# Economic & Political Roundup

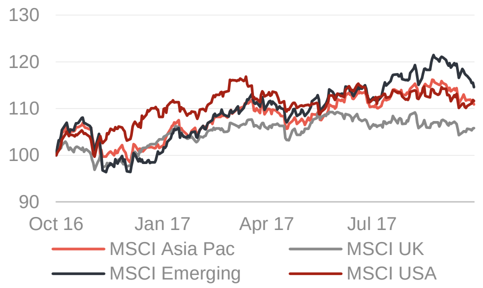
A collation of recent insights on markets and economies taken from the comments made by chairmen and investment managers of investment companies – have a read and make your own minds up. Please remember that nothing in this note is designed to encourage you to buy or sell any of the companies mentioned.

| Exchange Rate | 30/09/17 | Chg. on month % |
|---|---|---|
| GBP / USD | 1.3398 | +3.6 |
| USD / EUR | 0.8464 | +0.8 |
| USD / JPY | 112.51 | +2.3 |
| USD / CHF | 0.9683 | +1.0 |
| USD / CNY | 6.6528 | +1.0 |

Source: Bloomberg, Marten & Co

## MSCI Indices rebased to 100

Time period 30/09/16 to 30/09/17




Source: Bloomberg, Marten & Co

| | 30/09/17 | Chg. on month % |
|---|---|---|
| Oil (Brent) | 57.54 | +9.9 |
| Gold | 1279.75 | -3.2 |
| US Tsy 10 yr yield | 2.3336 | +10.2 |
| UK Gilt 10 yr yield | 1.365 | +32.0 |
| Bund 10 yr yield | 0.462 | +28.3 |

Source: Bloomberg, Marten & Co

QuotedData is pleased to announce that it was awarded ***Highly Commended, Best Investment Trust Research*** at the 2017 Investment Week Investment Research Awards for our note on Pacific Horizon – ***Brave new world***

## Roundup

Sterling bounced against the US dollar during September and was stronger against most currencies. The oil price was quite strong as the International Energy Agency (IEA) raised its projections for oil demand. Gold eased a little. The Bank of England dropped more hints about raising rates and this hit gilt yields. In sterling terms, most markets fell. Notably, emerging markets gave up some of their summer gains.

## Global

Diverging views on inflation, worries about consumer debt and the unwinding of quantitative easing.

The managers of Ruffer Investment Company say that inflationary risks are rising. Geoffrey Howard-Spinks, chairman of New Star Investment Trust, thinks that inflation rises over the coming months are likely to be modest. The managers of that fund think deflationary forces may hold inflationary pressures at bay. Peter Burrows, chairman of UIL, highlights low wage inflation as a positive for investment markets. Tom Walker, manager of Martin Currie Global Portfolio, is concerned about increasing consumer debt and thinks that the Federal Reserve may be cautious about raising rates. The managers of Mid Wynd say they are not gloomy as they think equities are not over valued and debt levels are manageable. The managers of Highbridge Multi Strategy warn that the unwinding of QE may not result in an orderly transition.

## United Kingdom

Brexit, interest rates, inflation, QE, and domestic politics are all highlighted by commentators. A few managers are optimistic, however.

Allister Langlands, chairman of Standard Life UK Smaller Companies, says the full implications of the Brexit decision will take time to take effect. Harry Nimmo, manager of that fund, warns that the oscillation in views on the outcome of Brexit talks will become increasingly fraught. Tom Bartlam, chairman of Jupiter UK Growth, says that investor sentiment has been impressively resilient in the face of Brexit negotiations so far. Steve Davies, manager of that fund, believes Mrs May is here to stay. He also says that investors should not ignore the possibility of a chaotic, cliff-edge Brexit.

Neil Honebon, chairman of Murray Income, talks about interest rate rises and cautions that there will be casualties along the way. Charles Luke, manager of that fund, thinks that the balance of risk is on the downside (a sentiment echoed by the managers of Dunedin Income Growth), Charles is also concerned about rate rises. The managers of Invesco Perpetual UK Smaller Companies think the pace of rate rises will be very gradual. Rupert Barclay, chairman of Sanditon, thinks the unwinding of quantitative easing may weigh on equity markets. Simon Fraser, chairman of Merchants Trust, agrees that valuations are, in many cases, still reasonable. The managers of that fund see opportunities in sectors such as retail, leisure and financials. The managers of JPMorgan Mid Cap think interest rates will remain at rock bottom for some time and cite a number of reasons why they are optimistic.

Philip Remnant, chairman of City of London, suggests that investors in search of income look to large cap equities. Michael Hughes, chairman of JPMorgan Mid Cap, says mid cap stocks are a source of more reliable income.

Tim Chapple, manager of Aurora, is concerned about possible government interference in the UK housing market. Robert Lister, chairman of Aberdeen Smaller Companies Income, implies that higher inflation needs to be factored into investment decisions. The managers of Mercantile are most worried about the geopolitical landscape and say that markets may become more volatile.

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## Global emerging markets

Frontier markets are attractively valued but there is some nervousness about emerging market valuations

The managers of Aberdeen Frontier Markets highlight the 30% valuation discount that their markets trade at, on average, to developed market equities. Hélène Ploix, chairman of Genesis Emerging Markets says that there are plenty of reasons to be wary of the short-term environment in emerging markets, including a fear that China's economy is less healthy than it appears. The managers of that fund say that they are encouraged that economic growth has stabilised after many years of decline.

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## Commodities and natural resources

Demand and constrained supply is supportive for most metals but oil is range-bound

Geoff Burns, the chairman of City Natural Resources, is concerned about increasing geo-political risk and rising debt levels but sees positive impacts on demand for commodities and natural resources from China's 'one-belt-one-road' initiative. The managers of that fund give a detailed round up of the sector. They say that, encouragingly, major mining corporations are showing restraint in the face of rising prices but think oil is range-bound.

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## Debt

SME lending holding up, cheap property finance is available but not for developments. Defaults are low and CLO issuance is high.

David Warr, the chairman of Hadrian's Wall Secured, says that SME lending is holding up despite the challenges facing the UK economy. The managers of Starwood European Real Estate Finance draw conclusions from a recent spate of research pieces published on the UK property market. Existing buildings can get finance at very low rates but development finance is much harder to come by. The managers of Blackstone/GSO Loan Finance note that defaults are low, CLO issuance has been high and they think senior loans are well positioned. However, high yield bonds offer no more yield than senior loans but are riskier. The managers of CVC Credit Opportunities list a number of factors that could create volatility in credit markets. They think that inflation will continue to rise. The managers of ICG Longbow think REITs and others are calling the top of the London property market where finance seems to be available cheaply.

## Property

Valuations are challenged by hurdles such as Brexit, commentators say focus on property's income returns. Industrial property and property outside London might be more attractive.

Vikram Lall, chairman of F&C UK Real Estate, says the outlook is dominated by Brexit but thinks property income should prove defensive. The manager of that fund concurs. He also draws attention to the possibility of interest rate rises. Andrew Wilson, chairman of UK Commercial Property, is comforted by lower debt levels in the sector than in 2007/2008, low levels of development, low vacancy levels and liquidity in the market. The manager of that fund says investors are becoming more risk averse. The managers of Regional REIT point out that industrial property is forecast to experience the highest rental growth in 2017. The managers of Real Estate Investors, which is focused on property in and around Birmingham, take us through the prospects for that part of the market – they are upbeat. Martin Moore, chairman of Secure Income REIT, says valuations have risen to a point where it is hard to find attractive acquisitions.

GCP Student Living takes us through the dynamics of the student accommodation market, with particular attention to London. Impact Healthcare REIT looks at the drivers of demand for residential care homes in the UK. Gary Kennedy, chairman of Green REIT, is enthused about the Irish economy. The managers of that fund attribute this in part to Brexit, which is attracting firms looking for an English-speaking country within the EU. They think though that investors are favouring prime property in their market. Macau Property Opportunities takes an in-depth look at Macau's economy and property market.

## Other

In addition, we have comment on Asia from Schroder Asia Total Return; on Korea's stock market's remarkable resilience, from Weiss Korea Opportunity; on the United States from James Ferguson, chairman of North American Income; on Eastern Europe, from BlackRock Eastern European (where they think valuations look attractive); on Latin America, from BlackRock Latin American (where they lament Brazil's ongoing political crisis); Qatar, from Qatar Investment Fund (where they give a detailed account of the impact of the spat between Qatar and its Arab neighbours); Vietnam, from Vietnam Enterprise Investments; Infrastructure, from International Public Partnerships; Private equity, from Oakley and Harbourvest.

## Contents

# Global

(compare Global funds **here**)

**Ruffer AIFM, managers, Ruffer Investment Company:** To many the financial crisis is a distant memory and is viewed in the past tense. To us, the sequence of events leading up to the crisis and those that have happened since 2008 have only managed to defer the day of reckoning - the seeds of the next crisis (or is it part of the same crisis?) are sown and are well past the germination stage. 2008 was a rap on the knuckles of the western world. For too long we had eaten tomorrow's cake today using debt to bridge the gap. The belief of the world's central banks was that sharply lower interest rates would buy the time needed to get the house back in order. But far from using this window of opportunity to tighten belts and deleverage the opposite has happened. Cheap borrowing costs have allowed debt growth to continue unabated. On its own this might not be problematic if it was accompanied by strong economic growth, but this has not been the case.

Once again, we have eaten tomorrow's cake today but this time at a moment when we were still trying to atone for yesterday's binge. At this crucial juncture the stakes are now higher and the options more limited. On top of this (and to some extent because of it) there has been another important development in the last 12 months; the political winds have changed. Austerity is a vote loser and is off the table and the have-nots are voting for change. This means more spending to try to boost growth and more borrowing to fund that spending. The inflationary risks were already high and they are about to get higher.

What this boils down to is a transfer of wealth from the world's savers to the world's borrowers and now the political wind is firmly behind this movement. The mechanism for this change is financial repression; keep interest rates below the rate of inflation. This has been happening for some time in the UK, US and Europe and is likely to become more extreme. Unlike the last crisis, the hiding places will be few and far between. Index-linked bonds will play a critical role but the path to this denouement is unlikely to be a smooth one.

The question we are frequently asked is 'When?' and our answer, depending on how facetious we are feeling, ranges from 'Don't know' to 'Don't care'. Think back to 2006 – it did not matter whether you identified that it would be Lehmans rather than Bear Stearns that would bring down the banking system, the useful insight was to spot that at some point a systemically important bank would fail – the house of cards was already teetering and the signs were there. The situation is similar today; the catalyst is less interesting than the outcome.

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**Geoffrey Howard-Spink, chairman, New Star Investment Trust:** Inflation rises are likely to be modest over the coming months and, as a result, the pace of monetary tightening by the world's major central banks is likely to be slow. Such an environment would benefit equities at the expense of fixed income securities. The pattern of steady economic growth and relatively low inflation is likely to be sustained over the coming months.

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**Brompton Asset Managers LLP, managers, New Star Investment Trust:** Inflation trends will have a significant influence on financial markets over the coming months. Equities and other real assets should benefit if inflation continues to rise slowly from subdued levels and the pace of monetary tightening is gradual. Conversely, longer-duration assets such as longer-dated bonds could post losses if inflation continues to rise.

Some equity markets such as the US were trading at the start of the current financial year on high valuations compared to historical standards. The strongest potential for further gains may, therefore, exist in lowly-valued markets where central bank monetary policy is accommodative such as in Europe ex-UK, emerging markets and Japan.

It is possible that deflationary forces such as the growth in self-employment and technological change may hold inflationary pressures at bay. The lack of wage inflation despite historically low unemployment in the US and UK supports this view for now. The recent environment of high equity valuations, moderate economic growth and low inflation may persist for some time.

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**Peter Burrows, chairman, UIL:** We have made the point for some time that markets in general remain outside normal historic parameters. From a monetary policy perspective, we remain in an environment where unconventional tools are being deployed, such as negative interest rates in a number of countries and quantitative easing ("QE") still being implemented in both Europe and Japan.

From a political perspective, we continue to witness a rise in populist politics with a move away from established parties and candidates as voters seek change. We are also witnessing an increase in geopolitical tensions in places such as North Korea and Turkey.

All of these factors, individually and collectively, create uncertainty and ultimately could have negative implications for markets. These issues are a concern from an investment perspective.

However, despite this uncertain backdrop, it is encouraging to see that most economies are still delivering positive GDP growth with low inflation and especially low wage inflation which should be positive for corporates and in turn investment markets.

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**Tom Walker, manager, Martin Currie Global Portfolio:** Sentiment towards the investment prospects for different parts of the world has undoubtedly shifted - we highlight the greater enthusiasm for Europe and concomitant downward shift in sentiment to the US. However, sentiment swings around readily and we still believe the US economy holds the key to global economic prospects. In that respect, if there has been any change in interest rate expectations at all this year, it is that the Federal Reserve may be more cautious in raising rates than had been thought at the start of 2017. Certainly, the sharp upward move in long-term interest rates that accompanied President Trump's arrival has been halted and slightly reversed.

The rise in consumer debt is a concern. There was a time when higher interest rates may have been applied to dampen demand for credit, but central bankers seem reluctant to use a blunt tool like interest rates which could, if applied clumsily, lead to another economic downturn. As a result, it is hard to see interest rates moving meaningfully higher anywhere in the world for the foreseeable future - there is little inflation, only modest growth and - perhaps with the exception of the FAANGs - the general mood is perhaps better described as 'fragile', rather than 'euphoric'.

So while our caution mounts as new highs are achieved on markets, low interest rates have underwritten equity markets for some time and may continue to do so.

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**Simon Edelsten, Alex Illingworth and Rosanna Burcheri, managers, Mid Wynd:** Market commentators seem increasingly gloomy - we do not agree. Stock markets have certainly performed well over the last seven years, but bull markets do not die of old age, nor does the economic cycle. We believe that major market set-backs tend to come from broad over-valuation of equities or unsupportable debt in economic systems.

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**Highbridge Multi Strategy:** Looking ahead, we expect that we will start to see how the effects of imminent Fed tapering of their $4.4 trillion balance sheet as well as the approach of another rate rise are going to be digested by markets. This will not necessarily be an orderly transition. With the ECB and the Fed sounding more hawkish (despite recent attempts by both to backtrack on said hawkishness), we believe that markets are more likely to increasingly focus on the reality of the global unwinding of the great QE experiment with the ECB's €4.2 trillion balance sheet to consider in Europe, and, while likely even further off, the JPY502 trillion balance sheet at the BoJ. Adding it all up, that is close to £11 trillion of global central bank balance sheet capital to be unwound in the coming months and years, an unprecedented number that has the potential to significantly impact markets globally and across asset classes.

