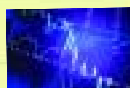
HFM COLUMBUS
Asset Management Ltd

Investment Strategy

Fourth Quarter 2017

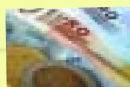
Overview



General - The recovery in synchronised global growth remains intact with Europe and Japan surprising on the upside. Global inflation is peaking following the stabilisation in energy costs. Interest rates are set to remain low though Central Bank rhetoric has become more hawkish and we sit on the cusp of a tightening cycle, albeit a long and shallow one. UK growth set to slow as household disposable incomes fall. There is the likelihood of an interest rate rise should inflation remain stubbornly high. Geopolitical concerns have swung away from Europe towards the US where Trump remains a loose cannon. Equity markets remain a tug of war between improving fundamentals but expensive valuations. The key supports for risk assets remain intact; economic growth and corporate earnings have been accelerating whilst global inflationary expectations have waned. However, we are feeling increasingly cautious as a lot of this good news is already discounted in share prices. Government Bonds are moving sideways; deflation fears have eased but we are not entering a sustained cycle of robust economic growth. The significant tightening in spreads over the last 18 months has whittled away the value in Investment Grade and High Yield credit. Commercial Property remains resilient but is a yield rather than a capital growth story at this mature stage of the cycle. Valuations across all asset classes remain high which is likely to suppress portfolio returns in the coming years. The euro has been the strongest major global currency this year and the US dollar the weakest. Sterling rallied last quarter. Gold strengthened to US$1300oz. whilst Oil rebounded to a two year high approaching US$60/bl. *Page 3.*

United Kingdom - Brexit negotiations, the bounce in the sterling, sticky inflation, a possible rise in interest rates and question marks as to the sustainability of economic growth are all headwinds to the market. Companies need to deliver the forecast double digit earnings growth to keep the market on an upward path. *Page 7.*

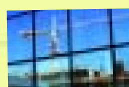
United States - The economic outlook is still set fair and double digit earnings forecasts are the strongest for several years. Nevertheless, the valuation continues to look stretched so companies need to deliver what they are promising. Trump, as always, remains a wild card. *Page 8.*



Europe - Europe is turning into the great recovery story. The political clouds are clearing, the economy is finally looking in better shape, and the ECB remains supportive. Most importantly, earnings growth should be strong as revenues rebound and margins expand whilst valuations are not yet overly stretched. *Page 9.*

Emerging Markets, Asia and Japan - The EM and Asian equity markets continue to produce strong returns propelled by improving global growth momentum and double digit earnings forecasts whilst Japan is seeing an unexpectedly strong economic and earnings bounce. These markets remain best suited to higher risk/reward investors with a long term time horizon and acceptance of a high level of volatility. *Page 10.*

Fixed Interest - We expect Government Bond yields to continue tracking sideways in 2017, though the long term direction of travel is upwards as global economic momentum improves and Central Banks take small and tentative steps away from their super-loose monetary policies. The significant tightening in spreads over the last 18 months has whittled away the value in Investment Grade and High Yield credit. *Page 11.*

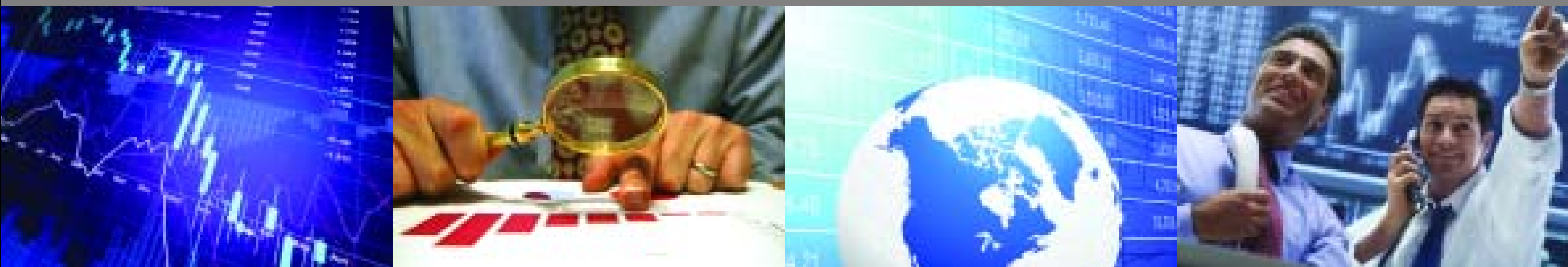


Commercial Property - The commercial property cycle has become increasingly mature and returns will be considerably lower than in recent years, driven almost entirely by rental income rather than capital growth. The asset class continues to be resilient and we expect annualised total returns of around 5% for the next few years. *Page 12.*

Commodities - As reflationary hopes have faded in 2017 so too has the fortunes of both physical commodities and mining and energy company shares. Neverthess, both Oil and Gold bounced in the last quarter which prompted a rally in share prices. *Page 12.*

Currencies - Stronger growth and improving politics have boosted the euro whilst muted US inflationary expectations, a more dovish Fed and of course Trump have had the opposite effect on the greenback. Sterling rallied strongly at quarter end, boosted by the possibility of a rise in UK interest rates. *Page 13.*

General Market Review



Summary:

- The recovery in synchronised global growth remains intact with Europe and Japan surprising on the upside.
- Global inflation is peaking following the stabilisation in energy costs.
- Interest rates are set to remain low though Central Bank rhetoric has become more hawkish and we sit on the cusp of a tightening cycle, albeit a long and shallow one.
- UK growth set to slow as household disposable incomes fall. There is the likelihood of an interest rate rise should inflation remain stubbornly high.
- Geopolitical concerns have swung away from Europe towards the US where Trump remains a loose cannon.
- Equity markets remain a tug of war between improving fundamentals but expensive valuations.
- The key supports for risk assets remain intact; economic growth and corporate earnings have been accelerating whilst global inflationary expectations have waned. However, we are feeling increasingly cautious as a lot of this good news is already discounted in share prices.
- Government Bonds are moving sideways; deflation fears have eased but we are not entering a sustained cycle of robust economic growth.
- The significant tightening in spreads over the last 18 months has whittled away the value in Investment Grade and High Yield credit.
- Commercial Property remains resilient but is a yield rather than a capital growth story at this mature stage of the cycle.
- Valuations across all asset classes remain high which is likely to suppress portfolio returns in the coming years.
- The euro has been the strongest major global currency this year and the US dollar the weakest. Sterling rallied last quarter. Gold strengthened to US$1300oz. whilst Oil rebounded to a two year high approaching US$60/bl.

