

## Economic & Political Roundup

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 minds up. Please remember that nothing in this note is designed to encourage you to buy or sell any of the companies mentioned.

### Global

Monetary stimulus continues to distort markets and is creating a sense of unease in some quarters.

Teddy Tulloch, chairman of EP Global Opportunities, says his concerns over valuation levels in some markets are tempered by the continued policy of monetary stimulus that is being applied around the globe. Kevin Carter, chairman of Murray International, believes the fact that \$13trn of sovereign and corporate bonds trade on negative yields is scarcely explicable. Lord Rothschild, chairman of RIT Capital Partners thinks preservation of capital in real terms is an important objective in an environment of very low interest rates, anaemic growth, weak demand, deflation in many parts of the developed world and a deteriorating geopolitical situation.

### UK

The UK referendum result is a dominant theme but most commentators feel it is too early to tell what the consequences will be. Some expect a slowdown later in 2016 or in 2017.

Helen Green, chairman of Acorn Income Fund, expects markets to suffer until there is a clearer picture of what a post-Brexit future holds. Chris Kinder, manager of Threadneedle UK Select, says mergers and acquisitions will continue to be a key theme as overseas companies take advantage of a weaker pound. Gervais Williams and Martin Turner, speaking in their capacity as managers of Diverse Income Trust, say institutional investors have a renewed interest in the smallest quoted stocks now that ...(continued overleaf)

Exchange Rate	31/08/16	Chg. on month %
USD / GBP	1.3138	-0.7
USD / EUR	0.8962	0.1
USD / JPY	103.43	1.3
USD / CHF	0.9839	1.5
USD / CNY	6.6793	0.7

### MSCI Indices rebased to 100

Time period 31/08/15 to 31/08/16



Source: Bloomberg and Marten & Co

	31/08/16	Chg. on month %
Oil (Brent)	47.04	10.8
Gold	1309.0	-3.1
US Tsy 10 yr yield	1.58	8.7
UK Gilt 10 yr yield	0.642	-6.3
Bund 10 yr yield	-0.066	-45.5

## UK (continued)

...growth expectations have moderated. They also say, in writing about Miton UK MicroCap, that superior dividend growth of AIM companies relative to FTSE 100 stocks should attract investors to the universe of the smallest quoted companies. Jamie Cayzer Colvin, chairman of Henderson Smaller Companies says that, following the vote, uncertainty is the only certainty. Neil Hermon, the manager of that fund, makes the point that, in the corporate sector, conditions are intrinsically stringer than they were during the financial crisis of 2008-9. William Meadon and Sarah Emly, managers of JPMorgan Claverhouse, say that extricating ourselves from the EU will not be easy or cheap.

## Europe

The manager of Fidelity European Values thinks both the re-run of the Austrian presidential election and the forthcoming Italian constitutional referendum have the potential to cause further upset in European markets. Although he sees value in financial stocks.

## Japan

The managers of Prospect Japan believe the tangible effects of Japan's corporate governance reforms are negligible. By contrast, Noel Lamb, chairman of Atlantis Japan, points out that, following the introduction of the corporate governance code, Japanese companies paid out over 50% of their aggregate net income for the fiscal year ended March 2016 in the form of dividends and share buy-backs. The manager of that fund thinks economic expansion in Asia will eventually provide a demand boost for Japan.

## North America

Davina Walter, chairman of JPMorgan US Smaller Companies, sees a chance for volatility as a result of the contentious presidential election but says set-backs can provide good investment opportunities for long-term investors. Don San Jose and Dan Percella, managers of that fund, highlight the valuation premium the market is giving to the companies with the strongest balance sheets. They also opine that Brexit is a political rather than a financial problem. Nicholas Villiers, chairman of Middlefield Canadian, expects Canada to be a beneficiary of recovering energy prices. The managers of that fund expect Canadian GDP growth to recover in H2 2016 and accelerate in 2017. Sarah Bates, chairman of JPMorgan American, bemoans the lack of policy detail from the two US presidential candidates. She anticipates that markets will be volatile in the run-up to the election. Garrett Fish, manager of that fund, sees a chance that US earnings announcements could surprise on the upside as the headwinds of US dollar appreciation and falling oil prices start to fade.

## Debt

GSO/Blackstone, managers of Carador, say the effects of Brexit on their markets were short-lived and so the CLO market has begun to improve. The managers of Fair Oaks Income Fund note that interest rate spreads on CLOs widened in H1 2016. They expect US default rates to continue to rise in H2 as commodity-exposed issuers continue to suffer. Neuberger Berman, managers of NB Global Floating Rate Income,

Political worries elsewhere in Europe

Japanese economic growth remains elusive

The US presidential election is expected to trigger volatility in markets. The recovering oil price could prove beneficial, especially in Canada

Default rates may continue to tick up but could undershoot market expectations

note that the US market is pricing in defaults of 4%. They think the actual figure may be between 2% and 3%.

### Renewable Infrastructure

Helen Mahy, chairman of The Renewable Infrastructure Group, thinks there will be a broad pipeline of investment opportunities in the renewable energy generation market, supported by the need for long-term energy security and clean energy. The managers of that fund highlight the need for investment in renewable energy given a developing shortage of generation capacity in the UK. They also foresee rising power prices in the UK. Alexander Ohlsson, chairman of Foresight Solar Fund, says the solar market in the UK could hit 12GW by the time the current subsidy regime ends in April 2017. They think this will be to the benefit of the secondary market in these assets.

### Property

Chris Russell, chairman of F&C Commercial Property, says that, while Brexit has created a climate of uncertainty in the property market, prime property in core locations may prove resilient. The manager of that fund, Richard Kirby, agrees with this assessment. He says there are concerns about the prospects for secondary stock and for development. James Hambro, chairman of Hansteen, focuses on the relative attractions of light industrial property. Andrew Wilson, chairman of UK Commercial Property, says UK commercial real estate continues to provide a significant yield premium to other assets and, compared to previous downturns, has lower gearing, higher occupancy and muted levels of new supply. Will Fulton, manager of that fund, says the UK real estate market was already slowing before the referendum. He expects increased pressure on capital values with Central London offices the worst affected area. Derwent London say central London's office vacancy rate remains low compared to historical levels but acknowledge that there is additional speculative development underway that could add 3% to the total stock. Richard Jewson, chairman of Tritax Big Box REIT, sees an opportunity for the big box logistics sector as institutional investors are attracted to their niche. The managers of that fund talk us through the changing retail environment and the benefits this has for their business.

### Other sectors

We also have commentary on Asia, Commodities, a comprehensive look at the global infrastructure market from BBGI, Private Equity, Reinsurance and Timber

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## Global

(compare Global funds [here](#))

**Teddy Tulloch, chairman, EP Global Opportunities:** The moderate growth in many of the world's major economies along with minimal rates of inflation has resulted in interest rates being held at historically low levels for a number of years. In Continental Europe and Japan, central banks are continuing to buy back aggressively their government bonds. While the US Federal Reserve had indicated that they would start to raise short-term interest rates, this has now been put on hold and there is unlikely to be an increase before the presidential election in November 2016. In the UK, the Bank of England reduced the bank base rate to a historic low of 0.25 per cent in August and announced a programme to buy GBP60 billion of UK government bonds.

Equities generally look much better value than bonds, but many share valuations are becoming increasingly expensive in absolute terms relative to historical levels. This is particularly true in the US where the S&P Composite Index has recently moved to a new all-time high despite the lack of growth in corporate earnings.

The health of the Chinese economy remains a key issue for equity investors, given its very significant contribution to global economic growth. However, we consider that a number of the concerns have been overstated and there is the potential for an improvement in corporate profitability which could have a positive impact on stocks in the Asia Pacific region.

Our concerns over valuation levels in some equity markets are tempered by the continued policy of monetary stimulus that is being applied around the globe as governments attempt to stimulate economic growth and resist deflationary forces. Such a policy seems likely to continue for some time.

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**Kevin Carter, Chairman, Murray International:** Previously both the Manager and I have highlighted the extreme distortions in the financial landscape that monetary policy choices have produced over the past eight years. It is now estimated that some thirteen trillion US dollars equivalent of sovereign and corporate bonds trade at negative yields. This is unprecedented and scarcely explicable. It remains to be seen how this will play out in financial markets and the global economy, but policy makers seem certain to find it a struggle to navigate successfully the environment we are now in.

Corporate earnings globally, but particularly in the developed markets, are under some pressure, and prospects are more than usually opaque as consumers are wary of the prevailing economic and interest rate environments they are facing.