In the shorter term, the upcoming months will likely also continue to see the interplay of politics and populism across the globe with some key elections in Italy and Germany up ahead and the ongoing ramifications of political missteps and Brexit negotiations in the UK and Trump's stalling agenda in the US. All told, the second half of 2017 looks to be a period that sets itself up for some further shifts on the monetary, fiscal and political stages and undoubtedly brings with it some great opportunities.

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## United Kingdom

(compare UK funds **here**)

**Allister Langlands, chairman, Standard Life UK Smaller Companies:** In the last 15 months a number of events have occurred which will have significant bearing on the future macro-economic landscape and which were not foreseen by most commentators: the Brexit vote; the appointment of Donald Trump; the election of a minority government in the UK to name but three. Because these outcomes were unexpected, the immediate reaction was all the more acute as a result. The full implications of the Brexit decision, in particular, will take time to take effect.

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**Harry Nimmo, manager, Standard Life UK Smaller Companies:** In March 2017, the starting gun was fired with the invoking of Article 50 of the Lisbon Treaty, bringing to an end the United Kingdom's membership of the European Union. 29 March 2019 is the target date for exit from the EU meaning that a deal needs to be apparent by

October 2018 if the European and United Kingdom parliament are to have time to ratify the agreement.

There is just no way of predicting the turn of events. My guess is that the oscillation in views on the outcome will become increasingly fraught between now and October 2018. If the last year is anything to go by the last thing one should do is obsess about the macro scenarios.

Investors should not become obsessed with Brexit, because in the long run, stock selection is more important than market timing, and investors and fund managers should focus on the long-term investment horizon.

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**Neil Honebon, chairman, Murray Income:** It is hard to argue that the uncertainties in the political sphere have cleared recently, and that remains a major risk for markets in the year ahead. Economic and foreign policy construction has become more erratic with considerable scope for market surprises, especially perhaps in currencies. Financially, real interest rates are still aberrantly low and history tells us that some reversion is inevitable, although the exact path and timing are unclear. Low or even negative real interest rates are important because they encourage investors to take more risk; they distort the allocation of capital and valuation of future cashflows; they enable the improvidently-financed to survive. When rates do revert, there will be casualties. If the impact of low rates has been more obvious on financial asset prices than on economic activity, it seems likely that Central Banks will have to tread very carefully to avoid unsettling markets in their first steps back from the massive monetary experiment.

In the UK specifically, wage growth is again not keeping up with inflation, and that provides a serious constraint on economic growth. The Bank of England has already warned about borrowing levels and trends. For many UK-listed companies, however, domestic economic conditions are not paramount. The outcome for overall company profit growth and thus for UK dividends will be crucially dependent on overseas earnings and the level of Sterling, which has already recovered a little from its lows against the US dollar. As previously, it seems a wise way to moderate these investment risks is to focus on sustainable and growing income generated from well-financed balance sheets.

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**Charles Luke, manager, Murray Income:** Equity market performance over the last year has been strong helped by an improvement in the global growth dynamic, generally market-friendly political outcomes and the maintenance of low interest rates. From here the balance of risk probably lies to the downside with the prospect of rising interest rates impacting on an increased corporate and personal debt burden, heightened geopolitical risks and the evolving policies of the US president. For the UK the principal factor is the outcome of and uncertainty caused by the negotiations to leave the European Union.  In an environment where in general equity valuations appear full and a broadly positive outlook is already priced in we feel that it makes sense to be cautious.

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**Rupert Barclay, chairman, Sanditon:** Since the start of Sanditon Investment Trust, the manager has argued that Quantitative Easing programmes have heavily distorted asset markets. Now that monetary policy is being tightened in the world's largest economy, both through more persistent interest rate increases and plans to reduce the size of the Fed's balance sheet, we will see whether equity markets can take monetary tightening in their stride. Your manager believes there will be an equal and opposite effect on equity markets as QE programmes are stopped and reversed.

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**Tom Bartlam, chairman, Jupiter UK Growth:** The failure of the Conservatives to obtain a clear parliamentary majority in the UK general election has created greater uncertainty about the Government's negotiating strategy for Brexit. What has become clearer is that the Government has been listening to the concerns of business about the dangers of an abrupt exit and appears to be moving towards the negotiation of a two or three year transition period after 2019. The ebb and flow of the negotiations will inevitably continue to have an influence over financial market performance in the interim, but investor sentiment has remained impressively resilient so far.

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**Steve Davies, manager, Jupiter UK Growth:** Investor sentiment towards the UK remains very subdued and the unexpectedly close outcome of June's general election has added an extra element of uncertainty in the short-term.

We may be in the realms of "weak but stable" government for the time being, with Mrs May's leadership likely to last somewhat longer than generally expected. The Conservative party will be very wary of holding a potentially divisive leadership battle anytime soon, particularly if such a move precipitated another general election which might let Jeremy Corbyn into Number Ten. Mrs May's credibility has been severely dented and she will be forced into a much more inclusive style of government.

The optimist in me hopes that this should improve the chances of a slower and more economically friendly Brexit being negotiated with the EU. However, the realist must also acknowledge that a weak government and a bitterly divided range of opinions about Brexit makes it foolish to dismiss the possibility of a chaotic, cliff-edge Brexit as the Article 50 clock ticks inexorably on.

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**Philip Remnant, chairman, City of London:** The UK's negotiations to exit the European Union are set to dominate the political and business news in the year ahead. The uncertainty as to the UK's future trading relationship with the EU will continue to affect adversely business investment. Inflation should moderate, giving some respite to the consumer, as the effect of the lower level of sterling falls out of annual comparisons. Looking overseas, the momentum of economic growth is now well entrenched in the US and Europe.

[*Holding*] large capitalisation equities should be an advantage in the year ahead if growth is more rapid overseas. In any case, the dividend yield of large capitalisation equities is significantly higher. Compared with the other traditional income streams of fixed interest and property, equities provide an attractive combination of yield and income growth.

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**Michael Hughes, chairman, JPMorgan Mid Cap:** The UK mid cap sector has suffered from negative comments about the impact of the UK leaving the European Union. We feel these comments are over-pessimistic and that UK companies are well placed to take advantage of new opportunities in faster growing countries outside the Eurozone area. Indeed our managers have reported on a higher level of optimism from the companies they are invested in than appears to be reflected in recent media reports.

Since the start of the new millennium, the mid cap sector has substantially outperformed the large cap indices despite the major disruptions from global financial and political events. Moreover, the sector is being recognised as a source of more reliable income.

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**Georgina Brittain and Katen Patel, managers, JPMorgan Mid Cap:** The outlook for the UK economy is mixed. It is all too easy to paint a gloomy picture in the short term. Consumer confidence is down, consumer spending is down, GDP forecasts have recently been reduced, and business investment is down. Add to this rising inflation and rising consumer debt levels, all against the backdrop of a destabilising UK election which provided a minority Government, and a further 18 months of Brexit negotiations.

However, few of these are surprises (bar the election outcome). On the positive side, it is clear that interest rates will continue to remain at rock bottom for some time to come. Unemployment is at a 40 year low at 4.4% and the employment rate (the proportion of people of working age who are in employment) is over 75%, which is the highest figure since records began in 1971. Foreign direct investment into the UK continues to be strong; and as predicted, our weak currency is proving a boon to UK exporters.

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**Tim Chapple, manager, Aurora:** In April 2016, we mentioned the Government "White Paper" on housing as a potential risk to housebuilding investments. Political uncertainty increased further with the General Election in June, with Alok Sharma MP becoming the sixth Housing and Planning Minister in seven years. Trading conditions for housebuilders have recently benefited from government policy tailwinds, including: selling public land to housebuilders; easing the planning system and providing financial assistance to buyers through the Help to Buy scheme. Whether these tailwinds continue to blow quite so hard is unlikely to become clear until the new Minister has found his feet and the White Paper turns into something concrete.

The potential outcome of the Brexit process is so uncertain that spending much time pontificating is pointless, although clearly it needs to be acknowledged as a risk. A "bad Brexit" (for whatever reason) will probably hurt consumer sentiment and have real negative consequences for the economy. Even a "good Brexit" is unlikely to be plain sailing.

For all the uncertainty around Brexit, Trump/North Korea and terrorism, stocks have been buoyant.

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**Robert Lister, chairman, Aberdeen Smaller Companies Income:** The uncertainty arising from Brexit and the risk of over-exposure to potentially slowing growth in the UK needs careful consideration. Unfortunately such consideration will remain difficult until we obtain more clarity on the likely direction of some of the key negotiating topics on Brexit including trade deals, customs unions and freedom of movement. Another important consideration is the impact of higher inflation. What we do know is that businesses that have proven best equipped to counter inflationary forces tend to have stronger pricing power, flexible supply chains and diversified earning streams.

**Jonathan Brown and Robin West, managers, Invesco Perpetual UK Smaller Companies:** As we pass the 10th anniversary of the start of the financial crisis, the unprecedented central bank policy response of vast levels of quantitative easing and record low interest rates may be approaching an end. Whilst this should be seen as evidence that economies are finally on a more sustainable footing, it is likely to have implications for the value of assets. The withdrawal of stimulus will inevitably create turbulence for markets. The structural headwinds to economic growth posed by negative demographics in developed economies, combined with the high level of indebtedness, both at a governmental and personal level, places a significant constraint on the pace with which central banks can "normalise" monetary policies. So whilst we are seeing policies to curb some of the negative consequences of "easy money", such as new regulations to reduce the growth in unsecured consumer credit, we believe increases to central bank interest rates will be very gradual. So far the negative impact of this change in direction has been most apparent in bond markets, where valuations are at historical extremes. The impact on equity markets, if anything, has been positive. This is probably due to the flow of new investment being diverted from bonds into equities where valuations are broadly in line with historical averages. So whilst we feel we are in at the end of an era, we believe there is still money to be made through careful stock selection.

Without a doubt, the biggest risks affecting the investment outlook are political. With Brexit negotiations finally underway, the enormous complexity of reaching a comprehensive deal is becoming apparent to all. The question is the ability of our politicians to negotiate a good deal. To compound the situation, the general election result has yielded a situation that is far from "strong and stable". It is not inconceivable that if another election occurred in the short term, we could face a change in government.

Whilst some indicators suggest a softening in the UK economy, it continues to defy the more bearish post Brexit predictions. The fall in sterling has inflated the cost of living, thereby squeezing consumer spending, but we are hopeful that this effect is now abating as we pass the anniversary of the Brexit vote. Unemployment remains at its lowest level for 40 years and there are signs that labour shortages are finally exerting upward pressure on wage settlements. It is not impossible to envisage a situation in a years' time where real wages are back in growth and the outlook for consumers is more positive.

The external demand environment continues to benefit company earnings. The European economy is finally growing at a decent rate and unemployment, albeit still double the UK rate, is gradually declining. US economic growth continues, although the hope of a more expansionary fiscal regime under Donald Trump is now fading. The current picture in Asia is also positive. Japan has returned to growth and China, despite the obvious imbalances in its economy, is still growing more rapidly than the other major economies.

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**Simon Fraser, chairman, Merchants Trust:** The Brexit negotiation process combined with high levels of consumer debt and rising inflation, have raised the risk profile for the UK economy. However, the outlook for growth in the rest of Europe and other major economies is more positive. UK listed companies offer exposure to a diverse range of industries and markets, with the majority of revenues and earnings coming from abroad. Whilst the UK stock market has made strong gains in recent years, valuations in many cases are still reasonable.

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**Simon Gergel, manager, Merchants Trust:** The growth rate of the UK economy has slowed this year. There remain further risks to the economy from high levels of consumer debt and the impact of inflation on real earnings, as well as uncertainty in the corporate sector caused by Brexit. However, the Bank of England continues to stimulate activity with extremely low interest rates, a week pound is helping exporters and employment levels remain high.

Overseas, the prospects for growth in the Eurozone look better than for some time, the US economy looks steady, and China continues to help world growth and spur the demand for many commodities.

The UK stock market is not purely exposed to the UK economy. The majority of sales and profits in UK listed stocks comes from overseas operations, spread across many industries and different geographic markets.

Although stock markets have been trading near to all time high levels, there remain plenty of opportunities to buy sound businesses trading on reasonable valuations, with attractive dividend yields. Most domestic stocks are pricing in a difficult environment. Although an element of caution is understandable, there are several companies in sectors like retail, leisure and financials, that seem undervalued under most realistic longer term scenarios.

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**David Barron, chairman, Dunedin Income Growth:** The All-Share Index continues to trade at high levels compared to the past and, with elevated equity valuations, your Manager remains wary that this could unwind. The UK faces a period of uncertainty as the nature of the exit from the EU remains under discussion and, although the economy has proved resilient so far, there is scope for those companies more domestically exposed to be impacted as a result.

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**Ben Ritchie and Louise Kernohan, managers, Dunedin Income Growth:** We have seen a period of strong equity market performance during the last eighteen months helped by an improvement in the global growth dynamic, generally market-friendly political outcomes and the maintenance of low interest rates. From here the balance of risk probably lies to the downside with the prospect of rising interest rates and heightened geopolitical risks potentially impacting equity market valuations. For the UK, a key factor is the outcome of, and uncertainty caused by, the negotiations to leave the European Union. In an environment where, in general, equity valuations appear full, we believe that it makes sense to be cautious.

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**Guy Anderson, Martin Hudson and Anthony Lynch, managers, Mercantile:** Lead indicators of economic growth have undoubtedly displayed improving momentum across the globe since the fourth quarter of 2016 and after what have been several sluggish years this is translating into improving end markets for many of the companies that we meet. In the UK the economic outlook is not as strong but the economy is proving to be more resilient than had been expected and monetary policy has been accommodating. These factors combined should provide a positive backdrop for equities.

In contrast to this, the geopolitical landscape presents a host of risks, some of which could present far-reaching challenges in the future but which have not yet caused a discernible impact. The lack of volatility in financial markets has been a surprise, but will not last forever.

## Asia

(compare Asian funds **here**)

**Robin Parbrook and King Fuei Lee, managers, Schroder Asia Total Return:** With Asian indices up around 25% year to date in US dollar terms, are we in a bubble? In the view of your portfolio managers, who have managed money over three bubbles in Asian equities (1993, 2000 and 2007), we can honestly say that at the current point we do not think we have a bubble in Asian equities (yet). Many of the valuation measures we look at - such as price to core earnings and the percentage of stocks that trade below our estimate of fair value - are expensive, but they still have some way to go compared to the bubbles of 2000 and 2007.

