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Monthly summary | Investment companies

January 2018

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.

Roundup

Donald Trump's tax reforms were well received by US corporates. Markets hit new highs in December with the UK market having a particularly good month. This was helped by strong performance from mining stocks and energy stocks (on the back of a higher oil price) as global growth picks up.

Global

Faster growth in economies and earnings seems to be making commentators more optimistic but are investors complacent about risk?

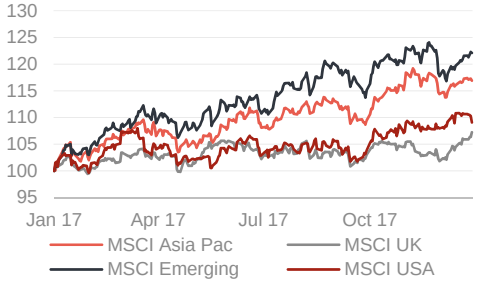
James Will, chairman of Scottish Investment Trust, notes that policy responses to populism have been seen in a positive light by markets. The manager of that fund believes there are now signs of complacency in investors' attitude to risk. Katy Thorneycroft, manager of JPMorgan Elect Managed Growth, says that recession risks are muted, and a combination of global earnings upgrades and loose financial conditions are supportive for stocks. The managers of Seneca Global Income & Growth think inflationary pressures will remain fairly benign, allowing central bank policy to stay essentially accommodative. Peter Ewins, manager of F&C Global Smaller Companies, believes favourable economic conditions should be reflected in company results. Nick Greenwood, manager of Miton Global Opportunities, finds it hard to imagine meaningful interest rate rises but wonders whether investors may be less inclined to lend to highly indebted nations, individuals and corporations.

Exchange Rate	31/12/17	Chg. on month %
GBP / USD	1.3513	-0.1
USD / EUR	0.833	-0.8
USD / JPY	112.69	+0.1
USD / CHF	0.9743	-0.9
USD / CNY	6.5068	-1.5

Source: Bloomberg, Marten & Co

MSCI Indices rebased to 100

Time period 31/12/16 to 31/12/17



Source: Bloomberg, Marten & Co

	31/12/17	Chg. on month %
Oil (Brent)	66.87	+5.2
Gold	1302.8	+2.2
US Tsy 10 yr yield	2.4054	-0.2
UK Gilt 10 yr yield	1.19	-10.5
Bund 10 yr yield	0.423	+15.6

Source: Bloomberg, Marten & Co

United Kingdom

Valuations are high, especially in a narrow range of sectors.

Norman Yarrow, chairman of Dunedin Smaller Companies, cautions that valuations of good quality companies are elevated. The manager of that fund agrees and says that equity valuations are vulnerable if growth slows. Jonathan Cartwright, chairman of BlackRock Income & Growth, points out that two thirds of revenues for companies listed in the UK come from overseas. The managers of that fund see increasing pressure in the UK consumer space. Carolan Dobson, chairman of Schroder UK Growth, notes that the UK market's rise has been concentrated in a relatively small number of sectors.

Inflation is high but its persistency is uncertainty

James Henderson and Laura Foll, managers of Lowland, think UK inflation may stay high for longer than forecast and hence interest rates may rise further than expected. Katy Thorneycroft, speaking in her capacity as manager of JPMorgan Elect Managed cash, disagrees. She notes signs of weakness in the housing market, consumer confidence and retail sales.

The directors and managers of small cap funds promote the virtues of their chosen investment focus,

Steven Bates, chairman of F&C Capital & Income, addresses Brexit and says many of the businesses here will prosper regardless of the Brexit outturn. Thomas Moore, manager of Standard Life Equity Income, says mid-cap and small-cap companies offer superior dividend growth prospects to those of large-cap companies. Ciaran Mallon, manager of Invesco Income Growth, cautions that sterling could strengthen but sees recovery potential in Brexit-hit stocks. Robert Talbut, chairman of Shires Income, thinks markets may be more volatile, juxtapositioning elevated valuations and a number of potential political and geopolitical flashpoints. Andy Pomfret, chairman of Miton UK MicroCap, thinks that the attractions of Micro Caps will become more evident as the UK economy slows, a sentiment echoed by the fund's managers.

Don't worry, be happy

Nick Train, manager of Finsbury Growth & Income, urges investors to look through macro-economic and political issues and trust that things will work out fine in the end.

Asia

Asian markets have had a good run and there is some debate about whether they are now fully valued

The managers of Schroder Asia Pacific suggest that investors keep a close eye on the impact of China's self-induced slowdown. They wonder whether Asian equities are due a pause for breath or a correction. The managers of JPMorgan Asian single out Korea as an attractively valued market. They are concerned about short-term growth rates in India. Ian Hargreaves, manager of Invesco Asia, likes both Korea and India. He points out though that valuation multiples in Asia are above long-term averages. David Shearer, chairman of Aberdeen New Dawn, says that equity valuations appear reasonable given improving growth prospects and favourable external conditions.

Europe

Notes of caution after a strong run in European markets

Rodney Dennis, chairman of Henderson European Focus, reports that Europe's bull market is mature yet points out that periods of exuberance can be both long-lasting and extreme. The managers of JPMorgan European Smaller note that European equity valuations are still at a big discount to US peers but say the market has not had a significant correction for some time.

Debt

While 2018 could see more volatility in bond markets, yields are unlikely to rise sharply

Donald Adamson, chairman of Invesco Perpetual Enhanced Income, says low yields and a shift towards normalising monetary policy provide a challenging backdrop for 2018. The managers of the fund are cautious. They are keeping a close eye on the tapering process at the ECB. Robert Jennings, chairman of Sequoia Economic Infrastructure, notes that the infrastructure finance model in the UK has become more politicised post the Labour Party conference. Angus MacPherson, chairman of Henderson Diversified Income, cites a number of risks that could give rise to higher volatility in 2018. The managers of that fund do not expect to see yields on corporate bonds and loans rising in the short term.

Property

Property markets are healthy in the UK's regions and in Europe

The managers of Drum Income Plus REIT say that, in their market, strengthening occupational demand is supportive of rental growth. Mike Adams, CEO of Octopus Healthcare, managers of MedicX, talks us through developments in the NHS as they affect the company. In Europe, office rents are rising as demand pick up in line with economies. Retail property is being held back by the growth of online spending but this is benefiting the logistics market.

Other

In addition, we have comment on China from JPMorgan Chinese, emerging Europe from Baring Emerging Europe, and India from JPMorgan Indian. We also have in depth looks at the global healthcare market, from Polar Capital Global Healthcare, and the uranium market from Geiger Counter. There is also a discussion of factors affecting environmental markets from Jupiter Green, Infrastructure from GCP Infrastructure and Utilities from Ecofin Global Utilities and Infrastructure.

Contents

Global

(compare Global funds **here**)

James Will, chairman, Scottish Investment Trust: I have previously discussed the anti-establishment mood that seems to have characterised recent voting on both sides of the Atlantic. The most obvious examples are the Brexit vote, the election of Donald Trump and the unexpected result in the UK 'snap' election.