In the Peleton

Summer normally finds me in California or Cape Cod, San Francisco or Boston, sun and surf, burgers and baseball so I was somewhat bemused to find myself instead cycling 350km down the Danube towpath form Passau to Vienna with my daughter Izzy, a formidable domestique, and the missus, a plucky lanterne rouge. My pre-cycle scepticism proved groundless; the scenery was glorious, the sun was baking and the metronomic rhythm of the pedals gave me time to ponder as to which was the best decade for pop music, choose my favourite 5 films of the 1980s, and deliberate over the extended cycle (get it?) in global stock markets.

Coming back from a holiday gives the opportunity for a big picture 'fresh look' at markets before being

bogged down in the day to day noise. My 'fresh look' this time was a nervous one as the background is unusual and the outlook uncertain. Unusual because of Central Bank monetary policy and the debt accumulation, globalisation and technological disruption of the last decade; uncertain because of high asset price valuations and geopolitics. We are not bearish; we just think it is going to be hard to achieve decent returns in the next few years. A lot of good news is already priced into equities which limits the upside, but with economic and profit growth still looking supportive then nor is there an obvious reason for a sharp fall. Rising inflation or falling earnings expectations will be red flags but at the moments neither is flying. Similarly, with growth neither disinflationary nor reflationary then Bond yields should continue to mark time around current levels. Our concern is that fundamentals need to remain supportive just to eke out gains, should they turn south then there is risk of considerable capital loss.

Macro….When the doves cry

The growth outlook remains pretty supportive in the medium term with Europe and Japan surprising on the upside and Asia and the Emerging Markets also looking perky. US growth has been a bit underwhelming however and hopes of a reflationary 'Trump bump' have all but disappeared. Central Bank monetary policy is still very supportive, though crucially the rhetoric is starting to become distinctly and purposefully more hawkish. With the global economy late cycle and the huge accumulation of global debt then interest rates will continue to remain very low by historic standards. However, there is a marked change of emphasis with at least the beginning of a 'normalisation' (i.e. tightening) process underway, though this will be a gradual and drawn-out process stretching over many years. The US Federal Reserve Bank is signalling further small interest rate rises in the coming quarters alongside a strategy of 'unwinding' its balance sheet by slowly running down the $4.5trn worth of Bonds purchased under the quantitative easing programmes since 2008. The ECB is will also be very conservative when eventually it begins the anticipated 'tapering' of its QE programme by buying less Bonds per month going forward. The UK is a bit of a special case with a more persistent inflation problem following the big fall in sterling post the Brexit vote last summer and the BoE is now signalling a possible 0.25% rise this quarter should the inflation numbers remain stubbornly high.

The change in global Central Bank policy has been well signalled and Bond yields look set to remain stuck in their current tight ranges with equities remaining the asset class of choice with dips still being bought irrespective of how expensive they look. And therein lies the rub, I can understand why investors, including ourselves, have continued to buy equities on an 'economies and markets will muddle through' basis but buying increasingly expensive asset classes is not a one way street and at some as yet unidentified point there will be tears before bedtime. With equity market P/E multiples looking stretched investors need to keep an eagle eye on earnings growth as this will be the main driver of share price returns. After several years of stagnation, growth expectations this year have been buoyant and thus far companies are delivering. In the US Q2 earnings season S&P500 companies delivered growth of 10%, whilst the Q2 season produced growth of around 12% in Europe and Asia and a whopping 20% in Japan. So far so good but comparisons with 2016 are flattered by the big bounce in Energy company earnings and with expectations so high there is scope for disappointment. Global earnings revisions have been pleasingly stable this year but are just beginning to point lower which is a trend that needs careful monitoring given the expensive valuations on which equity markets trade. Thank you as always to Schroders for their latest batch of consensus economic forecasts which compared with last quarter show a small increase in global growth expectations and a small fall in inflationary expectations.

	2017 GDP	2018 GDP	2017 CPI	2018 CPI
World	3.1	3.1	2.2	2.2
US	2.2	2.4	2.0	1.9
Eurozone	2.1	1.8	1.5	1.3
UK	1.6	1.4	2.7	2.6
Japan	1.6	1.2	0.5	0.8
Emerging Markets	4.9	4.9	3.2	3.2
China	6.8	6.4	1.6	1.9

Markets

The Equity and Bond markets have enjoyed a quiet summer, notwithstanding a few geopolitical wobbles centred on North Korea, with broadly supportive economic and corporate fundamentals. By and large the strong gains made in the first half of the year have been held onto, and in some markets added to, with Europe, Asia and the EMs particularly strong whilst Tech stocks across the globe continue to ramp up huge gains. Economically we are in Goldilocks territory 'not too hot, not too cold' but there were three bears in this fairy tale as well and it is unlikely that everyone will always live happily after ever after. Markets face the headwind of expensive valuations in pretty much all asset classes and, in the case of equities, leave little room for disappointment should earnings momentum not be sustained. Market dangers are predominantly two fold and, in a challenge to portfolio construction, are about as likely as each other. Scenario one is growth and earnings disappoint, inflation is subdued and we return to a deflationary environment which is challenging for equities but good for Bonds; scenario two is growth, earnings and inflation surprise on the upside and Central Banks accelerate their tightening, definitely bad for Bonds and a mixed blessing for equities, bad for some sectors, good for others. A third scenario is less likely but the worst case: 'stagflation' with stagnant growth but rising inflation, which would be bad for both equities and Bonds.

