

May 2014

A collation of recent insights on markets and economies taken from the comments made by Chairmen and Investment Managers of investment companies – have a read and make your own mind up. Please remember that nothing in this note is designed to encourage you to buy or sell any of the companies mentioned.

## Global economy

From John Scott, Chairman, Scottish Mortgage

I will restrict myself to noting that there has been continued progress at economic and company level. Political factors as always act as a de-stabilising element in the short term; the impact of the withdrawal of monetary stimulus may not be straightforward and there will be upsets as the Chinese economy adjusts towards an increasing domestic focus. However, overall the commercial and trading environment for companies is broadly benign. This, coupled with an outstanding and accelerating pace of technological advance across so many fronts, makes for an environment where well managed companies with sound strategies and an eye on the long term should be capable of making sustained and attractive returns.



From Rod Kent, Chairman and Will Wyatt, Chief Executive of Caledonia

It makes a pleasant change to be able to write that economic growth is finally returning to western economies, albeit at a low level. Asian and other developing economies continue to grow at a much faster rate than those in the west, though not without signs of slowing down. This has affected their stock markets and has brought valuations back to levels where we now feel comfortable to deploy capital in these regions.

Elsewhere, stock markets are now mainly being valued on a fundamentals basis, with earnings growth to the fore. We believe that the gains of the past two years will not be repeated to the same extent this or next year and remain wary of external events, which often lead to heavy falls in markets. In the UK, economic growth continues to pick up, but we face the

uncertainty caused by the Scottish vote on independence in September this year and a UK general election in 2015.

From A.R.Laing and R.P.A. Spiller, co-fund managers of Capital Gearing Trust

The aggressively accommodative monetary policy pursued since the early to mid '90s distorted both asset prices and the economy. The resulting crash presented a choice to the authorities: accept a major recession with associated deflation or run risks with inflation by conducting an experiment with exceptional monetary policy over a prolonged period. This latter choice - of course, the one chosen - has yet to play out, but at least it has preserved the world from a repeat of the 1930s. As expected by, for instance, Reinhart & Rogoff, growth has been sub-par as the process of deleveraging continues, but now confidence has risen and growth in the US and the UK has surprised economists by overcoming the headwinds of fiscal contraction. This has, however, been achieved by reducing the savings level in the US to 4.3% of income, only just above the 2007 trough. Continued growth therefore depends on rising investments, net exports or wages. All of these seem possible, though weak overseas demand may limit exports despite the help from shale oil.

Inflation is evident in the equity markets, even if not yet in consumer prices. Rises in the S&P 500 have been correlated directly to each episode of QE. Other asset classes have reflected the same influence, including high yield bonds and property. Historically, the medium-term prospective real returns from all assets at these

valuations have been close to zero on the assumption that the environment for interest rates normalises. If that is combined with an expectation of elevated levels of inflation - and that remains the most probable outcome - then the main aim of asset allocation now is the preservation of capital after inflation, costs and taxes; that may not be easy.

One key element is to keep the duration, and hence the exposure to rising long-term nominal interest rates, relatively short. For equities, momentum is still positive - the US is still printing, even if at a slower rate, and there are still opportunities in the closed-end world to produce predictable excess returns. Pitfalls for equities include some retreat from record profit margins in the US and a slowing of growth in China as that country grapples with its unbalanced economy and rapidly growing debt.

Sterling has responded to the expectation of higher interest rates in response to a growing economy on the back of an old-fashioned pre-election housing boom. If wages respond, there is a good chance that this will be maintained until the General Election. However, the prospect of a Labour administration might put downward pressure on the currency. That fear may influence markets as early as this summer. Moreover, a deteriorating current account and now rich valuation suggests the medium-term direction of Sterling is down, particularly against the U.S. Dollar.

## UK

*From Iain McLaren, Chairman, Investors Capital*

The UK equity market has recovered strongly since the lows of 2009. However, over the past two years, equity market returns have been driven by a re-rating of the market rather than through underlying growth in corporate earnings. While valuation metrics are not unduly stretched, the valuation gap between equities and other asset classes has narrowed. Against this background it is encouraging that the corporate sector remains in good health and the economic outlook continues to improve.

*From Anthony B Davidson, Chairman Shires Income*

A year ago I wrote that investors needed to remain mindful of the risks posed by rising indebtedness in the US and the potential for sovereign default in some European countries. These two concerns remain. US Government expenditure is increasing and as we witnessed with last autumn's "shutdown" in Federal services the Republicans and Democrats remain polarised as to how to resolve the issues. Meanwhile, in Europe we have seen sovereign yields falling, in many cases to pre-crisis levels. That should be welcome news, but if we consider one of the countries hardest hit by the crisis, Greece, debt to GDP still stands at 175%. Hence, it is hard to say that their problems are resolved. The market believes that the ECB will in effect act as a backstop for any country that again finds itself in difficulties. That remains an unproven concept.

More positive has been the strength of the recovery in both the US and UK. Much investor attention is now focussed on the US programme of tapering, a gradual withdrawal of stimulus that suggests increasing confidence in prospects there. In the UK the housing market is key to confidence and, although not back at peak levels, both volumes and prices have recovered strongly. Unemployment has declined and inflation has fallen below its 2% target. That is helpful in that it eases the pressure on the MPC to raise interest rates. Expectations for growth in the domestic economy have been revised sharply upwards. Recovery is starting across much of Europe and, in the absence of concerns regarding sovereign debt, might be expected to continue.