President Clinton's victory in the 1992 US Presidential election has often been attributed to the slogan "It's the economy, stupid" and this catchphrase remains highly relevant today. Large sections of the population, in a number of countries, feel disadvantaged in the current economic environment. Government policies have favoured asset prices with unintended consequences for the cost of living.

Markets do not operate in a vacuum and, to date, have generally interpreted this shift in the political climate as a positive development. This is justified, to some extent, as stimulatory measures to boost the 'real economy' may well improve the prospects of sections of the corporate sector. On the other hand, some of the more radical measures occasionally mooted, no doubt with the best of intentions, have potential to harm sections of the corporate sector and will not necessarily achieve their end purpose.

The US Federal Reserve, which sets the tone for global monetary policy, has continued to increase interest rates from a very low base and has started tentatively to reduce the stockpile of bonds purchased to lower long-term interest rates. Other central banks have taken this cue and have started either to reduce, or at least slow, the rate of increase in stimulatory measures. This is evidenced by the recent interest rate increase by the Bank of England and the planned reduction in European Central Bank bond purchases. Markets have undoubtedly benefited from low long-term interest rates and it remains to be seen how dependent these low rates are on central bank largesse.

As ever, there are a number of events which could potentially destabilise markets if the worst fears come to pass, or potentially boost markets if they are successfully resolved. Of the prominent events, tension in the Korean peninsula remains confined to sabre-rattling while some modest progress seems to have been made in the Brexit negotiations.

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Alasdair McKinnon, manager, Scottish Investment Trust: The late Andy Grove, founder and former CEO of Intel, distilled his thoughts about management into a book called "Only the Paranoid Survive". However, I've always thought this would make a good title for a book about investing.

The reason for this is that a successful investor has to continually question their every assumption because things can, and do, change. The political environment is never static, new competition can emerge, advances in technology can drive structural change, management can remove their focus on the core business and apparently successful business models can mask hidden flaws while apparently unsuccessful business models can evolve positively.

The views of the crowd are a particularly poor predictor of future investment performance because the crowd extrapolates recent history and assumes it is a constant.

We could debate whether particular asset classes are overly elevated but perhaps less in question is that there have been a number of years of good returns and there are now signs of complacency in investors' attitude to risk. To some extent this is understandable as the world is awash with cheap money and the curators of this capital are desperate for a return. Symptoms of this excess are the appearance of get-rich-quick schemes such as cryptocurrency investments and the fact that an acronym (FANG) has been attributed to a narrow group of stocks which are all viewed as sure-fire winners.

This is not to say that the wider market will fall but more to observe that the risks currently being taken in some areas may not be justified by the future returns. The spread of valuations across the market is wide.

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Katy Thorneycroft, manager, JPMorgan Elect Managed Growth: Summer worries over geopolitics and a period of weaker US inflation data are offset by the continued and synchronized pick-up in global growth. Despite the relative maturity of the US business cycle, recession risks remain muted and a combination of global earnings upgrades and loose financial conditions are supportive for stocks.

Equity returns in the late market cycle are typically positive unless financial conditions tighten sharply. The slow pace of rate normalisation and lack of inflationary pressure create a good environment for equity market returns, but we remain watchful for any deterioration in data, in particular employment, business confidence and consumer lending metrics.

For investment trusts, we would note that discounts to net asset value have generally narrowed, and this warrants some caution. However, in a favourable environment for equities these levels of valuation should not be cause for concern.

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Seneca Investment Managers, manager, Seneca Global Income & Growth: We continue to believe that the global economy as a whole is moving from recovery to expansion phase. The US has been leading this advance, as evidenced by its four interest rate hikes, and is now firmly in expansion phase. Others are lagging, and it may be a little while longer before Japan and Europe are able to make the transition.

However, although the economic picture has improved, we think inflation pressures will remain fairly benign, thus allowing central bank policy to stay essentially accommodative. Yield curves remain quite steep and it will take many more interest rate hikes before they become inverted.

Thus, the picture for equities remains generally sound, though in expansion phase one should expect returns to be a little lower than in recovery phase.

Yields are likely to come under pressure both from rising inflation pressures that one should expect during the expansion phase, as well as from the Fed unloading some of its $4 trillion of holdings.

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Peter Ewins, manager, F&C Global Smaller Companies: Calling the outlook for markets as a whole is always challenging, not least at the present time due to a myriad of potential political challenges, whether they be Brexit, the Spanish regional elections in December, the national elections in Italy in 2018, or the progress of tax reform in the US. Risks to financial markets in relation to evolving central bank

policies should not be dismissed. On the other hand, economic conditions remain favourable and should be reflected in company results.

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Nick Greenwood, manager, Miton Global Opportunities: The consolidation of the private client stockbroking community into a small number of major chains continues apace. This has significant implications for the investment trust movement. This is because these brokers were until relatively recently the dominant buyer of trusts. Rathbones and Smith & Williamson came close to merging during the summer. If this transaction had been successful, it would have created an operation managing GBP52 billion worth of assets. The scale of such an organisation would have dictated increased standardisation of client portfolios. Inevitably, this would have reduced the number of investment trusts owned by the organisation as it would be impossible to source sufficient investment trust shares on the open market to allocate across all portfolios. To put this challenge into context, FTSE 250 index constituent Halfords has a market capitalisation of GBP640 million. Assuming that an investor needs to allocate at least 1% of their portfolio in order "to move the needle" then a combination of Rathbones and Smith and Williamson would in practice have to buy virtually every share in Halfords or a similar sized company to make any investment worthwhile. Therefore, the process of consolidation is forcing private client brokers to steadily reduce their exposure to investment trusts.

On a more positive note, there is increased interest from the self-directed investor. Their interest is often triggered by articles in periodicals such as Moneyweek, Investors Chronicle and Shares Magazine that highlight the advantages enjoyed by investment trusts.

Looking forward there is an intense sense of déjà vu. Despite much speculation that interest rates are about to rise, it is difficult to envisage any increase proving meaningful. Nearly a decade of freely available easy to service credit has seen debt levels surge in many corners of the financial system. Economic activity would grind to a halt if interest rates returned to levels even close to those historically considered normal. Therefore, an environment of excessively low interest rates is likely to persist for some time yet. However, a point may be reached where investors decide that they want much higher rates for lending to highly indebted nations, individuals and corporations. Whilst for now there are no warning signs emanating from the fixed interest world, such a development would send markets into a completely different environment.

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United Kingdom

(compare UK funds **here**)

NM Yarrow, chairman, Dunedin Smaller Companies: The outlook for the UK economy is likely to continue to be impacted by the continuing uncertainties around the outcome of the Brexit negotiations. With the recent downgrading of growth forecasts and the expected reduction in inflation as the impact of the depreciation of Sterling works its way through the system, the prospects for further interest rate increases in the near term seem limited. The outlook for the global economy, however, remains reasonably positive and it appears likely that the major central banks will seek to tighten monetary conditions and reduce either the rate or absolute size of their stimulus packages.

With increasing earnings derived from abroad, many smaller companies in the UK are protected from the domestic economic uncertainties. However, following a strong period of performance for equity markets, valuations, particularly those of good quality companies, remain elevated. Although valuations are not stretched by historic standards, this could justify a degree of caution in the event of any form of economic disappointment.