A fourth scenario is less to do with the economic and business cycles and is the risk of a terribly damaging left-field 'black swan' such as Lehman in 2008 which by its nature is unpredictable and hence difficult to build portfolio insurance against. The only way to properly protect against a 'black swan' is be very defensive at all times but in doing so there is potentially a huge lost opportunity cost in terms of missed market returns while you have been sitting in cash gnawing at your fingernails. This is something many investors have been doing since 2008 by running for the hills at the sight of any trouble, be it assorted crises in the Eurozone or the Russian invasion of Crimea. Distinguishing between what in retrospect was a black swan rather than just a red herring is well-nigh impossible, North Korea currently an example par excellence.

The ones you love…

….always hurt you the most. The typical UK Equity Income fund used to consist of Banks, Oils, and Tobacco companies, huge cash rich companies pumping out dividends of 5% year after year. The 2008 financial crisis put paid to Bank dividends and in just a couple of days in July the dividends of the two other equity income stalwarts, Petrol and Cigarettes, suddenly look a bit more questionable. With another dividend paying stalwart the pharmaceutical giant AstraZeneca falling 15% in a day when its blockbuster cancer drug 'Mystic' disappointed in a trial this was certainly a black month for the much beloved UK Equity Income funds. Coming at a time when FTSE100 dividend cover has declined to a meagre 1.5x with food retailers and miners having cut dividends in previous years this is all a bit depressing.

Government attitude to the tobacco industry has always been a balancing act between revenue collection (tax on fags) and healthcare. The pendulum has now tilted in favour of health with the American FDA saying that cigarettes kill and they are going to enforce lower nicotine levels, making cigarettes less addictive. Tobacco companies are now firmly in the cross-hairs of regulators and legislators, putting their existing business models and long term future profitably under pressure. Similarly the announcement by the UK Government to phase out new petrol and diesel driven engines and replace them with electric by 2040, matching a similar move by the French, is a threat to the Oil companies. As battery technology gets ever better and cheaper, the days of the internal combustion engine become increasingly numbered with the newly launched Tesla Model 3 being billed as the poster child that will bring electric cars to the masses, the Model T of the digital age. The world is going to be using significantly less oil as the car companies will act well ahead of the deadline, as indeed Volvo has already done. The oil companies will no doubt ramp up their investment into renewables and, as with the tobacco industry, change will be over many years but the direction of travel has been signalled and it is not necessarily to the advantage of the UK investor who has been happily relying on these dividend giants for income payments for the last few decades.

Price versus Value

The S&P500 index has risen 1600% over the last 30 years and the FTSE100 by 1200% but have other assets done better? Maybe Emerging Markets, Tech stocks, Kensington house prices, classic cars, Premier Cru Clarets, Gold, Diamonds or Rolex watches? While the prize probably goes to Tech with Amazon (up 50,000% since launch in 1997) and Apple (a mere 30,000% since launch in 1980 with most of it in the last decade) but a more left field asset class is a contender - footballers. The first £1m footballer was Giuseppe Savoldi from Bologna to Napoli in 1975 (not Trevor Francis, he was the first Brit in 1979), the first £50m was Kaka in the Real Madrid galactico boom in 2007 and now we have gone totally crazy with Neymar moving from Barcelona to PSG for £200m. Ronaldo, Pogba and now Neymar and Mbappe are the most expensive footballers but it is a moot point as to whether they offer value or not, the key determinant of any investment purchase. This will depend not so much on whether their brilliance on the pitch will deliver trophies to their clubs but whether they will drive revenues from TV deals, sponsorship and merchandising. Renowned long term growth investor Nick Train has recently bought a position in Man Utd, the first new addition to his portfolios in over two years arguing that live sports have become the most sought after global entertainment franchises because they are never ending and don't reach a sell-by date in the way that even the great TV shows like Sopranos and Mad Men eventually do. As such Amazon, Facebook and Netflix could soon be pitching against the traditional cable and satellite broadcasters Sky and BT for Premiership football rights. Man Utd is commercially the biggest dog in the yard but there are plenty of clubs keen to usurp it, ergo transfer fees will continue their stratospheric rise as ever more money chases the biggest names.

The key question for an investor in whatever they are buying is whether price equates to value and footy has had a few howlers in this respect, notably Eric Djemba Djemba 'so bad they named him twice' at Man Utd and Winston 'the bench' Bogarde at Chelsea. As for this summer's window, Man City's £50m purchase of Kyle Walker would not have looked out of place during the Weimar Republic. AUM in our Quadrant DFM portfolios are edging up to the £300m mark which we have (hopefully) wisely and prudently invested over the years on our client's behalf in traditional asset classes. However, this is quite a transfer kitty even by Real Madrid and PSG standards and given the strongly upward historical trend in the transfer market I'm wondering whether to look for a bit of 'alternative' investment exposure on our clients' behalf. How about 'investing' in Harry Kane and then loaning him out to my beloved but beleaguered Everton in the January transfer window?

Scores on the Doors

IMA Sector Average	2017 ytd to end Sept (%)
UK All Companies	9.6
UK Equity Income	8.0
Europe ex UK	16.1
North America	4.5
Japan	8.7
Asia Pacific ex Japan	16.8
Global Emerging Markets	17.4
UK Gilts	-0.6
UK Index-Linked Gilts	-1.6
Sterling Corporate Bonds	3.1
Sterling Strategic Bond	4.1

Figures from Financial Express Analytics

Markets rather paused for breath in the last quarter but as the numbers show it has still been a pretty good year for equity investors with Europe, Asia and the EMs continuing to lead the charge. The differential between returns from European and US funds is all about currency; Wall Street and the European bourses have produced a similar return in local terms but sterling has strengthened 8% against the dollar (reducing returns to the sterling based investor) but weakened 3% against the euro (which has enhanced returns). Style wise growth continues to outperform value in 2017 with some large sector divergence, Energy continuing to be weak but Technology super strong with the FAANGs racking up big gains in the US and equivalent performance from the monster Chinese tech stocks. It remains tough going for Fixed Income investors with UK Gilts and Linkers under water this year as UK Bond yields have pushed out in the last few weeks, though Investment Grade and High Yield Bond funds are still producing a positive return. Absolute Return funds are having a steady year producing returns of around 3% and given we see these fund as Fixed Income proxies with their 'benchmark' being the Sterling Corporate Bond sector average then they are pretty much doing their job. Similarly, the 'bricks and mortar' Commercial Property funds have returned around 4% thus far this year.