Equity markets are forward looking and investors have begun to discount these rosier prospects in the valuations they are prepared to ascribe to shares. Multiples have expanded as share prices have increased without commensurate growth in profits. This has eroded some of the attractions of domestic equities relative to both other asset classes and overseas equity markets. Valuations do not appear to be unreasonably stretched but further progression in markets will likely need economic recovery to manifest itself in rising corporate profitability. Any further strengthening of sterling will represent an additional headwind to this.

*From D Warnock, Chairman of Troy Income & Growth*

Stock markets have certainly entered this year on a more fragile footing than they ended the last. With broad stock market valuations significantly overextended relative to their long-term average, many share prices remain vulnerable to a de-rating should events conspire to derail the QE-inspired optimism. The conflict in Ukraine serves as a cautionary reminder that the catalyst for a correction could come in a number of guises.

**From Thomas Moore, fund manager, Standard Life Equity Income**

Monetary conditions remain loose in the US, even a year after the first talk of tapering. Policy-makers globally are making it clear that they want to be quite convinced of an entrenched recovery in employment before



monetary stimulus is withdrawn completely. In Europe and Japan, there is now the prospect of further monetary easing.

Such conditions are supportive for equities, which offer the prospect of further earnings and dividend growth. Dividend yields remain attractive relative to the yields available from other asset classes.

Following the broad-based rally in 2013, investors are likely to be increasingly selective as valuations have now recovered to more reasonable levels. Consequently, we expect a period of greater discrimination as the market searches for attractively valued businesses demonstrating sustainable earnings growth.

In this environment, we remain confident that our active investment process will allow us to identify further attractive investment opportunities across the UK market.

**From Sir Laurence Magnus, Chairman, JPMorgan Income & Capital**

The UK's economic prospects have improved significantly over the last 12 months, with unemployment falling much faster than forecast, corporate profitability remaining resilient and inflation staying subdued.

Although the violent turbulence that affected world stock markets during the period 2007 to 2012 has lessened, a number of major uncertainties remain. These include the continuing (and increasing) indebtedness of sovereign borrowers, which cannot be sustained in perpetuity. In addition, there is the prospect, at some point, of a return to rates of interest which are not depressed almost to zero through quantitative easing and other interventions by Central Banks in money markets.

**From Steven Bates, Chairman, F&C Capital & Income**

The UK economy remains fairly well set ahead of the Scottish referendum in the autumn and the General Election next year. Inflation is subdued and interest rates seem unlikely to rise in the near future. The deflationary trend is a surprise to some as it is counter-intuitive in an era of very loose monetary policy, but the inflation in the economy as a whole is visible in asset prices rather than in consumer goods. Low interest rates are also necessary because the underlying fiscal dynamics of the economy haven't changed much since the Global Financial Crisis, and the capacity to withstand a contraction is limited. These factors lie behind what remains a reasonable equity market story, with valuations attractive particularly in contrast to cash and bonds. Most of the market rise in recent years has been on the back of increasing valuation, rather than earnings growth and so it is fortunate that the earnings outlook is somewhat better on the back of an improving economy. We are moderately optimistic about the prospects of further progress in equity markets.

**From Rosemary Banyard, Andy Brough as managers of Schroder UK Mid Cap**

After a strong run, the mid-cap segment of the UK stock market is now facing several headwinds. The first of these is rising UK political risks as we approach the vote on Scottish independence and thereafter a general election in May 2015. There have already been sudden interventions in political areas such as energy subsidies, betting duties and compulsory annuitisation, and other consumer-facing sectors remain vulnerable to policy change. A second headwind is the rising tide of IPOs, principally from private equity

houses seeking to de-gear while interest rates are low. The supply of new issues is such that investor appetite may soon be sated.

In an era when global competition and rapid change is making top line growth elusive for many companies, we observe some resorting to the heavy capitalisation of costs to protect reported profit margins while others are focusing investor attention on headline earnings numbers which adjust out large exceptional charges. The managers remain vigilant on these matters.

Notwithstanding these challenges, the focus remains on investments with sound finances, prudent accounting, organic growth and where possible pricing power.

**From Jim Pettigrew, Chairman, Edinburgh Investment Trust**

Your Board and Manager remain vigilant in light of a mixed global macro-economic outlook and also as a result of higher share prices and higher valuations across the UK equity market. Taking this into account, we look to the current financial year with guarded optimism whilst not anticipating a repeat of the returns enjoyed last year.

**From Mark Barnett, Portfolio Manager, Edinburgh Investment Trust**

The UK equity market has struggled to find a convincing direction in 2014. The outlook is likely to remain challenging for the foreseeable future due to a combination of elevated valuations and an environment of continued flat corporate profit growth. In fact the recent earnings season was notable for the number of profit warnings from large corporates. Despite the well-publicised improvements in economic growth in the UK and US economies, the current valuation of the market represents a level which reflects this optimism and which may struggle to be maintained if the pace of earnings growth does not accelerate. The other significant reasons for caution over the near term are a reduction in the scale of asset purchases under the policy of quantitative easing in the US, uncertainty about the strength of economic growth in the developing world especially China, and a heightened level of political risk both in a domestic context ahead of the UK General Election and internationally due to the Ukrainian/Russian situation.

Despite the overall cautious tone of these comments, I believe there remain some pockets of undervaluation within the UK stock market. The key to navigating the near term is to remain highly vigilant about the strength of corporate performance and to remain judicious in portfolio selection, given the increase in valuations.