Ed Beal, manager, Dunedin Smaller Companies: Prospects for the UK may be uncertain but the outlook for the global economy remains reasonably positive. Global growth is running in the region of 3.6% and is expected to strengthen marginally in 2018. In the US, the recovery is continuing, leading to an expectation that interest rates will rise again and that the Federal Reserve may begin to reverse some of the stimulus that it has been deploying. Indeed, the underlying data suggests that both the US and Chinese economies are displaying levels of economic activity consistent with a higher level of growth than that indicated by the current readings for Gross Domestic Product.

The US economy is performing strongly, as illustrated by expectations for a number of further interest rate increases in 2018. However, the political turmoil that surrounds the Trump Administration is raising the risk profile and the need to further extend the debt ceiling could prove problematic.

The Eurozone is increasingly healthy with growth running at its highest level since the start of the financial crisis. The European Central Bank has announced that it will begin tapering, by reducing its asset purchases to EUR30 billion per month in January. The region has come through a number of potentially damaging elections with its prospects intact and, as such, political risk has given the appearance of reducing over the course of the year, though at the time of writing, failure of the German coalition talks have raised the possibility that Angela Merkel's position will be further weakened.

In aggregate, emerging markets appear well positioned as they benefit from a synchronised increase in global growth. The Chinese economy has grown strongly during 2017 and, although there may be some efforts to curb credit growth, the recent 19th Party Congress suggested that stability and, hence, economic growth remain the priority.

In the domestic economy, inflation has reached 3% and the Bank of England raised interest rates for the first time in seven years. It was notable that the committee remained focussed on the risks to the economy and indicated that further increases were some way off. It is expected that, as the impact of the depreciation of Sterling works its way through the system, so the currency-induced inflationary pressures will begin to ease. The recent autumn budget brought with it a disappointing reduction in growth expectations with the economy now expected to expand by just 1.4% per annum over the next five years. That said, forecasting is implicitly imprecise and the potential ramifications of Brexit, both positive and negative, will almost certainly mean further revisions are necessary. In the meantime, the Chancellor's statement contained some supportive measures, with housing and infrastructure grabbing the headlines. In the absence of material interest rate increases, which do look unlikely from here, one might expect these measures to be supportive of growth even if the consumer will suffer a decline in real incomes until at least the end of 2018.

It is worth remembering that smaller companies are not just a proxy for the UK economy. In aggregate, this part of the market has become increasingly internationalised over the last decade. Although they may lack the breadth of

overseas exposure that characterises their larger counterparts, smaller companies do benefit from an increasingly globalised earnings stream.

Although the major central banks are at different points in the interest rate cycle they are generally pointing towards a tightening of monetary conditions and a reduction in either the rate of or absolute size of their stimulus packages. All of which suggest that policymakers have a broadly favourable view of the outlook. However, we note that valuations, particularly for good quality companies, remain elevated, and any disappointment in the levels of growth has the potential to result in a de-rating of equity valuations.

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Jonathan Cartwright, chairman, BlackRock Income & Growth: In his Autumn Budget, the Chancellor of the Exchequer announced that UK GDP had remained resilient overall, although UK productivity, consumption and investment growth had fallen. The Office of Budget Responsibility has revised its UK growth forecasts for the coming year down to 1.5%. However, overall growth is expected to remain positive and unemployment in the UK is now at its lowest rate since 1975. The rate of inflation has now reached 3.1%, but is expected to fall towards the Bank of England's 2% target over the medium term.

There remain risks associated with the UK's exit from the European Union ('EU') although, at the time of writing, there are indications that the UK Government may have reached agreement with the EU on the quantum of the Brexit "bill" and is able to move forward to discuss matters of trade. The delay in reaching this position has negatively impacted the UK economy and a resolution should allow both sides to progress on to the important topic of trade negotiations. This development should be positive for the UK economy, although there remains substantial uncertainty on how the Brexit process will play out and its ultimate impact on the UK economy, particularly the UK financial services sector. In this context it is worth remembering that the UK equity market derives well over two thirds of its revenues from currencies other than sterling and for our largest companies the principal driver of future returns will be events in the global rather than domestic economy.

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Adam Avigdori and David Goldman, managers, BlackRock Income & Growth: We see increasing pressure in the UK consumer space as rock bottom household savings are coupled with rising household debt levels. Whilst we remain cautious in this area, we certainly do not treat all companies equally. By focusing on those companies that can generate cashflow from strong business models, have strong balance sheets or scope for management driven self-help, we are able to access some of the major domestic opportunities starting to emerge.

As ever, we remain believers that over the longer-term earnings and cashflow growth tend to be the dominant driver of share prices. Where equity markets fail to recognise that, corporate buyers have the potential to exploit the opportunity. With a combination of continued sterling weakness and a low interest rate environment fuelling cheap debt, we believe that M&A activity will remain a theme for many months to come.

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James Henderson and Laura Foll, managers, Lowland: The tightening of global monetary conditions has begun, led by the US. It is likely that interest rates in the UK will rise in the short term and the very accommodating monetary policy in Europe will slowly be tightened. The question for investors to struggle with is how far and fast

rates will be increased. The UK has above target inflation but the consensus view is that this is very much a product of sterling deprecation and it is certainly less of a problem in strong currency countries. However, the full effect of sterling's fall will take time to be fully reflected. Increased costs of imported items are being partly absorbed by companies and slowly fed through in order not to lose market share. At the same time wages will not grow at a lower rate than inflation indefinitely, despite the low level of unemployment. These factors may result in inflation staying higher for longer than currently forecast and result in interest rates rising further than expected.

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Nick Train, manager, Finsbury Growth & Income: We know that currently some shareholders worry about Brexit and other macro-economic or political issues, but we continue to believe that the most rational way to respond to these concerns is to work on the following assumption. "Everything will work out just fine in the end." This may read as complacency, but the truth is that ever since the FT All Share was first calculated, back in 1962, there has always been something to worry about. The index had a base value of 100 in 1962 and now stands at 4130 - that's a 7% pa compound return, excluding dividends. Those returns, earned from the compounding profits of well-run UK companies, have accrued despite dramatic political, economic and social changes. We think it sensible to assume steady wealth creation will continue.

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John Baker and Sarah Emly, managers, JPMorgan Elect Managed Income: The domestic economic and political outlook for the rest of 2017 and beyond has become more uncertain, due to the unexpected UK Election result and by concerns over the Government's negotiating powers for Brexit. Whilst the domestic economy is showing some signs of faltering, the global economy is accelerating and corporate profits have done well on the back of rising global demand. UK equities continue to offer an attractive dividend yield, with the prospect for dividend growth, whilst providing a hedge against rising UK inflation. We continue to prefer equities to low yielding bonds.

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Katy Thorneycroft, manager, JPMorgan Elect Managed Cash: The first rate rise in a decade was widely expected by markets and the Governor Mark Carney suggested that two more rate rises would be required over the next three years in order to return inflation to target. The immediate impact on the UK economy of the increase in interest rates should be manageable but we note that there are already signs of weakness in the housing market, consumer confidence and retail sales. Concerns that the outcome for the UK economy may be less positive than the BoE's assumption would now justify an expectation of less than two rate rises in the next three years.