Conclusion…..Tug of War

Markets remain in a tug of war between improving fundamentals but expensive valuations. The key drivers for equities remain in place with economic and profit growth supportive and inflationary expectations waning. However a lot of this good news is already priced into equities which limits the upside and there is little room for disappointment should earnings momentum not be sustained. Similarly, with growth neither disinflationary nor reflationary then global bond yields should continue to mark time around current levels. Whilst we consider that the conditions which lead to a savage bear market do not appear to be in place there are though some long term headwinds. The global economy is now late cycle and swirling above the monthly data there is a more generalised concern that the structural factors which led to the credit crunch and its deflationary aftermath have not gone away; high global debt to GDP, demographics (baby boomers turning from spenders to savers), technological disruption, and wealth inequality. These factors mean that the long term trend for global growth has likely been reduced from its multi-decade 3% GDP growth per annum to closer to 2%. Coupled with expensive valuations, this lower growth trend leads us to believe that long term returns over the next few years will be muted and below the long-term average for equities and Bonds. Though not our central case, the possibility of a large fall is always hovering over the market, especially when the high valuations offer no protection against unexpected bad news. Bearing in mind the old saw 'stock markets climb up an escalator but fall down a lift' we made a gentle start last quarter in lowering the equity risk in the Cautious and Conservative Model Portfolios.

Specific Market Reviews: *United Kingdom*

- The UK economy is steady enough for now but the clouds are gathering. Q2 saw a marginal improvement in GDP growth following a weak start to the year with the economy expanding 0.3% q/q, driven by a pick-up in the services sector which accounts for around 75% % of the UK economy. Growth though remains subdued with negative real wage growth (inflation higher than earnings growth) likely to suppress consumer activity into 2018. Unemployment is at its lowest level since 1975 but despite a tight labour market wages are only growing at 2% y/y, which helps to explain why inflation isn't rising as fast as many feared. Indeed, inflation is likely to peak in the next few months as the base effects of the recovering oil price and fall in sterling drop out of the rolling monthly numbers. With Brexit negotiations a headwind the UK economy will likely be treading water over the next few years with the British Chambers of Commerce recently downgrading its growth forecasts to 1.2% for 2018 and 1.4% for 2019.
- Mark Carney continues to be the King of Nowcasting and Mixed Messages, flip-flopping between dovish and hawkish rhetoric. The Bank of England downgraded 2017 GDP growth expectations in the summer to 1.7% guiding markets to believe that interest rates will remain unchanged until at least Brexit in March 2019. However, the August CPI number was an above forecast 2.9% y/y and there is a sense that wage pressures are finally picking up, something the removal of the public sector pay cap will only escalate. Consequently in the MPC September meeting statement Carney suggested a likely rise in rates, maybe as soon as November, despite the fragility of the economy and the uncertainty of Brexit. Carney is probably ruing his haste in reducing the Base Rates to 0.25% in the immediate aftermath of the Brexit vote last summer leaving rates lower than economic conditions merited and so needs at least one rise just to get back to par.
- One of the strongest tailwinds driving the equity market's strong upward move over the last 15 months has been the weakness in sterling post the Brexit vote. This is a blessing for exporters and a huge boost for the big multinational companies domiciled in the UK but whose earnings are predominantly overseas and so are now around 15% higher when translated back into sterling. These companies dominate the FTSE 100 and All Share indices and have seen strong price rises. All plain sailing but the sudden and unexpected threat of a UK interest rate rise has boosted the pound in the last few weeks turning the tailwind into a headwind and was the main reason for the pull back in the indices in September.
- The UK stock market is not cheap at 14.5x forward earnings but neither is it excessively expensive, and is supported by a dividend yield of around 3.4%. As long as the projected double digit increases in corporate earnings are met then the market still looks in reasonable shape.

Carney is suggesting a likely rise in rates, maybe as soon as November

Summary: Brexit negotiations, the bounce in the sterling, sticky inflation, a possible rise in interest rates and question marks as to the sustainability of economic growth are all headwinds to the market. Companies need to deliver the forecast double digit earnings growth to keep the market on an upward path.

United States

- US economic data has been pretty consistent this year with inflation continually surprising to the downside, employment numbers to the upside and a general sense of growth being a bit underwhelming given the high hopes at the beginning of the year. GDP growth rebounded in Q2 after a disappointing start to the year and both consumption and manufacturing surveys remain fairly upbeat but any hopes that growth is going to ramp up strongly in the coming quarters are increasingly wistful. Auto sales have been particularly weak, lending standards at Banks have continued to tighten and wage growth has been disappointing, all of which put pressure on the US consumer. The much hyped boost from tax reforms is still being touted by Trump but looking increasingly tenuous given his inability thus far to pass any meaningful legislation.
- US inflation is proving to be the dog that didn't bark in the night with the monthly CPI numbers consistently subdued. The Federal Reserve Bank remains short of achieving its inflation mandate of 2% which augers against any significant increase in the pace of tightening, which remains in the slow and gentle lane. The Fed is signalling a possible small rise this quarter followed by three more next year, though market expectations are less hawkish. The Fed is also beginning its 'balance sheet normalisation' programme by slowly running down the $4.5trn worth of Bonds purchased under the quantitative easing programmes since 2008. This will be done by re-investing part rather than the whole proceeds of maturing Bonds thereby reducing the monthly amount it invests in the Bond market.
- Q2 earnings grew by around 10% driven by the Energy, Financials and IT sectors. Revenue growth was a healthy 5% in the same period. This all sounds very good but the fly in the ointment is that rather than historic numbers the market concentrates on future earnings expectations and Q3 y/y estimates have fallen from 7.5% in June to 5% currently. Estimates of 9.5% growth for 2017 as a whole is still very healthy but this marks a slowdown in the second half of the year given that expectations in January were for growth of 11.5%. By the standards of the usual analyst January over-expectation this isn't that much of a 'miss' but the direction of travel is not in the right direction and should the earnings outlook deteriorate further the market is likely be somewhat querulous given the lack of valuation support.
- Valuations continue to look stretched with the S&P500 trading on a forward P/E of 17.5x, not as horrifically expensive as some market commentators make out given that bond yields are so low but still well above long term averages. With no expectation of further multiple expansion the elevated 2017 earnings projections leave little room for disappointment and need to be delivered to keep the market on an even, let alone upward, trajectory.

