October 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.

In this month's roundup

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Global economy (*compare global funds here*)

In the short term, as ever, there are doubts and concerns. These vary every year, but they are always with us. Politically we face acute crises in the Middle East and Eastern Europe. At home there is the potential for constitutional, fiscal and regulatory change following the Scottish Independence referendum on 18 September 2014. At this stage, it is impossible to see what the implications of the result will be. Economically, Western Europe's recovery from the financial crisis is disappointingly sluggish and there is much uncertainty as to how long the current extraordinary low interest rates will be maintained and what the effect will be if and when unconventional monetary stimulus is reduced and eventually withdrawn.

Fixed interest investments are extremely expensive by historical standards, though they may remain so for a long time, and equities only look attractive by comparison - in their own terms they too are expensive, if not to the same degree as bonds. However, we live in a time of innovation and scientific advances in a host of areas, comparable to the periods when railways were being built and the chemical, electrical and automobile industries were being developed. This has created a wealth of opportunities for investors. *Richard Burns, Chairman, Mid Wynd*

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Global equity markets have recovered their poise since the panic selling of 2009. Valuations are quite high compared with historical levels, but are supported by central banks, who are keeping interest rates - and government bond yields - low. Indeed, while many equities trade on high earnings multiples, they often have attractive dividend yields and have sufficient spare cash to buy back shares. Since the global financial crisis, a range of companies have 'put their houses in order' and now have healthy cash flows and strong balance sheets even if sales growth remains modest. High quality businesses that can profit from growth in the global economy without taking excessive risks...should continue to deliver superior returns to those available from other asset classes, such as bonds or cash.

At current levels, we are wary of holding stocks whose valuations seem to reflect a hope that we will see a vigorous recovery in the global economy (particularly where share prices seem to be discounting a strong rebound in Europe). *Simon Edelsten, Alex Illingworth and Rosanna Burcheri, Fund managers, Mid Wynd*

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While the global economy continues to expand at a moderate pace, the challenges within global financial markets remain both significant and large in number. A great deal of investor anxiety lies beneath the calm surface as the attention of Western authorities focuses on inflation and the timing of possible interest rate rises. Meanwhile, policy change at both economic and political level continues to be a distortive market force with returns in the short to medium term likely to be muted. Despite this testing and changeable investment backdrop, the Investment Manager believes active management is set to remain a key driver of investment returns over the longer term as many positive investment opportunities are taken advantage of. *Simon Davies, Chairman, JPMorgan Overseas*

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While we are unlikely to see the dramatic performance in equity markets that was experienced over the last 12 months, we remain positive in our outlook for equities. The key drivers remain in place, namely improving global growth, accommodative monetary policy, and still-supportive valuations. The company results season has seen some of this economic growth feed through into corporate earnings, the anticipation of which drove much of the valuation multiple expansion over the last year. An environment such as this would typically be positive for more economically sensitive, cyclical areas of the market. Continued M&A activity would also be supportive of equity markets. Corporate deals have soared this year amid renewed confidence from company management teams with company margins at all-time highs and cash flows generation strong. Looking forward, we will need to see continued economic growth and sensible central bank policy guidance for this to continue.

Investors will be keenly monitoring the resilience of the global economy in the face of possible rising interest rates, as the continuing strength of the US economy and improving labour market has brought forward expectations of rate rises. This need not be threatening for financial markets and economic growth, provided the US Federal Reserve communicates any interest rate increase with the same clarity and consistency as they did in reducing the economic stimulus. In contrast, in Europe, the economic and company earnings outlook remains less assured and in the advent of weaker inflation data, the European Central Bank may consider further stimulus as a last resort. *Jeroen Huysinga, Investment Manager, JPMorgan Overseas*

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Many commentators and investors are characterising 2014 as a year of normalisation for the global economy. In contrast, we believe we are moving deeper into unchartered territory in terms of government intervention with free markets and manipulations to the price of money. Using the UK as an example, GDP growth and unemployment are back at 10 year averages and property prices are booming; but interest rates are at 300 year lows supplemented by additional expansionary policies. Central Bankers around the world have been explicit that they are unhappy with current trend growth and are willing to pursue all available options to achieve a higher rate - specifically this includes tolerating higher inflation as a consequence. The preferred tools have shifted from QE and low interest rates, the benefits of which seem to accrue mostly to the rich, to "supporting the real economy" via state directed lending such as Help to Buy or Funding for Lending. Even the previously recalcitrant ECB has joined in on the act, targeting lending to small and medium sized businesses and enforcing a negative deposit rate to encourage/force banks to lend - the lines between carrot and stick are blurred. It seems to us that the wanton stimulus of policymakers will become more extreme and experimental in an effort to achieve escape velocity. All the while they are walking the tightrope of monetary instability with deflation on one side and inflation on the other - the teetering funambulist is wobbling in the latter direction.