One of the positive results of the current complacent and borderline euphoric market conditions is that implied equity volatility has dropped substantially, with the VIX index - a measure of US stockmarket risk - hitting its lowest ever point in July. This has made buying protection relatively cheap, and put option prices in Asia are now the lowest for some time.

It is at the stock level that we find ourselves in more of a conundrum. At this point in the cycle we would normally be looking to switch into lower-risk stocks that have lagged, whilst taking profits from higher beta holdings that have exceeded even our high estimates of fair value. This time round we are struggling. We think many of the less market-sensitive sectors which look cheap may stay cheap as they face disruption (e.g. utilities, telecoms, consumer staples, commodities). Sectors we view as structurally challenged due to disruption and rapid technological change comprise a substantial portion of the Asian markets.

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## Korea

(compare Asia single country funds **here**)

**Andrew Weiss, manager, Weiss Korea Opportunity:** We don’t pretend to be able to explain the short run response of markets to geo-political developments. During the first half of the year, as well as the past twelve months, periods in which global stock markets have done exceptionally well, the South Korean stock market has been one of the best performing of the major stock markets. This was a period during which South Korea’s President was forced to resign and both the former president and the senior management of Samsung were indicted over corruption charges; the U.S. elected a president who ran on a protectionist platform (South Korea’s economy is heavily dependent on exports), and who, upon taking office, immediately pulled the U.S. out of the Transpacific trade agreement; and China, which is one of South Korea’s major trading partners, discouraged cultural and trading ties with South Korea in response to the deployment of an extended range missile defense system, THAAD, in South Korea. More recently, the South Korean minimum wage was increased by 16%.

The threat to South Korea from North Korea remains troublesome. North Korea has been successfully testing solid fuel missiles which could potentially enable it to launch nuclear missiles on short notice from mobile launch pads. North Korea is accumulating a small arsenal of nuclear weapons. Although they might not be suitable as warheads on intercontinental ballistic missiles, they could potentially be used against South Korea. Once North Korea gains the ability to attack the U.S. it may become emboldened to take more aggressive actions against South Korea.

China has taken a very aggressive position against the deployment of THAAD in South Korea. The radar that is part of the THAAD system reaches far into China. As noted above, the Chinese government has retaliated by creating obstacles for South Korean businesses and entertainment groups, and have reduced tourism from China to South Korea. However, the threat from North Korea is likely to induce Japan to deploy a more sophisticated missile defense system. If Japan were to deploy THAAD, that might defuse Chinese sentiment against South Korea. But for now there is a substantial risk of South Korean companies suffering from Chinese retaliation against THAAD.

The South Korean public seems remarkably unflappable, but sentiment could easily change. By most measures the South Korean stock market remains cheap and seems likely to benefit from its strong technology sector and highly educated work force. However, while retained earnings continue to accumulate, so too do the geo-political risks.

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# United States

(compare North American funds **here**)

**James Ferguson, chairman, North American Income Trust:** GDP growth of 2.6% was recorded for the second quarter of 2017, which was much improved relative to the revised 1.4% growth in the first quarter and was consistent with our Manager's outlook for improvement throughout this year. Growth was supported by an increase in consumer spending, whilst business investment also had a positive impact. Achievement of the 4% growth target of the Trump administration seems unlikely in the medium-term, particularly given the continued political stalemate, which reduces the likelihood of policy initiatives being implemented.

Our Manager however, at present believes that corporate fundamentals continue to improve steadily. Valuations remain above long-term averages; this is supported by the continued environment of low interest rates. Companies will need to show an acceleration in earnings and cash flow growth for share prices to appreciate further. Earnings growth is also now increasingly reliant on economic growth, given that it has become more difficult to expand profit margins as wage and input inflation both increase.

There has been a wide divergence in returns between various investment styles and sectors, with high growth companies in technology and healthcare having outperformed materially over the past year. Many cash generative companies which pay dividends have been out of favour but this sector of the market is becoming more attractive because the risk of higher interest rates has been discounted.

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## Global emerging markets

(compare global emerging markets funds **here**)

**Aberdeen Fund Managers, managers, Aberdeen Frontier Markets:** Frontier equities had a good year to June 2017. Structural improvements in specific markets have been well-received, including further steps towards currency liberalisation in Nigeria. A more encouraging global growth environment, alongside improving corporate earnings and better sentiment towards Frontier Markets more broadly, have all contributed to slowing outflows to the asset class. We believe this is set to continue over the next few months.

We are particularly excited about Asia, given robust growth, modest inflation and attractive stock-picking opportunities; while Africa is well-positioned for a recovery on the back of significant currency adjustment and a return to growth. Although upcoming elections in Kenya could bring some volatility in the coming months we remain upbeat about the outlook for our Kenyan corporates and valuations remain undemanding.

By their very nature Frontier Markets represent a riskier investment proposition than more developed markets. Resource-rich countries' markets remain heavily influenced by fluctuating commodity prices, while liquidity issues are prevalent across the board. However, even with the recent rally, frontier equities still represent an attractive risk-reward opportunity for investors given their lower correlation to mainstream asset classes, as well as a discounted valuation of roughly 30% to developed market equities. Frontier Markets tend to be under-researched and we see compelling opportunities to find new investment prospects. Whilst volatility can be a feature of these markets we are positive about the prospects for the asset class over the long term.

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**Hélène Ploix, chairman, Genesis Emerging Markets:** My report to shareholders a year ago noted the variety of challenges facing emerging markets companies, which included increased competition, declining penetration opportunities, a lack of business-friendly reforms, along with - in many cases - high valuations. While the past year's 20%+ absolute returns are welcome, they have of course meant that valuations have become even more elevated, while none of the other issues have receded. At the same time, a more positive view about the health of the Chinese economy may well turn out to be less warranted than many investors seem to believe, and some countries (arguably Brazil, Turkey, South Africa) have seen political governance quality move backwards rather than forwards.

There are thus plenty of reasons to be wary of the short-term environment. We believe very strongly, however, that investors should keep in mind the longer-term attractions underpinning emerging markets. The income levels of populations in developing countries populations are gradually moving towards those in developed markets; progress in governance - while not linear - continues to take place at both country and company level; and emerging stock markets still exhibit significant inefficiencies for investors who can identify them.

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**Genesis Asset Managers LLP, managers, Genesis Emerging Markets:** As we have noted in previous Manager's Reviews, the key risk in our view remains China. Policymakers are trying to do three things: rebalance the economy from investment to consumption, reduce financial leverage and achieve a soft landing. It has become apparent that they cannot achieve all three at once and in the near term they have allowed credit to continue to build, favouring short-term growth over long-term economic reform.

However, we are encouraged that emerging market economic growth has begun to stabilise after many years of decline. In addition, many of the excesses of the cycle following the global financial crisis, such as elevated corporate profitability, high commodity prices and overvalued currencies, have now reverted to a more sustainable level. Although valuations are not attractive across the board, we are still finding interesting opportunities in a variety of markets.

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## Eastern Europe

(compare Emerging European funds **here**)

**Neil England, chairman, BlackRock Eastern European:** Whilst many commentators are concerned that the major developed markets are now at – or approaching – their all-time peaks, Emerging European equity markets stand out as a rare value opportunity. Indeed, even after the strong gains of the last eighteen months, the index is still 40% below its pre-crisis peak and the portfolio managers refer to a 'lost decade' of performance. We believe that Emerging Europe will continue to benefit from economic recovery and that the attractive valuations provide compelling opportunities for investors in our region. [*We*] therefore view the outlook for the region with considerable confidence.

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**Sam Vecht and Christopher Colunga, managers, BlackRock Eastern European:** Emerging Europe is just beginning to leave behind a lost decade of performance. The strong gains of 2016 and the first six months of 2017 still leave the index more than 40% below its pre-crisis peak. Compared to the US S&P which is more than 55% above its pre-crisis peak, we believe that Emerging Europe continues to provide a fertile ground to deliver further returns. Emerging Europe valuations are still below historical trends, investor positioning remains light and the region has the potential to benefit from several positive developments. The equities trade on less than half the multiple of its developed peers, despite having higher dividend yields, growing earnings and strong free cash flows.

In the Central European economies of Poland, Czech Republic and Hungary, inflationary pressures continue to build, giving the potential for the region's banking sector to break away from the destructive low rate environment. After several years of inflation rates being around zero and in some cases negative, we are seeing inflation returning to these countries on the back of accelerated wage growth, lower levels of unemployment and increased investment spending in the region. In particular, banks present an investment opportunity in our view given their sensitivity to a rise in interest rates.

In Greece, we have seen successful progress made on the second review of the country's third bailout. Greece has just been able to access the financial markets for the first time in several years, which we feel will unlock significant pent-up investment demand into the country. The Greek financial sector is still much cheaper than its peers, reflecting its recent difficulties and provides room for substantial improvement if the situation normalises. Furthermore, the recent successful conclusion of the Second Bailout Review may eventually lead to the subsequent admission of Greek bonds into the ECB quantitative easing program, providing the government with a lower cost of debt and reassuring investors. This coupled with an acceleration of GDP growth should prove to be just what the banks need to leave behind any questions on solvency.

In Russia, the sanctions noise has proved a headwind, however the positive monetary and fiscal policies are continuing. With the economy in good shape, improving consumer sentiment and record low inflation, there is room for interest rates to be cut, further aiding the economic recovery. Valuations are low, dividend yields are high and the potential remains for the market to re-rate on lower interest rates.

Finally, Turkey remains a trading market prone to fits of exuberance and excessive pessimism. The economy has been normalising and we expect further improvement in tourism trends. The expectations of falling interest rates coupled with the government's Credit Guarantee Fund are supporting the market, specifically the financial sector. However, the challenging political backdrop coupled with the spectre of tighter global liquidity constrains the upside in our view.

Taken together, we believe that the economic recovery of the region, the uncorrelated equity returns of the different regional markets, the attractive valuations supported by high dividend yields, and the lost decade of performance yet to be recovered, continue to make the Emerging European equities an attractive opportunity for investors.

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## Latin America

(compare Latin American single country funds **here**)

**Carolan Dobson, chairman, BlackRock Latin American:** It has been frustrating to watch the first steps towards structural reform in Brazil blown off course by further political scandal. The region still needs to adjust to an economic environment where subdued commodity prices require greater fiscal discipline and also needs to provide a stable background more conducive to making long term investment decisions. The feared negative impact on Mexico's economy, from the election of President Trump has so far been less than expected however.

The prospect of a modest economic recovery in Brazil following the sharp slowdown, coupled with further reductions in interest rates, should provide scope for further progress in the region's largest equity market. Elsewhere our portfolio manager favours Peru and Argentina, where the prospect of continued infrastructure spending in Peru and further steps taken in Argentina towards obtaining emerging market status should continue to be positive factors.

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**Will Landers, manager, BlackRock Latin American:** As we enter the third quarter, our positioning and outlook remain relatively unchanged. We continue to be overweight Brazil, Peru and off-benchmark Argentina, while being underweight Chile, Colombia and Mexico. In the near term, negative sentiment concerning another potential presidential scandal has reversed the green shoots seen over the last couple of months in Brazil and has put President Temer's term and reform agenda into question. Despite weaker market confidence on the General Prosecutor's decision to charge President Temer with passive corruption, we expect a scenario whereby continuity of government persists. As such the primary drivers for Brazilian equities should remain the same: a) the continued easing cycle (albeit at a slower pace) by the Central Bank which should help to bring forward the needed economic recovery; and b) progress on the reform agenda, especially pension reform, which should help to bring stability to government accounts in the medium term. Once the latter passes, we believe that this will open the door for the Central Bank to bring the easing cycle further forward, and potentially bring rates lower than market expectations. Meanwhile, despite a more conciliatory tone from the US government on the trade front, we maintain our cautious view on Mexican growth, and therefore our below benchmark weighting (despite a PRI win in the gubernatorial election in the state of Mexico in early June, results were not conclusive as to the likelihood of a MORENA (the National Regeneration Movement) victory in next year's presidential elections). We continue to be underweight Chile due to rich valuations and lack of free-float liquidity, and despite slower than expected progress on the infrastructure front, we continue to favour Peru among its Andean neighbours. Argentina remains another top focus for the strategy as fundamentals persist, with the recent correction providing a positive entry point for longer-term investments.

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## Qatar

(compare other single country funds **here**)

**Nicholas Wilson, chairman, Qatar Investment Fund:** The Qatari economy slowed during the period with 2016 GDP growth of 2.2% and a further decline is expected for 2017. After 15 years of budget surpluses, 2016 showed a deficit of USD9.2bn with a further deficit forecast for 2017.

The ongoing rift with Saudi Arabia, UAE, Bahrain and Egypt is expected to continue for some time and will inevitably have a negative impact on economic performance. Although any sustained recovery in hydrocarbon prices is not expected, the lifting of the LNG development moratorium with a 30% increase in LNG production is expected to have a positive effect on the economy. Assuming an eventual resolution of the diplomatic rift, our investment adviser believes that medium to long-term growth prospects should remain healthy driven by a strong infrastructure pipeline, strong fiscal spending and supportive demographics.

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**Epicure Managers Qatar Limited, re Qatar Investment Fund:** On 5 June 2017, the governments of Saudi Arabia, Bahrain, the UAE and Egypt cut ties with Qatar, accusing it of supporting terrorism. These countries closed land, air and sea borders with Qatar, giving Qatari nationals within their borders two weeks to leave and instructing their own nationals in Qatar to leave immediately. Yemen, the Maldives and the Tobruk government in Libya subsequently joined the boycott. The four Arab nations issued a 13-point list of demands to Qatar on June 22, which included shutting down of Al Jazeera news channel, toning down its relationship with Iran, cutting ties with certain political groups and shutting down the Turkish military base in Doha. Qatar was asked to respond in ten days, which was later extended by another 48 hours at the request of Kuwait. The deadline ended on 4 July 2017. On 5 July

2017, Saudi led allies decided to continue the blockade after Qatar refused to agree to the demands.

**Qatar's export dependence on its GCC neighbours is relatively limited; however, imports could become costlier in the near term**

Total exports from Qatar to Bahrain, Egypt, Saudi Arabia and the UAE contributed about 3% of Qatar's gross domestic product (GDP) in 2016. Qatar continues to supply gas to the UAE through the Dolphin gas pipeline, despite the severing of diplomatic ties. It pumps around 2 billion cubic feet of gas per day to the UAE.

The majority of Qatari exports are destined for Asia: Japan (20% of total exports in 2015), South Korea (19%), India (12%) and China (6%). Asian countries account for a majority of LNG exports (c.67% in 2016) while the MENA region accounts for a lower share (c.9%). The Investment Adviser does not envisage significant disruption in exports to the Asian region from the current stand-off.