## Europe

**From Rodney Dennis, Chairman, Henderson European Focus Trust**

This time last year I mentioned the importance of a strong valuation discipline... in the context of the perceived scarcity of both growth and income and that stocks exhibiting either characteristic might be bid up beyond fair value. Since then, European equity markets have broadened and former laggards such as banks and even utilities have come in from the cold. It is not just sectors that have experienced a rehabilitation: the performance of the Continent's so called peripheral markets, culminating in the recapitalisation of the Greek banking system and the return of that country's sovereign to capital markets marks a quite astonishing turnaround from only two years earlier. Whether it is a turnaround in economic fortune or a 2007 style rerun of the grasp for yield is a moot point.

There have also been notable U-turns at the political level: France's President has performed a particularly impressive volte-face as he has abandoned his "soak the rich" agenda in favour of corporate tax cuts. The latter is to be much welcomed in an economy which had succumbed to sclerosis.

All of the above simply underscores how necessity is the mother of invention or, in Europe's case, the mother of change.

**From Dale Robertson, investment manager, The European Investment trust**

Stock markets have moved ahead in anticipation of a recovery in profits in European companies. Whilst this is normal at this stage in an economic cycle, it does mean that aggregate valuations have now run slightly ahead of events.

From Carolan Dobson, Chairman of JP Morgan European Smaller Companies

The European small cap index consists of more than 1,000 stocks and other stocks closely aligned with it. However, the average stock in this sector is covered by only four analysts compared with seventeen for large cap stocks. This under-researched sector therefore presents good opportunities for investors.

From Jim Campbell, Francesco Conte as investment managers of JPMorgan European Smaller Companies

If last year was all about economies getting less bad, our impression from conversations with corporate



management is that economies began to stabilise late in the year and are now showing signs of improvement. The periphery of Europe has undergone dramatic economic change and most of these countries now, if not already, are very close to achieving primary and current account surpluses. This change has come about at significant social cost but with surprisingly little unrest. Thankfully the hard work appears to be paying off as these economies are finally showing signs of improvement based on fundamental and structural change that should enable them to grow in a sustainable manner. The United States, after a weather related economic pause in the first quarter of 2014, appears to have accelerated

its growth trajectory and emerging markets, having endured a bout of current account deficit fears, appear to be stabilising.

Despite so much good news, markets currently are being held back by fears over civil unrest in Ukraine, concerns around the end of loose monetary policies, generally lacklustre earnings and fear of an electorate backlash at the upcoming European elections. We believe that central banks will maintain loose monetary policies for some time to come; European Central Bank President Draghi and Federal Reserve Bank Chair Yellen have repeatedly confirmed that they wish to remain accommodating as both deem unemployment levels to be unacceptably high. The current pause in the markets can be viewed as a phase of consolidation, rather than a top, following the rapid rise of the last twelve months.

Despite these uncertainties, we continue to identify attractively valued investment opportunities. The companies we talk to are generally finding life easier than they have at any time since the peak of 2007 and, whilst today their businesses are some way off those peaks, the hardship of the intervening years has made management and balance sheets much stronger. If we combine the economic upturn with a resurgence in corporate activity, such as the proposed mega-cap mergers of Lafarge and Holcim in cement, Pfizer and AstraZeneca in pharmaceuticals and GE and Siemens with Alstom in the engineering sector, we can look to the future with continued optimism

## Emerging Europe

From Steven Bates, Chairman, Baring Emerging Europe

The major markets in which we invest are at exceptionally low valuations, admittedly for obvious reasons. Anyone who thinks, as does your Board, that something approaching normality will reassert itself over the medium term is being offered the opportunity to invest at prices which offer the prospect of significant return.

From Matthias Siller, fund manager, Baring Emerging Europe

A large part of the Emerging European market trades at multi-year lows relative to Developed Markets. Recent evidence of increased fund flows into the region, in spite of the politically induced volatility, makes us positive that the attractive combination of cheap valuation and solid growth prospects will continue to attract attention and prove rewarding for investors over the longer term.

## Asia

From James M Long, Chairman, JPMorgan Asian

In comparison with the performance returns generated by European and American stock markets over the last six months, the return generated by the overall Asian market is disappointing. However, despite differing fortunes, there were some highlights amongst the constituent countries which make up the Asian ex Japan Index and stronger European and American economies can only help to support the Asian export market going forward.

From Ted Pulling, Sonia Yu, Jeff Roskell – investment managers of JPMorgan Asian

Over the past three years, investors in Asian stock markets have had to contend with persistently declining earnings forecasts. Every year, the consensus expects earnings to rise by 12-16% and every year earnings only increase by 0-8%. The trend will recur in 2014, but we think the numbers will be better i.e. expectations started the year lower and the depth of the cuts should be less. Regardless, valuations have continually provided downside support. What we need is a catalyst to propel markets higher. There is no visible catalyst. The result is that European and American stock markets have significantly outperformed Asian and global emerging markets and that the former are materially more expensive in valuation terms than the latter. Empirical data tells us that this disconnect does not last forever. We can also be confident that the recovering economies in Europe and America will inevitably lead to stronger Asian exports.