should the earnings outlook deteriorate further the market is likely be somewhat querulous given the lack of valuation support

Summary: The economic outlook is still set fair and double digit earnings forecasts are the strongest for several years. Nevertheless, the valuation continues to look stretched so companies need to deliver what they are promising. Trump, as always, remains a wild card.

Europe

- The news just gets better as the Eurozone is finally recovering from the 2011 sovereign debt crisis with growth broadening across all member states. The Eurozone grew by 0.6% y/y in the three months to June (and at a y/y rate of 2.1%) its fastest rate for five years and twice as fast as the UK over the same period. European growth is beginning to have a more self-sustaining look to it as growth spreads from exports to consumption and even in some places investment. The one fly in the ointment could be the strength of the euro which if it continues could cause a headwind for exporters, though it could also lower inflationary expectations which would make the pace of any ECB tightening even more glacial. Year to date the euro had strengthened 3% against sterling and a whopping and completely unanticipated 11% against the hapless greenback.
- The ECB is signalling that it is considering taking its foot off the easing pedal and eventually dialling back its level of stimulus with Mario Draghi now saying 'deflationary forces are now being replaced by reflationary ones'. Be prepared then for some winding down or 'tapering' of QE by the ECB but Draghi is the most skilful of operators and with inflation still low the ECB is likely to remain very accommodative for a long time yet with any tightening being tentative and gradual.
- The geopolitical backdrop is now far more stable and the much feared anti-Eurozone populist revolt has not materialised. Rather than being the vote that signalled the end of the EU, Brexit has instead galvanised the remainder of the EU to form an even stronger union. However, the disappointing showing of Merkel's CDU party and the surprise success of the far right AfD in the German elections shows that political uncertainty has not gone away. We're not talking Theresa May here but Merkel's position in both Germany and Europe is certainly diminished post the election and she faces a difficult and potentially lengthy process of cobbling together a coalition, presumably with the Free Democrats and the Greens who are hardly natural bedfellows.
- Earnings estimates for 2017 continue to be in the heady realms of 12%. The Eurozone recovery lags several years behind that of the US and European earnings have been contracting since 2011. Now though revenues are growing and margins improving from depressed levels driving a strong corporate recovery which should underpin share prices. Earnings numbers are flattered by the big bounce in Energy company earnings and ex Energy the earnings growth is around 7% y/y, still healthy though obviously not quite so eye-catching. The strength of the Euro means we have probably seen a peak in upwards earnings revisions but as long as we don't seen a sharp downtick then markets should be pretty sanguine. Investors have fled for the hills over the last few years on political concerns and flow data shows that they have only recently started to return which suggests that if earnings growth remains healthy and political risk subdued then more money could return to European equities.

revenues are growing and margins improving
from depressed levels
driving a strong corporate recovery

Summary: Europe is turning into the great recovery story. The political clouds are clearing, the economy is finally looking in better shape, and the ECB remains supportive. Most importantly, earnings growth should be strong as revenues rebound and margins expand whilst valuations are not yet overly stretched.

- Asia and the Emerging Markets have been the best performing asset class this year as they find themselves in something of a sweet spot. The acceleration in developed market economies coupled with solid consumption growth at home is boosting corporate earnings which are expected to rise by around 13% this year. China continues to avoid a hard landing and sails merrily on whilst Brazil and Russia have clambered out of their recessions. Further tailwinds are provided by the continuation of loose global monetary policy and the weakness of the US dollar, both of which tend to promote money flows into riskier asset classes. Asian current account deficits have fallen in recent years making these countries less dependent on foreign capital and so reducing the chances of another Asian currency crisis.
- There has been a marked change in market leadership this year. Commodity and energy stocks led the rally in 2016 but this year industrials, consumer discretionary and especially technology stocks have driven returns. Indeed, there is somewhat of a 'FAANG' style effect with big gains from Chinese tech behemoths Baidu, Tencent and Alibaba. This rather reflects the changing shape and composition of the Emerging Markets over the last decade.
- Despite the big gains in stock prices this year EM markets still remain attractive on a valuation basis, trading on an undemanding 12.5x forward earnings which is a whopping discount of around 25% to developed markets.
- The IMF waded into the Chinese debt bubble debate in August warning of a 'dangerous growth in debt' laying the foundations for a Chinese version of 2008, a view reinforced by an S&P ratings agency downgrade of Chinese sovereign debt in September. Economic growth in China has been beating expectations in the first half of this year and the IMF has upped GDP growth forecasts to 6.7% this year and 6.4% next but warned that much of the growth is driven by unsustainable increases in public and private debt with total domestic debt forecast to be 300% of GDP by 2022.
- I spluttered over my sashimi when I saw the Japanese Q2 GDP y/y growth rate of 4%, far higher than the forecast of 2.5% and a continuation of the longest streak of successive positive quarters since 2006. Business investment rose but the best news was that the domestic consumer is finally reaching into his pockets splurging on big ticket items like cars and fridges. Consumer confidence is being helped by a tightening in the labour market and wages are edging up. Inflation is still barely positive so the BoJ will keep its foot down on the printing presses with its QE policy of targeting a zero yield on 10 year JGBs all very positive for stocks. Unlike pretty much everywhere else equity market valuations are at reasonable levels and there is an ever improving environment of corporate governance, share buybacks and higher dividend pay-outs. This being Japan however, there must be a 'but' somewhere…

despite the big gains in stock prices this year
EM markets still remain attractive on a valuation basis

Summary: The EM and Asian equity markets continue to produce strong returns propelled by improving global growth momentum and double digit earnings forecasts whilst Japan is seeing an unexpectedly strong economic and earnings bounce. These markets remain best suited to higher risk/reward investors with a long term time horizon and acceptance of a high level of volatility.