Qatar has one-year reserve of primary materials needed for major construction projects. The Investment Adviser considers the near and medium-term impact on the infrastructure programme is manageable. However, if the current conditions continue, Qatar will have to source building materials from elsewhere, which could possibly widen the budget deficit.

The airspace blockade has forced Qatar Airways to shut down 52 routes and incur additional costs from diverting flights on other routes. Qatar has approached the International Civil Aviation Organization's (ICAO) to resolve the airspace dispute.

**Qatar seeks to limit damage from the stand-off with Saudi led allies**

While the sanctions have disrupted flows of imports and other materials into Qatar from these neighbouring countries, Qatar has moved to address any potential food and material shortage by sourcing alternative sources of supply.

Qatar is heavily dependent on Saudi Arabia for its food imports (it imports roughly 40% of its food overland through Saudi Arabia), but the Qatari authorities have routed shipments through Iran, India and Turkey, mitigating the impact on food supplies and other materials.

**Qatar's Central bank should be able to handle tightening of liquidity**

The Saudi central bank has ordered Saudi banks not to increase their exposure to Qatari clients and not to process payments in Qatari riyals. The UAE Central Bank has asked local lenders to run an enhanced customer due diligence for any accounts held in the six Qatari banks.

December 2016 data from the seven Qatari listed banks shows deposits and other funding from GCC countries accounted for c.8.2% of total liabilities (QAR 88.9 billion). At the end of April 2017, Qatari banks' net external debt totaled about USD 50 billion and had an average maturity of less than one year. With a significant portion of this debt in Europe and Asia, Qatari banks should be able to handle any possible withdrawal of Gulf deposits. Moreover, Qatar Investment Authority (QIA) has injected billions of dollars of cash in Qatari banking system to shore up liquidity.

**Expect a negotiated settlement, at some point**

The Investment Adviser considers the near and medium term economic impact from the current stand-off for Qatar is largely manageable, given the country's small size (2.7 million population), its wealth (GNI/capita of USD 84,000) and net foreign assets (reserves and investment funds are more than 250% of GDP), as well as its relatively limited trade ties with the blockading nations.

There is room for both sides to come to a settlement, however, the timing of this is uncertain. In the meantime, the Qatari market is expected to remain volatile, depending on news flow. The Investment Adviser still sees most businesses in Qatar functioning as relatively normally.

The Investment Adviser believes that Qatar is well positioned for continued long-term growth as macroeconomic fundamentals remain strong. However, if the stand-off between Qatar and its neighbours continues, it could have short term impact on economic growth. While the Investment Adviser believes that there is room for both sides to come to a conclusion, the timing of normalisation in ties is uncertain. A peaceful resolution is most likely and anticipated to happen gradually.

Oil prices above budgeted levels (USD 45) would provide the Qatari government flexibility in continuing its commitment to planned major infrastructural projects in line with the Qatar National Vision 2030. Additionally, Qatar's fiscal buffers and sizeable assets should help it maintain its stable position in the GCC region.

The Qatari government is likely to continue with its investment spending program despite the current situation as it prepares for FIFA 2022, driving the nation's non-hydrocarbon sector growth. Moreover, Qatari authorities plan to invest heavily on new development of gas projects in the North field is expected to improve the contribution to GDP from the hydrocarbon sector.

The Investment Adviser believes that although the Qatari economy is strong enough to sustain the current challenging situation, markets could be volatile until a settlement is reached.

# Vietnam

(compare Asian single country funds **here**)

**Wolfgang Bertelsmeier, chairman, Vietnam Enterprise Investments:** The outlook for Vietnam's market in the second half of 2017 remains positive thanks to the stable growth of the economy: GDP is expected to grow by 7.4% while inflation is expected to remain at below 4%. The SOE privatisation programme is expected to include large companies. The market's valuation still very reasonable compared to regional peers (2017 forecasts for the 50 largest companies yield an overall PER of 14.3x on earnings growth of 17%).

**Vu Huu Dien, manager, Vietnam Enterprise Investments:**

**Macro economy**

**Despite a slowdown in Industry and Construction sector, GDP growth likely beats 2016**

Vietnam's second quarter economic growth accelerated to 6.2% year-on-year, led by the recovery of the Industry and Construction sector. GDP grew by 5.73% in the first half of 2017, marginally higher than the 5.65% in the first half of 2016.

Nonetheless, growth remains below the Government's target: Calculations indicate that GDP needs to grow by 7.4% in the second half of 2017 to achieve the full year target of 6.6%. The Government is keeping to its target and is taking steps to reach this.

In the first half of 2017, the Service sector, accounting for 44% of GDP, grew by 6.9% its highest rate since 2010. The agriculture and fishery sector (11.2% of GDP) recovered as expected, growing by +2.6%, from a decline of 0.2% year-on-year in the first half of 2016.

However, the good performance of the service and agriculture sectors was not enough to compensate for the sharp unexpected slowdown in the industry and construction sector, which accounts for 34% of GDP. This sector grew at a slower pace than expected in the first half of 2017 (5.8%), compared to 7.4% in the first half of 2016.

The main factors contributing to the slowdown in the Industry and Construction sector were: (1) limited coverage of the private sector in GDP calculation; and (2) the decline in the mining sector, as well as mobile phone production.

1) The survey used in the GDP calculation of General Statistics Office ("GSO") has historically been heavily skewed toward SOEs and major FDI manufacturers, with limited coverage of the private sector. However, from our observation, it is the private sector that has been the most exciting part of Vietnam's industrial production in the last three years. The best measure to gauge this would be the PMI, a survey of 250+ companies, the majority of which are private, and that number has been remarkably solid. We estimate the the first half of 2017 PMI at 53.2, the highest the first half ever, versus just 51.6 in the first half of 2016, a good indication of the improving growth in the private sector. On the ground, we see a wave of private companies raising new capital to finance their expansion in order to meet growing demand, something that their SOE counterparts may encounter constraints doing due to budgeting issues.
2) Mobile phone and oil production: Mobile phone production was flat year-on-year due to a large reduction in the first quarter of 2017 production by Samsung Vietnam. Model changes and seasonality explain the sudden drop. Meanwhile, Samsung is ramping up its production of semi-conductors and displays in Vietnam, which will lead to a recovery in these segments in the coming quarters. However, oil and mining production may continue to face headwinds. But lower oil production would have more of an impact on the fiscal budget rather than on household income, and thus does not significantly impact the overall consumption picture.

In a way, the relatively disappointing first half of 2017 Industry and Construction number is a fair reflection of the current state of SOEs, but it does not accurately capture the dynamic of the private industrial sector, which is rapidly expanding and becoming a much more critical part of the equation. 2017 GDP growth may be lower than our forecast of 6.6% compared to 6.2% in 2016; however, we will keep our forecast for now.

**Inflation remains benign and monetary policy accommodative**

Core inflation should be benign at around 1.5% in 2017, as the economy is still operating below capacity for many sectors. Headline inflation was 2.5% year-on-year in June and 0.2% year-to-date, much lower than the market anticipated at the beginning of 2017. Despite the CPI going negative for a second consecutive month in

June, we still expect price increases in 2017 due to higher healthcare and education fees and rising costs of foodstuffs and petroleum.

According to the GSO, as at the end of June, bank credit grew by about 8.0% year-to-date, or about 20.0% year-on-year. This compares to estimated growth of 7.1% compared to 8.4% in the same period last year. This is still in line with the Government target of 18.0% for the year, as the second half credit growth is always higher than the first half growth. The first half credit growth was concentrated more in good banks with low NPLs and low LDRs, so the cap on credit growth of 18.0% for many banks would limit overall credit growth in the second half.

Given benign inflation and lower-than-desired GDP growth, the State Bank of Vietnam ("SBV") cut interest rates in early July. The refinance rate will decrease to 6.25% p.a. from 6.50%, while the discount rate will decrease to 4.25% p.a. from 4.5%. In addition, the maximum lending rate for short-term loans will be reduced by 0.50%. As such, the measure of the SBV aligns with general Government guidance to ease interest rates in order to bolster credit and economic growth in the second half of 2017. Hence, the SBV is likely to lift the credit growth cap for some major banks in the second half. However, given the modest extent of the rate reduction, we think its impact on the overall economy will not be significant.

**Bad debt solution programme and clean-up of banking sector**

Despite the banking sector having recovered, and substantial bad debts having been written off in the last five years, Vietnam Asset Management Company ("VAMC") still has US$10.3bn worth of bad debts on its balance sheet. VAMC has resolved US$2.2bn worth of bad debt (2015-current), bringing total bad debt down from US$12.5bn to US$10.3bn. It plans to resolve another US$6.6bn by 2020, leaving only US$3.7bn unresolved.

To facilitate VAMC in resolving bad debt, in June, the Government's proposal on a bad debt resolution program was approved by the National Assembly. Regarding collateral, the debt resolution program is expected to empower the banks with a wide range of new options, including the ability to take full control of the assets that they hold as collateral, to sell these assets at market price - even if it is lower than book value, and to expedite judicial proceedings against delinquent borrowers.

The new resolution would also allow the VAMC to buy off-balance sheet bad debt and sell it at the market price. This would accelerate the process of resolving the bad real estate debt, which constitute a large portion of the problem loans in the system. Additionally, in order to mitigate the negative impact on banks of bad debt resolution, the booking provision for fee and interest receivables would be spread over a ten year period. The resolution would be in effect for five years, with a possible starting date of August 2017.

**External position and currency: Remain solid**

Vietnam's exports reached US$98bn in the first half of 2017 (+18.8%), much higher than the 6.0% growth in the first half of 2016. Key drivers were electronics, cell phones, which accounted for US$31bn (+25% vs. the first half of 2016), and agriculture-related products (US$10.3bn, +19.5%). A rapidly rising new export item is fruits, which approached US$2bn in the first half, representing a stunning growth rate of 50%.

The US remained the largest export market at US$19.6bn, +9.8%, vs. +12.8% in the first half of 2016. The EU was second at US$18.2bn, +12.8% compared to +9.5% in the first half of 2016. We expect exports to the EU to increase further as a result of the rectification of VN-EU FTA in early 2018. An unexpected surprise was the surge in exports to China - to US$13bn, up 42.5%. Key contributors to export growth to China were electronics and fruits. Given the significant increase in China's middle class, the demand for tropical fruits there is increasing at around 15% per year. Vietnam is shifting from traditional rice farming to fruit plantation, which has a much higher economic value. We expect Vietnam's exports to China will continue to increase in the coming years.

Imports came in at US$100.5bn, up 24.1% in the first half of 2017 vs. zero growth in the first half of 2016. We divide imports into three categories: (1) machinery, equipment and component parts (US$43.8bn, +27.0%); (2) intermediate and input materials (US$48.4bn, +22.6%); and (3) consumption (US$8.3bn, +18.6%). Machinery and equipment imports grew particularly robustly to US$18.4bn, +37.8% vs. -5.9% in the first half of 2016.

China remained Vietnam's largest import market at US$27.0bn, +16.8%. However, the most surprising market was Korea, which accounted for US$22.5bn of Vietnam's the first half of 2017 imports, up 52%, consisting mostly of machinery and input materials.

The first half of 2017 trade deficit was US$2.5bn, resulting from a surge in machinery imports (+37.8% vs. -5.9% in the first half of 2016 - equivalent to a net US$5bn in additional imports) and a recovery of domestic consumption. The surge in machinery imports and the increase in Korea's export to Vietnam at that same time was a coincidence in our view and seems consistent with the expansion of Korea's Foreign Direct Investment ("FDI") in Vietnam. As such, the trade deficit is not an issue yet. However, it is likely that Vietnam will continue to have a trade deficit in 2017.

In the first half of 2017, registered FDI surged by 54.8% year-on-year to US$19.2bn, a strong recovery from the slowdown in registered FDI in May, +1.7% year-on-year. The key drivers were the US$4.9bn registered by two large FDI power projects. However, disbursed FDI rose only 6.5% to US$7.7bn in the first half of 2017. We think the FDI disbursement is approaching its peak. However, Vietnam has probably passed the stage of taking all FDI projects, and it now needs to be selective rather than focus on high FDI numbers.

Analysts are concerned about the slowdown in committed Official Development Assistance ("ODA") as Vietnam has moved out of the low-income country category. However, we think concerns are overdone, as Vietnam still received US$22bn in committed ODA, which it has not been able to disburse. The key reason for slow ODA disbursement is a lack of local capital contribution. So the slowdown in ODA commitment may not be a bad thing, as interest payments start as soon as the commitment is signed.

Forex reserves reached US$41bn at the end of 2016, compared to US$29bn in 2015. In the first quarter of 2017, the SBV reported a surplus of US$1.4bn in its Balance of Payments ("BOP"). Given the outlook for the trade balance, FDI, FII and ODA, we project a surplus of US$5.5bn for 2017.

The VND was stable during the first half of 2017, with the dong appreciating by 0.1% despite two Fed rate hikes. This was possible thanks to an environment of effective and flexible SBV monetary policies, and solid external positions. However, increasing demand for imports and a probably slightly negative current account deficit may put some pressure on VND at the end of this year. Given our expectation of benign inflation and a huge USD inflow into strategic deals from SOE divestment, it is hard to see how the VND will depreciate more than 2% in 2017.

**Conclusion**

Economic growth is likely to be below the Government's target. The slowdown in the reported growth number is explained by parts of the State sector, specifically, the mining sector. However, the private sector, which creates the majority of jobs, continues to do well. Both service and domestic consumption should continue to motor ahead as the key growth engines in 2017. For all the fears at the start of the year from both Fed rate hikes and a trade deficit in the first three months, the FX rate has been remarkably calm in 2017. We expect a slight downward adjustment to the VND toward the end of 2017.

Vietnam is experiencing moderate, stable growth. The biggest risk to the Vietnam story, arguably, does not come from within. Global uncertainties that were created in 2016-17 are likely to persist. However, with a Government committed to reform, and macroeconomic indicators pointing in the right direction, Vietnam has never been better positioned to face these headwinds.

**Outlook**

A stable macroeconomic environment, and an accommodative monetary policy, continue to support the financial market. The recent interest rate cut was a signal that liquidity will not be tightened anytime soon. The Government continued to implement policies that further improve transparency in the market, such as Decree 71/2017/ND-CP, which regulates corporate governance and information disclosure that public companies must adhere to. The Government also issued further directives to help enforce previous policies, such as one that requires public companies to at least register their shares for trading on UPCoM. This should also help deepen the market.

We expect the pace of IPO/Privatisation offerings to accelerate considerably in the second half of the year, which is when most deals traditionally take place. Our pipeline for the second half of 2017 already includes several big names.

