monetary policy, as the US continues to raise interest rates. The Chinese yuan is at its lowest level against the US dollar since May 2017. The Chinese services sector grew at a slower rate in July but is still expanding. However, when considered alongside the indicators for the manufacturing sector, the composite reading shows a muted rate of expansion - which could tip into contraction in the near future. The manufacturing sector looks to be softening with new export orders falling at their fastest rate in two years. The Politburo has indicated that official policy stance has moved towards one of loosening policy to support short term growth. The authorities have injected cash into the market and tax cuts introduced. The Bank of Japan (BoJ) shifted its asset purchase programme, doubling the level to which it will allow 10 year yields to climb from 0.1% to 0.2%. Therefore the BoJ will purchase bonds to suppress the yield. It will continue to buy ETFs but now linked to broader Topix index rather than Nikkei. Its aim is to get inflation to around 2%. The Japanese stock market has regained its status as the second largest market in the world due to the Chinese equity market falling 17% since the start of the year with $2.29trn knocked off its value. The Japanese market is down 4% with the yen up 1%. Japan's service sector expanded at a steady pace in July with new business and jobs growth at a four-month high.

COMMERCIAL PROPERTY

The UK commercial property market continues to attract a diverse and active investor base, with interest still strong from international purchasers of London properties. Domestic institutions and private equity houses have been more aggressive in the logistics market. Structural changes in the occupier market, linked to changes in the retail sector and rising demand for logistics capabilities are shaping occupier decision making. Online shopping is changing the way retailers operate and high street brands have to adapt or fail. Investors continue to favour a lower-risk approach focused on high-quality properties in sought-after locations, occupied by financially strong tenants. The exception to this is where favourable demand/supply occupier market dynamics support a selective approach to letting with some value in short leases and development opportunities.

EMERGING MARKETS

Sentiment towards emerging markets had been negatively affected by the ongoing tensions over trade tariffs. This said, emerging markets performed relatively well in July when it appeared that the US/EU trade tensions were easing. Nevertheless, the US is talking of imposing more tariffs on China as well as Russia and has now re-imposed them on Iran, so markets are likely to remain volatile. Russia has seen inflation remain low at 2.3% with the expectation it will increase to the 4% target in 2019. Its central bank has kept interest rates at 7.25%. India has seen economic indicators pick up with the services sector particularly strong. The Reserve Bank of India increased interest rates by 0.25% to 6.5%. Presidential candidates are currently being selected in Brazil ahead of the October election. The next government will be faced with the challenge of reforming the pension system, which adds an unsustainable 3% of GDP to the national debt stock every year.

FIXED INTEREST

The first half of 2018 has been a difficult period for fixed interest assets against a background of rising interest rates and inflation, especially in the US. Yields on 10 year US government bonds (Treasuries) have gone through 3% on a few occasions with investment grade spreads moving wider. Global monetary policy is diverging with US interest rates increasing. UK rates are on an upward trend currently, whilst both European and Japanese

FIXED INTEREST continued

rates are unchanged. The threat of a trade war has impacted on corporate bond spreads as it increases uncertainty for companies. High quality government bonds will continue to provide "safety" in times of equity market uncertainty which the ongoing imposition of trade tariffs by the US stimulates. The gradual withdrawal of quantitative easing in Europe will have some impact on bond demand and therefore prices. Whilst economic growth continues to be positive, high yield bonds should perform relatively well.

OUR VIEW

The US continues to dominate the global economic agenda. President Trump knows that the US is the world's most important customer; as a businessman he takes the view that it should behave like it. The US exports only 7% of GDP with many of its exports not easily substituted from other suppliers. The Chinese tariffs imposed on US soya beans and other products are a pin-prick – after all, a tiny fraction of the new tariff revenues from imports will subsidise the soya farmers, if necessary. Vast agricultural subsidies are not big news in the US. There are rumours of domestic political unrest in China too, as President Xi Jinping's muscular foreign policy offends his nation's most important customer and China's economy slows.

We have previously warned of over-valued media/tech stocks in the US and have sought increased refuge in more defensive areas of the equity market. Clients are not therefore over-exposed. Despite undoubted corporate strengths, German business is beginning to suffer the consequences of trade tensions. Therefore, we have realised some of our considerable profits from German equities whilst maintaining core exposure in the firm belief that German business will continue to perform over the longer term. As a defensive measure, exposure to Europe has been or is being reduced in favour of increased US exposure. We reduced Asia Pacific and emerging markets exposure some time ago, largely in favour of Japan.

Our Sterling investors have large positions in UK equities but the rewards have been varied of late. The commentariat likens the UK's position as the EU's largest customer to 'fake news', refusing to accept the UK has any position from which to negotiate with the EU. Whichever side of the EU debate one sits on – both sides have strengths in their positions - ultimately mutual political pragmatism will ensure that a deal is done in some form. Business despairs on the sidelines, unable to make long term plans whilst such uncertainty persists; this is affecting sentiment towards the shares of UK domestically-oriented companies which remain unloved assets presently.

We suspect that the UK economy is growing more quickly than official figures suggest because the employment figures, those for tax revenues and certain other indicators all suggest an economy that is growing at a reasonable rate. Virtually any 'Brexit' deal will propel markets upwards whilst ongoing uncertainties create a see-saw effect.

In both global and domestic terms, investors are less confident than they were – with strong flows into less risky asset classes. There are many who **hope** President Trump and his policies are a Force 9 disaster soon to release a vile tempest on the US and hence the World. Others **fear** it may be the case. There are no certainties but the sun seems likely to shine on the US and its corporations for some time yet. European and Japanese companies are really doing rather well; their growth may have slowed, but the global economy is still growing and domestic demand in their home markets relatively stable. China is increasingly a worry. The government is correctly focussed on stimulating domestic demand, but all arms of government and much of corporate China are now too heavily indebted. With the US refusing to play ball, China cannot so easily export its way out of danger. We fear a global problem could arise in China/Asia Pacific and to a lesser degree, from certain highly indebted emerging market economies. It is definitely time to rein in excess risks within portfolios for all that fair returns may still be achieved.