2014 will be a crucial year for Asia politically and geopolitically. New leaders will take the helm in India and Indonesia and hopefully accelerate much needed reform and investment in these two countries. We are observing political developments carefully. In China, the new leadership has mapped out aggressive and necessary plans and reforms, which will cause pain as they are implemented. China has a difficult road ahead, especially as the economy commences the deleveraging process. Growth cannot be allowed to slow to the point that it affects employment, but growth will slow. Everybody accepts this and the reality is reflected in equity valuations. Geopolitically, tensions in the South China Sea and the East China Sea are unsettling and could lead to sharp (but probably temporary) market declines if relations deteriorate.

## China

From William Knight, Chairman, JP Morgan Chinese

As China embarks on a multiyear deleveraging process, the government has indicated that no large stimulus plans will come through in the short-term. However, we do see small steps in reform underway. Supply-side reforms such as state-owned enterprise reform, break-up of monopolies, tax reduction, interest rate liberalisation and fewer government controls are needed to support growth and get it onto a sustainable path, instead of heavy reliance on demand-side management such as infrastructure spending or property sector policy swings. We expect the macro environment to stabilise going into the second and third quarters of 2014, mildly rebounding from the first-quarter low. This is likely to be underpinned by selective easing recently initiated by the government, including increased infrastructure spending, a pick-up in social housing and tax cuts for small and medium enterprises.

We are turning more cautious on Hong Kong and anticipate continued market volatility in the near-term given the investment community's concerns over China's economic slowdown, as well as expectations of rising interest rates in the US. Conversely, we have been increasing our weighting in Taiwan, particularly in exporters given their positive leverage to a pick-up in the US import growth. This includes stocks in the technology and medical precision sectors which are in the midst of a positive earnings revision cycle.

**From Howard Wang, Emerson Yip, William Tong, Shumin Huang, managers of JP Morgan Chinese**

In China: The macro environment should begin to stabilise going into the second and third quarters. This is likely to be underpinned by selective easing recently initiated by the government, such as increased infrastructure spending, a pickup in social housing and tax cuts for small and medium enterprises. Overall, we expect growth to remain at the low end of the 7%-8% GDP range when the new leadership carries out structural reforms to improve quality of growth.

In Hong Kong: Market volatility will remain in the near term given the concerns over China's economic slowdown as well as rising rate pressures in the US. The commitment to reforms in China, while negative for short-term growth momentum, should result in more sustainable growth path and market re-rating. Despite market speculation, property tightening policies in Hong Kong are unlikely to be reversed any time soon. Sectorial growth stories remain in Hong Kong, including the gaming sector and companies benefitting from economic recovery overseas.

In Taiwan: The healthy global macro backdrop will drive earnings growth for the technology sector of another 10%-15% in 2014, following profit growth of 30%-40% in 2013. A key event to monitor is whether the Cross-Strait Service Trade Agreement can be passed by Taiwan's legislature in May or June this year. While the service pact will have less impact on the technology sector, it will meaningfully benefit Taiwanese financials.

## Japan

**From Neil Gaskell, Chairman, Aberdeen Japan**

The outlook for Japan is one of the most significant economic uncertainties in the world today. The direction of the third largest economy is an important component of world growth and the ability of Abe's government to sustain the inflation and growth that they have successfully initiated is the key to the outlook for the economy. It is premature to expect a sea change across all Japanese companies but the tide of change is rising.

**From Aberdeen Asset Management as managers of Aberdeen Japan**

At the policy level, the Japanese economy faces headwinds from the recently introduced consumption tax rise from 5% to 8%. The government intends to push forward a massive stimulus plan to counter the negative effects of the tax hike, although the longer-term sustainability of these policies is questionable. That said, numerous companies are already diversified, with much of their earnings derived from outside Japan. In addition, the stronger government and weaker Yen, as compared to previous years, have certainly lifted sentiment.

For investors, what is heartening is that Japanese corporates are gradually focusing on shareholder returns, and corporate governance is improving. These changes should enhance Japan's investment story for the longer term.

## India

**From Hugh Bolland, Chairman, JPMorgan Indian**

After a difficult year to 30th September 2013, it is pleasing to report on a strong six months for the Indian market. In the short term, the market is likely to be volatile as a result of the recent election, but our investment managers remain positive over the long term given attractive equity valuations and expectations of continuing growth.

From Rukhshad Shroff, Raj Nair as investment managers of JP Morgan Indian

The results from the national elections were better than even the most optimistic expectations. The B.J.P led by Mr. Narendra Modi won a clear majority, the first in 30 years. Effectively, for the first time since foreign investors began investing in Indian equities, there will be a government that is not dependent on coalition partners for survival. This gives Mr. Modi the independence to pursue his stated agenda of kick-starting the economy.

From William Salomon, Chairman, New India Investment Trust

The last few months have seen Indian business distracted by electioneering. Buoyed by pre-election zeal, the markets anticipated a victory for the BJP, but not on the scale which has unfolded which will likely extend the celebratory mood. However, the new administration faces the same challenges as the departing Congress party. Growth is anaemic, the key industrial sector lacks momentum and the potential for a drier-than-usual monsoon season could put pressure on food prices. A revival in much-needed infrastructure spending would certainly help and expectations are that this will be high on the new government's agenda. Expectations of an economic recovery are high but the challenges remain given the Congress party remain in control of the Upper House for at least another year and as there is no guarantee that Modi's success in his home state of Gujarat can be replicated on a national level. Change in a country as large and diverse as India must necessarily take place over many years.