After a short period in the sun, Japan is once again unloved. The same foreign investors who surged into Japan a year ago have demonstrated short attention spans and are beginning to question the substance to Prime Minister Abe's reform agenda. At odds with this view, we see change continuing to gain traction as tough decisions have been made in pushing through an increase in the consumption tax from 5% to 8% and with exciting reforms to the government pension fund around the corner. We have also seen positive wage growth for the first time in 15 years (this is a key piece of Abe's jigsaw) and inflation has been positive for 12 consecutive months - quite a boast in Japan.

Protection continues to cost us but unlike last year this has not been offset by gains elsewhere. Interestingly this problem afflicted us in 2006 when the market was at its most exuberant prior to the financial crisis. Record low volatility, narrowing credit spreads, high valuations and investor complacency all suggest that the market is riding for a fall and the flip side of this coin is that there is no appetite for protection - risk is the only game in town. The ostriches may be having their day in the sun but we doubt this will last. *Ruffer LLP, as managers of Ruffer Investment Company*

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UK (*compare UK equity funds here*)

Equity markets have performed strongly over the last year. The global macro-economic environment has been getting gradually better with world GDP forecast to show faster growth in both 2014 and 2015. This is being driven mostly from developed rather than emerging economies.

The UK economy has seen a strong recovery with a number of upgrades to economic growth over the last year. There has been a noticeable improvement in the housing market, with a rise in prices and transaction levels, aided by low interest rates and Government initiatives. The unemployment rate has fallen and there are signs that wage inflation is starting to rise, albeit modestly. All these factors are boosting consumer confidence. With the UK economy strengthening, the focus has now shifted as to the likely timing of an interest rate rise. Guidance on this matter from the Bank of England has fluctuated over the past few months but the consensus view is that we can expect the first move in late 2014 or early 2015. However, as it currently stands, rates are expected to rise slowly and to levels well below historic norms which should allow the nascent UK economic recovery to continue.

After the rise in the past few years, stock market valuations are now back to long-run historic averages. Corporate profitability has proved robust but has not shown much growth in recent years. It is difficult to see the market making material progress from current levels without an increase in corporate earnings. However, given an improving economic backdrop we are hopeful that the outlook for corporate profitability is improving somewhat. Mergers and acquisition activity is currently subdued as management teams are unwilling to take on financial leverage in the face of perceived economic uncertainty. An increase in M&A would be helpful for smaller companies in particular as mergers and acquisition activity tends to be focused in this area. *Neil Hermon, Investment Manager, Henderson Smaller Companies Trust*

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The interest rate environment has been incredibly benign during the year, with base rates in the UK remaining at half of one percent for more than five years now. A similar pattern is evident in the US, Europe and Japan. Under the influence of continued injections of QE across the developed world, strong economic growth in the UK and US and recovery in Europe and Japan have been established. In the UK, consumer confidence and industrial production are very buoyant. The housing market in London and the south east is showing signs of overheating. The ripple of higher house prices is spreading across the UK as the Government's help-to-buy scheme is starting to take effect. Corporate profit growth, particularly in the more cyclical sectors, is accelerating. The Chinese economy is slowing but still showing 6% plus growth. Oil prices have remained quite stable at around $110 per barrel, even though political instability in the Ukraine, Syria and Iraq has made the world a more dangerous place. Partly in response to this sterling has strengthened against most international currencies over the past year.