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**Lord Rothschild, chairman, RIT Capital Partners:** The [first half of 2016 has] seen central bankers continuing what is surely the greatest experiment in monetary policy in the history of the world. We are therefore in uncharted waters and it is impossible to predict the unintended consequences of very low interest rates, with some 30% of global government debt at negative yields, combined with quantitative easing on a massive scale. To date, at least in stock market terms, the policy has been successful with markets near their highs, while volatility on the whole has remained low. Nearly all classes of investment have been boosted by the rising monetary tide. Meanwhile, growth remains anaemic, with weak demand and deflation in many parts of the developed world.

Many of the risks which I underlined in my 2015 statement remain; indeed the geopolitical situation has deteriorated with the UK having voted to leave the European Union, the presidential election in the US in November is likely to be unusually fraught, while the situation in China remains opaque and the slowing down of economic growth will surely lead to problems. Conflict in the Middle East continues and is unlikely to be resolved for many years. We have already felt the consequences of this in France, Germany and the USA in terrorist attacks.

In times like these, preservation of capital in real terms continues to be as important an objective as any.

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## UK

(compare UK funds [here](#))

**Helen Green, Chairman, Acorn Income Fund:** Political and market reaction to the Brexit vote has unfolded rapidly in the few weeks since the period end. A new Prime Minister was selected and assumed the role with minimal delay following David Cameron's resignation and this removed one element of uncertainty overhanging markets. The longer term economic consequences of Brexit are difficult to judge given the many potential trading arrangements that might be negotiated with the EU and other countries.

Markets will suffer from the uncertainties surrounding the UK's exit from the EU until there is a clearer picture of what the future holds. The Bank of England, aiming to pre-empt any trend towards recession as a result of Brexit, have cut interest rates to 0.25% and recommenced quantitative easing and this has helped stimulate a broad based market recovery. The initial rally in the last week of June was restricted to larger companies. But at the time of writing small and mid cap indices as well as the FTSE 100 index have recovered to levels which are higher than they stood at immediately preceding the Brexit vote.

Brexit may make some investments less attractive but will also open up new opportunities.

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**Chris Kinder, manager, Threadneedle UK Select:** The decision to leave the EU has created significant economic and political uncertainty. A mild UK recession is likely and indeed the Bank of England has responded meaningfully to reduce interest rates and expand QE. Across the globe, the authorities are using various stimulus measures to try and deliver economic growth, and in some cases government bond yields are now in negative territory. Therefore, equities that can deliver reliable, well-covered dividend streams should continue to be sought after.

We are still wary of other macroeconomic issues. At present, China is wrestling with its own banking crisis, policy fatigue is widespread, global growth is slowing and debt levels are heightened. The UK's Brexit vote is also likely to cause further political and economic challenges for Europe.

Following the leave vote, larger caps and defensive stocks have been far more resilient in these choppy markets. While investors may be tempted to sell down domestics and buy more dollar earners, we would argue it is probably now too late to

make this adjustment given the scale of the outperformance of defensive large caps versus cyclical domestic stocks since the vote.

Mergers & acquisitions will continue to be a key theme, as overseas companies see the weaker pound as an opportunity to dust down UK bid targets. UK investors who can maintain a longer-term focus and withstand some turbulent times will likely be rewarded with exciting opportunities.

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**Gervais Williams and Martin Turner, managers, Diverse Income Trust:** We believed that, as the world economy moved beyond the credit boom, it was more advantageous for UK equity income investors to spread their capital over a wider opportunity set of holdings. Whilst smaller companies often have greater vibrancy than their larger competitors, during the credit boom this factor has become irrelevant. However, now that world growth expectations have moderated to previous norms, there are indications that institutional investors have a renewed interest in stepping up their capital allocation into the smallest quoted stocks.

Following the Brexit vote, the share prices of many UK-quoted companies have become much more volatile. Many have been marked down considerably, even those where their underlying prospects may have improved after the devaluation of sterling.

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**Jamie Cayzer-Colvin, chairman, Henderson Smaller Companies:** After the most dramatic couple of months in British politics, the implications of the Brexit vote are yet to play out fully in markets. Uncertainty is the only certainty and it is clear that volatility will continue until investors feel confident that the way forward for the UK is resolved. We may also find that interest rates remain at the current very low levels for longer and this, together with the weakness in the exchange rate, is likely to affect valuations and investor sentiment over the coming months. Any move back to more normal conditions may therefore be sometime away. However, as always in markets, there will be some companies that do better than others. Exporters can take advantage of the lower value of the pound and companies looking to invest can take advantage of lower rates.

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**Neil Hermon, manager, Henderson Smaller Companies:** The surprise EU referendum result precipitated a sharp negative shock to markets around the globe. We have witnessed a seismic moment in UK political, social and economic history. The repercussions of the referendum will, however, only become clear over the coming years. For the moment, it is impossible to estimate the long-term political impacts for the UK and it is also very difficult to predict the future economic impact.

On the political front, the Prime Minister has been replaced, the Leader of the Opposition is facing a leadership challenge, and the SNP is already talking about a second Scottish independence referendum. More broadly in Europe, the very future of the EU may be at stake. Meanwhile, we have no idea yet what shape Brexit will take and what will be the outcome of trade negotiations with the EU and the rest of the world.

In the weeks since the referendum, we have seen a sharp decline in the value of the pound. The FTSE 100 has been resilient, but that reflects the international nature of large UK corporates and the extent of their international earnings. The more domestically focused small and mid-cap indices have been harder hit. The general consensus is that the UK economy is set for a period of slowdown, if not recession.



In the corporate sector, conditions are intrinsically stronger than they were during the financial crisis of 2008-9. Balance sheets are robust and dividends are well supported. Although corporate profitability may come under pressure, companies are better placed to deal with the fall-out from an economic slowdown. In addition a large proportion of UK corporate earnings comes from overseas, even among smaller companies, and will be boosted by the de-valuation of sterling.

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**Gervais Williams and Martin Turner, managers of Miton UK MicroCap:** During the [six months] to April 2016, there was a growing number of dividend cuts by stocks in the FTSE 100. Whilst this included a number of companies operating in the oil and mining sector, where commodity prices have fallen sharply, it also included supermarkets, mainstream banks and engineering companies such as Rolls Royce. The overall effect of these dividend cuts reduced the aggregate dividend growth of the FTSE 100 Index, so that it was essentially flat.

Although the lack of world growth is not helpful for smaller quoted companies either, there are a number of such companies where their immature market positions mean they are well placed to invest for productivity increases. Not all will be successful, but generally we are upbeat about their prospects for generating additional sales at attractive margins over the coming three years. If they achieve this then they should be in a position to pay a growing dividend stream to their shareholders. To some degree this pattern has already started coming through with the dividend growth on the AIM exchange estimated by Peel Hunt to be growing at around 10% per year. Whilst the current level of dividend yield on AIM stocks is standing at about half the level of the FTSE 100, we believe their superior dividend growth is a good reason for investors to increase their exposure to the universe of the smallest quoted companies.

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**Andrew Sutch, chairman, JPMorgan Claverhouse:** The medium and longer term effects of the referendum result on UK companies, and on the UK economy as a whole, are still unclear. Since the result, UK equity markets have fluctuated significantly, with the large falls immediately after the vote being reversed subsequently. Sterling has weakened considerably, which has generally benefitted large-cap companies, many of whose revenues are earned largely overseas.

I think that we must expect continuing volatility over the coming months and that the likelihood of slower growth, a weaker currency and rising inflation will be problematic for many of the companies within the universe in which the Company invests. However, there will be winners as well as losers; the winners should include those companies which benefit from international earnings.

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**William Meadon and Sarah Emly, investment managers JPMorgan Claverhouse:** Extricating ourselves from the EU will not be easy or cheap. Much will depend on whether the divorce is quick or slow and amicable or acrimonious. Prime Minister May has her work cut out.

There is a significant risk that whilst the complex and lengthy discussions with the EU take place, many corporate investment plans are put on hold. Worse, some companies may not have the patience to wait for politicians to reach a deal and will initiate steps to move some or all of their UK operations overseas. Unemployment would then rise and consumer confidence fall, causing purchases to be deferred or cancelled. Economic growth (which was already fragile) will then probably slow. In



short, the likelihood of a UK recession in 2017 has increased considerably. The authorities are likely to respond with further fiscal and monetary stimulus although with interest rates already at very low levels, the Governor of the Bank of England has admitted that "there are limits to what the Bank of England can do".

Against this precarious backdrop it would be wrong for us to be too prescriptive as to how events will play out. However, for the foreseeable future at least, we would expect markets to remain volatile and the pound weak. But as prices gyrate, opportunities will arise.