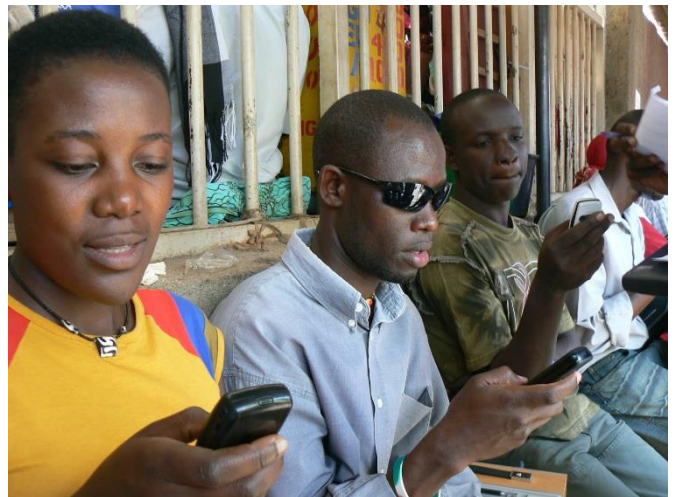
Indian equities are at all-time highs this calendar year, on the back of election euphoria. At the corporate level, many companies are beginning to look expensive following the rally. While the IT sector has suffered some profit-taking after a long run-up, it still looks costly, and the same goes for many consumer stocks. As such, there is potential for some volatility ahead. However, a revival in economic growth would likely support earnings in cyclical sectors, which should underpin valuations there.

Regardless, India's long-term attraction as an investment destination remains undiminished. With excellent demographics and a multitude of well-run, shareholder-friendly companies, disciplined stock-pickers with a longer investment horizon should be well rewarded.

## Frontier Markets

From Audley Twiston-Davies, Chairman, BlackRock Frontier Markets

Frontier Markets have continued to significantly outperform Emerging Markets into the first quarter of 2014 and we believe that many countries in the Frontier universe offer significant growth, value and yield. However, much of the significant demand for Frontier Markets over the last year, with a surge in inflows from both Frontier funds and higher allocations from Emerging Market funds, has been deployed in sub-Saharan Africa, where the budget and current account deficits are a cause for concern.



## Private Equity

From Simon Borrows, Chief Executive, 3i

Further regulation across the financial services industry is presenting additional challenges for our business through further costs and increased complexity.

The current environment is a tricky one for new investments. There is an excess of capital looking for investment opportunities and this has driven up sellers' price expectations.



### From Ed Warner, Chairman, Standard Life European Private Equity

An improving macro-economic environment and broadly favourable listed equity markets, coupled to signs of increasing mergers and acquisitions activity in Europe, should result in a continuing flow of realisations from the Company's portfolio. This is particularly true for those investments made in 2006-07, which are mature. Increasing mergers and acquisitions activity should also result in a rise in deal flow for new investments.

### From Michael Bunbury, Chairman, Harbourvest Global Private Equity

Many of the world's economies still have some way to go to return to a more normal state following the 2008/9 financial crisis. Undoubtedly that will result in higher short-term interest rates in the developed economies in due course. However, the recovery in the world economy, although patchy and relatively anaemic in many countries, appears in general to be entrenched and many areas of the private equity market are buoyant.

## UK Property

### From Chris Grigg, Chief Executive, British Land

We remain positive about the outlook for our markets although you could argue that political risks, both at home and abroad, are greater than they were a year ago and these may have an impact. In London, we see rental growth along with the letting up of completed development space being the key drivers of our Offices performance given yields have already compressed significantly. In Retail, away from London, investor appetite is strengthening and retailers are clearly more confident about the outlook for consumer spending and looking to take space in the best locations. We are more positive about the potential for further yield compression and expect rents for high quality space to benefit over time as consumer spending continues to improve.

### From Robert Noel, Chief Executive, Land Securities

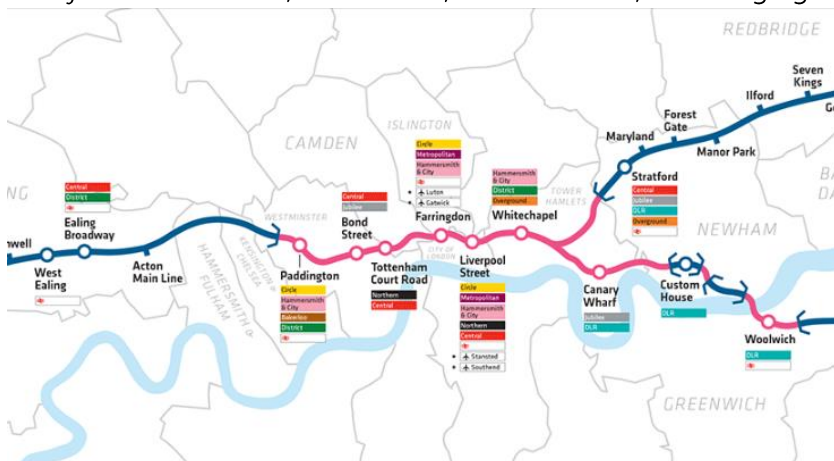
The lead up to a general election is bound to bring an element of uncertainty to the business community. However, extraordinary events aside, we do not expect to see a correction of the balance between supply and demand in the London office market over the next two years. There is not enough efficient, technically resilient space for businesses and this bodes well for our committed speculative developments.

We recognise that the risk profile of future speculative development is changing as competition for sites has increased, construction costs are rising, and development activity is set to pick up. As a result, any new development commitments in the near term are likely to require pre-lettings.