The constantly improving economic backdrop driven by ultra-low interest rates and QE has helped smaller companies markets to rise by around 300% from the lows of early December 2008 with some commentators suggesting that an asset bubble is in the process of being formed. First sight of a future of rising interest rates caused significant weakness in smaller companies from March 2014 onwards. Monetary authorities are now seen as being more cunning in their ability to pull the levers that drive the world economy. There is growth in the belief that, to paraphrase Gordon Brown, 'the economics of boom and bust have been banished'. We do not share this view.

At this time many of the more cyclical industries are moving towards profit margin levels that are quite close to those last seen in 2007. Cyclical stocks, after five years of recovery, have now delivered strong long term earnings records that make the earnings growth track record of our consistent quality growth holdings look quite pedestrian.

The new issues market since March 2014 until recently has been remorseless. While providing new investment opportunities, it has seriously sapped the strength of markets as investors have had to sell existing holdings to buy the new companies. Summer provides a lull to these activities which will return in the autumn.

Acquisition activity is likely to increase from very low levels over the next 12 months. There is no shortage of well financed large companies looking to bolster growth further down the market cap. spectrum.

Whilst investment returns should be good over the next five years, it is unlikely that smaller companies will deliver the spectacular returns of the previous five years. A period of rising interest rates may begin later this year which should temper the extraordinarily supportive current business environment. 'Boom and Bust' is not over. The interconnectedness of global markets and banking systems, the very high levels of sovereign and personal debt and increased levels of geopolitical instability, particularly in regions where vital oil & gas resources are to be found, all suggest that caution should be the watchword. *Harry Nimmo, Manager, Standard Life UK Smaller Companies*

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Equity markets need growth in profits to make significant near term gains. It may be possible for the rating of markets to continue to improve but this is clearly a process with only limited scope. Faster profits growth has proved elusive in the UK over the last few years. There are some signs that the underlying picture is improving. For example surveys of the dominant service sector are optimistic about activity. However, there are some immediate problems which will need to be overcome for sustained growth. At the highest macro-economic level the lags associated with monetary policy make it very difficult to judge when growth might accelerate beyond the moderate recovery so far achieved. It is possible also that globalisation is having the perverse effect of raising labour costs for companies in developing economies to which activities have moved while depressing profitability. At the same time real wages in advanced economies have been falling because of the same process with effects on consumer confidence and demand. At a more mundane level the recent strength of sterling has been cited by many companies as a reason for disappointing profits. This is a more cyclical influence and can be expected to stabilise fairly soon given the level it has reached.

The international political scene looks bleak. It is very difficult to know how far possible future outcomes have already been discounted and there is clearly scope for shocks. The most vulnerable point for markets is probably the price of oil which has been very stable helped by US shale oil production and quite weak OECD demand. The fact that both Russia and Iraq are major producers is disturbing although it doesn't seem to have had any effect so far. *P A F Gifford, Chairman, Murray Income*

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Over the past couple of years the FTSE All-Share Index has appreciated by around 30% on a total return basis, yet corporate earnings have remained essentially flat. It seems improbable that the market will be able to make further progress unless earnings growth resumes. Although an improvement in economic growth is likely to be a helpful underlying dynamic, profit growth is likely to remain hard won with debt funding costs unlikely to reduce further, taxation benefits more difficult to obtain and the prospects of rising domestic interest rates likely to provide a further headwind. An additional concern may be the complacency and elevated animal spirits evidenced by recent IPO activity that has resulted in a number of companies with weak business models coming to the market at premium valuations. It seems unlikely, therefore, that the market will be able to deliver similar levels of returns to those of the past couple of years.

Unsurprisingly, given the share price movements we have witnessed, it is becoming more difficult to find attractively valued investment opportunities. It may well be the case that larger companies, on the basis of their more attractive valuations and increasing desire to crystallise value through becoming more focused, outperform their smaller peers. We believe that globally competitive businesses with strong balance sheets will prosper over the long term and ultimately offer the best earnings and dividend growth prospects. *Charles Luke, Aberdeen Asset Managers Limited, Investment Manager, Murray Income*