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## Asia

(compare Asia ex Japan funds [here](#))

**Peter Arthur, chairman, Aberdeen Asian Income Fund:** Investors continue to proceed with caution. While it is early days yet to ascertain the full extent of Brexit's impact, your Manager's preliminary assessment is that the effect on Asia is fairly limited. Asian currencies have been much less volatile than their continental counterparts, and fundamentals remain relatively sound. The region's central banks showed commitment by keeping monetary policy accommodative and some are coordinating fiscal policy and pursuing structural reforms to encourage growth. China continues to be a source of some anxiety and along with it, fears of market imbalances in commodities. The oil-price recovery has benefited manufacturers and exporters after a prolonged rout, but it is unclear if oil prices will continue to languish over the longer term. That said, the long-term drivers of growth and potential in Asia remain persuasive.

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## Europe

(compare European funds [here](#))

**Fidelity European Values:** Market returns, in the last few years since the global financial crisis, have largely been driven by rising valuations. This has resulted in the valuation of continental European stock markets being above the average of the past thirty years. This level of valuation leaves the market vulnerable to a shock like the 'Brexit' vote. Although the direct exposure of continental European companies to the UK economy is relatively low at about six to seven percent of sales and profits, the knock-on impact, in terms of uncertainty and the risk of a domino effect threatening the integrity of the European Union, will likely pressure markets in the short term.

The re-run of the Austrian presidential election, in late September, and the Italian constitutional referendum, in October, may both cause further upset. Central banks will react, as shock absorbers, to try to stabilise markets and support economies and there may be some fiscal response, too, from governments, although the room for manoeuvre in much of Europe is limited by large budget deficits and high levels of government debt. Much will depend on the continuing health of economies outside Europe.

Ultimately, however, it is corporate profitability and real dividend growth that will drive stock prices and the recent volatility is bound to throw up some stock-picking opportunities, perhaps, for instance, in sectors like financials where it seems as if 'the baby is being thrown out with the bath water'.

## Japan

(compare Japanese funds [here](#))

**Prospect Japan Fund:** Japan remains vulnerable to slowdown in the global economy and geopolitical turmoil, particularly in major trading partners, as well as by volatile swings in currency exchange rates and interest environment due to domestic and overseas monetary policy.

While the Abe administration and BoJ remain poised to provide additional stimulus as needed, inflation expectations remain muted, and CPI turned negative with the largest monthly decline since 2013 recorded. While the delay of the consumption tax increase is positive, the Abe administration's success rollout of stimulus spending and regulatory reform remain necessary catalysts for long-term economic growth. Fundamentals on the corporate level remain strong, and while tangible effects of corporate governance reforms are negligible, a widespread and ingrained refocusing on investor return should be a long-term positive.

**Noel Lamb, chairman, Atlantis Japan:** Recent data from Japan indicate an uneven economic performance but there is no doubting the authorities' determination to suppress deflationary expectations and restore the economy to a moderate growth-path. The Bank of Japan has embarked upon a negative interest rate regime to revive bank lending and a stimulative fiscal package is likely to be passed by the Diet in the autumn of 2016. Economists are projecting modest growth in the 0.5%-1.0% range for the fiscal year ending March 2017. Despite the handicap of operating in a stronger JPY environment, analysts expect Japanese corporate earnings growth to be sustained in the current fiscal year.

Spurred by the new Corporate Governance Code, reform has begun to sweep through Japanese corporate management to the direct benefit of shareholders. I was pleased to learn that Japanese companies have paid out over 50% of their aggregate net income for the fiscal year ending March 2016 through increased dividends and share buybacks. The advisory team, have also observed a noticeable acceleration in merger and acquisition activity by corporates.

**Atlantis Investment Research Corporation, managers of Atlantis Japan:** Prime Minister Abe has little to show for his efforts to kick-start the economy which continues to struggle against deflationary headwinds despite the Bank of Japan's proactive monetary stance. However, there are some emerging green shoots with unemployment at its lowest level in years, exports showing signs of improving and capital investments heading higher. Consumer spending, supplemented by 'in-bound' tourist demand, remains essentially flat. However the tight labour conditions are contributing to moderate wage gains which could contribute to improving consumer confidence and subsequently household spending. The Bank of Japan's introduction

of negative interest rates is showing signs of having a positive effect on the housing market.

Japan's economic problems, in part, have been due to a sluggish world economy, especially in China and Southeast Asia. However there are signs that the worst is over and that we will see stronger world growth over the coming few years. Economic expansion in Asia will eventually provide a demand boost for Japan. Companies across a broad spectrum are investing in offshore production and sales and service facilities. Japanese companies continue to be world-leaders in a wide range of areas including medical equipment, automobiles and automobile parts, measuring equipment, semiconductor manufacturing equipment, new materials such as carbon fibre and software, including game software.

A stable to weaker JPY/USD rate would have a positive impact on the trend of exports, the profitability of exports and the continuation of the inbound flow of visitors from overseas.

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## North America

(compare North American funds [here](#))

**Davina Walter, chairman, JPMorgan US Smaller Companies:** At the time of writing this statement investor sentiment remains cautious, especially for riskier asset classes such as US smaller companies as they do not offer the compensation of attractive dividend yields. We are also seeing a contentious presidential election as well as entering the holiday period which in the past has produced volatile markets as bad news (or good) can trigger sharp moves on light volumes. There is clearly much uncertainty in markets and reasons to be cautious over the short term, however these set-backs often produce good investment opportunities for long term patient investors.

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**Don San Jose and Dan Percella, managers, JPMorgan US Smaller Companies:** US equity markets thus far in 2016 have experienced modest gains with the S&P 500 Index gaining 3.8% and the Russell 2000 returning 2.2% in US dollar terms. However, behind these numbers, investors have suffered a wild ride, with the market dropping 11% early in the year before a powerful rally reversed the losses, only to end the reporting period on another volatile note.

The opening weeks of 2016 were dominated by investors concerned about the outlook for economic growth worldwide, particularly China and the emerging markets. Commodity prices plunged again and stock markets around the world followed. Markets appeared to be discounting an imminent recession in the US too, with credit spreads widening alarmingly. However, economic data from the US suggested that growth was actually continuing at a modest but steady pace, while the Federal Reserve (the 'Fed') repeatedly provided a soothing commentary on the future direction of monetary policy. Selling pressures from short term investors abated, shorts were covered, stock prices recovered and even commodity prices showed signs of life.

While geopolitical events dominated the headlines, June economic releases were generally favourable. The third estimate of first quarter 2016 GDP showed that the real economy grew at a seasonally adjusted annual rate of 1.1% in the first quarter,

higher than the second estimate of 0.8%. The employment situation remains healthy along with rising wages, which bode well for US economic growth, of which approximately 70% of US GDP is driven by consumption.

Recovering commodity prices, a stabilising US dollar, signs of continued US economic growth and the realisation that the "Brexit" is a political problem rather than a financial crisis contributed to equity markets recovering the majority of losses during the first half of the year.

While the market's resilience is impressive, the tone of the market remains defensive. As bond yields declined further and investors searched for safe havens, the utilities and consumer staples sectors were the major beneficiaries year-to-date within the Russell 2000, followed by the materials & processing sector, which advanced from the recovery in commodity prices. The financial services sector in the Russell 2000 resisted the negative impact of the Brexit results much better than their larger peers as their businesses tend to be more domestic oriented with limited exposure to both the UK and Europe.

We continue to remain constructive on the outlook for US equities. Despite sluggish earnings growth, increasingly gloomy forecasts for global economic growth and a noticeable apathy towards equities on the part of so many investors, equity market indices such as the S&P 500 sit just a few percentage points from all-time highs. Equity valuations do look rather full in conventional price/earnings terms, but the risk premium on offer versus bonds still looks very generous. After all, 65% of the stocks in the S&P 500 now yield more than a ten-year Treasury bond. Based on our company level research analysis, we think earnings growth will improve somewhat into 2017, as the drags from the US dollar strength and energy weakness fade from here and the domestic economy continues to expand, leading to modest positive returns.

Within the market, the contrast between the haves and have-nots is increasingly stark. For almost two years now, investors have focused on stocks seen as the least risky; dividend payers in relatively stable businesses. Unmistakable evidence of risk aversion is everywhere. Companies with the strongest balance sheets sell at a 20% premium to the market and the weakest more than a 20% discount.

Recent economic reports continue to indicate ongoing growth in the US economy, marginally increasing the probability that the Fed will raise rates in September. Further out, it is too early to predict the impact of the forthcoming US Presidential elections on markets and the wider economy but it is reasonable to expect some volatility in markets ahead of 9th November, which may delay the Fed's decision.

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**Nicholas Villiers, Chairman, Middlefield Canadian Income:** In light of the Investment Manager's view that interest rates will remain lower for longer, together with relatively strong economic fundamentals in Canada and the United States, equities in these two countries should continue to outperform. Canada, in particular, will benefit from the recent recovery in energy prices as well as from international fund flows due to the volatility abroad.