In retail, a return to economic growth and real growth in wages is welcome news for retailers, but we still do not expect this to translate into rental growth across the entire retail market.

### From Brian Bickell, Chief Executive, Shaftesbury

Recovery in business and consumer confidence is increasingly evident, both in the UK and other countries affected by the global financial crisis. The ever-growing popularity of London's world-renowned attractions, many of which are in, or close to, the West End, are bringing increasing numbers of visitors and spending.



Similarly, London's status as an international business hub continues to attract businesses, particularly from the media, creative and IT industries, stimulating development of new office schemes in and around our locations and adding to employment opportunities for London's rapidly growing population.

Crossrail, currently the largest infrastructure transport undertaking in Europe, is expected to increase London's rail capacity by 10%. Providing more

comfortable travelling conditions, and reducing congestion at nearby Underground stations, it will improve accessibility to the West End, and consequently is proving to be an important catalyst for regeneration. In addition to developments in the vicinity of the stations now under construction, major public realm improvements are now being planned which will provide greater capacity for the expected substantial increase in visitors to the West End. The Tottenham Court Road and Bond Street transport hubs are together, expected annually to handle 220 million passengers by 2026.

#### From Nicholas Vetch, Chairman, Big Yellow

Increasing political uncertainty and interference, combined with an exuberant housing market in London and the South East, gives scope for some trading volatility in the short term. That said we have high confidence in our core markets as we believe that a number of factors will be helpful to our continued growth.

We consider that a large part of the anticipated net immigration and population growth in the UK will continue to concentrate in London and the South East.

We also note that new housing developments in London are at a multi-decade high and as completions increase this should translate into more housing transactions. Land in London and the South East continues to be increasingly scarce for non-residential development.

#### From Toby Courtauld, Chief Executive, Great Portland Estates

On the demand side, the speed of the economic recovery has surprised on the upside, and renewed optimism is driving business confidence. A recent survey by The London Chambers of Commerce and Industry found that 72% of firms in London expect turnover to rise in the year ahead, the most optimistic outlook since the quarterly surveys began in 1989. The strengthening of business confidence is feeding into business expansion and, in turn, tenant demand for new space. For the year ended March 2014, central London take-up was 13.7 million sq ft, exceeding its ten year annual average for the first time since 2011. This trend is expected to continue with office-based employment in inner London, a key driver of demand for office space, expected to increase by an average of 2.1% p.a. over the coming five years.

On the supply side, the development pipeline remains relatively muted compared with previous cycles with development activity still constrained by a lack of development finance. Meanwhile vacancy levels in our core markets remain low. Across the central London office market as a whole, development completions in the year to March 2014 of 4.5 million sq ft were 178% higher than the prior year. In the core of the West End, the focus of our activities, completions totalled only 1.6 million sq ft.

Looking forward, we can expect a pick up in the speculative development pipeline as developers have started to respond to improved levels of demand and the prospect of rental growth. However, forecast supply remains below the long-term average and the lead time between development starts and completions means it will be some years before any meaningful amount of new space can be introduced.

Tenant needs continue to evolve and in particular there is strong evidence that employers remain focused on positioning their businesses to win the 'war for talent' through providing their current and prospective employees with an attractive working environment. Equally, businesses remain cost-conscious and are attracted to well-located, modern space, preferably close to good public transport links and crucially where they are able to increase the density of their occupation.

The barriers to development continue to increase, with the often lengthy planning consent process becoming both more complex and costly. In addition, construction costs are beginning to rise, although from a low base.

Compared to a year ago, the property capital value indicators are broadly neutral, although bond yields have increased and the real yield spread has reduced. However, the weight of money looking for London property has not diminished resulting in a record year for investment transactions and supporting property values. Rental value indicators remain strong with economic growth metrics, the key driver for rents, surprising on the upside. As a result, we expect that the occupational market will continue to favour the landlord with rental values for sensibly priced, well-located buildings growing over the medium-term.

### From J.G. Whateley, Chairman, The Local Shopping REIT

The national trend for the retail sector has shown positive signs in recent months, including a notable improvement in the performance of shops selling household goods. There has been a notable decline in the number of household name retailers going into administration since Christmas. Market commentators appear to agree on the likelihood of this trend continuing into the latter part of 2014, fuelled by continued upward employment trends and low interest rates and a resurgent housing market. The investment market for local shopping assets remains healthy, with auctions and private treaty sales reporting strong volumes and results for well-let assets in better locations.

Whilst the overall picture is increasingly positive, we expect the trading environment for individual local shopping and convenience retailers to remain highly subject to regional and local factors. Many local retailers are still seeking to recover from bouts of heavy discounting and price competition that spilled into their market from the supermarket sector during 2013. Others face increasing challenges arising from technological change, particularly internet shopping, home delivery and "click & collect" although these factors appear less marked in local and convenience shopping.



Overall we expect sub-sector to continue to perform with the same resilience and opportunism that it has displayed during the recent period of turbulence.

### From Aubrey Adams, Chairman, Max Property

Improving economic growth combined with strong capital flows seeking to enter the UK property market provides a favourable backdrop. Given the excesses of the previous boom and severity of the downturn, the return of a buoyant property market has prompted some to question its sustainability. Property yields are compressing but, for the property sectors in which Max operates, this reflects genuinely improving fundamentals. Whilst yields may be edging towards historic lows for Central London offices, the outlook for rental growth is excellent with falling vacancy rates, strong occupational demand and a limited speculative development response. Meanwhile in the regions, secondary industrial yields have until recently remained at elevated levels reflecting the previously fragile nature of the recovery and we invested with the expectation of a rebound in prices once economic confidence returned. It is, therefore, pleasing to see growing optimism and positive sentiment now starting to be reflected in these markets.