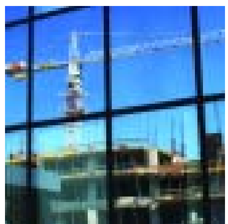
Fixed Interest

- With global inflation numbers generally on the low side of forecasts it has been a fairly soporific year thus far in the major developed market Bond markets. German yields have pushed out as Eurozone growth has surprised on the upside whereas US 10 year Treasuries have come in a bit as US growth expectations have cooled. A feature of the US markets has been a flattening of the yield curve this year with 2 year rates rising but 10 year falling. UK Gilts have been a little more exciting of late, as discussed below. Local currency EMD markets have been the best performing sovereigns with the sharpest contraction in yields.
- Central Bank rhetoric is turning more hawkish but markets remain pretty relaxed about the glacial pace of tightening next year as there will likely be little in the way of rate rises and the balance sheet shrinkage (selling assets purchased under QE) in the US and tapering (slowing down) of asset purchases by the ECB has been well signalled. Should the pace of tightening increase due to an unexpected pick-up in growth or inflation however then the Bond markets will sit up and take more notice, and not in a good way.
- UK Gilts had marked time until a few weeks ago with received wisdom in the market being that while Brexit negotiations went on there would be no rate rise and 10 year yields would remain nailed to the floor around 1%. However, a surprisingly hawkish statement from the MPC September meeting implying a possible rate hike sooner rather than later somewhat put the cat among the pigeons and pushed 10 year yields out to 1.35%. Our expectation is that UK inflation will peak in the coming months and that the tightening cycle in the UK will shallow and lengthy. As such, we don't see great upward pressure on UK Gilts, though as we always say the risks are asymmetric with more chance of a significant upward rather than a downward move in yields.
- The collapse in Government Bond yields after the 2008 financial crisis, the compression of credit spreads, the abundance of liquidity, the long and shallow economic growth cycle and the absence of inflation has led to a Golden Age for investors in corporate credit. Over the last 8 years the IA UK Gilts sector average has produced a return of 47%, well ahead of the long term historical annual average return, but even so this has lagged well behind the returns of 59% from the UK Sterling Corporate Bond (investment grade) sector. This in turn lags the return of 68% from UK High Yield sector where spread compression has been most extreme showing that investors have been prepared to take increasing amounts of risk in the hunt for income. The highest return is a whopping 93% from the UK Index Linked Gilts sector, seemingly very strange given this has been period of slow growth and little inflation but a result of the very long duration of the asset class.
- Much ink has been spilt (not least by me) on 'Bond bubbles' and the unsustainability of yields at record low levels for infinity but far less is written about the compression of corporate bond spreads to such low levels, leading to the possibility of a 'coiled spring' effect. From already tight levels in January, spreads have declined a further 20bps in Global Investment Grade and 70bps in Global High Yield. Credit investors may be a little too complacent about this, especially in the High Yield space, with the potential for a 'triple whammy' of rising Bond yields, expanding spreads and lack of liquidity which could be very painful indeed. Even if this is just me being over-egging the pudding (as usual) the low underlying yields and tightness of the spreads certainly reduces the potential for upside in the asset class to pretty slim pickings.

Central Bank rhetoric is turning more hawkish but markets remain pretty relaxed about the glacial pace of tightening

Summary: We expect Government Bond yields to continue tracking sideways in 2017, though the long term direction of travel is upwards as global economic momentum improves and Central Banks take small and tentative steps away from their super-loose monetary policies. The significant tightening in spreads over the last 18 months has whittled away the value in Investment Grade and High Yield credit.

Commercial Property



- Returns from the asset class have been surprisingly (and pleasingly) resilient thus far in 2017 with the IPD UK All Property Monthly index returning 6.5% to the end of August. The expectation in January had been that returns this year would be wholly from rental income but in practise capital values have also risen. The strongest sector has been Industrials and the weakest Retail. Returns for the Office market have been divergent being weak in Central London but strong in the regional markets. Transactions have remained buoyant, due in part to the weakness of sterling stimulating the interest of overseas buyers. Indeed, two of London's landmark buildings the 'Cheesegrater' and the 'Walkie Talkie' have gained new owners this year.
- The uncertainty created by Brexit and it debilitating effect on companies' decision making is a significant cloud over the sector but nevertheless there are positives which have led to the resilience of the returns. Certain areas of the market are seeing strong demand, small distribution warehouses close to towns as online shoppers demand ever tighter delivery windows being one example. Compared with the aftermath of 2008, oversupply in the market is far less evident, tenant demand appears stronger, equity rather than debt financing has played a more important role in property purchases over the past few years and the Banking sector is in a far healthier shape.
- Rising bond yields are not positive for Commercial Property but the near 4% yield difference between UK Gilts and UK Commercial Property is still around 2% ahead of the long term average leaving plenty of headroom before property comes under pressure on valuation terms.
- The surprisingly strong performance from Commercial Property in the fourth quarter of last year and thus far in 2017 is probably linked to the general level of bullishness about economic growth in financial markets, most noticeably in equities. As this effect fades and the Brexit date looms ever closer we would expect returns to moderate but still remain positive. Our longer term view remains that returns from the asset class will be in mid-single digit, generated almost entirely from rental income with little if any increase in capital values.

Summary: The commercial property cycle has become increasingly mature and returns will be considerably lower than in recent years, driven almost entirely by rental income rather than capital growth. The asset class continues to be resilient and we expect annualised total returns of around 5% for the next few years.