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Recent economic data has been indicative of a recovery in the UK. Although this domestic improvement is positive news for UK smaller companies, it is somewhat offset by the lacklustre recovery within the Eurozone which appears fragile. The spectre of deflation, coupled with concern over the potential impact on growth of the ongoing geo-political issues in Russia and Ukraine add to the Eurozone's woes. In the UK, the strength of sterling has acted to erode some of the gains made by companies trading with the primary export markets of the Eurozone and U.S, although more recently the pound has weakened amid uncertainty around the outcome of the Scottish referendum. The inevitable rise in interest rates - as intimated by the Bank of England - may also create more challenging conditions for growth. However, against this backdrop your portfolio manager believes that there is still much to be positive about, not least the exposure of UK smaller companies to the more benign domestic environment, a strengthening labour market and increasing consumer spending. *Ian Barby, Chairman, Invesco Perpetual UK Smaller Companies*

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Heightened geopolitical risks and the ongoing reduction in central bank stimulus are currently weighing on investor sentiment, and there is no doubt that these factors could have an impact on company prospects over the coming period. Uncertainty about the outcome of the Scottish referendum and the UK election in 2015 may also cause some short-term concerns - although the next government will remain constrained in what economic actions it can take by the ongoing requirement to reduce the budget deficit. That said, there are many reasons to be optimistic: (a) The broadening economic recovery in the UK is a clear positive for domestic businesses and the improving situation in the US and Japan will benefit export business exposed to those regions; (b) The currency headwinds that UK exporters have been facing are showing signs of abating, putting less downward pressure on forecasts; (c) The selling pressure from fund managers moving up the market cap scale will reach an end once those allocation switches have been completed; and (d) Valuations still look reasonable and we are seeing signs of increasing takeover activity after a particularly quiet period. *Jonathan Brown, Portfolio Manager, Invesco Perpetual UK Smaller Companies*

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Economic growth has become established in the UK and US, and the debate has moved on as to when interest rates will be increased from the emergency level introduced during the financial crisis. In Europe, hopes of an improvement in growth are battling against the deflationary forces resulting from the continuing weakness of many European banks. Emerging markets continue to hold much long term potential despite current difficulties in some countries.

Share prices tend to discount the future and an element of derating is occurring during 2014 after the strong rise in share prices during 2013 and 2012, and ahead of a likely rise in interest rates. Given low UK inflation and the weakness in wage increases, any upward move in interest rates is likely to be gradual. As a result, equities are set to remain attractive on a dividend yield and growth basis relative to fixed interest and bank deposits. *Philip Remnant CBE, Chairman, City of London Investment Trust*

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The UK economy continues its recovery prompting upgrades to forecasts for GDP growth. This backdrop will support the growth of UK businesses, and despite recent setbacks in the UK mid cap sector, which our investment managers believe have been primarily as a result of profit taking and not underlying shortcomings within the mid cap universe, they remain confident that the sector will continue to generate interesting and rewarding opportunities. *Andrew Barker, Chairman, JPMorgan Mid Cap*

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Given the recent geopolitical upheavals seen in the Ukraine, Gaza and Iraq, the resilience of UK stock markets may have come as a surprise. However, while recent events on the global stage are clearly disturbing, we see good reason for the equanimity currently displayed by equity markets in the developed world.

The economic backdrop in both the US and the UK continues to strengthen. Forecasts for GDP growth have increased again in both countries; in the UK the Bank of England recently upgraded its UK outlook to 3.5% growth in 2014, and 3% in 2015. Inflation remains subdued and unemployment continues to decline at a rapid pace. Although interest rates are likely to rise in the next six months or so, any rate rise is likely to be gradual and monetary policy will be set in a way that helps to sustain growth and employment. Current low wage inflation is likely to affect the consumer, but this should result in rate rises being tempered.

The message from UK businesses also continues to improve. A recent report by Lloyds indicates companies are at their most confident in over 20 years and business activity continues to rise across the country. This should lead to an increase in capital expenditure - an important ingredient for future growth. Following the recent pull-back in mid cap equities over the summer, we are very comfortable with valuations and the earnings outlook.