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**Middlefield Limited, managers of Middlefield Canadian Income:** On June 23rd, the UK held a referendum and, to the surprise of many, voted to leave the European Union. Although Brexit's direct impact on North America is difficult to quantify, it is expected to be a drag on the British economy and may result in a UK, or even European, recession.

However, the severity of the slowdown will also depend on what type of arrangement is negotiated with the European Union. While the political impact will be important, central bankers will also be monitoring the situation closely and have promised to do "whatever it takes" to counteract any negative economic implications. This will almost certainly keep interest rates "lower for longer" not only in the UK and Europe, but also in the U.S. and Canada in an effort to encourage consumers and corporations to borrow and spend.

Recent economic data in both Canada and the United States has been mixed, albeit generally constructive. Canada's GDP growth is projected to recover in the latter half of 2016 and accelerate in 2017, in part due to the recovery in oil-related business investment as well as the infrastructure focused fiscal stimulus by the federal government. In the United States, the data also points to slow, but positive, economic growth. On balance, recent payroll data has been strong and retail sales have been trending higher, pointing to healthy momentum for consumer spending, the largest component of economic growth. In addition, corporate earnings are now starting to reaccelerate after an extended period of softness. Notwithstanding the positive momentum in the domestic economy, the challenges to global economic growth are a concern, suggesting the Federal Reserve will stay on the sidelines for at least the next few months. In fact, the U.S. 10-year treasury yield traded at new all-time lows of below 1.4% in early July.

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**Sarah Bates, chairman, JPMorgan American:** After the political surprise of the referendum result in the UK, we have a sense of uncertainty about the outcome of the Presidential election in the US in November. Politics is perhaps having a greater impact than usual. There is little clarity at this point over the detailed policies to be presented to the electorate by either Hillary Clinton or Donald Trump, the main candidates for the US Presidency. So it is possible that we are in for a period of some volatility. However, market timing is difficult and very often costly.

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**Garrett Fish, manager, JPMorgan American:** One bright spot for US equity markets could be the upcoming earnings season. We have maintained the view that S&P 500 earnings will reaccelerate as the headwinds of a rising US dollar and lower crude oil prices begin to fade. Even though the US dollar gained in value relative to sterling during the first half of 2016, the US dollar lost value relative to a broader basket of currencies. The movement in crude oil prices from the first quarter to the second quarter was even more positive. Crude oil futures averaged \$45.64/bbl. for the second quarter, a 35.7% increase from the prior quarter average price of \$33.63/bbl. Improved corporate profits would most certainly be welcome.

Brexit uncertainty, a contentious US Presidential election, unconventional monetary policies and low economic growth rates around the world lead us to believe that more volatility lies ahead. Yet we are also of the view that the strongest positioned and most attractively valued securities will fare best.

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## Commodities and natural resources

(compare commodity and natural resources funds [here](#))

**Ian Cockerill, chairman, BlackRock World Mining:** There has been much discussion as to whether the cycle has turned for mining companies but what is clear is that the sector is likely to benefit going forward from decisions taken to reduce capital expenditure, repair balance sheets and cut costs. Outside of industrial commodities, demand for gold reflects macro uncertainties and geopolitical challenges. The next six months should see continued interest in 'safe haven' assets with decent dividends.

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**Evy Hambro and Olivia Markham, managers, BlackRock World Mining:** We are obviously delighted with the strong performance of the sector to the end of June but we are very aware that things rarely continue to rally at the same rate for long periods of time. In addition, the rally we have been through is in part a bounce from the very depressed point reached in January, as well as it being enhanced by the weakness in the pound post 'Brexit'. If you remove the currency impact, share prices in US dollar terms have returned to levels last seen in June 2015 and, with commodity prices supportive of this move, it is likely that we will need to see additional catalysts during the balance of the year to justify further gains.

The other key factor relates to whether the support measures in China remain in place for the balance of the year allowing commodity markets to move more rapidly into deficit or they are pulled and markets give up part of their gains. It is also important for mining companies to remain focused on cost reduction and disciplined on capital allocation in order not to see this rally as a reason to start reverting back to old ways. Hopefully, the memories of the last few years are sufficiently fresh to prevent this from happening.

Outside of industrial commodities we remain positive on precious metal producers given the supportive back drop for underlying relevant metal prices and the improved equity fundamentals such as competitive free cash flow yields.

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## Debt

(compare Debt funds [here](#))

**GSO/Blackstone Debt Funds Management LLC, managers of Carador Income Fund:** We believe the current environment is supportive for credit products. Sell-side economist forecasts, on average, indicate that the U.S. economy is expected to grow at 2% in 2016. Easy monetary policies from Fed and its global counterparts will continue to encourage investors to seek yield in credit products. However, we continue to monitor many potential market pitfalls such as a sudden reversal of those policies, upcoming elections in the U.S. this year and Europe next year, and international capital flows.

As the effects of the Brexit result were short lived, technicals in the CLO market have begun to improve in both the primary and secondary markets.

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**Stuart Cruickshank, chairman, P2P Global:** With a favourable employment market, increased house prices over the past five years, and improved consumer affordability, consumers' creditworthiness in our markets remains strong. The pace of growth has declined on several [*online lending*] platforms as some lenders have chosen to cut back on new investments. Marketplace lenders also face heightened regulatory scrutiny on both sides of the Atlantic. Whilst some platforms may struggle with increased regulatory requirements, the more established players are expected to benefit as a result of additional requirements from regulators which strengthen their business practices. The powerful proposition of low cost non-bank lending will continue to accelerate demand for loans from high quality borrowers creating new markets and growth avenues.

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**Fair Oaks Capital, managers of Fair Oaks Income Fund:**

### ■ Bank loan market overview

The Credit Suisse Leveraged Loan Index returned 4.2% in the first half of 2016. As at the end of June, the US loan market twelve month rolling default rate by number of issuers stood at 2.22%, up significantly from the 0.81% and 1.19% rates at June 2015 and December 2015 respectively. We expect that the US loan default rate will continue to increase moderately in the second half of 2016 driven primarily by further defaults of commodity-exposed issuers.

We believe that increased bank loan price volatility is now a structural feature of the market due primarily to technical factors such as reduced dealer inventories and the importance of retail funds as the marginal buyer or seller in the loan market. The loan market's reaction to global events (e.g. Brexit) can benefit CLOs, as their closed-ended nature and lack of mark-to-market requirements allow them to take advantage of dips in loan prices.

### ■ CLO market overview

During the first half of 2016, new issue volume reached US\$26.2 billion in the United States and €7.2 billion in Europe, down significantly from the same period last year in the US (US\$60.4 billion) but relatively flat in Europe (€7.8 billion). Arbitrage in both markets continued to be challenging given wider CLO liability spreads and the resilience of loans prices - we estimate that the average new issue CLO loan portfolio price in June was in the 99.0-99.5 range given need to avoid commodity linked and lower rated issuers. AAA rated CLO spreads were 172 bps at the end of June 2016, 17 bps wider than on 30 June 2015 and 20 bps wider than when the Company was launched (12 June 2014). The spreads in BB and B rated mezzanine notes have increased to 942 bps and 1418 bps respectively on 30 June 2016 from 646 bps and 824 bps on 30 June 2015.

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**Paul Read, Paul Causer and Rhys Davies, managers of City Merchants High Yield:** The UK's vote to reject membership of the European Union has raised a number of uncertainties. That said, the initial reaction to the referendum result was more moderate than might have been expected. However, the full impact of this event on our markets will only become clear over time, as we see the direction of the economic fundamentals and learn more about the future shape of relations between the UK, the European Union and the wider world. We remain cautious in our outlook and retain an overall defensive stance in the portfolio although we acknowledge the



[*European Central Bank's Corporate Sector Purchase Programme*] will continue to provide a strong technical support to markets. There are still pockets of value, particularly within the financial sector and corporate hybrids.

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**Neuberger Berman, managers of NB Global Floating Rate Income:** Our outlook for the loan market remains positive. Generally we feel that issuers are performing steadily, leverage is being controlled and cash cover metrics are strong.

As at the end of July, the market is pricing in a default rate of around 4%, which is well beyond our 2016 expectations of 2-3%. We believe that U.S. GDP growth will continue in its recent range. In the absence of rate rises we continue to believe that loans are attractive given the returns on offer, the expected low volatility compared to other risk asset classes and their senior secured nature.

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## Infrastructure

(compare Infrastructure funds [here](#))

**David Richardson, chairman, BBGI SICAV:** The secondary market for infrastructure assets remains fierce with demand far outstripping supply. Prices have therefore remained high. The world economic environment remains volatile and the additional complication of the UK's withdrawal from the European Union will undoubtedly cause markets to be wary.