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Steven Bates, chairman, F&C Capital & Income: The expansion in the global economy has been underway now for several years, albeit at rather a muted pace. The monetary authorities around the world are gradually attempting to bring some semblance of normality back to interest rates, but caution remains the watchword, as debt levels are elevated and economies are still fragile. This is arguably a slightly less benign environment than that which has reigned in the last couple of years, but it is also not a harbinger of doom and gloom. Most stock market analysts would not be surprised if markets trod water for a while. Valuations (in general) are somewhat elevated and investors seem complacent about risks in both economic and political spheres.

In the UK, things are quite difficult, largely because of the uncertainty surrounding Brexit and the fact that economic activity seems to be suffering as a result. Again, the UK is not an island (metaphorically, anyway) and many of the businesses here will prosper regardless of the Brexit outturn.

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Julian Cane, manager, F&C Capital & Income: After such a long period of strong share price returns, it's especially important to consider the valuation of the stock market. As noted above though, any examination of the metrics of the Index tends to be distorted by the very largest companies as the collective importance of the mid-cap and small-cap indices is outweighed by the mega-caps. The picture for valuation is somewhat mixed at the headline level. The price/earnings ratio shows valuations on this measure to be less expensive than the most recent past, but still a long way above average. By contrast, the yield on the Index is somewhat above its long-term average and this would tend to indicate that stocks were reasonably good value.

Both of these valuation measures are by necessity fairly crude and they are absolute measures. Although we can assess value relative to their own past history, there is no comparison against other possible investments. When the yield on equities is compared to the interest rate on cash or the yield on government bonds, it is clear that equities continue to offer an attractive return.

Over the long-term, it is also worth remembering a bond can never give you a higher return than that forecast at purchase – the investor can only receive back the coupons and face value of the bond, nothing else. This makes any bond investment vulnerable to inflation while equities as a real asset should be able to offer at least a degree of protection, adding a further attraction to their investment case.

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Thomas Moore, manager, Standard Life Equity Income: The UK political environment remains highly uncertain, which has resulted in a divergence in valuation between stocks and sectors, as investors have tended to spurn small and mid-cap stocks in favour of defensive large-cap stocks. Heightened short-term political uncertainty can result in a shift in investor focus away from corporate fundamentals.

We remain cautious on some of the traditional large-cap income sectors, such as Pharmaceuticals and Consumer Staples, where dividend growth is set to be constrained by weak growth and low levels of dividend cover. While we have found some valuation opportunities among large-cap sectors, notably Oil & Gas, we continue to identify superior dividend growth prospects within mid-cap and small-cap stocks.

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Ciaran Mallon, manager, Invesco Income & Growth: The UK stock market has maintained its upward trajectory of the last eight years, notwithstanding a backdrop of rising interest rates and increasing geopolitical tensions. Meanwhile there remain headwinds to withstand, including the as yet unknown impact of Brexit implementation, with economic growth likely to remain subdued. In the US, the "Trump effect", and hopes of enhanced economic growth, has now waned. In China, there is a risk of a slowdown in the capital investment cycle later this year. Additionally, sterling could strengthen further from still depressed levels, creating pressure on forecasts for the overseas revenues that comprise the major part of FTSE 100 company earnings. There is, however, further recovery potential in the Brexit-hit stocks.

Richard Talbut, chairman, Shires Income: Any debate regarding the prospects for the domestic economy is dominated by the Brexit process. Currently there is little clarity regarding the outcome which will materialise, how long it will take to reach or how much it will cost. Such an environment creates material uncertainty for investors. However, companies and fund managers alike need to work with the information that they have.

In the meantime, the domestic economic fundamentals show rising inflation, with the CPI reading reaching 3% in September. The upward pressure arose principally from food and transport costs which have been pushed higher by the weakness in Sterling. At the time of the increase in interest rates following the period-end, the Governor of the Bank of England, Mark Carney, also expressed a view that no further increases are expected in the near term.

Although the major central banks are at different points in the interest rate cycle, they are generally pointing towards a tightening of monetary conditions and a reduction in either the rate of or absolute size of their stimulus packages. This all suggests that policy makers have a broadly favourable view of the outlook for their economies. Indeed, when one considers the outlook for the global economy the prognosis is quite positive. Although there is the potential for additional political disruption, investors have so far looked through this and focussed on the fundamentals.

The US economy is continuing to grow strongly and, whilst this will inevitably slow at some point, Europe is recovering well and growth is picking up across the region. Elsewhere, the increasingly significant Chinese and Indian economies also appear on good growth trajectories. In the former, the recent Communist Party Congress seemed to re-emphasise the importance of further developing domestic demand while the reform agenda in the latter still appears intact.

Valuations, and in particular those of good quality companies, remain elevated, and any disappointment in the levels of growth achieved has the potential to result in a de-rating of equities. For the time being, and despite the fact that we are entering a rising interest rate cycle, markets are in an optimistic frame of mind. However, the number of potential political and geopolitical flashpoints that could materialise, together with the uncertainty generated by the likely scaling back of central bank support to global financial markets, should make investors vigilant to the possibility of more volatile market returns than have been enjoyed over the last few years.

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Andy Promfret, chairman, Miton UK MicroCap: Both larger and smaller companies find it easier to generate growth when the wider economy is expanding as well. However, one of the overlooked features of microcap stocks is their greater ability to buck the wider economic trend when growth is more subdued.

The key point is that, during the period of globalisation when growth was plentiful, some microcap advantages were not appreciated. Now that the UK economy is slowing, however, these factors are becoming more important again. Certainly, it is interesting to note that since [*May 2015*], the best returns in the UK equity market have come from the smaller company indices in spite of a significant devaluation of sterling during this period.

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Gervais Williams and Martin Turner, managers, Miton UK MicroCap: There are headwinds ahead as the UK concludes negotiations on our exit from the EU. Concurrently, UK consumer expenditure may be subdued for some time. Both of these factors may affect the prospects of both larger and microcap stocks.

It is natural to assume at times like this that the largest multinational stocks may enjoy the best of the opportunities, but when growth is scarce, corporate agility and nimbleness becomes particularly important. That is why microcaps sometimes buck the wider economic trend and why microcap stocks have often generated the greatest outperformance at times of economic challenge.

Although the UK economy may not grow as well as others for a period, this need not imply that a UK microcap strategy has lost its relevance. If anything, with world productivity stagnating over the last 10 years, we believe it has become even more important to back individual companies with attractive capex opportunities.

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Carolan Dobson, chairman, Schroder UK Growth: There have been times in the last 18 months when it has felt that little can keep the UK stock market down. There may be uncertainty about the UK's future out of the EU; the Conservative government may be less secure; and interest rates may be rising for the first time this cycle, but the market is still a sixth higher than in the middle of last year.

One cause has been the bounce in corporate profitability after sterling's fall and the increase in commodity prices, but one wonders how much longer both will continue to drive the market. The rise has been concentrated in a relatively small number of sectors.