While political uncertainties will increase ahead of the General Election next may, the clear majority in the Scottish referendum in favour of maintaining the Union removed a significant uncertainty for investors. However, the ultimate political and economic consequences for all members of the UK may take some time to emerge. Nevertheless, it is our expectation that markets will be higher in a year's time, although there will continue to be bouts of volatility along the way. *Georgina Brittain, William Meadon, Katen Patel, Investment Managers of JPMorgan Mid Cap.*

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Europe (*compare European equity funds here*)

Fears that "tapering" of monthly asset purchases by the Federal Reserve Bank, America's central bank, would lead to rising bond yields and falling equity prices have so far proved wide of the mark. It may be that when interest rates begin to rise - from an historically low base - the market may see this development as proof of a stronger economy. However, with 10 year German bunds yielding 0.96 per cent., and Spanish bonds yielding less than US Treasuries, the attraction of European bond markets is less than compelling, especially if the authorities take steps to minimise the risk of deflation. Meanwhile, UK and European shares at least offer the prospect of rising dividends as well as capital appreciation. *Hugh Priestley, Chairman, Jupiter European Opportunities*

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Emerging Markets *(compare Emerging Markets funds here)*

The past twelve months saw frontier markets deliver on their promise as economic growth across many of our markets was translated into earnings growth. We remain confident in the longer term frontier story backed by strong growth, healthy corporate and sovereign balance sheets, favourable demographics, large natural resource endowments and attractive valuations.

We note that interest in frontier markets has increased and there is a risk that continued foreign investor inflows may push valuations to unsustainable levels. So far this is not the case with the MSCI Frontier Markets Index trading on trailing Price to Earnings and Price to Book multiples of 12.1x and 1.9x respectively at period end. Furthermore, the index only represents a small subset of the opportunities available in the hugely diverse frontier space.

Political risk has always been paramount when investing in individual frontier markets. Renewed conflict in the Middle East and the rise of militant extremism in Sub-Saharan Africa are two issues that we will be monitoring especially closely over the next year. So far, manager meetings and country visits by the investment team [*have confirmed*] that many companies within frontier markets continue to deliver strong growth despite these headline-grabbing events.

The strong run in UAE and Qatari equities ahead of their promotion to the MSCI Emerging Market Index and subsequent sharp sell-off highlights the risks of pursuing an index based strategy. *Advance Emerging Capital Limited, managers of Advance Frontier Markets*

In many ways the economic environment for emerging markets companies has become more positive in recent months. It seems that concerns over the 'tapering' of the United States' quantitative easing programme are lessening as the gradual pace of change makes it more likely that the majority of countries can adjust to a new environment.

[*Our manager*] sounds a longer-term note of caution for investors, however. The Manager suggests that emerging markets companies may not be able to maintain the same levels of profitability over the next few years as they have over the last decade, and hence that future stock market returns may be lower than those to which investors have become accustomed.

As a Board we take the view that in this environment the variation in performance between good and bad companies is likely to widen, and therefore that the importance of good stock selection only increases. A well-diversified portfolio of high-quality stocks - managed by a proven stock-focused manager - remains, we believe, the best way of generating attractive returns from emerging markets over the medium to long term. *Coen Teulings, Chairman, Genesis Emerging Markets*

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Whilst we continue to believe that the long-term outlook for emerging market companies remains strong, our bottom-up analysis suggests the portfolio is likely to deliver a lower return going forward than over the previous decade. Over the last three years, the portfolio return on equity has fallen from over 22% to around 16%, and our analysis indicates that, although there may be a recovery in some sectors, we do not anticipate the portfolio profitability recovering to previous levels. In addition, growth in many industries is likely to be slower as penetration rates in emerging markets have increased, for example beverage consumption, bank credit, mobile telephones, the shift to modern retail trade, cement and steel consumption in China. There are still many areas of under-penetration (e.g. banking in India, consumer goods in Africa, e-commerce globally) but looking at the portfolio in aggregate, companies have fewer opportunities for reinvestment than a decade ago. Companies may deliver results that exceed our expectations but we prefer to be cautious, especially given the challenges China faces in rebalancing its economy and the uncertain impact of an eventual normalisation of interest rates in developed and some developing economies. *Genesis Asset Managers, LLP, as managers of Genesis Emerging Markets*

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Mining and Resources sector (*compare Commodity and Natural Resources funds here*)

Very little has changed with regard to the investment environment over the last year. Global economic recovery is happening slowly, more slowly in the Eurozone than in the United States and the UK, while the usual caveats apply to the Chinese, Indian and Brazilian growth stories. The end of ultra-low interest rates seems little closer, while quantitative easing continues on a huge scale, with the Eurozone apparently primed to pick up any slack in supply from the United States. We continue to believe that the threat of serious inflation will, sooner or later, mean the return of financial rectitude, but, as St Augustine might have it, not yet...