Commodities

- Base metal commodity prices rallied in Q3 as global growth prospects continued to improve driven by a raft of better than expected data in Europe Japan and the Emerging Markets. Energy and mining shares, which had been dragging their feet in 2017, responded though Energy is the only equity market sector still producing a negative return this year.
- Gold woke up from its 12 month slumber and rose back up to US$1300oz as markets looked for a safe haven while Trump and North Korea played chicken with their nuclear warheads. With US growth and inflation expectations cooling the prospect of significantly higher US interest rates and a stronger dollar are receding, which creates a further tailwind for the yellow metal.
- Having spent the last year marking time around US$50/bl. oil pushed up toward US$60 by quarter end, the highest level for over two years. Concerns that OPEC members would not comply with their output cuts have thus far proved largely unfounded whilst demand, especially from the Chinese, has continued to be firm. The upward move is perhaps surprising and not likely to be sustainable over the longer term as US shale producers are coping with ever lower prices, producing more oil and forever

exerting downward pressure on the price. The US Government estimates that American production will be at an all-time high in 2018, even higher than the 1970s. Our price range for ages has been US$40-US$60bl and this continues to be our stance.

- Mining companies made huge gains in 2016 because many had looked on the verge of bankruptcy. Mining company capex has fallen dramatically since 2012 with managements forced to take their painful medicine or else go under, slashing and in some cases passing on their dividends and embracing 'shrink to survive' strategies by shedding non-core operations. 2017 has been a different, more sedate, story with the 'despair to euphoria' bounce now priced in and these companies needing evidence of a robust earnings outlook to make further significant gains.

Summary: As reflationary hopes have faded in 2017 so too has the fortunes of both physical commodities and mining and energy company shares. Neverthess, both Oil and Gold bounced in the last quarter which prompted a rally in share prices.

Currencies

- The euro remains the blue eyed boy of the FX markets; the marked improvement in the political backdrop coupled with strong Eurozone growth in Q2 and strong survey data throughout the summer months boosted the euro to its highest level in two and a half years against the US dollar whilst against poor old sterling it has made an eight year high. Thus far in 2017 the euro had strengthened 3% against sterling and a whopping and completely unanticipated 11% against the hapless greenback.
- All change for sterling this quarter. Despite looking increasingly cheap on a purchasing power parity basis sterling had been struggling to rebound from its big fall last year as the possibility of a 'hard Brexit' continues to hang very heavily over sterling. However, the above expectation August CPI inflation number has raised fears that UK interest rates will finally needs to rise and sterling rallied sharply. Year to date sterling has gained 8% against the US dollar, 5% against the yen though has lost 3% to the rampant euro. For better or worse, sterling remains a hostage of fortune to Brexit negotiations.
- The greenback is looking increasingly embattled. The US dollar index (which measures the dollar against a basket of currencies of its major trading partners) has fallen 10% so far this year weighed down by Trump's chaotic tenure in Washington, softer inflation and a slowdown in the pace of Federal Reserve interest rate hikes. With European and Japanese growth surprising on the upside the dollar has somewhat lost the 'global growth leader' premium it has held since 2009. There is also a technical factor at play here; the dollar finished 2016 at a 14 year high, the epitome of the over-owned, over-loved 'crowded trade' with all the good news in the price. Fundamentals are still relatively supportive for the dollar (economic growth is OK, interest rate differentials are still in place) but the Trump factor is just too overwhelming.
- The Economist Magazine recently published an update of its much beloved Big Mac Index which rather emphasises the point that for all the column inches looking for reasons for the dollar weakness in 2017, the real reason may be simply that the dollar had become hugely overbought over the last decade. According to Burgernomics, the dollar is still around 35% overvalued against the yen, 22% against sterling and 15% against the euro. On this basis the dollar isn't really weak after all and in fact the only currencies the index considers to be more expensive than the dollar are those of Switzerland, Norway and Sweden. The countries to which Man vs. Food tourists should be heading to get most burger for their money are Egypt, South Africa and Russia.

the dollar has lost the global growth leader premium it has held since 2009

Summary: Stronger growth and improving politics have boosted the euro whilst muted US inflationary expectations, a more dovish Fed and of course Trump have had the opposite effect on the greenback. Sterling rallied strongly at quarter end, boosted by the possibility of a rise in UK interest rates.

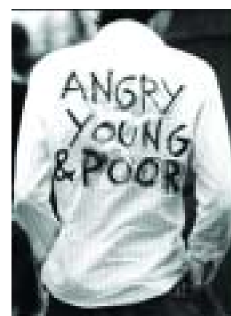
UNPLEASANT TRUTHS COMFORTING LIES

How Did That Happen?

Writing about politics in a wealth management publication is arguably a high risk manoeuvre with the potential to offend or enrage clients somewhere along the line. This is a bit like slagging off a football club in print which is something I seem to get away with, presumably because everyone else feels the same way about Chelsea. My reason for writing about politics is that it is now very relevant to financial markets and because the pieces I wrote on Brexit and Trump last year were the articles clients seemed to find the most interesting, unlike my increasingly desperate efforts to make equity market valuations a racy and insightful topic for discussion. Of course, my opinions and assumptions are my own and feel free to strongly disagree with them.

Politics hasn't mattered much to stock markets since my blue button debut on the floor of the London Stock Exchange in 1981 but suddenly Washington, Downing Street, Brussels (and sadly Pyongyang) are writ large as the tectonic plates in society appear to be shifting in a generational change. The end of WW2 began three decades where social welfare was the dominant global theme before giving way to a subsequent three decades when free market capitalism transformed our lives. Reagan and Thatcher were the architects, the fall of the Berlin Wall the defining image. The pre-1980 era was difficult for financial markets, a time of boom and bust, while post 1980 has been a golden age before the excesses of the free market have led us to a crossroads with populism and nationalism pushing back the previously unstoppable rise of globalism. We Brits viewed this as an amused spectator as Europe appeared to be imploding and the US elected a clown for President but we are suddenly centre stage as Brexit and a perplexing General Election leave us flirting with a different political and social consensus to the one we had become used to.