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Schroder Investment Management, manager, Schroder UK Growth: At present we are seeing attractive valuation opportunities in some of the more domestic cyclical areas of the market, where companies' earnings move in line with the UK's economic cycle. Whilst uncertainty around the UK's exit from the European Union is set to continue with upcoming trade negotiations, we believe this risk has been more than discounted in current valuations.

The outlook for the global economy appears buoyant, but we remain mindful that valuations for the market remain high in aggregate whilst market volatility remains low despite heightened uncertainty following the general election and as the Brexit negotiations start.

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Asia

(compare Asian funds **here**)

Schroder Investment Management, manager, Schroder Asia Pacific: Over the last 12 months, investors have taken a relatively sanguine view of global equity markets. The stance has been rewarded and Asian equities have more than participated in this strength. The scale and extent of returns naturally raises the question of whether enough is enough, and at least a pause for breath, or a correction, is imminent.

Perhaps the first point to make is that many fundamental supports to markets remain in force. Purchasing managers' data ('PMIs') paints a picture of an impressively co-ordinated upturn in global growth, with 80% of countries solidly in expansion territory. Equity valuations relative to bonds remain in extremely attractive territory, and there have been few of the usual signals that surround a market peak such as narrowing

market breadth, widening credit spreads or excess investment by corporates. This suggests that the outlook for the region's exporters remains relatively sound, although the pace of expansion is likely to moderate over coming quarters as comparisons get more demanding.

As regards the external environment for Asia, the extent of any tapering following on from recent US Federal Reserve and European Central Bank announcements must be taken seriously. However, the $300bn projected withdrawal by the Federal Reserve over the next twelve months must be seen against a total central bank balance sheet expansion globally of $11trn since 2009, and in aggregate central bank balance sheets are likely to still grow until the fourth quarter of next year. The key will remain inflation expectations, and the risks here surround tightening labour markets (including a surge in European companies reporting labour shortages) and the impact of supply curtailments in China.

As regards domestic conditions in Asia, the impact of the self-induced (and hopefully controlled) slowdown in Chinese growth will need to be closely monitored. Our calculation is that this can be smoothly managed, aided by the broadly helpful global environment in terms of liquidity (helped by a gently weaker US dollar) and robust trade flows. The October political transition in China has seen a smooth entrenchment of President Xi, but accompanied by the departure of a number of more pro-reform cadres. In all probability, the prospect of real reform has receded, with the exception of supply curtailments in a number of basic industries driven by the pressing need to tackle pollution. Credit growth will remain a key lever of State economic control. Although there must be an eventual end to the process, we believe it is too early to incorporate the serious long-term consequences of the debt build up given that China continues to enjoy a strong external balance and growth is gradually shifting towards services and the consumer.

We also take heart from the fact that the corporate sector around the region is generally in robust health. Outside sectors and companies whose investment patterns are determined by state and government led priorities, capital spending discipline remains impressive, resulting in a strong expansion in underlying cash flows and stronger balance sheets. Valuations remain somewhat below historic averages, suggesting that, barring a reversal in global growth, regional markets can make further progress in the year ahead.

We remain cautiously optimistic, we are also mindful of history.

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Richard Titherington and Ayaz Ebrahim, managers, JPMorgan Asian: Asian equities have performed well since the beginning of 2017, supported by both a benign macro-economic environment and strong growth in corporate earnings. The global growth and reflation picture continues to improve, while the weaker US dollar has been beneficial for the Asian region. In addition to these positive external factors, a pick-up in intra-regional trade and better domestic consumption are driving GDP growth, translating into rising corporate earnings. Following this strong period of performance, Asian equities are no longer trading below average valuations, with trailing price to book close to its 10-year average.

From the country perspective, Korea continues to appeal, as valuations remain attractive whilst earnings momentum is strong, particularly in sectors such as financials and technology. [*In*] China there are concerns over high levels of debt and its government's ability to successfully implement lasting structural reforms; at the same time, growth rates are trending lower, though economic data has been generally strong, as are earnings trends.

In India the number of short-term risks to growth increase. At the same time valuations levels have become extended while the underlying earnings trend remains lacklustre. Looking further ahead we retain a positive view on the longer-term outlook, as a number of reform measures such as the implementation of the Goods and Services Tax are on track but do not believe this will be reflected in returns for some time.

Technology remains a key sector, especially in areas such as e-commerce/ internet, semiconductor and in hardware components such as sensors and camera lenses. The turnaround in domestic consumption should also benefit discretionary spending, fuelling Asian brands' ambition to take on multinationals in their own categories. Insurance continues to be an interesting area given the wide protection gap in countries such as China and India, while the current level of commodity prices may indicate company specific opportunities in selected names in materials and energy sectors.

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Ian Hargreaves, manager, Invesco Asia: Asian markets have recovered strongly from the lows in February 2016, rising by close to 70% in sterling terms. There are several reasons to expect returns to be more modest in future. Firstly, valuations are now less attractive than before. The MSCI AC Asia ex Japan Index is now trading at 13.2x 2018 expected earnings and 1.8x trailing book value. While reasonable against other global equity markets, these valuation multiples are above their long-term averages.

Secondly, as a result of higher valuations, further sustainable market performance is likely to become more reliant on a continuation of positive earnings momentum. However, two important drivers of the improved macro environment for earnings, Asian export growth and Chinese economic growth, have now peaked. In a number of Asian countries, export growth has accelerated to over 20% year on year. This is unsustainable in the current global demand environment. There is also clear evidence that Chinese economic momentum is now slowing as a result of policy tightening and slower credit growth. While consumption has been quite resilient so far, property sales, infrastructure investment and exports are all now slowing. So, while there are always exceptions to be found, it is unlikely that Asia can experience a broad-based acceleration of earnings against this backdrop.

Thirdly, Asian market performance has been quite narrow in 2017 with returns coming disproportionately from the technology sector, both internet and technology hardware. This is similar to trends seen in other global equity markets. The technology sector has also dominated Asia's earnings revisions so the good performance has been based on sound fundamentals. However, we feel less optimistic about future returns given the record valuations seen in some internet stocks and the risk that we are nearing the cyclical earnings peak in some areas of technology hardware.

India is differentiated by the fact that it is at the bottom of its business and credit cycles. Meanwhile, under Prime Minister Modi, India has begun to deliver on its economic reform agenda. The implementation of the Goods & Services Tax, the approval of the new Bankruptcy Code and the recapitalisation of the state-owned banks are forming a solid foundation for future economic growth. It is notable that after a long period of disappointing economic and earning trends, there are recent signs that the economy has started to accelerate.

Another source for attractive investment ideas is South Korea which is amongst the cheapest markets in Asia. This discount partly results from the high representation of cyclical stocks in the market and the uncertainty caused by aggressive behaviour of

the North Korean regime. However, South Korea's history of poor corporate governance has also been a significant factor in the discount. This is best demonstrated by the low average dividend pay-out ratio which is about 20% lower than the average for Asia ex Japan. However, we believe that this is beginning to change for the better with positive implications for valuations. Firstly, Samsung Electronics has moved to a capital return policy which outlines that at least 50% of free cash flow will be returned to shareholders in the form of dividends and share buybacks. As South Korea's most successful company, Samsung's more shareholder-friendly actions are likely to be copied by other business groups. Secondly, the Korea National Pension Service, a large shareholder in many South Korean companies, has become more forceful in demanding better shareholder returns. We see value in a number of sectors in South Korea such as banks, insurance, autos and utilities.