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**BBGI SICAV:** A key theme among investors remains the search for high quality income, particularly from asset classes uncorrelated to general equity market volatility. This has made PPP infrastructure a very desirable asset class in all the regions where BBGI is active.

In the current market environment, yields on many asset classes such as gilts, government bonds and cash deposits remain at or close to historically low levels. There is very strong demand from both established and new investors to the sector, bidding aggressively for PPP assets because of the attractive risk adjusted returns they generate. Demand for infrastructure investments continues to exceed supply and is resulting in continued upward pressure on pricing. While this continues to be positive for portfolio valuation, it does make it more challenging to source accretive transactions in the secondary market.

## Canada

The Canadian market continues to deliver an impressive and transparent pipeline of primary development opportunities within a strongly supportive political environment. It also contains an emerging secondary market and there is a large range of project sizes.

In the 18 months to 30 June 2016, 25 primary PPP transactions closed with a transaction value in excess of CAD 15 billion. The five most active regions of the country were Ontario, Saskatchewan, Alberta, British Columbia and Quebec with a number of future projects announced or planned in a variety of sectors.

In addition to its robust primary market, Canada also benefits from an emerging secondary market. The Canadian secondary market is expected to see some activity in 2016 as a number of projects developed over the last couple of years come into operation. Many of the projects which were developed over the last 3-5 years had prohibitions on re-sales until after construction completion. It is expected that the equity interest in some of these projects may soon start to trade as these prohibitions lapse.

## ■ The US

The US is one of the largest infrastructure markets globally in terms of potential, with a substantial requirement for private investment. It is estimated that USD 3.6 trillion in infrastructure spending will be required in the US by 2020.

The scale of this infrastructure investment requires the government to look to the private sector to play an increasingly important role in delivering its critical projects. In response, most jurisdictions have now introduced specific legislation to enable PPP investment, with a primary focus on the transport sector.

Despite its promise, in the last 18 months only 5 primary development PPP projects reached financial close with an aggregate value of slightly in excess of USD 2.4 billion. We are however cautiously optimistic that future infrastructure spending may exceed recent levels, especially given that increased infrastructure investment has been a key tenet of both the Republicans and Democrats election platforms.

## ■ Continental Europe

2015 was a reasonable year for the European PPP market, and 2016 is shaping up to be a better year. During 2015 the aggregate value of PPP transactions which reached financial close in the European market totalled EUR 15.6 billion. 49 PPP transactions closed, including five large transactions (i.e. transactions in excess of EUR 500 million).

The UK was the most active market in terms of deals closed. In second place was Turkey, followed by Germany and France (five deals each) and the Netherlands (four deals). Ten countries closed at least two deals and 12 countries closed at least one PPP transaction in 2015.

In Europe, the transportation sector remained by far the largest in terms of value and represented more than 60% of the transactions closed. Education is the second most active sector followed by health care.

Germany and the Netherlands are two of the more promising PPP markets in Europe with new road projects planned under the PPP model. Another promising PPP market is Norway. The Norwegian government has committed to the delivery of up to eight major road PPPs. The government has so far procured only three highway projects as PPPs.

## ■ Australia & New Zealand

With a mature and continuing PPP market, Australian PPP deal flow has remained consistent. The need for significant private investment in the nation's infrastructure is anticipated to result in the emergence of a variety of innovative funding and financing models.

In the PPP pipeline, there are rail and light rail projects that are due for tender. Sydney Metro Northwest and Southwest are set to receive funds from the electricity networks' sale and the Parramatta Light Rail is scheduled to announce its preferred

route by the end of this year. Prison and social housing projects are also in the pipeline.

Another promising market is New Zealand. The central government has plans to invest more than NZD 110 billion, equivalent to over GBP 58 billion, into infrastructure over the next 10 years.

## ■ United Kingdom

The UK remained the most active market in Europe by number of projects, with a total of 15 transactions closed in 2015 (compared to 24 in 2014). The UK was also the second-largest market in Europe with a total deal value of over GBP 1.7 billion.

Negative media coverage and anti-private finance opinions reduced enthusiasm for private finance, thus making the near term pipeline less attractive. However, innovative and adaptive PPP models in Scotland, combined with pre-referendum announcements regarding a renewed focus on infrastructure investment, were expected to result in improvements in the current UK market conditions over time and as such provided grounds for optimism.

The UK, post the Brexit referendum, is now however embarking on what could be a prolonged period of political and economic uncertainty. It is still too early to assess with certainty the impact of this vote on the future of UK PPP infrastructure investment. Although unclear it is unlikely, at least in the short term, that the Brexit decision will have a major impact on those projects which are currently underway as one would expect those to be stable enough to continue through to completion.

## ■ Secondary Investment Activity

The Management Board believes the secondary market continues to be imbalanced, with significantly more investment capital targeted towards the particular market segment than attractive investment opportunities, which impacts pricing and valuation.

In this competitive environment, vendors are requiring prospective purchasers to price in potential life-cycle savings, aggressive tax structures, portfolio efficiencies and other upsides that may not be realised.

## ■ Brexit

The referendum on the UK's membership of the EU on 23 June 2016 saw a majority vote in favour of leaving the Union, with the results leading to volatility and uncertainty both politically and in currency and financial markets.

Many experts are expecting Sterling to remain weak relative to other currencies and some are predicting higher inflation in the UK. In these uncertain times we believe that infrastructure will continue to be viewed as a safe haven asset with markets remaining open for high quality infrastructure offerings. Moreover BBGI expect the recent reduction in interest rates by the Bank of England to further fuel this demand for quality infrastructure offerings.

Theresa May's apparent backing of UK-Treasury-backed bonds for infrastructure could indicate an increase in the scope of the Treasury's GBP 40 billion UK guarantee scheme. May, who officially succeeded David Cameron on 13 July, had earlier highlighted Infrastructure in her campaign. In a speech announcing her bid to become Conservative leader on 11 July, May advocated "more Treasury-backed bonds for new infrastructure projects". We will wait and see what unfolds.

## Private equity

(compare Private equity funds [here](#))

**Mark Tennant, chairman, F&C Private Equity:** Towards the end of the half year, on 23 June, the UK voted in a referendum to leave the European Union, a result that was widely unpredicted. Although sterling was weak ahead of the vote, it has weakened considerably since. The longer term implications of the UK leaving the EU will take time to discern. Although there are relatively few companies which are directly and immediately affected either positively or negatively, almost all are influenced by the levels of business and consumer confidence that result from the Brexit vote. At this stage the main impact appears to be, unsurprisingly, a tendency in some quarters to hold back or pause before committing to new deals. For deals which involve a UK/EU interface, we should expect some adjustments to timing and terms to reflect the new and projected realities. For a large section of our portfolio, without direct UK involvement, business activity continues relatively uninfluenced. It is also likely that in due course new investment opportunities will be created by the new environment and we would expect a number of our partners to carefully and selectively take these.

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**Hamish Mair, manager, F&C Private Equity:** Macro-economic factors command attention because they can be summarised with a few statistics and facilitate generalisations. They are also famously difficult to predict. Political developments are usually less relevant for the business and investment environment but they can be even more unpredictable and consequently can cause shocks. We are in the immediate aftermath of a political shock with economic consequences. At the level of individual businesses and from the perspective of investors with long term committed and illiquid capital there is no alternative but to proceed with business plans whilst being prepared to adapt and adjust as the background economic landscape changes. Private equity as a mode of investment benefits from, but does not require, a strong economic background for success. Private Equity managers are better used to accepting and pricing risk than most market participants. Many of them also have the skills to help managers of portfolio companies adjust and refresh plans in the light of changed circumstances.

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## Reinsurance

(compare Reinsurance funds [here](#))

**Blue Capital Global Reinsurance Fund:** The continuing convergence of traditional reinsurance and capacity from capital markets provides insurance companies with additional flexibility in their risk transfer solutions and establishes the capital markets as a sustainable complement to traditional reinsurance. However, this convergence has also created challenges. The January 2016 underwriting period was another competitive one, characterised by pressure to reduce prices and offer more generous contractual terms and conditions. The Reinsurer's January trades that the Company invests in were executed with an average risk adjusted rate decrease of approximately 4 per cent. compared to January last year.

Following the June 2016 renewals, it appeared that price reductions had begun to moderate and the market showed continued signs of nearing a bottom with risk

adjusted pricing down only 2 per cent. when compared to last year. We believe the stabilizing pricing environment was influenced in part by technical pricing discipline, and a continuing trend of increasing demand for open market reinsurance limit replacing the Florida Hurricane Catastrophe Fund.

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**Nigel Barton, chairman, CatCo Reinsurance Opportunities:** On 23 June 2016, the UK held a referendum in which it voted to leave the EU ("Brexit"). The longer-term impact on the Company, and, more particularly, its investors, of the result of the Brexit referendum in the UK, is unclear. It is dependent on the terms of the settlement between the UK and the EU which will govern the UK's post-Brexit relationship with the EU. While Brexit is not inevitable until the UK's withdrawal arrangements are agreed, it is politically highly likely.