In short, we expect 2014 to be a good year for the commercial property market. The extent to which this positive momentum carries on into 2015 and beyond is dependent upon the UK's economic recovery being sustained and the level of property prices. In any cycle, there is always the potential for prices to overshoot but in our judgment we are not yet at that point.

### From Simon Laffin, Chairman, Assura Group

It remains a disappointment to us that continued disruption from the NHS reorganisation is causing a significant slowdown in the approval procedure of new premises for GPs. There is near universal agreement that more care should be delivered by primary health providers, as it is both more efficient and preferred by patients, but the truth is that GPs often simply do not have the facilities to be able to offer this. When the Government does turn its mind to tackling this issue, as surely it must, it will find a private sector willing to supply the capital at highly competitive rental levels, which are themselves regulated by government employees. It is a highly efficient and cost effective model for private sector funding of state infrastructure.

Whilst the current economic and political climate had depressed both open market rent reviews and new developments, the Board believes that open market reviews are a lagging indicator and as the economy continues to recover, this will feed through into rent reviews in the future. Once the NHS reorganisation settles down, we also believe that the overwhelming need for replacement and upgrade of GP surgeries will reassert itself and demand will recover.

### From Caroline Burton Chairman, TR Property

The economic fundamentals across Europe are now more favourable for real estate than at any time in the last six years. The return to growth experienced in the UK, Scandinavia and Germany is now feeding into tenant demand and rental growth. Real wage inflation and rising house prices are key drivers of renewed consumer demand, a fundamental building block of growth. Sources of debt finance, both traditional banking and non-traditional (private equity, insurance companies and private placements), have broadened and become increasingly competitive, to the benefit of companies we invest in. Simultaneously many listed property companies have been able to take advantage of the capital markets (both debt and equity) to further reduce their cost of finance. Elsewhere in Europe, even though rental values have not begun to increase, property investment markets are thawing fast as capital seeks to buy into these perceived recovery plays, particularly in the peripheral nations.

Our managers remain positive towards those markets where rents are responding to tenant demand even though many share prices are standing at, or in excess of, historic asset values and they remain confident about the inherent growth in these well managed businesses. They remain positive on the economic outlook in the UK and alongside the activity in the existing UK physical portfolio they have been seeking to selectively increase the physical exposure focusing, as they have done in the past, on office and industrial property in the South of England.

Our concern rests with the exuberance of investors where underlying tenant demand remains fragile. With fixed income returns looking increasingly unappealing capital is seeking alternatives such as commercial property. However rapid asset value inflation may lead to poorer than expected returns in the medium term if the anticipated economic improvement does not translate into growth and jobs.

### From Marcus Phayre-Mudge, Fund Manager of TR Property

The difference in the broad economic outlook between the UK and much of the Eurozone has never been so stark. The UK is experiencing one of the fastest economic recoveries amongst the world's advanced economies and growth of 3% is predicted for 2014. We remain confident that the increase in business activity and consumer confidence will translate into more demand for commercial property from tenants and investors. In residential exposure we see the strength of Sterling and political intervention (through greater taxation) as headwinds for overseas investors. All investors are aware that it is more than highly likely that the UK will be the first European country to raise rates.

Scandinavia, and in particular Sweden remains of great interest. The outperformance of the Swedish property companies over the last 12 months confirms that we are not alone in this view. It benefits from a better economic outlook than much of the Eurozone and the Riksbank have been determined in their efforts to keep the currency from strengthening too much. The housing market is steady (if a little hot in key cities) but real wages are rising. The commercial property market is liquid and valuation is transparent.

Eurozone CPI (a measure of inflation) has been below 1% year on year in each of the last six months, averaging just 0.7% since October 2013, even with Germany as the positive outlier. The consensus is for some form of unorthodox monetary stimulation by the ECB during H2 2014 following the reduction of the base rate to zero. It is this expectation of major policy adjustment which is driving both equity markets upwards (even as many European corporates fail to meet earnings expectations) and bond yields further down. The short term result is that a number of Continental European property companies which have a weak outlook for earnings growth are enjoying unexpected, and in our view unwarranted, share price appreciation. However the message is clear; 'don't fight the ECB'. Peripheral European bonds have also benefited from this stimulus expectation and this will continue to feed into local asset prices. It's always an uncomfortable position for fundamentally driven investors like ourselves when such extraordinary credit liquidity coupled with the elimination of sovereign tail risk (through central bank promises - Draghi's key July 2012 comment '...we will do whatever it takes...') drives down both yields and bond spreads as investors use the policymakers backstop as an open ended insurance policy.

This discomfort doesn't stop us from understanding the market's appreciation for property assets but as always we remain focused on those businesses and markets likely to enjoy a genuine supply/demand

disequilibrium. I would remind shareholders it is the serious lack of new construction over the last five years which really emboldens our medium term positive prognosis.

## Infrastructure

**From Graham Picken, Chairman, HICL Infrastructure**

With the attractions of infrastructure investments better understood, new and additional capital has entered the market. As a result, it has become more challenging to source investment opportunities with the risk-reward characteristics of earlier acquisitions.