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David Shearer, chairman, Aberdeen New Dawn: Companies in the Asia Pacific region should continue to benefit from improving growth prospects and favourable external conditions. Corporate earnings have been robust amid a synchronised worldwide recovery underpinned by largely encouraging macro-economic indicators, including benign inflation, healthy trade flows and strengthening foreign exchange reserves. Global monetary policies remain supportive, as major central banks adjust monetary policy slowly to avoid shocks to the system and a sharp contraction in liquidity. In addition, equity valuations appear reasonable.

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Europe

(compare European funds **here**)

Rodney Dennis, chairman, Henderson European Focus: The period under review and extending back into 2016 has been dominated on the macro level by political concerns. There have been referenda and elections; most notably this year in the Netherlands, France and latterly Germany where the concerns of a comprehensive political upset have impacted the markets and, at the time of writing, remain unresolved. Notwithstanding that, it is clear that there are powerful discontents not far below the surface that will continue to have an influence on politics and policy making in Europe. In the last part of the financial year under review, there has been renewed unrest provoked by the Catalan "referendum", reminding everyone that the direction for Europe is far from settled. Although these events dominate the news and are clearly very important for the future of the Continent, accurately predicting every twist and turn and its impact on financial markets is, in our view, very unlikely.

There has been a very strong performance from all financial assets whether bond or equities, both in developed and emerging markets. Furthermore, this exceptional asset price performance has extended out to encompass real assets from real estate to the more exotic assets like fine art, fine wines and even vintage cars. There are a range of theories as to why this has occurred, but prime amongst those reasons must be the unprecedented central bank monetisation of debt.

European equities have been full beneficiaries of these favourable developments. It is your Fund Manager's opinion that this bull market is in a mature phase and that, as with all asset classes, eventually there will be a reversion to the mean. Exactly when that happens is not possible to forecast and it is worth remembering that periods of

exuberance can be long-lasting and potentially extreme in nature. Vigilance for any indicators of impending reversion will be essential.

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Francesco Conte and Edward Greaves, managers, JPMorgan European Smaller Companies: The supportive economic backdrop was illustrated by the fact that, unlike previous years, 2017 forecast profits have actually risen throughout the year. The valuation of European equities remains approximately in line with its long-term average and at a significant discount to the US, with meaningful growth potential. Central bank policies are supportive; while the Fed is set to begin reducing its balance sheet, the ECB continues its quantitative easing policy with Mario Draghi reiterating the ECB's commitment to keeping rates low until their bond buying is done. While political risks have increased in Spain and Germany, they nevertheless appear to be contained and do not pose systemic risks as in neither case is the sentiment anti-EU. In Spain, the national government has taken control of Catalonia and has called for new elections in the region. In Germany, while Chancellor Merkel has yet to form a government, the most likely outcomes are either a grand coalition with the socialists or renewed elections which would likely result in another pro-EU centrist government.

We believe that concerns around the impact of the strengthening euro on European manufacturing are overblown. With production spread throughout the world, revenues and costs for many European companies are generally well matched, reducing any foreign exchange impact on profits. As a result, the historic relationship between the euro and the performance of European manufacturers has been poor.

This positive outlook is attracting asset flows into European equities. We are cognisant of the fact that the market has not had a significant correction for some time.

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China

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

William Knight, chairman, JPMorgan Chinese: The 19th National Party Congress confirmed the policy road map for the next ten years with an emphasis on supporting a balanced growth of the economy and financial stability with importance given to environmental issues and consumption. The much-publicised Belt Road initiative which emphasises the 'China Dream' of becoming an outward looking predominant global trading nation, is taking shape. A cautionary note for investors is whether there will be sufficient checks and balances in the system to provide sufficient warnings of road bumps ahead before they are actually reached. However, other than that, the outlook is positive with strong external growth supporting the macro-economy and a greater understanding of the needs of investors

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Howard Wang, Rebecca Jiang and Shumin Huang, managers, JPMorgan Chinese: Economic rebalancing is progressing well and deflationary pressures have subsided through supply side reforms and foreign exchange liberalisation. Although the stimulus is being withdrawn, economic growth is being driven by the consumer and exports. The deleveraging has been aimed at non-bank lending, as interbank rates have been allowed to rise, while the prime lending rates that fund the real

economy have remained stable. This has driven lending back to the mainstream large cap banks like ICBC. As a result, the rate of lending growth and rate of debt accumulation have started to slow. This time, the PBOC has ensured sufficient liquidity in the system to offset capital outflows. Although policy risk remains in China it appears that the authorities have executed this last round of tightening quite successfully. Despite debt levels remaining high, the slower pace of the build-up and the shift in sources of the lending are incremental positives.

Further on the policy front, the 19th National Party Congress took place in late October highlighting China's economic priorities and laying out the policy roadmap for the next couple of decades. While there are no major surprises, there was an emphasis of quality over quantity in terms of growth objectives, which supports not only financial stability but also a more balanced growth path focusing on environmental issues and consumption, which are key positives for investors.

MSCI's decision, in June, to include some A-share representation in their China index (5% from June 2018) has been well received. Although the near-term impact on the A--share market is expected to be limited, the long-term positive implication for the development of the onshore markets is extremely positive. The decision acknowledges the significant effort China has made to liberalise their capital markets and improve accessibility to foreign investors. It is hoped that this will provide a much-needed catalyst for the lagging China A-share market. The higher foreign participation should help rebalance the investment styles and horizon of the market which is currently dominated by retail investors. In addition, foreign investors are likely to focus on the quality companies in sectors enjoying structural growth which have been favoured by this portfolio.

The outlook continues to be positive for Chinese equities given the supportive outlook for corporate earnings, the accommodative liquidity conditions and strong external global growth supporting the macro-economy.

Emerging Europe

(compare Emerging European funds **here**)

Steven Bates, chairman, Baring Emerging Europe: Globally it has been a roller-coaster of a year from a political point of view, and it is hard to see the soap operatic nature of public life fading into the background. Global economies are now growing in a co-ordinated fashion and the likelihood is that in the US and UK, some form of quantitative tightening will get under way in the year ahead. As mentioned earlier, markets have benefitted from the fuel of easy liquidity and may hiccup when confronted with the reality of rising interest rates. Nevertheless, the tightening measures are likely to be quite anaemic compared with previous cycles, because growth is not that robust, there is very little inflation and the underlying global economy remains fragile. All of this suggests that Emerging European markets will have a reasonably supportive background and should be able to generate attractive growth by developed market standards, yet this remains visible through a prism in which valuations are low by global standards.

Baring Fund Managers, manager, Baring Emerging Europe: Emerging European equity markets have performed strongly over the last two years and we believe there are three key factors that could sustain this in the future.