With the expected listing of a number of major companies, not all of which may be investible, there is the potential for some distortion to the VN Index in the second half of 2017. We believe that once the dust has settled, companies with better growth and value will perform better in the long run.

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# Commodities and natural resources

(compare specialist commodities and natural resources funds **here**)

**Geoff Burns, chairman, City Natural Resources:** The result of the UK general election in June was another demonstration of both the uncertainty that characterises our public world, and the central position that political risk has come to assume in any assessment of the outlook generally, and of our investment portfolio more particularly. If the Conservatives' loss of a majority in the face of the forthcoming Brexit negotiations might be dismissed as a little local difficulty, the instability of President Trump's United States cannot be. The US administration's notification of intent to withdraw from the 2015 Paris climate change agreement and the threat to start an investigation over Chinese intellectual property rights abuses and policies under the punitive Section 301 of the 1974 Trade Act could hardly be more directly relevant to us, while tensions mount concerning relations with Iran and the Middle East. Then, there are North Korea's nuclear ambitions, and related aggressive posturing, which have had a positive effect on our gold holdings of late.

In spite of this increased geo-political risk, equity markets continue to move ahead, with few signs that the post Financial Crash bull market is done. The most important factor underpinning it is the ever growing level of global debt, which is now in excess of $150 trillion, well over twice the size of the global economy, more than one third of which is government debt. The extraordinarily low interest rates that have allowed this expansion of debt are something that I have written about before; they cannot continue for ever, but it is futile to guess when the day of reckoning will dawn.

In the meantime, there are a number of positive indicators for commodity markets, not least increasing confidence as to Chinese stability and its continued solid growth rate, alongside a determined focus on the $5 trillion Belt and Road initiative, which will be an important driver of commodity demand for the next decade.

Cheap gas for power generation and abundant oil supplies are combining with the plunging costs of renewable power and electricity storage, and the rise of electric cars, pointing to a brave new world in which Tesla's place as the most valuable car manufacturer in the United States is symbolic.

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**Ian Francis, Keith Watson and Rob Crayfourd, managers, City Natural Resources:**

**Economic trends encouraging**

Improving economic conditions among major economies and the boost to US growth prospects promised by President Trump flowed through into the New Year, allowing investors to look through the belated succession of post-election rate increases by the Federal Reserve and sustaining commodity price rises into the March quarter. However, investor risk appetite and commodity prices subsequently fell back after Chinese authorities implemented another bout of measures to reduce financial sector risks and cool property prices, whilst Trump's growth plans stalled having failed to gain Senate funding approval. Neither factor, we believe, alter the resilient underlying picture; China's pre-emptive measures reflected a belief that regional growth could accommodate the moves which help reduce future systemic risks from overleverage while post-election fund flows appeared to exaggerate the incremental benefit of proposed United States infrastructure investment.

While exuberance has dissipated we remain encouraged by improvement in the macro environment trends. Notably, China is managing to sustain better-than-expected economic growth despite the dampening effect of earlier interventions and credit growth is rebounding. Elsewhere the United States continues to recover without contribution from Trump policy while the New Year also saw improving European economic trends. The latter two points should lead more hawkish central bank policy over the next 12 months including a further US rate rise and a reduction of European Central Bank stimulus. In the longer-term, we also highlight that China's underlying consumption growth of higher value metals such as copper has been incredibly resilient despite financial market volatility.

**Supply side discipline**

Of equal importance, following years of declining investment from the mining major's, many commodities are feeling the effects of a drop-off in the rate of new supply additions. This is especially the case for base metals which led gains. Zinc saw the LME price rise over 30% during the year to June and it continues to rise. The zinc market looks increasingly tight following the closure of large mines such as Century and Lisheen, and environmental audits are limiting domestic Chinese output. Warehouse inventories continue to be drawn down to levels approaching 10 days-worth of demand and prices are responding accordingly. Copper was the next best base metal performer rising over 20% through the year. Nickel was weighed down by easing export legislation by the two largest producers, Indonesia and the Philippines, though we remain optimistic on its outlook due to its increasing usage to produce higher quality stainless steel and possible use in developing battery technologies.

Encouragingly, major mining corporations are showing restraint, with management instead focussing on free cash flow generation, debt pay down and shareholder returns. Expenditure budgets for greenfield development projects remain minimal. China also continues to tighten domestic mining regulations and where necessary is forcing a consolidation to form national champions. At current valuations we believe future growth would more sensibly focus on acquisitions of existing output, which ultimately would not add incremental supply.

Bulk commodities also performed well, though proved markedly more volatile than base metal prices, with environmentally focused closures in China the major driver. Coal fed power stations and metal refiners continue to favour higher grade inputs to reduce polluting emissions. Coking coal prices were highly volatile against this backdrop, highlighting a market that is clearly much tighter than many had anticipated, with Australian benchmark product trading from below $100/t to a high of $300/t before settling around $200/t at the time of writing. This dynamic is also reflected within iron ore, with higher grade iron imports up significantly at the expense of lower grade domestic Chinese iron ore. This was evident with the 62% Fe benchmark trading a $10-20/t premium to the 58% Fe benchmark. The Company has little exposure to iron ore, preferring instead to focus on metals like zinc and nickel which also benefit from a steel quality upgrade cycle in China and which have less potential for significant growth in supply.

**Insurance still has value**

Gold lagged industrial metals' performance with prices declining 4% over the financial year. Cyclical "risk" assets were the clear beneficiary of fund flows at the expense of safe haven assets during the period. Donald Trump's surprise election as US President was a significant driver behind this. His pro-US growth stance and prospect of rising rates saw a rapid and significant withdrawal of funds from precious metal funds. Gold's lagging performance has subsequently played catch up and precious metals prices have latterly garnered support from US dollar weakness as stubbornly low US inflation prompted more dovish commentary from the Federal Reserve, reducing expectations of further US rate rises. At the same time the European Central Bank flagged a willingness to taper its programme of quantitative easing. Equally importantly, recent escalating tensions with North Korea have provided further boost to safe haven assets and therefore gold prices. Notwithstanding geo-political risks the ever rising US debt ceiling, expected to be reached in October, provides a reminder to the still high debt levels globally and value of insurance in such an environment.

**Energy opportunities less obvious**

Oil also lagged other commodities with prices remaining very much range bound, as expected. Despite prices responding relatively well to OPEC and Russian production quotas introduced around the turn of the calendar year, a rise in US onshore production has usurped the mantle of swing producer. In-so-doing, US production has raised questions as to the strategic sense in OPEC and Russia continuing or deepening output cuts. Oil remains capped in the mid $50's per barrel by a wall of

2018 forward selling from US shale producers, highlighting their economic incentive level. Saudi's 2-3 year programme of fiscal reform, targeting a neutral budget based on a $40 per barrel crude price, represents a reasonable floor. Though oil prices ended the period unchanged at $46 a barrel, related equities declined.

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## Debt

(compare debt funds **here**)

**David Warr, chairman, Hadrian's Wall Secured Investments:**

The low overall level of interest rates produces real negative interest rates on Gilts, with resultant adverse ramifications to savers. Monetary policy, combined with a highly prescriptive regulatory framework for bank capital has created a credit market that, by historical standards, is exceptional. Large well-capitalised borrowers, or borrowers that attract less regulatory capital, can borrow at negative or nominal real rates of interest. Borrowers who do not meet these or other criteria, including many SMEs, have less access to capital.

The overall economic outlook for the UK remains uncertain. The consequences of Brexit, the changing value of the Pound Sterling, inflation levels and interest rate policy are unclear. The effects of the transfer of thousands of relatively high-paying jobs from the UK to the European Union ("EU") in connection with the Brexit process on other employment, property prices, and government tax collections only adds to the uncertainty.

Lending to UK SME companies has historically been remarkably resilient in the face of such challenges.

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**Starwood European Real Estate Finance:** A number of property finance research pieces focussed on the UK were released during the quarter. These include the De Montfort University lending survey, Savills Financing Property 2017 presentation, Laxfield Capital's 8th Property Finance Barometer and a new piece of research: Capita's inaugural Real Estate Finance Market Trend Analysis.

The De Montfort University lending survey is the leading commercial property financing research piece on the UK market. The semi-annual report provides insights into the opaque lending market with hard data sourced from many market participants including the Group. The year end 2016 survey was released at the beginning of May and reports that total year end 2016 debt secured by commercial real estate in the UK is relatively unchanged at £208.7 billion, down 1.5 per cent year on year. The Brexit effect can be seen in a number of the outputs, with average loan-to-values ("LTVs") down, and average margins up slightly; but the largest effect has been a reduced acquisition financing volume as transaction numbers fell. Average LTVs for prime office lending are down 5 per cent, margins are up 15 basis points between year end 2015 and year end 2016 and new loan origination is down 17 per cent to £44.5 billion. A larger proportion of activity, at 61 per cent of the total is refinancing compared to 44 per cent in 2015.

The proportion of loans made by UK Banks was higher at 47 per cent this year versus 34 per cent last year. This is likely related to the larger proportion of refinancings versus new acquisitions, where incumbent UK banks benefit from existing relationships within the lending book. Syndications are down from £18 billion to £14 billion, reflecting a lack of paper rather than a lack of appetite. Lending volumes continue to be dominated by a small number of players - 62 per cent of new loan origination by volume came from only 12 institutions (six UK banks, two German banks, one North American bank, one insurance company and two other international banks). Only UK banks and non-bank lenders reported larger balance sheets at year end 2016 than 2015. In particular origination volume by US banks fell 56 per cent and insurance companies fell 46 per cent (reflecting reduced larger transaction activity). Non-bank lenders continue to take a market share of around 10 per cent of the market. 76 per cent of mezzanine / junior debt is held by non-bank lenders with a further 18 per cent held by insurance companies and only 6 per cent held by banks.

The Savills' report repeats many of the findings from the De Montfort Survey, which was published a month earlier, adding some further observations in their Financing Property 2017 report. Savills write that "Property has rarely been so financeable" comparing the UK All Property Equivalent Yield and average all in cost of money and showing the all in cost of real estate debt is at historical lows and the spread between property yield and financing cost being at historical highs. Savills also note that development finance is not growing significantly and is at less than half the levels of 2007 and 2008. This theme is in line with what we are seeing in the market but we also see a risk that as an increasing amount of development financing is being provided by alternative lenders (especially on the larger tickets), this could be missed from survey data, as these lenders are less likely to report their lending to the survey.

Both Savills' and Capita's reports highlight the general desire of the lending community to do new business. Savills quote 81 per cent of lenders expressing a desire to increase their lending while Capita say that 52 per cent of lenders are looking to grow their lending teams and 71 per cent are looking to grow their lending book over the next year. Both highlight the variety of different lender types in the market and there is such a diversity that Capita divide lenders into twelve separate categories.

Capita's report was released after the general election: interestingly they see very little macro nervousness among lenders despite uncertainties from Brexit and the recent general election. Evidence of the market shrugging off Brexit uncertainties for prime London properties can be seen in lower margins being achieved on recent larger London financings. For example, according to Debtwire the "Cheesegrater" (122 Leadenhall Street) financing for CC Land was priced at Libor+ 150bps and, also according to Debtwire, London and Regional have refinanced 55 Baker Street at 175bps over Libor for the 60 per cent LTV senior loan and 450bps over Libor for the 60-70 per cent LTV junior loan. This represents some of the lowest post global financial crisis mezzanine pricing we have seen in the UK.

The challenge to obtain UK development financing can be seen in the results of the Laxfield survey which shows that borrowers' development loan margin expectations are up 21 per cent in the six month period ending 31 March 2017 versus the previous six month period. This appears to be an issue which is affecting the UK specifically and we continue to see much stronger availability of development financing in most other countries around Europe. Laxfield report the six months ending 31 March 2017 was the second slowest by volume after the preceding six months, with volumes of UK commercial property financing requests down by 20 per cent on the same period last year from £11.8 billion to £9.5 billion. At the same time the number of financings reported was up from 162 to 173 so we are seeing a higher number of smaller deals making up a lower overall volume. The De Montfort data backs this up: average loan size fell considerably between 2015 and 2016 with over 50 per cent of loans being in the £100-500 million range in 2015 and just 8 per cent in 2016. Laxfield also report borrower expectations on margin for most LTV points were up in this period.

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## Blackstone/GSO Loan Finance:

### Bank Loan Market Overview

Though we saw a reversal in performance across rating quality during the second quarter of 2017, it was not enough to overcome the outperformance of lower-quality loans during the first quarter. Over the first six months of 2017 in Europe, the Lower Tier (CCC, Split CCC and Default) of the Credit Suisse Western European Leveraged Loan Index ("CS European Loan Index") gained 3.52% while Middle Tier loans (Split BB, B, and Split B) and Upper Tier loans (Split BBB and BB) gained 1.96% and 1.19% respectively. In the US, the Lower Tier of the Credit Suisse Leveraged Loan Index ("CS US Loan Index") gained 4.32% while Middle Tier loans and Upper Tier loans returned 2.11% and 1.22%, respectively.

The technical backdrop continues to be particularly strong as the supply of new paper in the loan market mismatches the incremental demand for these products. The issuer-friendly conditions have resulted in consistently low new-issue yields and aggressive structures. Many issuers, who tapped the market in early 2016, have returned this year to reprice or refinance.

In Europe, institutional new issuance reached €49.7 billion for the first half of 2017 versus €22.7 billion during the same period in 2016. Institutional U.S. loan issuance totalled $297.0 billion for the first half of 2017, up significantly from last year's $127.8 billion first-half tally. Primary market conditions continued to be favourable for issuers in both markets, with re-pricing and re-financings continuing to account for the majority of loan issuance, resulting in relatively scarce net supply in the face of sustained demand.

Default activity remains modest with the lagging 12-month loan default rate of the S&P European Leveraged Loan Index and S&P/LSTA Leveraged Loan Index finishing June at 2.20% and 1.54%, versus 2.40% and 1.58% at year end, respectively. Strategists forecast loan default rates to remain below their long-term averages.

### CLO Market Overview

The low volatility environment through the first half of 2017 has been favourable for CLO issuance on both sides of the Atlantic. During the first half of 2017, European CLO issuance was €8.4 billion and US CLO issuance was $52.5 billion versus €7.2 billion and $26.2 billion respectively during the first half of 2016.