**From Ian Reeves, Chairman, GCP Infrastructure**

The various types of long term infrastructure lenders that have emerged in recent years, including institutions, debt funds and to a lesser degree the bond markets, only serve a limited section of the Company's broad target market. These lenders tend to be limited in how they can lend in terms of loan length, size, security, project technology and construction exposure.



Developers in a variety of renewable energy sectors, particularly various areas within the biomass sectors, are still struggling to find long-term lenders. This lack of credit has created a number of attractive investment opportunities in

renewable energy projects that are supported by government subsidies in one form or another.

The yields available on most secondary, availability-based PFI transactions fall below levels where they are attractive.

## Debt markets

**From Paul Read & Paul Causer, managers of Invesco Perpetual Enhanced Income**

The high yield bond market has continued to deliver strongly positive returns in recent quarters, despite the weaker conditions we have seen across the wider bond market. The market is now quite fully valued, in our opinion, and we see little potential for further capital appreciation from current levels. Yields and spreads are low by historical standards.

## Utilities

**From Ecofin Water & Power Opportunities**

Against a background of slowly improving prospects for global growth but continuing concerns about emerging economies, the weakness of Euro-zone growth and the prospects for interest rates, particularly in the United States, the outlook for the sectors in which the Company invests is improving. While challenging for many industry participants, fundamental changes affecting utility, infrastructure and energy markets in the developed markets are creating new opportunities for investors, as is the need for new investment in these industries. The modest outlook for global growth and the nature of the changes taking place means, however, that the dispersion of returns in equity markets is likely to be great which will put a premium on asset allocation and stock selection.

In the current market, North America still represents the best risk reward profile with increased visibility on the economy, a benign regulatory environment, relatively less market volatility and a very large and diverse investment universe. Power markets are changing due to environmental regulation, the growth of renewable

energy generation and regional capacity constraints while the shale energy revolution is driving massive new investment in infrastructure such as pipelines.

In Continental Europe, after years of industry turmoil, conditions are stabilising and much of the sovereign and regulatory risk in the utility sector is reflected in equity market valuations. Politicians also appear to be becoming more supportive of the power industry out of a concern for the security of future energy supply following a massive investment in renewable energy, years of under-investment in thermal power plants and the resulting high energy costs for industry and households. As a consequence, the sector is looking more attractive to investors given the values and yields on offer and managements' strategies are once again becoming a key differentiator of company performance.

In the United Kingdom, the investable universe is small and political risk has increased as energy affordability has become an issue in the run-up to a General Election in May 2015. A major theme in the power sector is the closure of power plants and the slow pace of investment in new generating capacity which is leading to declining reserve margins which, over time, should lead to higher power prices and more incentives for new investment. The water sector has also been going through a periodic regulatory review which saw valuations come down to more attractive levels before the review provided investors with greater clarity about allowable returns.

We see value in Europe in utilities with recovery stories and sustainable dividends and in a range of power and energy transmission companies in the United States. The role of natural gas, as a low cost and low CO<sub>2</sub> emissions source of power generation, is one of the major themes in the global power industry. Renewable energy, although transformational in power industry terms, is still subject to changing government energy policies.

## Healthcare

*From James Robinson, Chairman, Polar Capital Global Healthcare*

We have recently seen a significant correction in the biotechnology sector which has prompted questions as to whether the prolonged rally in healthcare has now come to an end. Our managers believe that a correction in biotechnology was probably overdue and would not be surprised to see the sector recover from this setback. Our manager believes that large pharmaceutical companies will be beneficiaries of current and forthcoming innovation through their in-licensing and M&A strategies with biotechnology and we are also increasingly optimistic about the strength of pipeline development at several of these companies where any success should have a favourable impact on share prices.

*From Dr Daniel Mahony and Mr Gareth Powell, managers, Polar Capital Global Healthcare*

Our investment thesis on the pharmaceutical industry has started to evolve. As investor concerns regarding patent expirations have dissipated, the key questions now relate to mid- and long-term growth potential. Drug pipelines seem to be improving across the sector, not least because of the way the large companies have looked to the innovators in the biotechnology sector as a source of new drug candidates. However, we think that we will begin to see a great dispersion of returns going forward based on the perceived strength of each company's pipeline and, therefore, its earnings growth potential.



This view is consistent with the business development activity across the sector. Large companies continue to compete with each other to in-license the best drug candidates from smaller biotechnology companies. In addition, we have seen management teams looking to dispose of business units that they see as non-essential and acquire assets that can help build strength and scale in their key growth areas. The most recent example of this was a three-way asset swap between Eli Lilly, GlaxoSmithKline and Novartis that was announced after the end of the reporting period. The industry seems to be "moving

the chairs around" as companies prioritise their growth objectives and look to build competitive advantages

accordingly. We see these developments as a positive for the sector as a whole but it seems likely that certain companies will fare better than others in these endeavours.

On a broader healthcare perspective, we continue to see a lot of innovation occurring within smaller companies in the biotechnology and medical technology sectors. We are also very interested in the emerging area of digital health that has the potential to disintermediate and disaggregate the current healthcare system - this has the potential to create new risks and opportunities within the sector. Our investment focus remains on companies that have products or services can help cut the costs of healthcare - a critical issue for governments given the aging population.

Collated from publicly available information and edited to remove fund specific information where possible. This note was produced by James Carthew<sup>†</sup> for QuotedData. QuotedData is part of Marten & Co which is regulated by the Financial Conduct Authority.

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