Currently, the main Emerging European markets find themselves at different stages of the economic cycle. Aided by global, but also regional developments, the current economic expansion shows little signs of abating. The substantial earnings upgrades exhibited across many markets are indicative of the pronounced effects the economic expansion has had on corporate profitability. Importantly, the share of corporate profits in the overall economy of Central European countries remains low following years of contraction.

Emerging European companies and economies are in good shape and it is our belief that they are less susceptible to global shocks than in previous cycles. The majority of Emerging European listed companies have used the recent years to improve financial health, overseen by management teams not afraid of taking tough decisions. Increasing cash flow generation and levels of equity are indicative of this development.

We take note of the growing understanding of the benefits of Environmental, Social and Corporate governance (ESG) policies, most tangibly seen in increasing dividend payments. Support for clearly defined ESG policies by Emerging European stock market listed companies, encourages us to believe that increased transparency and managerial responsibility stand to benefit shareholders going forward.

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India

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

Richard Burns, chairman, JPMorgan Indian: In contrast to this time last year, when demonetisation had just happened and its impact on the economy was impossible to gauge, the outlook for the Indian economy seems more assured this year. The long awaited national Goods and Services Tax, which is expected to make the economy work much more efficiently, was introduced at the beginning of July and in October a major recapitalisation of the state banks was announced, which should mean greater availability of credit to businesses and consumers. These developments are both welcome and necessary and they confirm that, despite delays and setbacks, India is continuing to make progress in fundamental structural reform to its economy. With the global economy benefiting from improving conditions in North America and Europe, there is every hope that India's growth rate will be more rapid in 2018 than it has been in 2017.

Whether this will translate into further increases in Indian share prices is less certain, given the high valuations commented on in the Investment Managers' Report. However, I firmly believe that India, with its great human potential and huge scope for improving economic efficiency, is a market which has great appeal for a long-term equity investor.

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Rukhshad Shroff and Rajendra Nair, managers, JPMorgan Indian: After the strong performance of the market over the past three years valuations may pose a headwind for equities, given that relatively slow earnings growth is expected, especially in mid and small caps, and where valuations are near ten-year highs. This is particularly relevant in the context of the disruption following the launch of the GST in July, as the economy adapts to the most significant change in the economic landscape in several decades.

Nonetheless, GST is likely to be a significant positive in the long term as the sustainable growth rate of the economy is likely to rise, with the formal economy gaining share from the informal economy, which will struggle to operate in the new tax regime. A combination of the forced clean up of non-performing loans through the bankruptcy code and the bank recapitalisation plan is likely to be a key step in the process of starting a new investment cycle in the long term. This should lead to a revival in earnings growth, which remains cyclically depressed. Earnings have been flat over the past three years, since Mr. Modi came to power, though they have compounded at 11% over the past twenty-five years (with very strong 20%+ periods of strong cyclical performance). Therefore, any recovery in the cycle is likely to be the key catalyst for equity returns over the next three to five years.

India is going through a 'reset': many long-held traditions and practices are being reformed and new laws and procedures are being implemented. Many of these changes are difficult and indeed initially quite painful. That this is happening when the economy is cyclically weak, only magnifies the impact. Much needs to be done yet and as is often the case with many countries, the journey will not always be smooth. It is [*our*] belief that the broad direction is right. As the economy recovers to a higher than current level of sustainable growth rate and the country's ability to attract capital continues to improve, the top down view remains encouraging. When combined with vibrant entrepreneurship, our ability to find well managed businesses, with sustained growth prospects, remains intact. Overall, notwithstanding the many inevitable challenges, we remain upbeat about the outlook for Indian equities.

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Biotech and healthcare

(compare biotech and healthcare funds **here**)

James Robinson, chairman, Polar Capital Global Healthcare: The key drivers for our sector of demographics, innovation and the need for greater efficiency remain intact. Our Managers see many investment opportunities arising from ongoing structural change and have significant overweight positions in both US health insurers and medical technology.

Meanwhile valuations of the healthcare sector remain reasonable both in absolute terms and relative to stock markets as a whole, indicating that its superior mid to long term earnings growth prospects have yet to be discounted.

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Daniel Mahony, Gareth Powell and James Douglas, managers, Polar Capital Global Healthcare:

Structural Change as the Next Major Investment Trend in Healthcare

We believe that the healthcare industry has embarked on a period of major structural change driven by the need to improve the efficiency of healthcare systems. We see similar issues in different countries around the world, and in many ways the biggest perceived risks for healthcare - that current government spending is unsustainable and healthcare systems are at breaking point - could be the biggest catalysts for change. Healthcare systems around the world need to deliver better healthcare to more people for less money.

Major structural change in healthcare systems has two important implications for investors. The first is that large, incumbent companies in the industry may face significant headwinds, competitive pressures or permanent changes in their core businesses that they may find difficult to address or circumvent. Clearly, we need to avoid investing in such companies. Importantly, with information technology as the major force of disruption, change may come from unexpected places in unanticipated ways.

The second is that companies who are able to adapt and exploit the opportunities of structural change may enjoy multi-year revenue and earnings growth - an opportunity for both large and small companies. It is always easy to spot the winners with hindsight; the challenge is to identify who will be successful during a period of major change.

Ageing Population Puts a Strain on Healthcare Systems

A key concern for governments and health insurers around the world is how to manage the impact of an ageing population. There are two aspects of this with respect to healthcare spending - one is driven by demographics and the other stems from the use of new technology.

Healthcare costs per capita stratified by age suggest that the annualised cost for a 60-year-old is at least double that for a 40-year-old. Moreover, these per capita costs continue to grow as individuals advance into their 80s. Therefore, as the population in a country ages - especially the post-war baby boomer population that started retiring in the US in 2011 - the cost of healthcare will increase.

Technological innovation also plays a role as it can be argued that people aged 65 today are far healthier and more active than their parents' generation at the same age. New technology has played a critical part in healthy living but it comes with a cost. For example, products such as hip and knee implants and the use of stents for cardiovascular disease were not as widespread 30 years ago but are now standard procedures in all developed markets.

Information Technology is the Disruptive Catalyst

The information technology sector has been responsible for major disruption of a number of industries over the last decade but the impact on healthcare has, until recently, been modest by comparison. Advances in information technology, especially data analytics, are beginning to help governments and health insurers predict the healthcare needs of a population and to measure the value of a product or a service.

Most reimbursement systems have historically been based on a fee-for-service type of system with little regard for the quality of care that has been provided. This is already beginning to change as governments and insurers start to use data to measure value and clinical outcomes. For example, the US Centers for Medicare & Medicaid Services (CMS) has been set a target of converting 90% of fee-for-service payments to value-based purchasing by 2018.

Governments and Insurers are Driving Change in Healthcare Delivery and Management

While stock markets have remained focused on the political moves in the US to repeal and replace Obamacare, we think there is a broader trend emerging. Governments around the world realise that they need to take advantage of new technology to deliver better care to patients. The challenge is how to facilitate this given the constraints on government spending. Healthcare looks set to remain high on the political agenda and governments will continue to look to the healthcare

industry for new technologies and modes of delivery that can improve the efficiency of healthcare systems.