Strong global demand for both US and European CLO liabilities has supported tightening across the debt tranches close to post-crisis tights. AAA spreads in Europe hit a post-crisis low of E+83bp, while the US reached a 3-year tight of L+118bp. The relatively low cost of CLO liabilities provides an attractive investment opportunity for primary income notes due also in part to the greater reinvestment flexibility versus older vintage CLOs with higher cost of debt. As a result, equity investors are exercising their control rights to refinance and reset (extend) CLOs, which should also help offset the compression of underlying loan spreads. Year to date, CLO refinancing transaction volume totalled €14.2 billion in Europe and $98.6 billion in the US.

**Market Outlook**

We believe the most important theme for the credit markets is the overwhelmingly strong technical backdrop. We continue to see strong institutional inflows into managed accounts and appetite for CLO liability by investors remains robust. With volatility in rates, we think sponsors may favour issuance in the loan market and we have already seen an increased preference for loans over bonds.

We believe the current environment is supportive for credit products. Economist forecasts, on average, indicate that the US economy is expected to grow at between 2-3% in 2017, based on GDP growth. The unemployment rate is forecast to fall to 4.3% in 2017, which should support the improvement in US household balance sheets. With the Federal Reserve leading the way with tightening monetary policies, the epoch of "cheap money" may be drawing to a close. Despite this, there is still significant demand from yield hungry investors with high yield coupons at all-time lows. With Brexit negotiations underway between the UK and Europe, we continue to stand vigilant, knowing from experience the ability of political events to spook markets.

In the meantime we believe senior loans are well positioned, providing investors with yield and relative performance stability. High yield bonds should also continue to benefit from negative interest rates but provide yields similar to senior loans with more risks, in our view.

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## CVC Credit Partners European Opportunities:

**Market Opportunity in Credit Opportunities & Special Situations Strategies**

Looking ahead to the rest of 2017 the manager is optimistic about opportunities in the credit markets. The continued FX fluctuations and the seemingly relentless flow of re-pricing activity during H1 2017 presented significant opportunities for the manager's Credit Opportunities and Special Situations strategies. The manager believes that pockets of volatility, and continued regulatory changes due to the changing geopolitical landscape, will support its healthy pipeline of new investments. Examples of opportunity-inducing events include:

- Repositioning of Central Banks;
- Monetary and fiscal policy changes in key economies, including the U.S and Europe;
- German and Italian parliamentary elections;
- Brexit negotiations between Britain and Brussels and its impact on investment and growth on the UK economy; and
- Uncertainty around the sustainability of Italy's public debt.

In the Special Situations space, the manager continues to evaluate credits in the energy sector, particularly in Europe where subsidies for renewable energy production and infrastructure have been reigned in. Attention will also be given to assets in the retail, shipping and the U.S. healthcare markets, where fluctuating oil prices and changing regulatory regimes should contribute to the asset flow and price volatility.

Whilst the manager is of the belief that defaults may take longer to materialise in the current climate, acknowledgement is given to the Fed's interest rate rises during 2017 and the consequences this may have for over-levered credits.

**Conclusion**

Political uncertainty is set to continue in H2 2017, with the continuation of the tough Brexit negotiations. President Trump's continuing changes to economic and foreign policies will also be keenly watched by investors. Despite the risks, our core scenario is that global growth and inflation continue to pick up for the rest of the year. Within fixed income, we expect European leveraged loans to outperform, as stronger economic growth should support corporate earnings provided that the ECB remains accommodative (although on a lower basis) through the rest of 2017.

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**ICG Longbow:**

**Economy and Financial Market Update**

UK GDP growth eased to 0.5% during H1 2017 (down from 0.8% in the same period last year), largely a result of a slowdown in consumer expenditure. Consequently, many commentators have moderated their full-year growth forecasts, with the Bank of England forecast now at 1.7% (from 1.9%) for 2017 and 1.6% (from 1.7%) for 2018. Even these reduced levels are comfortably above the 0.8% forecast for 2017 in the aftermath of the Brexit vote, and the 1.4% forecast as recently as November 2016.

With inflation running at 2.9% in the year to June 2017, wages have fallen by 0.7% in real terms over the period, contributing to the slowdown in consumer expenditure described above. However, employment growth has continued and even accelerated, with 175,000 jobs created in the three months to May 2017 and 324,000 jobs created in the last 12 months. Of note, 360,000 new full time jobs were created in the year, with a loss of 44,000 part time jobs, which somewhat contradicts a media narrative of a labour force facing 'zero hours' contracts and the gig economy. This new job creation brings total employment to over 32 million for the first time and unemployment to 4.5% of the workforce - the lowest since 1975.

Five-year swap rates have remained steady at circa 0.75% for the last three months, as the Bank of England has left base rates unchanged believing the outlook for inflation remains stable. That said, the Monetary Policy Committee appears to be becoming more hawkish with two members now voting in favour of a rate rise.

**Occupational Demand/Supply**

Over the last quarter, the RICS floorspace availability survey pointed to a softening market for all sectors. Retail is the only sector showing a material growth in availability, whilst industrial and offices are largely in the same position as a year ago, with industrial still the most supply constrained market.

In terms of new construction activity, Markit Ltd confidence surveys have pointed to a marked retraction over recent months - with the cause attributed to uncertainty over Brexit. This is reflected in the Deloitte Crane Survey for H1 2017, which shows a 6% reduction in Central London construction activity. However, City construction activity points to circa 3.5 million square feet of completions in 2019, of which 2 million square feet is located in towers in Bishopsgate, timed to coincide with the UK's actual exit from Europe.

The relatively low levels of construction activity in the regions and higher activity in London, coupled with a slowdown in Central London leasing activity has resulted in a rise in void rate in Central London offices to circa 7% - a level broadly in line with the IPD all property figure.

**Property Investment Market**

The increase in investment activity in the UK commercial property market observed in Q1 2017 continued into Q2, resulting in H1 aggregate transactions of £25.8 billion, in line with the five year average. This figure was however, flattered by a number of sizeable Central London transactions, including British Land's £1.15 billion sale of the Leadenhall Building to Hong Kong-based CC Land Holdings Ltd, and Great Portland Estates' £435 million sale of Rathbone Place to WestInvest Gesellschaft Für Investmentfonds and Deka Immobilien Investment.

This trend of large sales by leading UK REITs to international investors continued into Q3, with Canary Wharf and Land Securities Group plc agreeing a well-publicised £1.28 billion sale of the 'Walkie Talkie' to LKK Health Products Group Ltd. In addition, St Modwen Properties plc agreed a £470 million sale of a Nine Elms site to a reported Chinese buyer.  Additionally several large corporates, including KPMG, Lloyds Banking Group and Anglo American plc, have commenced marketing their headquarters buildings on a sale and leaseback basis. This trend confirms London's enduring appeal for international investors but perhaps indicates the REITs and others calling the top of the London market.

More broadly, the MSCI UK All Property Quarterly Index reported a 2.0% rebound in capital values in H1 2017, offsetting 2016's 1.3% decline. Looking forward, consensus remains for a period of limited capital growth, resulting in all property income yields of circa 5% per annum being the main driver of property returns in the short to medium term.

**Finance Market**

The UK banks continue to show restraint in their lending appetite, with LTVs typically in the 50% to 55% range. According to the semi-annual De Montfort University lending survey, released during the period and reflecting H2 2016 activity, more aggressive pricing by international lenders and insurers has resulted in margin compression for senior loans secured on prime property, but otherwise the Investment Adviser has observed loan margins widen over the last twelve months. Benchmark interest rates (both 3-month LIBOR and the 5-year swap rate) remain extremely low by historic standards and the overall cost of finance remains very affordable for borrowers.

Mezzanine lending remains competitive, in a market that is notable for its low volume of transactions, with larger opportunities now being marketed on a global basis through brokers such as Eastdil Secured LLC and Jones Lang LaSalle IP Inc. Also notable is the continued reduction over the last several years in lending to UK regional markets, where De Montfort University figures show a fall in aggregate loan exposures from circa 75% in 2010 to circa 53% today. These twin trends reinforce the Investment Adviser's view that best value, and lowest competition, is to be found outside of prime, big-ticket London deals.

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## Infrastructure

(compare infrastructure funds **here**)

**International Public Partnerships:** The market outlook remains positive. Infrastructure ranks highly on many Government agendas; this asset class is a key economic driver to growth and delivering positive social benefits. The global scale of the capital investment ambition of governments is significant and we anticipate this will generate more investment opportunities.

Political uncertainty and consequential economic risk present potential market-wide challenges, which need to be analysed and assessed as and when they materialise.

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## Private equity

(compare private equity funds **here**)

**Oakley Capital:** After many years of weak global recovery, 2017 has brought signs of improvement. Trade and manufacturing output growth have picked up, helped by firmer domestic demand growth in Asia and Europe, and private sector confidence has strengthened. Policy uncertainty remains high however, trust in government has diminished and wage growth is still weak.

Despite this backdrop, private equity continues to make strong returns, sustaining its outperformance of other asset classes over 3, 5, 10, and 20 years. Three year returns stand at 9.8%1, topping Real Estate, Infrastructure, Hedge Funds and the MSCI World Index.

No surprise therefore that private equity fundraising is at its highest level since the year's pre financial crisis, with 2017 set to eclipse 2016 for private market fundraising. These inflows have led to a ten year high in the total value of private equity investments with €42.9 billion2 invested in European companies in Q2 2017. This demand has contributed to prices reaching record highs with average enterprise valuation multiple paid by a buyout firm for a European company reaching 11.6x2 EBITDA, exceeding the previous 2016 high of 10x.

The exit environment is showing strength across all routes with private equity year to date sales up nearly 30% in value compared with H1 20163.

Looking to the second half of 2017 geopolitical and economic uncertainty is likely to remain.

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**Harbourvest Private Equity:** The private markets continue to be favourable for sellers, with M&A and IPO activity continuing at a strong pace. Partly as a consequence of the resulting cash flow to investors, fundraising has gained momentum through the year, with record amounts raised globally in 2017 to-date. However, levels of uninvested commitments ("dry powder") remain high, meaning competition for assets is strong and prices are being driven upwards. In this environment, private equity managers are scrutinising deals in more depth to ensure that the entry valuation is fully justified by the investment case, and that good returns are achievable even under the assumption of a declining valuation multiple through to exit.

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## Property

(compare UK property funds **here**)

**Vikram Lall, chairman, F&C UK Real Estate:** The outlook continues to be dominated by Brexit, with considerable uncertainty still remaining about the likely outcome of negotiations and the nature of the exit process. The UK general election occurred towards the end of the reporting period and, although the property market appears to have been little affected at the headline level, the result has added to the uncertainty, particularly surrounding business investment. Economic growth has disappointed recently and the extent to which fiscal austerity will be pursued is also unclear. Monetary policy was eased further in the wake of the Brexit vote but the timing and extent of policy normalisation will be a factor affecting the property market outlook.

In an environment of relatively lower growth and increased economic and political uncertainty, property's income return should prove an attractive defensive characteristic to investors.

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**Peter Lowe, manager, F&C UK Real Estate:** Brexit will inevitably be a major factor influencing investors for several years. There remains considerable uncertainty about the outcome of negotiations, the timetable for withdrawal and the impact on the economy. The consensus economic outlook is for sustained but fairly modest economic growth and some moderation in inflation. In this environment, we would expect investors to continue to favour core products and prioritise the longevity of a secure income stream. The other major uncertainty is the likely path of interest rates. Sentiment is moving towards a likely upward move, although the timing and speed of change is unclear. The scope for further yield compression to drive performance may be limited, and we would expect income to be the major driver of performance over the coming years.

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**Andrew Wilson, chairman, UK Commercial Property:** The UK continues to be caught in a period of political uncertainty. The indecisive result of the UK general election has added a further layer of complexity to the Brexit negotiations and has resulted in an uncertain political environment the likes of which has not been seen in this country for decades. While the economy seems to have shrugged off the outcome of the election, the depreciation of sterling following the decision to leave the EU has increased inflation, weakened consumer confidence and led to a slowdown in the economy. This has resulted in a number of UK GDP growth forecasts recently being pared back, among them being that of the Bank of England which cut its 2017 forecast from 1.9% to 1.7%.

In relation to the UK real estate market, a level of normality has returned following the volatility experienced after the Brexit vote, with the sector continuing to provide a yield profile that is attractive when compared with other asset classes. In addition, the fundamentals of the sector remain strong compared to previous cycles with lending to the sector at a lower level than in 2007/2008, relatively limited development, lower vacancy levels and liquidity in the market with investment volumes above the long term average. In this environment the steady, secure income component of a portfolio, with an elevated yield that continues to provide a significant margin compared to other asset classes, is likely to be the key driver of returns.

The Industrial sector is expected to be the best performing sector over the medium term. Geographically, the City of London is forecast to be one of the weakest markets due to the uncertainties over how Brexit will affect the financial services industry, a major employer in London.

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**Will Fulton, manager, UK Commercial Property:** UK real estate continues to provide an elevated yield compared to other assets in a market which has stabilised following last year's post-Brexit upheaval. Lending to the sector is at a lower level than in 2007/08 and liquidity remains reasonable. At the same time development continues to be relatively constrained by historical standards, with below average vacancy levels in most markets, which should help to maintain the positive returns that the sector is currently recording. In this environment, the steady secure income component generated by the asset class is likely to be the key driver of future returns. The market is expected to continue to be sentiment driven in the short term as the political and economic impact associated with the UK's withdrawal from the European Union continues to evolve. The retail sector continues to face a series of headwinds that may hold back recovery in weaker locations due to oversupply and structural issues. Given the backdrop of continuing heightened macroeconomic uncertainty, investors are becoming more risk averse and better quality assets are once again broadly outperforming those of a poorer quality.

In 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, real estate as an asset class should be well placed for the longer term.

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**Regional REIT:** In the first-half of 2017 total investment in UK commercial property was £27.2bn, according to research from Savills1, a 1% increase on the same period in 2016. There was a contrasting investment performance between the first two quarters of 2017, with the regions outperforming London in Q1 2017 but with Q2 2017 seeing a reversal and London outperforming.

Investment continued to shift away from London in Q1 2017 whilst investment in the regions rose, with Scotland and the west of England doing particularly well, and overall investment for the regions was up 15% year-on-year. In Q2 2017, however, contrasting with the general downward trend of recent quarters, investment volumes in London rose to £7.1bn, 10% above the five-year quarterly average. The resurgence in London was affected by a number of big-ticket deals completing during the second quarter of 2017. The investment performance across the regions was, however, more mixed in Q2 2017, according to data from CoStar. Investment in Scotland was £330m (42% below the five-year quarterly average), contrasting with the strong performance in Wales and the East of England, where investment was 117% and 50% respectively above their five-year quarterly averages.