In the meantime, EU law and regulations currently in place or implemented in the UK before Brexit will still be binding, although, in the longer-term, there will, almost certainly, be an overhaul. However, the most likely short-term effects of the referendum will be economic. Changes in the value of Sterling, inflation rates, yields on gilts and bonds, stock market fluctuations and hence, increased market volatility, will provide challenges.

The excess capacity in the property catastrophe reinsurance and retrocession markets continues to prove a challenge, with signs that the reinsurance cycle is permanently changing given the more fungible nature of capital flows.

In a low interest rate environment, the appetite of capital market investors for catastrophe risk remains strong and there appears to be no sign of this waning. Property catastrophe risk offers pension funds and other institutional investors an asset class that is uncorrelated to equity investments, and which continues to offer attractive returns, in spite of ongoing competitive pressures.

Encouraging signs are being seen that other ILS managers are taking a disciplined approach to underwriting, with a willingness to turn down business that is not priced adequately. This is reflected in the slowing of rate reductions at the mid-year June/July 2016 renewals. Willis Re have noted that "standalone insurance-linked securities (ILS) funds showed discipline through the first quarter of 2016".

Despite the more recent increase in insured losses during 2016, insured losses over the past three years have been significantly below average, with exceptionally quiet Atlantic hurricane seasons. US landfall hurricanes have historically been the biggest contributor to annual catastrophe claims. \$37 billion of global insurance losses were caused from natural catastrophes in 2015, well below the \$62 billion average of the previous ten years (according to Swiss Re sigma).

Despite the relatively low occurrence of major catastrophic loss activity, the experience of the past six months has once again been a reminder of the potential for substantial losses emanating from a wide range of catastrophic perils, including floods, windstorms, earthquakes, wildfires and severe convective storms.

## Renewable Infrastructure

(compare Renewable infrastructure funds [here](#))

**Helen Mahy, chairman, The Renewable Infrastructure Group:** Indications are that the strong demand for yielding infrastructure, including renewables, will continue, and if a "lower for longer" environment for interest rates establishes itself, this may enhance this demand. A more definitive resumption in growth in power prices will be an important factor in the performance of the renewables sector as a whole as well as in maintaining a dividend growing with inflation and a resilient net asset value over the years ahead. In addition, long-term energy security and clean energy imperatives are expected to support a broad pipeline of renewables generation and supporting technologies.

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**The Renewables Infrastructure Group:** The momentum towards a cleaner global energy system has been reinforced in the aftermath of the United Nations Framework Convention on Climate Change meetings in Paris (the 'COP 21') in late 2015 as nearly 200 countries around the world deepen their commitment to carbon reduction including renewables generation as a key component. In addition, governments are looking at the supporting technologies and infrastructure required to embed renewables effectively into energy networks.

The recent UK vote in favour of leaving the European Union does not alter the UK's desire and requirement to reduce carbon emissions. The UK has ambitious domestic targets in place as set out by its own legislation. The Climate Change Act of 2008 established a target for the UK to reduce its emissions by at least 80% from 1990 levels by 2050. The Act established a system of five-yearly carbon budgets, the fifth of which was formally approved by Parliament on 30 June 2016 and aims to limit annual emissions to an average of 57% below 1990 levels by 2032.

Electricity capacity margins (the average amount of extra electricity available compared to peak winter demand) are especially tight in the UK. Last winter spare capacity was just 1.2%, the lowest in a decade. Low wholesale power prices have made it uneconomic for older and less efficient power stations to stay open and coal-fired power stations, which are heavy carbon emitters, are being decommissioned at a faster rate than new generating capacity is being installed.

In addition, there is increased uncertainty as to whether the planned additional electricity interconnector capacity with Europe will be built. With the UK having voted to exit the EU, there are questions about whether such new interconnection will qualify for funding from the European Investment Bank (EIB) or the European Fund for Strategic Investments (EFSI). In the case that interconnector development is scaled back, the likely result is heightened security of supply pressures and higher peak electricity pricing than would have otherwise occurred.

The Managers believe that renewable generation will play an important role to fill this supply gap as well as demand response initiatives, power storage, energy efficiency investments and new build gas-fired generation.

As an EU member, the UK is required to generate 15% of its energy from renewables by 2020 under the European Union's Renewable Energy Directive. Although by leaving the EU the UK may no longer be obliged to hit these targets or any successor targets (unless agreed as part of any secession agreement), the Managers do not view this as significant as in respect of the roll-out of new projects to 2020. The renewables required to meet the 2020 target have already been largely built or are

expected to be commissioned (in particular taking into account the expected growth in offshore wind). In respect of longer-term commitments, the Climate Change Act's ambitious carbon reduction targets will require a substantial and continued contribution from renewables.

### Financial Markets, Currencies and Power Prices

If lower sterling values persist, we are likely to see higher import prices for dollar/euro-denominated coal and gas inputs for the electricity market. As gas-fired power stations tend to set the marginal cost of electricity in the UK, natural gas price rises tend to result in higher power prices.

Recent increases seen in short-term power prices as well as the benefit to UK projects of any currency-based movements in wholesale power prices, are positive indications for power prices in the coming years. The decommissioning of older fossil fuel plants, the expected normalisation of gas supply and storage levels after several recent warm winters and the factoring in of higher carbon costs in the light of the continued impetus towards achieving a cleaner global economy may be among the positive factors in wholesale power pricing in the UK and Europe.

### Implications of the UK leaving the EU

Uncertainty surrounding the implementation of Britain's departure from the EU may bring volatility to global markets in the near term, with some overseas buyers potentially being dissuaded from investing in the UK. This may present buying opportunities if valuations overreact. That said, thus far the Managers continue to see strong demand from investors for yielding renewables assets, likely driven by increased expectations for continuing low interest rates (in the UK, Europe and further afield) as well as a longer-term trend in investor allocations to the infrastructure asset class more broadly.

There may be other indirect effects on the renewables industry, for example in relation to equipment pricing or potential tariffs on electricity where it is traded. It is unclear as yet whether the UK will remain within the EU's Internal Energy Market, which facilitates the trading of power through its interconnectors, or the Emissions Trading System ("ETS"), which provides a single market for carbon permits. However, the Managers would expect that the UK will wish to remain members of both or at least to operate in a manner consistent with this position.

The UK is a leading advocate of carbon trading on a wide geographical basis, and there is precedent for countries which are outside the EU to participate in the ETS. In addition, the UK has its own significant policy measure on carbon reduction, in the form of the Carbon Price Support (CPS) mechanism in Great Britain, forming part of the Climate Change Levy legislation.

Whilst it is too early to tell what the broader economic impact of the EU Referendum vote will be across financial markets as a whole, in the near-term, the relative weakness of sterling has benefits for UK wholesale power prices. The Managers believe that long-term fundamentals remain in place - in particular the UK and European governments' commitment to supporting renewable generation as part of a cleaner energy strategy and moderate long-term growth in power prices.



## UK

Following the accelerated closure of the Renewables Obligation for new onshore wind and solar projects in March 2016 (subject to certain grace periods up to March 2017 for certain projects that were already at an advanced stage at the time of announcement of the early closure), TRIG's current deal flow in Great Britain is dominated by ROC projects that were connected to the grid prior to the March 2016 deadline. Going forward, politically-driven constraints mean that the next Contracts-for-Difference (CfDs) - replacing ROCs as the mainstay support scheme for new projects in the UK - are likely to be focused on offshore wind. In the UK budget in March it was announced that the government will auction up to a further GBP730 million of CfDs (following the first successful CfD auction in early 2015 in which 2GW of mainly wind generation secured 15 year fixed-price support) to support the development of up to 4GW of offshore wind and other technologies (excluding onshore wind and solar).

The Northern Ireland Renewable Obligation closed in May for large-scale onshore wind and closed in June for small-scale onshore wind, both with grace periods for projects which meet certain criteria. It is currently unclear how the Northern Ireland Assembly will support the deployment of renewable energy moving forward, although a range of options could be explored, drawing on opportunities presented by the GB energy market and the Single Electricity Market (SEM) across the island of Ireland.

The Company expects that the deployment of new onshore wind and solar in the UK will slow in the years ahead.

We would note that the secondary market for onshore wind projects in the UK remains healthy as projects continue to transition from developers and utilities to long-term income-seeking owners.