While for the most part stock markets have continued to gorge themselves at the trough of easy money, commodity prices have had only the crumbs to feed on. Prices have firmed, with old and new international crises, until recently, providing a measure of support for the oil price, but only at a level that has allowed the shale oil revolution in the United States to prosper without choking off economic growth. Gold has flickered, but with bullion having fallen 30 per cent from its highs, and miners more than twice that, it had every right to do so.

The resources sector has stabilised, helped by the cancellation of a number of capital projects, the consequences of which have still to work their way through the system, and a renewed focus on shareholder value, the benefits of which should be seen over the next year-or-so in the shape of increased returns. The medium term case remains as compelling as ever, world population growth and increasing urbanisation underpinning an expanding demand for resources. It is not possible to predict when a sustained recovery in the sector will arrive, but it is possible to say with certainty that it is closer. Geoff Burns, Chairman, City Natural Resources

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Debt finance *(compare debt funds here)*

There continue to be issues within the provision of SME finance globally. The banks are constrained by a number of factors. Firstly there is the risk averse nature of their approach at present, driven partly internally and partly externally as a reaction to the excesses of the past; secondly there is the move towards a more purely quantitative approach to credit underwriting that inevitably makes many businesses unbankable, and finally there is the approach towards capital that now requires the banks to provide more capital against certain types of business, making that business less profitable for the banks than historically was the case. The first of these three can be seen as a cyclical phenomenon, and there are already signs that the banks are tentatively beginning to push back against the regulators' more cautious approach. However, the other two factors will inhibit the banks' ability and desire to compete in many areas of SME finance for many years to come.

At the same time there is increasing acceptance of new, principally online, SME finance providers that are providing funding that is not available through the banks. As these new providers of finance grow, so interest amongst institutions to invest in the loan assets originated is growing. Many new platforms are moving towards a more institutional provision of capital to fill their loans, rather than a broader based P2P model. We expect this to continue and for there to be a realisation that access to loan origination capability has an inherent value in itself in time. *Patrick Firth, Chairman, GLI Finance Limited*

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Renewable Infrastructure Sector *(compare renewable infrastructure funds here)*

The sector that has driven the increase in installed capacity has been the large scale, ground based installations, a market that is continuing to see high levels of activity. In the period since our listing, installed capacity across the UK has grown from c.700MWp to an estimated 2.2GWp. It is a big success story for the renewable energy industry and the sector continues to have very high public approval ratings.

We also expect to see growth in other sectors of the UK solar market, which should create attractive opportunities. For example, the UK government is looking to encourage significant investment into the commercial and industrial market. In July 2014, the Department of Energy and Climate Change ("DECC") offered significant insight into its ambition for this sector by targeting growth in installed capacity from below 3GWp in March 2014 to 11-12GWp by 2020. It is estimated that this step change in capacity would require investments of GBP12-13 billion, double what has been invested in the previous three years. The majority of this should come from commercial and industrial installations.

There are challenges ahead for future investments as the market moves to different pricing mechanisms through CfD and targets a wider range of projects including commercial and industrial sites. We believe this will lead to new and exciting projects in which to invest. *John Rennocks, Chairman, Bluefield Solar Income*

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Indications are that the second half of 2014 will see continued growth in the primary market for agriculturally situated, large-scale sites albeit, as the 31 March, 2015 ROC deadline approaches, less activity is expected for sites that are significantly bigger than 5MWp. Continued investment activity is expected for sites around the 5MWp size as the subsidy drop is a manageable event should the installation get grid connected post-31 March, 2015.

The Consultation currently being undertaken indicates that the current government would like to see significant growth in the installed capacity of solar on and around commercial and industrial buildings. As part of this Consultation, the government is talking to industry to look to further incentivise investment in the sector and has regularly articulated ambitious installation targets.

The growth in primary and secondary assets for large ground based solar assets is expected to continue. As currently proposed in the government's Consultation and as the March 31, 2015 ROC deadline approaches, the Investment Adviser is aware of increased risk in funding assets through construction if the asset is significantly bigger than 5MWp. *Bluefield Partners LLP, managers of Bluefield Solar Income*

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