Research from CoStar shows that the increase in overseas investment seen in Q4 2016 continued throughout the first-half of 2017. Foreign investment as a share of total spending reaching record levels in Q2 2017 at 52%, accounting for £6.5bn of the total spend, up 41% from the same quarter last year. Inward investment from overseas was predominately focused on London which led to the stronger performance of London in Q2 2017.

### Occupational Demand in the UK Regional Office Market

CBRE estimates that the take-up of office space across ten key regional cities reached 2.8 million sq. ft. in the first-half of 2017, 5% lower than the take-up in the first-half of 2016. Additionally, the take-up in the first-half of 2017 was 4% below the average of the same period over the last five years. Although some regions have experienced a reduced take-up in comparison to previous periods, demand proved resilient in the first half of this year in cities such as Edinburgh, Leeds and Manchester, all of which experienced increased levels of occupier demand for space in comparison to the first-half of 2016.

In terms of the new development of office space in regional cities, research from Savills highlights that approximately 38% of speculative development over the next three years will be in the form of refurbishment, which in turn is set to increase average rents throughout the UK. Occupier demand is likely to continue throughout 2017, this combined with limited supply and lack of development makes for a positive outlook and upward pressure on rents in the regional markets.

### Rental Growth Continues in the UK Regional Office Market

According to Savills, a shortage in Grade A office space in regional markets is likely to put upward pressure on rents during the second-half of 2017. The strongest rental growth is expected in cities with lower levels of available Grade A office space, including Bristol and Manchester. It is anticipated that the lack of supply will also result in rental growth for newly refurbished office space in the core regional markets.

Research from JLL expects headline rental growth for the core 8 regional office markets to remain well supported throughout 2017, with falling supply levels for prime properties in the UK's cities to result in an uplift in rents as the year progresses.

The Asset Manager anticipates that positive sentiment will result in continued demand for regional office space throughout 2017, with limited supply of prime properties resulting in rising demand for high-quality secondary properties and recently refurbished office buildings.

### Occupier Demand Strengthens in the UK Industrial Market

In the first-half of 2017, take-up on units over 50,000 sq. ft. in the UK industrial and logistics market totalled 16.5 million sq. ft. Despite this take up being below the level of demand experienced in the second-half of 2016, it indicates a 2% increase above the level recorded during the first-half of 2016. In terms of regional markets, occupier demand in the Midlands remained particularly strong in the first-half of 2017, representing 32% of total take-up recorded. Other regions which experienced continued demand were the North West, London and the South East, contributing 30% of overall demand.

Research shows that the online retail market grew by c.16% in 2016, totalling £133 billion, with a continued move from in-store to online shopping. Forecasts for 2017 anticipate continued growth in online retailing of approximately 14%. According to Cushman & Wakefield, e-commerce related occupiers accounted for 30% of total take-up figures throughout the UK in Q1 2017.

Cushman & Wakefield has highlighted that a fall in suitable speculative development has resulted in a rise in the number of occupiers choosing purpose-built solutions. Recent research indicates that the 12-month development pipeline was 10% lower in Q1 2017 when compared to the same period last year; speculative development only accounted for 35% of the overall development pipeline.

The Asset Manager anticipates the combination of growing demand, limited supply, and lower levels of development, will deliver rental growth throughout 2017.

**Industrial Rental Growth Continues**

The industrial market, essentially the regions outside London, experienced the highest rental value growth in 2016, showing a c. 4% increase according to IPD. However, the most recent figures from IPD indicate that rental growth slowed slightly in June 2017, to 3.9% annualised.

According to the Investment Property Forum UK Consensus Forecast, rental growth forecasts for all property rose to 0.9% as at September 2017. Industrial market forecasts are set to experience the highest rental value growth of c. 3% in 2017 according to IPF. Additionally, estimates indicate average rental growth rates for 2018 and 2019 of 2.1% and 1.7% respectively.

Research by Cushman & Wakefield indicates that the supply-demand imbalance will result in an upward pressure on prime industrial rents throughout 2017. Annual prime rental growth ranged from 3.1% in the West Midlands to 13% in Yorkshire (for units 100,000 sq. ft. or larger) during Q1 2017.

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**Real Estate Investors:** Against a backdrop of economic and political uncertainty, in particular the Brexit discussions, we anticipate continued demand for income producing regional property investments and expect valuations to remain strong in H2, with interest rates remaining at a record low.

More generally, the occupier market is stable and substantial development is taking place to accommodate HMRC, HSBC, HS2 and the continued growth of high end manufacturing, together with the growing motor industry requirements at Jaguar Land Rover and BMW. All this activity will bring significant employment to the region, which in turn has boosted demand for housing, both rental and sales. This has naturally driven substantial residential development across Birmingham, the Black Country and the West Midlands, and we are seeing rental and house price growth.

However, it is possible that there may be moments of concern during this period of uncertainty, that may provide a "short term" buying opportunity to a well established and credible buyer.

According to Colliers International, despite post-EU referendum uncertainty, pricing and volumes have held firm, mostly due to the insatiable demand from overseas investors, who took advantage of sterling's devaluation. Indeed, foreign buyers acquired £16.2bn worth UK assets in the first seven-and-a-half months of the year, representing 51% of all transactions. Demand for real estate assets has also come from local authorities aiming to take a more active role in the regeneration of their locations, who can also take advantage of the low cost of debt on offer from the Public Works Loan Board (PWLB).

The Midlands' regional yield discount to London is still evident but there has been a noticeable shift in focus from the South East markets to core regional markets including Birmingham. There has also been strong interest in more secondary assets which is in part due to a lack of availability of prime assets. In H2 2017 prime yields are expected to remain unchanged, although transaction volumes are likely to increase as vendors look to capitalise on the depth of investor demand.

Recent press comment has also identified Birmingham as an emerging tech hub and further growth within this sector is expected. We anticipate further space requirements to follow as a consequence of the gathering momentum around the delivery of HS2 and its associated supply chain. Active demand in the first half was boosted following HS2 securing Royal Assent in late February, which is likely to be reflected in lettings as the year progresses. Consequently, vacancy levels have continued to fall and landlords are beginning to have the upper edge in negotiations.

We expect property yields to remain stable or compress further, particularly with the secondary market place increasing demand and a shortage of investment stock at the end of the year. Our local economy is going through a period of 're-birth' and will continue to do so, regardless of some of the national economic uncertainty and will benefit further as the uncertainty falls away.

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**Martin Moore, chairman, Secure Income REIT:** The commercial property market is currently polarised between strong investment demand for very well let properties but muted interest in short let or weak covenanted income streams.  A similar divide operates between enthusiasm for assets in logistics and alternative sectors such as healthcare but much weaker interest elsewhere.  This is reflected in REIT share prices with companies in the favoured sectors trading at or above NAV whilst the remainder typically trade at 20-30% discounts.  This has been the position for over a year now since the Brexit vote and, in our view, is unlikely to change any time soon. In a lacklustre UK economy, interest rates and bond yields are likely to continue to remain low, underpinning the search for yield - particularly a sustainable, growing yield.  With the outlook for rents in most property sectors now either flat or declining, an increasing amount of capital is bidding for the limited amount of stock that occupies the few remaining bright spots in the market.  This continues to put upward pressure on valuations, adding to our returns but makes sourcing new acquisitions that are accretive to shareholder returns more challenging.

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**GCP Student Living:**

International student numbers, which have been the primary driver of applicant growth over the past five years, have remained strong.

The UK has some of the highest-ranking universities in the world, with three in the top 10 and seven in the top 50 in 2016/17. The UK higher education sector generates c.£73 billion for the economy and contributes 2.8% of the nation’s gross domestic product.

Students have become increasingly globally mobile with, according to the OECD, over 4.5 million students studying abroad in 2014, more than double the 2.1 million internationally mobile students in 2000. This figure is forecast to reach 8 million by 2025. China, India, the Republic of Korea, Germany and Saudi Arabia are the top five countries with students going abroad, with almost one in six international students being Chinese, and Asian students accounting for 53% of all students studying abroad.

The world’s population is increasingly becoming more educated. In many of the world’s largest established economies nearly half of the population of 25 to 34-year olds has tertiary education.

The student body has also changed over the period, becoming younger and with a higher proportion of full-time students, as the decline in the number of part-time and mature students has continued since 2010. Full-time students now make up 74% of the student body, up from 62% at the start of the decade, and under-25s now make up three-quarters of all undergraduates and a third of postgraduates.

As well as changes in the age of students and their mode of study, the student body has become more cosmopolitan over the decade. In 2004/05, 4% of students came from the EU and 9% from outside the EU. By 2014/15, the numbers had increased to 5% and 14% respectively. The US is the most popular market for international students, with the UK in second place, though significantly stronger on a per capita basis. One of the UK's advantages is its average cost of living and tuition, which is generally lower than in both the US and Australia.

**HEI acceptance rates**

Acceptance rates for the 2016/17 academic cycle broke last year's record, with the intake of undergraduates entering UK higher education totalling c.535,000. Nevertheless, there were another c.180,000 students who applied for a place who did not get accepted, which shows a significant surplus demand in the sector.

On 13 July 2017, UCAS published application statistics for the June 2017 deadline, which showed that applicants for the UK and EU were down by 4% and 5% respectively, while non-EU international students were up 2% on last year. The reduction in UK student numbers has been primarily driven by a reduction in nursing degrees, owing to significant funding cuts, with the remainder coming from mature undergraduates who are more likely to be taking up apprenticeships under the new government schemes. EU student numbers were forecast to decrease following two record years of growth and the impact of the Brexit vote. However, this shortfall is not expected to have a material impact owing to the scale of student demand buffer outlined above.

International student numbers, which have been the primary driver of applicant growth over the past five years, have remained strong. We expect these numbers should continue to rise over the medium term, with the sector benefitting from sterling's depreciation and the impact of US protectionist trade and visa policies. The UK remains the second most popular global destination for those seeking higher education and the government has confirmed through the Brexit white paper that there is no limit to the number of genuine international students who can come to the UK to study.

**Student accommodation – supply/demand imbalance**

There is a fundamental supply/demand imbalance in the UK student accommodation sector which is responsible for the stability and the robust rental and capital returns produced in this financial year.

The UK has seen rising student numbers since the early 1990s, with the student population more than doubling over this period. Domestic student applications have increased despite an ageing population and international student numbers continue to grow at a disproportionate rate, as evidenced by the increase in international student application rates for the 2016/17 academic year.

There is a structural shortfall of purpose-built student accommodation in most of the UK. The supply of private student accommodation has failed to keep pace with the increasing demand owing to the following:

- the residential property market has recovered over the past few years, increasing land values as well as increasing the pressure on the private residential sector to house tenants other than students who are willing to pay higher rent levels;

- the private rented sector has become subject to greater local authority and government legislation for houses in multiple occupancy; and
- universities are not developing new accommodation as they are becoming more focused on their core competency of investing in education.

**The London market**

London has more world-class universities than any other city in the world. International students are attracted to London for a number of reasons including the reputation of London's universities, the quality of education and London's status as a social and cultural centre.

This is where the supply/demand imbalance is at its greatest. London has a number of important demand dynamics that separate it from the wider UK student housing market:

- Nearly one in three students in London are international;
- London has the largest number of international students of any city in the world with c.107,000 students in 2015/16;
- London is home to some of the leading HEIs in the world which attract a significant number of international students;
- London and the South East have over 30% of the entire student population of the UK.

On the supply side, the main constraints are as follows:

- availability of well-located sites is at its lowest and land prices have experienced significant inflation driven by residential development;
- the introduction of the community infrastructure levy in some boroughs has eliminated the commercial viability of many student schemes; and
- There are only c.90,000 purpose-built student accommodation beds in London, indicating a substantial undersupply.

**Student accommodation – the importance of design and quality**

Purpose-built student accommodation has evolved as a product over the past 15 years. Over this period, and in particular, following the introduction of tuition fees, students have become consumers in their own right and are making their investment decisions for their higher education not just on course alone, but also on a mix of quality of the academia and the quality and location of accommodation.

Increasingly, students are demanding high-quality living space with clever design, quality materials, TV areas, communal kitchens and social areas in the buildings which provide opportunities for social groups to form and bond, centred around work and play spaces. Likewise, they are demanding services that create wider social engagement such as talks, events, workshops and tie-ins with local businesses and educational establishments.

The leading players in the market are now providing facilities which mix academia, co-working and social spaces, providing a true campus environment.

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**Impact Healthcare REIT:** Five drivers influence the demand for, and provision of, care for the elderly, making it a potentially attractive market for well-capitalised asset owners and well-managed operators. In particular:

- People are living longer. The number of people more than 85 years old in the UK is forecast to increase from 1.6 million in 2016 to 3.6 million by 2036. This age group is in particular need of residential care, with 15.7% either in a care home or long-stay hospital bed.

- Supply has shrunk. The number of beds available has fallen, from 574,000 in 1996 to 460,000 in 2016 - a decline of 20%. More than 2,400 care homes shut in the five years to December 2015.
- The market is highly fragmented, with 69% of the market held by operators with fewer than 15 homes. The Group now owns 0.6% of the of the private care beds in the market. This offers scope for stronger asset owners and operators to grow through consolidation, and for asset owners to broaden the range of tenants in their portfolios.
- Severe pressure on the NHS. In the 12 months to June 2017, the NHS in England lost cumulatively 2,274,300 bed days through delayed transfers, an increase of 66% on 2010. 25% of the patients occupying these beds were waiting for a bed to become available in a care home. The average hospital bed costs four times more than the average care home bed.

Government funding is increasing. In response to these pressures, there is recognition across the political spectrum that adult social care needs more funding. The government announced a series of initiatives during the past two years. These were:

- a social care precept, allowing councils to increase council tax by 2% each year from 2016/17 to 2019/20. This was subsequently raised to 3% for 2017/18 and 2018/19, with the potential to raise £2 billion more a year by 2019/20;
- an improved Better Care Fund, providing an additional £4.4 billion between 2017/18 and 2019/20; and
- a new Adult Social Care Support Grant, providing £240 million to councils in 2017/18.

While major structural changes to adult social care are unlikely in the short term, further increases in government funding can be expected, given the political imperative to do so.

One consequence of these pressures - increasing demand, shrinking supply, the need to reduce pressure on the NHS and increased government funding - has been above-inflation fee increases. According to research by Christie & Co, national average fee increases for elderly care in 2017 (compared to 2016) were 6.3% in the private market and 5.2% in the local authority-funded market.

## Ireland

**Gary Kennedy, chairman, Green REIT:** The Irish economy has continued to experience strong economic growth, with all of the key indicators trending positive. Employment growth for the year to March 2017 was 3.5%, with Dublin based office employment growing at 5.7%. The unemployment rate dropped to 6.3% in August 2017, from 8.3% in June 2016. This compares with a peak of 15.2% in early 2012. Investment and consumer spending are the main drivers of economic growth, with core investment growth of 13.6% and core domestic demand growth of 5.4% in 2016 (source: Goodbody).