## Other Northern Europe

France is the second largest energy consumer in Europe and has ambitious national goals of achieving 32% renewable energy (including transport and heating) and 40% renewable electricity contributions by 2030. The country has signalled a continuation of its migration away from nuclear generation in favour of renewables. January 2016 saw the implementation of the Energy Transition bill to provide a continued stable regulatory framework for renewables development, including a transition to CfDs from FITs. French onshore wind additions are expected to be around 800MW per annum between 2016 and 2020 with significant levels of French large-scale solar PV additions also expected in the same period.

The Irish Renewable Energy Feed-In Tariff has supported the development of renewable energy projects with the installed capacity of onshore wind now at over 2.5GW. This regime closes to new projects from next year so the Company anticipates increased market deal flow from Ireland as new projects are constructed to meet this deadline. The Republic of Ireland aims to increase the overall energy consumption (including transport and heating) provided by renewable energy sources to 16% by 2020, with renewables targeted to contribute 40% of total electricity supply. A white paper published at the end of 2015 indicated that the Irish government is developing a new support scheme for renewable electricity, the details of which are expected to be published over the next year or so.

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**Alexander Ohlsson, chairman, Foresight Solar Fund:** The installed capacity of the UK Solar PV market continued to grow over the period with the Department of Energy and Climate Change ("DECC") estimating the total UK installed capacity to have exceeded 10GW by the end of March 2016. We expect this trend to continue over the next nine months with forecasts estimating an increase to 12GW by the time the ROC regime ends on 1 April 2017. The scale of UK installed capacity has created an active market in large scale secondary assets.

Although UK wholesale power prices continued their downward trend in Q1 2016, an upward shift was experienced in prices verified at the end of Q2 2016.

On 23 June 2016, the UK Government held a referendum in which the majority of the electorate voted for the UK to leave the European Union ("Brexit"). Whilst this result was unexpected, we believe the result will have a limited impact. The fundamentals of the UK solar sector are not underpinned by any EU regulation or legislation. The Renewable Obligation and the Levy Control Framework are enshrined in the Law of England and Wales and do not require transposition from EU Directives or other legislation.

In July 2016, it was announced that DECC would be dissolved and the departments functions would be transferred to the new Department of Business, Energy and Industrial Strategy ("BEIS") a combination of DECC and the Department of Business, Innovation and Skills ("BIS"). While the impact this will have on the renewable energy sector is at this point unclear, there are several positives that may result from the decision such as the ability for more co-ordinated policy decisions.

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## Timber

(compare Timber funds [here](#))

**Sir Henry Studholme Bt, chairman, Phaunos Timber Fund:** The economic outlook continues to be unpredictable and unstable with low oil prices, gyrating financial markets and slower growth in China dampening the political and economic environments, affecting businesses and their operations worldwide. Despite this volatility, the outlook for timber markets is positive. Brazilian pulp production continues to grow and charcoal markets are showing early signs of improving, albeit from a low base. In Uruguay expectations for a third pulp mill grow stronger while Chinese demand continues to support New Zealand log exports.

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## Property - UK

(compare UK property funds [here](#))

**Chris Russell, chairman, F&C Commercial Property Trust:** Following the EU referendum vote at the end of June there are unresolved political and economic issues which will continue to contribute to a climate of uncertainty in the property market. While the next few months should begin to see greater clarity on economic policy and Brexit strategy, a prolonged period of negotiation is likely before the final outcome is known.

This uncertain state of affairs will have some effect on both occupier and investor demand over both the short and medium-term, especially concerning City offices, secondary stock and development activity all of which the Company has a limited exposure to. Prime property in core locations may prove more resilient. Investors seeking an income stream should be attracted to an asset class with long-term contractual income yielding at least 4 per cent per annum, particularly if low interest rates limit profitable investment opportunities in other asset classes.

Brexit is important but is only one element in the outlook for property. There are wider global economic and political factors which will come into play and the UK remains a large, mature and relatively transparent market for UK and overseas investors. Following the fall in both sterling and gilt yields, and given the prospect of a prolonged period of low interest rates, well located and let property remains attractively priced against the current risk free rate of interest.

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**Richard Kirby, Fund Manager, F&C Commercial Property:** The outlook for property will be strongly influenced by the Brexit negotiations and we are now in a very uncertain phase as the implications of the vote are evaluated. We would expect investors to remain cautious and risk averse and for this to favour prime property in established locations.

Low interest rates may further support the prime end of the market while a lower sterling rate could potentially attract overseas buyers. The economic outlook is for lower but positive growth over the medium-term and for some increase in inflation. Monetary policy was eased in August 2016 and the Autumn Statement may provide greater clarity of the fiscal side.

There are concerns about the prospects for secondary stock and for development in a lower growth environment. The City and Docklands markets may see some fall from favour until finance firms' location plans are determined. We expect to see a more subdued performance from property and some uncertainty in the occupational markets but also opportunity as the initial shock dissipates and the path forward for the UK economy becomes clearer.

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**James Hambro, chairman, Hansteen Holdings:** We believe that the next few years will present a challenging landscape for investors. Solid income propositions underpinned by assets that will hold or grow their value will be very attractive. Light industrial property is one of the few areas of the property sector which has not yet surpassed its previous yield lows (value highs). Yields are still high relative to the cost of money.

Furthermore, the occupational market is enjoying a real boost on the back of the internet retailer revolution. Our properties are valued at materially less than replacement cost, hence there is very little new supply of equivalent properties.

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**Andrew Wilson, chairman, UK Commercial Property:** It is too early to be definitive about how the leave vote will affect the UK economy and the real estate sector in particular; however, the pervading heightened uncertainty implies a weaker second half of the year for the economy. In financial markets, 10 year benchmark bonds are at historical low levels, sterling has weakened by circa 10%, interest rates have been cut and sentiment surveys suggest a challenged economic backdrop ahead. The Bank of England has cut its forecast for economic growth in 2017 from 2.3% to 0.8%.

Until the position of the UK is clearer, particularly in regard to the detail of its exit from the European Union, it is hard to forecast outcomes with any accuracy. Whilst some political stability has been established in recent weeks, the outlook for the UK economy has weakened. It is too early to determine the level of impact that the increased uncertainty will have on the economy, the financial markets and the direct and indirect UK real estate market. However, UK commercial real estate continues to provide a significant yield premium to other assets. Compared to previous downturns the UK commercial property market has lower gearing levels, higher occupancy rates and muted levels of new supply, all of which should enhance the resilience of the asset class.

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**Will Fulton, fund manager, UK Commercial Property:** The implications of the UK's Referendum on EU membership have caused a complex interaction between politics, economics and markets which makes the coming months very difficult to predict. Given the ongoing political uncertainty the UK economy is expected to be affected negatively, although as market volatility rises safe haven assets will benefit. Slowly but surely, we are starting to get some early data, which is helping shed some light on the initial fallout.

These data points have tended to be survey-based 'soft' data, rather than official 'hard' statistics, which will be released with more of a lag. However, in most cases, we have seen signs of deterioration in activity. Some early indicators on retail sales by the Office for National Statistics (ONS) showed a fall in June, but stores suggested that bad weather rather than the vote to leave the European Union was to blame. More recent figures, released by the British Retail Consortium and KPMG for July, showed a rise in like for like sales, leaving open the question of how big the hit to the economy will be.

Although survey data can sometimes be erratic and overreact to short-term shocks, persistent uncertainty is likely to spur action by policy makers. Based on an expected stalling of growth over the second half of this year, and a downgraded GDP forecast of 0.8% from 2.3% for next year, the Bank of England has delivered a significant monetary easing package in response to the EU Referendum result. It shows the Bank's willingness to respond forcefully, and its confidence that it still has the tools and ammunition to support the economy.

Before the EU Referendum the UK real estate market was already at a mature phase of its cycle. Following the Referendum, a higher volume of sellers versus buyers is adversely impacting UK real estate capital values, although this is only just starting, as we go to print in August, to materialise significantly in index level data. Over the six months to end June, All Property recorded a 2.6% total return according to the IPD/MSCI Quarterly Benchmark, reflecting end-June valuations established prior to the EU Referendum result. This return was lower than the same period in 2015, led by marginally negative capital value growth which had already been expected by markets. Rental growth remained healthy at 1.2% in the six months to end June. The industrial sector generated the highest total returns across all sectors at 3.5%, helped by the positive capital gain for the six months to 30 June 2016. Office and Retail recorded 3.0% and 1.8%, respectively, in the same time period.

A slowdown in UK real estate was materialising prior to the EU Referendum. The economic outlook is being impacted by heightened uncertainty following the result, with lower business and consumer confidence. Given its direct correlation to economic activity, this is affecting UK real estate. We therefore anticipate increased pressure on UK commercial real estate capital values due to elevated investor caution and the expected weaker economic environment; the magnitude of decline will depend on the Referendum's actual impact on the domestic economy. From a sector

perspective, we expect Central London offices to be the most negatively impacted over the medium term given the linkages to European markets. We expect industrial and retail assets to be comparatively resilient, although not immune, given their higher yields. We expect long income assets with good tenants to provide most resilience in this environment.