Politics in the UK used to be a matter of class and principle; Labour was the party of the shop floor, the Conservatives that of business. You might not agree with their views, but politicians stood for something. Wilson and Callaghan were 'big Government' socialists whilst Maggie was full on free-markets turning the UK into one of the most open and business friendly countries in the world. Your vote mattered because the choices were very different. This has changed because the huge rise in living standards since 1980 has subverted class distinctions. The 'working class' is now much more affluent and aspirational with a standard of living they are looking to protect whilst the 'middle class' is increasingly populated by the swelling ranks of public sector employees with gold plated pensions, security of employment and supporters of the party of big government, the Labour Party. Alongside the blurring of traditional voter affiliations the nature of politicians themselves has changed. MPs are now much younger with minimal experience of life outside the Westminster Village; being an MP has become a career choice not a civic duty. I blame Bill Clinton for this and the example he set. The sad death of principled John Smith and consequent elevation of the odious Blair was the slipperiest of slopes; Cameron and Osborne hardly the most convincing pair of 'public servants' either.



If the rise in living standards and a consensus move from both parties to the middle ground explain the political environment over the last 25 years then the tipping point now, and the return to a more adversarial 1970s style politics, has been the polarisation of wealth and opportunity post the 2008 global financial crisis. Austerity has been at the root of the populist, anti-immigration, anti-globalisation, anti-establishment movement that has been rolling through Europe, the US and now the UK. Instead of 'middle class' and 'working class' in the UK we now have the comfortable 'haves' in well paid employment or enjoying generous pensions and the disgruntled 'have not's' on benefits, zero hour contracts or else in long term employment but seeing their wage growth stagnate for a decade. Demographics play a big part, setting young against old. The 'baby boomers' have had a golden life of secure and increasing prosperity

while the young 'austerity' generation now voting for the first and second time resent these oldies and their politics because they stole all the jobs, made housing unaffordable and saddled them with tens of thousands of pounds worth of student debt. If a nice old guy with a beard then turns up and offers to reverse this trend then it's no surprise that everyone under 30 looks on him as Father Christmas. If you haven't got anything in the first place then you haven't got anything to lose, even if this particular Santa Claus is a financially illiterate Marxist likely to turn UK economic progress back by 50 years. Throwing Brexit into the pot makes UK politics more turbulent still, especially as the angry, bitter and divisive campaign was so full of misinformation on both sides. The young in general are 'remainers', the old 'leavers', the irony being that if all the young voters who have rallied to the Corbyn flag had voted in the referendum then it is likely that we would still be 'in' rather than 'out' and with David Cameron still ensconced in No.10 rather than putting on the timber and attending music festivals.

It is a great irony that just as we Brits are struggling to keep our heads above water our erstwhile Euro cousins have started to swim again. Europe was for so long the epicentre of geopolitical risk, a hotbed of nationalism, a dysfunctional basket case, an unsustainable currency union teetering on imminent collapse and a stagnant economic bloc mired in deflation. Now though, a gentle calm has settled on the grand old continent. The insurgent nationalists have been put back in their box in France and Holland, though the success of the AfD party in the recent German elections showed that the far right nationalists are still a force in Europe. Merkel suffered a bloody nose and now cuts a diminished figure both in Germany and Europe following the poor showing of her CDU party. With the golden boy Macron in the Elysee Palace the Germany/France axis is looking the stronger than for many years though post the German election it may now be Emmanuel rather than Angela that becomes the key figure in driving the Eurozone bus. Macron may well turn out to be 'Le Phoney', all promise and no delivery, but for now the financial markets see Europe as an area of political stability, not an accident waiting to happen.

As for the land of the few, the home of the brave, you just despair. The Trump administration is pure Shakespeare, comedy and tragedy at the same time with its 'Government by Twitter' and revolving door of senior staff. 'Incompetent' doesn't begin to describe the chaos in Washington. Trump's dream of repealing Obamacare has hit the rocks, the 'biggest tax cut in history' may be heading the same way and he has lost the support of business leaders following his apparent support for White Supremacists in Charlottesville. Trump has been as bombastic, bullying and hectoring as always but achieved nothing. As for his forays in foreign affairs....

So what do financial markets make of this, and is politics a genuine threat to stable markets? As usual, nothing is straightforward because whilst 'populism' has been a global movement there are

marked differences in how it affects government thinking. The threat of a Eurozone break-up appears behind us, all very promising unless there is a sudden reversal in sentiment in which case markets would fall sharply now that they are no longer discounting this risk. Trump is a lame duck domestically but a dangerous liability in foreign affairs, playing nuclear war chicken with Kim Jong-un and having the capacity for doing something so stupid that a crashing stock market may be the least of our concerns. In the UK Jezza may never get the keys to No.10 but he is getting dangerously close and he has certainly made the political weather. Realpolitik demands that the Tories win back some of the populist ground lost to Corbyn, witness the ending of the public services wage cap for example. The anti-austerity policies of the last decade have peaked and will be gradually rowed back with a move to 'bigger government' with more state intervention in business, more focus on wealth inequality, no appetite for cutting taxes, deregulation and a general sense that market forces are to be distrusted and need to be curbed rather than encouraged. Tories may decry the Labour 'changey-hopey' stuff as being naïve pie in the sky but to do so effectively they need to come up with some change and hope strategies of their own, most notably on housing and jobs for the under 30s. The precarious nature of the weak and divided May Government and the horrible unpredictability of the Brexit process and its ultimate consequences hang very heavily over UK financial markets, though arguably more so over sterling and Gilts than the stock markets given the latter's international composition.

The markets may be drinking out of a cup half full, aware of the political threats but largely ignoring them. Populism may have retreated at the polls but it isn't going away so long as the socio-economic reasons that caused it remain; income inequality, debt, the demographic divide, globalisation, disruptive technology and immigration. These divisive issues remain at a time when the outlook for long term global growth is considerably lower than it has been during our lifetimes. That's not a good backdrop for society in general, or financial markets in particular, and whilst we may well continue to 'muddle through' for some years yet the ripples from the 2008 crisis may still turn into waves.

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