On the FDI front the IDA results for the first half of 2017 announced that job approvals, their key metric, was up 22% versus the first half of 2016, with 93% of IDA clients ranking growth prospects for their Irish companies from Good to Excellent. FDI has played a key role in the recovery of the Irish economy and continues to do so.

The country's debt to GDP ratio continues to fall below the EU average, with only a minor government deficit expected for 2017. Eurozone interest rates remain low, and are expected to continue to remain low for some time, while the Irish government 10 year bond rate stood at 72 basis points at 30 June 2017, both of which continue to be supportive of commercial property yields.

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**Stephen Vernon, executive chairman, and Pat Gunne, chief executive, Green REIT:** The market continues to absorb the implications of the UK's decision to exit the EU. Whilst acknowledging that it is potentially a headwind for the Irish economy, we have also been clear that we consider it an opportunity for our area of business, which is heavily weighted towards Dublin offices.

The Dublin office occupier markets remain healthy. The record take-up level in the second quarter of 2017 bodes well for those who have capital invested in the higher risk and reward area of office development in Dublin. At the same time, in Dublin the industry is developing speculative space equivalent to approximately 7% of our total market, well ahead of EU averages, so it is a time to remain disciplined in assessing risk around new speculative capital allocation decisions.

There are various perspectives on just how much Brexit has impacted on the latest take up figures, but the fact is that those international companies that are expanding in Ireland, be it from the financial services, professional services or TMT sectors, are using Ireland as a base for servicing their European business platforms. Accessing the EU through a proven English speaking and pro-business country such as Ireland must weigh heavily and favourably on those crucial investment decisions. While Ireland's 12.5% corporation tax rate is often cited as the predominant force in this context, it is one of a number of other factors, such as availability of workforce, and critically at this juncture, certainty of access to the EU market. Constraining factors include the inadequate provision of residential accommodation, which is a political priority, together with education facilities and infrastructure, both of which require investment and creative solutions.

On the capital markets front, the interest rate environment has remained relatively benign, with longer term interest rates best assessed off the 10 year Irish sovereign bond yield, remaining close to historic lows. Despite the tensions at geopolitical level around the globe, sustained low interest rates will likely offer continued support to real estate values, as a considerable gap remains between longer term interest rates and property yields, both in Dublin and across Europe. In fact, Ireland, and Dublin in particular, stands out as a market where yields for the best quality office assets may see further compression. There is now a growing consensus that yields will tighten as new investment stock comes to the market this coming autumn- winter season. Bifurcation between prime and secondary assets continues to widen in terms of value and liquidity.

With tapering being increasingly debated at policy level for both the US Federal Reserve and the European Central Bank, the resulting rise in interest rates is likely at some point to reduce the flow of capital being allocated to real estate as an asset class. This would lead to a continuation of this theme of bifurcation, with the usual flight to quality real estate in times of capital retrenchment. How long this will take is uncertain, but it may become a bigger discussion point over the next 12 to 24 months.

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## Macau

**Chris Russell, chairman, Macau Property Opportunities:** Macau's economy is forecast to grow at an average rate of approximately 8% this year and next on the back of a stronger China economy, improving gross gaming revenue and ongoing support by the Chinese government.

Large-scale new infrastructure developments will boost visitor capacity and support the city's growth momentum, as well as its transition into a world-class leisure and tourism centre. The much-anticipated Hong Kong-Zhuhai-Macau Bridge, set to open in 2018, is likely to be a significant game-changer, enabling greater ease of access to Macau's wide variety of attractions.

With a limited supply of new properties and barring any unforeseen negative economic or political developments, a continued recovery in property prices is the most likely future path.

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**Sniper Capital, managers, Macau Property Opportunities:**

**Macroeconomic Outlook**

Macau remains unmatched in its position as the world's largest gaming hub and it is also gradually gaining traction as a world-class leisure and tourism destination. These bode well for the territory's recovering economy and its global profile will continue to grow, as infrastructure developments further enhance its accessibility.

**The Return of Macau's Dynamism**

Macau is enjoying a genuine and meaningful economic recovery, following the sharp recession from 2014 to 2016.

Moody's Investor Services in May affirmed an "Aa3" rating for Macau and upgraded its outlook from negative to stable. This comes largely on the back of the recovery in gaming revenues, but is also supported by Macau's ongoing diversification towards non-gaming activities, which has underpinned gaming operators' profitability and enhanced the resilience of economic growth.

In the first half of 2017, real gross domestic product accelerated 10.9% year-on-year (YoY) to MOP185.14 billion (US$23.14 billion), due mainly to solid gaming and tourism growth.

The gaming sector, the heavyweight contributor to Macau's economy, had delivered 11 months of straight gains by the end of 1H 2017. Gross gaming revenue (GGR) is on an upward trend, having surged 25.9% YoY to US$2.5 billion in the month of June 2017. The growth in the gaming sector appears to be led by a recovery in the VIP segment, which is generating a revenue stream growing at triple the rate of those in the mass and premium mass segments. In the first half of 2017, the city's VIP gaming revenue rose 25% from the previous year to US$8.9 billion, while mass-market revenue grew 8% YoY to US$6.9 billion.

Looking ahead, GGR is expected to increase by 18% YoY for the entire year of 2017. An average annual growth rate of 9% is estimated for the next six years, which would boost GGR to potentially reach US$46 billion by 2022 - a similar level to the previous market peak of US$45 billion recorded in 2013.

Despite the positive growth in gaming revenues, it is noteworthy that any substantial increase in VIP revenue growth may attract further scrutiny by China's central government as part of its ongoing efforts to curb outbound capital flows. The more sustainable mass gaming segment is expected to grow alongside China's economic expansion and increasing gaming penetration among the country's middle-class population.

In recent years, Macau has been working hard to build a long-term sustainable economic model by focusing on growing non-gaming tourism and rebranding itself as an international integrated resort destination for families and the mass tourism market.

In 1H 2017, tourist arrivals increased 5.4% from 1H 2016 to 15.6 million, of which 66% were from mainland China. Macau has great potential to continue attracting Chinese outbound tourists, a market which is expected to hit 200 million by 2020. To continue to cater to this market, apart from building more family attractions, Macau is also working on its hotel room supply that stood at 36,600 rooms as of June 2017. Supply is expected to increase by 6% in 2017 and by another 7% in 2018 to reach around 41,280 rooms - still significantly below the 150,000 rooms in Las Vegas.

**Infrastructure Completions to Benefit Macau**

Several transportation infrastructure developments in and around Macau are supporting the city's growth momentum.

The new Taipa Maritime Terminal, which was delayed for seven years, finally commenced operations in June. The terminal better facilitates sea travel between Macau and the nearby cities, and helps redirect tourist traffic from Macau Peninsula's Outer Harbour Ferry Terminal to Cotai's arrival point, where the new integrated resorts cluster is located. Resorts along the Cotai strip, including the upcoming MGM Cotai and Grand Lisboa Palace, are likely to benefit from the new facility.

The northern extension of Macau International Airport's passenger terminal building will - upon completion later this year - enable the airport to handle up to 7.8 million passengers annually. In addition, six new routes between Macau and short- to mid-haul destinations will be launched this year, further boosting the city's connectivity in the region and supporting its tourism industry.

Within the Guangdong-Hong Kong-Macau Greater Bay Area (Hong Kong, Macau, Dongguan, Foshan, Guangzhou, Huizhou, Jiangmen, Shenzhen, Zhaoqing, Zhongshan and Zhuhai), the Hong Kong-Zhuhai-Macau Bridge will be completed by the end of this year. It is expected to commence operations during 2018, with some 50,000 vehicles forecast to traverse it each day by 2035. Hot on the heels of the bridge's completion is the Shenzhen-Zhongshan tunnel, which has a target completion by 2024 and is expected to see throughput of 90,000 vehicles daily. These two key connectivity infrastructure developments will be significant drivers of travel by mainland Chinese into Macau.

The projects will boost visitor capacity, reshape tourists' travel plans and routes to Macau, and help support the territory's transformation into a world-class leisure and tourism hub.

**China's Central Government Acts on Pledge of Support to Macau**

As expressed in the Chinese government's 13th Five-Year Plan and One Belt, One Road initiative, Beijing aims to diversify Macau's economy and to develop the territory as a top-ranked tourism destination.

To promote Macau's economic growth and encourage diversification, a series of support measures have been introduced, including a scheme that allows Macau-registered vehicles to enter Hengqin and a "free-to-travel yacht scheme" to promote leisure journeys on the waters between Guangdong Province and Macau.

**Hengqin Island - A Perfect Complement to Macau**

Hengqin's future development of non-gaming facilities is designed to work in synergy with Macau's economic diversification efforts. The island provides a respite from the tight labour market and limited land supply in Macau, and supports the city's mass tourism growth.

The non-gaming facilities on Hengqin are likely to benefit Macau's tourism industry, with visitors to the island expected to spill over into Macau and vice versa. Some key developments include: an SJM's project being developed in partnership with Hengqin Tourism and Transportation Services Centre in the Guangdong-Macau Cooperation Industrial Park; Sands China's partnership with Hengqin Chimelong International Ocean Resorts; Galaxy's hotel resort project; and MGM China's investment in a non-gaming project, whose details are undisclosed while still awaiting government approval.

**Risk and Uncertainties**

Macau's economy is heavily reliant on the gaming sector. With gaming concessions due to expire in 2020 and 2022, there are uncertainties in the industry as the government has yet to announce its plans for concession renewals or other changes being considered.

Additionally, despite a recent rebound in VIP gaming revenues, this segment remains volatile as it is highly exposed and responsive to any shifts in the China central government policies, one of which is the anti-graft campaign. Nonetheless, Macau has stepped up its audit on the junkets to become a better regulated gaming hub.

Although Beijing's moves to stem capital outflows are intended to control the devaluation of the renminbi, they have affected Macau's economic growth. The further strengthening of the US dollar may exacerbate the situation and add momentum to Chinese capital outflows, which in turn could have a material impact on Macau and the emerging markets.

The introduction in May of a new housing policy on mortgage loan caps for residential purchases is expected to dent investors' appetite for property, at least in the short term. Additionally, there are concerns that the central government may introduce further tightening measures in the mainland's property market, which could pose downside risks to the economy. Property is a key investment class and store of wealth for mainland Chinese. Therefore, any property cooling measures would not only curb private consumption spending in China, but also dampen Chinese investors' appetite for discretionary spending in Macau and elsewhere.

**Property Market Overview**

Macau property values are maintaining a positive, albeit gradual, growth momentum. In the first half of 2017, the total volume of residential transactions in Macau rose 40% YoY to 5,875 units, fetching a combined sale value of MOP39.3 billion (US$4.9 billion).

The number of pre-sale units increased 189% to 1,060, while the number of transactions involving existing residential units - comprising resale apartments and brand new units in completed projects - rose 26% to 4,793.

In the first six months of 2017, the average residential transacted price rose 29% YoY to MOP9,160 (US$1,145) per square foot.

While Macau's residential property market has been experiencing a gradual rebound in general, potential buyers of mid- to high-end properties are observed to still adopt a conservative approach in their purchase intention due to the higher quantum and the lower mortgage loan caps.

Amid steady growth in visitor arrivals and a recovery in retail sales, Macau's retail property market has also shown signs of improvement. In the first half of 2017, there were a total of 320 retail shop transactions, an increase of 16% YoY, fetching a total of MOP3,774 million (US$471.8 million).

**Housing Market Supported by Strong Demand and Limited Supply**

Macau's residential property market is expected to remain supported by demand from cash-rich locals and new families in search of housing upgrades.

In tandem with the city's growing population and affluence, residents' deposits reportedly increased 16% YoY in 2Q 2017 to an all-time high of MOP542.5 billion (US$67.8 billion). Concurrently, there is increasing new family unit formation, with 3,891 marriages registered in 2016 and 2,027 in the first six months of 2017, up 5% YoY and 2% YoY, respectively.

Macau residents remain the key driver of the residential property sales market, accounting for more than 97% of all transactions in the first half of 2017.

**Despite healthy demand, new housing supply will remain limited in the short- to mid-term.**

According to the Macao Association of Building Contractors and Developers, a total of approximately 13,000 new housing units are expected to come to market between 2017 and 2020.

The average household size in Macau is around three members. Given an estimated population increase of 65,100 by 2020 to a total of 710,000, some 21,700 additional units will be required. With such strong demand predicted for the next four years, Macau could face an acute shortage of housing units.

The availability of the already-scarce residential dwellings has been further restricted by the government land concession policy. Macau's authorities are reclaiming undeveloped land parcels from developers that have failed to complete their projects onsite by the expiry of their 25-year concession term. Until the disagreements are resolved between the developers and the government over the undeveloped sites, they will be left idle - further curbing supply.

In the residential leasing segment, landlords have been adopting a flexible approach to asking rents. The upcoming openings of new integrated resorts - MGM Cotai in 2H 2017 and the Grand Lisboa Palace in 2018 - will create more employment opportunities and are likely to bring in more non-resident workers, which will in turn generate leasing demand. As a result, rental levels are forecast to trend higher in 2018.

**Potential Impact of New Government Mortgage Loan Policy**

New government measures related to mortgage loan-to-value ratios took effect in May 2017, with the aim of facilitating the development of a stable housing market. The loan-to-value caps for residential and equitable mortgages on both foreign and non-first-time resident buyers have been lowered further, while those for first-time resident buyers have remained unchanged.

According to the Monetary Authority of Macao, the new policy is designed to curb excessive investment, promote stable development in the housing market and aid banks' risk management.

Since the mortgage policy has remained unchanged for first-time local homebuyers, it has had little impact on that segment. However, overall market sentiment is still likely to be curtailed to some extent, with those who already own residential properties taking a cautious approach to acquiring more assets.

**Looking Ahead**

Although uncertainties remain in the external macroeconomic environment - including possible future interest rate rises by the US Federal Reserve, China's attempts to control capital outflows and global political changes - the overall outlook for Macau's economy appears bright.

Key infrastructure projects, coupled with continued support from the China central government and a high degree of participation in the Guangdong-Hong Kong-Macau Greater Bay Area Scheme, will enhance Macau's connectivity with mainland cities and Hong Kong, stimulating economic growth and paving the way for the territory's transformation into an international tourism hub.

Amid this improving economic environment and powered by compelling long-term demographic trends, we believe Macau's property market will continue to make a gradual yet sustained recovery.

QuotedData

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