UK real estate continues to provide an elevated yield compared to other asset classes. Looking forward there are a number of important fundamental measures which should help stabilise the market - this cycle's experience of a more conservative real estate lending environment, below average existing vacancy rates in most markets, and relatively constrained development holding back supply. The current "lower for even longer" interest rate environment, coupled with an increasing investor global search for yield and the retention of the UK's standing as a transparent market with a robust legal framework, should all ensure the asset class is well placed for the longer term.

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**Derwent London:** The London office market is likely to face a number of challenges in the next few years, but London remains a major global city with significant economic and cultural attractions. It has also shown an ability to adapt to take advantage of events and economic trends.

We regard London office occupier demand as the most important measure of the health of our real estate market. The result of the EU referendum and the ensuing uncertainty is expected to lower demand levels. However, London is likely to remain an important and dynamic city with a number of inherent strengths which will continue to appeal to a wide range of international and domestic occupiers. Longer term, these attractions may be supported by new policies that the UK government introduces to mitigate any negative impacts of Brexit.

In the first six months of the year CBRE reported lower central London take-up at 5.5m sq ft. Against this background, central London's office vacancy rate has risen to 3.2% but remains low compared to historical levels. CBRE estimates that prime rents were either unchanged or marginally up in most London markets, with Victoria and Paddington seeing the strongest growth at 10% and 8%, respectively. JLL reported slightly higher active enquiries at 9.8m sq ft. However, we also need to consider longer term or potential demand. JLL has this falling to six million sq ft and, although this is 24% down from Q1, it is still 22% above levels recorded one year ago. It is how this develops over the next few years that will determine the medium term health of the central London office market.

Development activity in central London has been increasing with 1.7m sq ft of offices completed in the first half. There is currently another 13.0m sq ft under construction of which 45% is pre-let or under offer and all is due for completion by 2019. Adjusting for pre-lets there is currently 7.1m sq ft of speculative office space under construction, equivalent to an additional 3% of the central London office market. Over the same period CBRE estimates that there is another 13.3m sq ft that could be delivered. We expect that much of this potential supply will be delayed or reduced until the outlook for the London office market becomes more certain.

West End supply is lower with 2.5m sq ft under construction due for completion by 2019 of which 36% is pre-let or under offer. The current vacancy in the West End is 2.5%, and the speculative element of new supply under construction represents around 1.7% of the local market. CBRE estimates that there is scope for another 2.7m sq ft to be built in the West End by 2019.

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**Richard Jewson, chairman, Tritax Big Box REIT:** Although the outcome of the referendum vote on 23 June 2016 represented a shock to the financial markets, through decisive action to deliver a stable government and action from the Bank of England the UK has stabilised somewhat and the equity markets are recovering well. Even prior to the referendum, during the summer of 2015 the markets began to indicate a change of direction, placing greater value on certainty, quality and security of income. This trend has continued post the Brexit vote, stimulated by falling interest rates and market comment suggesting that these could remain low for some time to come.

UK retail continues to evolve, with e-commerce growth leading the way. Many of our properties have an e-retail focus and/or automation, aiding home deliveries or store replenishment. These facilities are delivering economies of scale benefits and cost savings crucial to competitiveness and efficiency in a market where the consumer has become ever more demanding.

Occupational demand continues to outweigh the supply of quality logistics buildings in the UK but this situation is even more acutely favourable for Big Boxes. The resultant strong rental growth is expected to continue, helping to grow our income and support our progressive dividend policy.

Moving forwards we see opportunity. Institutions are seeking to re-weight their commercial property holdings, reducing retail and offices in favour of industrials, distribution and other specialist sub-sectors. In these areas, specialist and experienced management teams are crucial to outperformance. The open-ended retail funds have been forced to sell assets in order to meet redemptions and whilst this is likely to be short lived, we are well placed to capitalise. It may be too early to tell, but the signs are that values for prime logistics have largely remained unchanged either side of the Brexit vote. There are credible arguments suggesting that secondary property could witness a weakening in yields, but for prime logistics we remain positive, supported by the notion that strong, secure, long-term income will remain a key focus for investors, particularly from prime assets let to institutional quality companies. With 10 year UK Gilts below 1% and negative interest rates offered on some European bonds, the pricing point at which our Investment Manager can secure stock remains attractive.

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**Tritax Big Box REIT:** The Big Box investment market is one of the UK's strongest economic sub-sectors. Over the past five years both domestic and global investors have been increasing their allocation to the sub sector, attracted by the secure and growing income streams secured against major brand occupiers with strong balance sheets. These occupiers are keen to commit to long leases to protect both their market position and the substantial levels of capital investment made into the buildings that they distribute from.

UK e-commerce growth continues to outstrip high street sales growth by a significant margin. The increased importance of modern logistics buildings to tenants' supply chains, particularly where they have effectively become an extension of retail, has put the sector at the top of many investors' shopping lists.

Whilst it is too early to analyse market data trends following the referendum vote, we are aware of a number of letting and investment transactions for prime logistics buildings which were agreed before 23 June and which have since successfully concluded without price change. It appears that the logistics sector remains a highly liquid, resilient and sought after asset class within a global context where there remains a continued search for secure and rising income streams provided by assets with strong capital protection profiles. The short term devaluation of Sterling has



further increased the attractions of the Big Box asset class to overseas investors, particularly those which are US dollar denominated.

UK prime logistics yields set a new benchmark when Legal & General paid 4.2% last year for a 25-year lease to John Lewis at Magna Park, Milton Keynes, compared to 4.00% to 4.25% for prime shops during the same period. In May of this year, Korean investors forward funded the development of Amazon's new facility at Bardon, Leicestershire, at a 4.5% yield for a 15-year term, which has set a new benchmark in the sector. The low yield watermark tends to be set by annuity funds; with a prime tone for non-annuity grade investments in the high 4%'s and low 5%'s. At these levels there remains an attractive "positive yield gap" over the cost of borrowing, with interest rates remaining stubbornly low. Consequently, for a relatively low risk premium, moderately geared investments continue to offer an attraction over the UK Government 10-Year Gilt. Whilst debt remains available for high quality investments, LTV levels remain well below those witnessed in the run up to the last recession, demonstrating that yield compression is not a function of purchasers over-gearing.

Although yields for prime logistics investments have compressed considerably, there are good arguments to suggest that this reflects a structural long-term yield repositioning for the sector, particularly for Big Boxes. This is because the market is recognising the crucial role that these large logistics facilities now fulfil in both direct e-retail and the adaptation of high street retail in meeting fast changing and increasingly demanding consumer shopping habits. Current yields are also supported by the strength of rental growth as mentioned above and the expectation that income growth will remain favourable. This is likely to be the key feature looking forwards to H2 2016 and into 2017, with lower total returns expected for commercial property due to reducing capital growth. The key component of total return is expected to be a healthy level of income return. We could see modest levels of yield compression at the prime end of the market but capital growth is more likely to be manifest through income growth (assuming a steady state capitalisation rate). For these reasons we see high quality income focused logistics investments remaining in strong demand in the UK investment market.

## ■ Key retail trends

A number of significant trends are driving demand for Big Boxes from major retailers. The continued rapid growth of e-commerce is an important factor, with retailers increasingly offering next day or even same day delivery, resulting in the need for highly efficient fulfilment facilities. Although online shopping is growing fast, it is still at a relatively early stage of evolution and industry estimates suggest it has much further to go. Retailers are also looking to make better use of space in their shops, giving more space over to displaying goods and less to storing stock. This, coupled with growth in click-and-collect shopping, requires them to have the ability to restock rapidly their stores.

According to IMRG in June 2016, shoppers spent 17% more online in June this year than they did in June last year, notwithstanding the result of the EU Referendum. It is encouraging that, both in the run up to the referendum, and the immediate aftermath, online sales growth remained strong.

These trends are leading retailers to change the way they structure their distribution networks. National distribution centres in central locations had allowed retailers to reach a large proportion of the UK population within the statutory limits on drive times. Growing motorway congestion is, however, leading them to develop regional distribution networks centred on Big Boxes. Cost is also a factor behind regional distribution platforms, reflecting the fact that rents and labour costs can be much



lower in some parts of the country. The availability of sufficient workforce is also a key influence on choice of location.

Both retail and non-retail tenants are demanding flexible, future proofed buildings. This can mean a substantial eaves height, allowing the installation of high-level racking or multiple mezzanine floors, which is particularly attractive as rents are calculated only on the ground floor area, not the building volume. Tenants may also want the ability to expand, favouring buildings with low site cover or the opportunity to extend on adjacent land.

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