Innovative Technology is Improving Clinical Success Rates

Over the last five years, it has become clear that the drug industry has embarked on a new wave of drug development. A number of new technologies, not least in the field of genomics, have enabled an advance in the understanding of the biology of diseases at the molecular level and so have helped to elucidate new ways of intervening with therapeutic agents.

More recently, we have seen emerging evidence that clinical success rates are beginning to increase - at least in Phase III clinical trials. A recent report by New Street Research suggests that over the last three years the success rate in Phase III trials has increased to 80% - historically, the industry average has been around 60%. This improvement is probably due to a number of underlying factors, driven by innovative technologies, which include a better understanding of the underlying disease, improved patient selection or advances in early drug development (to weed out compounds with unwanted side effects).

Moreover, recent comments by Scott Gottlieb, Commissioner of the Food and Drug Administration (FDA), suggest that he is looking to implement regulatory reforms that will reduce the costs of clinical development and accelerate the FDA approval pathway. The FDA is planning to invest in new technology that can assist in a faster and cheaper approach to drug development.

One important ramification is that investors are becoming much more confident of the potential of a drug candidate as soon as it delivers positive data from a Phase II trial. In general, we are seeing heightened expectations, and so valuations, much earlier in the drug development process than was historically the case. This is particularly evident for some of the smaller biotechnology companies where a single drug candidate is often the major driver of valuation.

While the increase in clinical success rates has increased investor confidence, and so had an impact on valuations and share prices, we believe that it will also precipitate an intensification in the competitive environment that may become more visible over the next year.

The accelerating pace of innovation means that the 'first mover' advantage is probably diminishing. For example, over the next two years we expect at least four companies to launch new migraine treatments that target the same mechanism - a new class of drugs called calcitonin gene-related peptide (CGRP) inhibitors. While high expectations of approval seem reasonable, we think investors may be over-estimating how much market share each company will take and the competitive pricing situation that may arise if a number of similar drugs are launched at the same time.

The improvement in clinical success rates is a double-edged sword. With many pharmaceutical companies chasing similar targets or diseases, the race is not necessarily to be the first to market but to show that a particular drug is differentiated from any potential competitors.

Grasping the Nettle of Value-Based Pricing

In prior reports, we have highlighted the move to value-based pricing, which has continued over the last year. The issue of product differentiation is critical when it

comes to demonstrating value - not just for drug companies but for all healthcare product companies and service providers. Nevertheless, with drug pricing in the political spotlight, there has been a lot of investor focus on whether drug companies will adopt new pricing models that reward positive clinical outcomes.

Perhaps the most notable example of this has been Novartis' pricing decision on its breakthrough CAR-T therapy, Kymriah. The CAR-T technology is a novel approach where a cancer patient's T cells are isolated; genetically modified in the lab so that they can recognise the patient's tumour; and are then injected back into the patient so they can target and kill the tumour cells.

Kymriah was approved for the treatment of patients up to 25 years of age with a type of acute lymphoblastic leukaemia (ALL). In clinical trials, 83% of ALL patients treated with Kymriah went into complete remission. Novartis has priced Kymriah at $475,000 for a course of treatment but will receive payment only for those patients who respond to therapy by the end of the first month of treatment. Novartis is effectively offering a 'money back guarantee' based on a specific clinical outcome. It will be interesting to see if other companies adopt similar pricing strategies with novel therapeutic modalities such as gene therapy.

The transition to value-based pricing needs to be considered alongside the improvement in clinical success rates and the accelerating pace of innovation. It is not sufficient to show 'efficacy' in a clinical trial with little regard to reimbursement and potential pricing pressure. Drug developers need to start addressing reimbursement issues during the early stages of the clinical development process. In particular, this includes how the 'effectiveness' of a novel drug will be evaluated in a real-world setting - in terms of how this will be measured, how a drug compares to potential competitive therapies and whether a company is prepared to offer a rebate to payers based on clinical outcomes.

For investors, especially in the biotechnology sector, we think it is important to consider the commercial risks of a new drug - especially if the perceived clinical risk has diminished. We think pricing, value and competition are important factors to consider when evaluating the risk/reward of the shares in a pharmaceutical or biotechnology company.

Consolidation in Medical Technology Industry has continued

Medical technology companies have not faced the same political scrutiny on pricing as the drug industry. However, unlike drugs, which are in general separately reimbursed in most countries, medical devices and equipment are purchased directly by healthcare service providers. Therefore, product differentiation has been critical for success in the medical device industry for many years. Nevertheless, with many healthcare providers facing value-based pricing for their services, the medical device industry is having to focus on how it adds value to its customers.

One trend that we have described previously is consolidation as a route to improving efficiency. In this way, companies can create economies of scale, broaden product portfolios, standardise products and processes, lower cost of goods, take market share and, most importantly, deliver cheaper solutions to their customers.

This consolidation trend has continued in the medical devices industry over the last year with the announcement of two large M&A transactions: Abbott's acquisition of St Jude Medical, which broadened its cardiology franchise to include pacemakers and implantable cardioverter defibrillators (ICDs), and Becton Dickinson's announcement to acquire CR Bard, which broadens significantly its product portfolio of hospital-based medical products.

Digital Health Market is Beginning to Evolve

Within medical technology and healthcare services, we see increasing interest and investment in the use of digital health - a broad term that describes a range of services and products arising from the convergence of information technology with healthcare. In particular, we are seeing more companies looking to use technology and data to monitor patients, manage chronic conditions and help medical professionals make better decisions. Ultimately, it is hoped that the use of data will improve clinical outcomes and so add 'value' to healthcare providers and improve the efficiency of the healthcare system.

While digital health is a new market opportunity, we think it is beginning to evolve with different types of applications and products for medical professionals and the consumer health space.

Perhaps the most dynamic area in this respect has been diabetes and blood sugar monitoring. The clear leader in this field for the last few years has been Dexcom, which pioneered the development and commercialisation of a continuous glucose monitoring (CGM) system that is used mainly by type 1 diabetic patients.

Abbott has now entered the CGM market with a new patch product, called Libre, which is arguably an inferior product from a technology perspective. However, Abbott intends to price the product at a significant discount to Dexcom when it launches in the US so that it can target the much larger type 2 diabetic population. Moreover, the product has already had considerable commercial success in Europe where many patients have been paying for Libre out-of-pocket.

In our view, Abbott is targeting what was a medical professional market and turning it into more of a consumer health market. This could prove to be the preferred business model for a number of digital health applications.

Robots and Artificial Intelligence Augmenting Not Replacing Doctors

The use of robots and artificial intelligence within healthcare has captured a lot of media attention. Within the surgical field, Intuitive Surgical has been the clear market leader for the last decade with its da Vinci system. It is also worth noting that Stryker has made excellent progress over the last year with its MAKO system for partial knee replacement and is clearly taking market share from some of the other players in the orthopaedic market.

The increased use of robotic surgery has helped to assuage physician concerns that robots or new technology will simply replace medical professionals. These technologies assist and augment the capabilities of a medical professional so that clinical outcomes for a patient can be more successful and reproducible.

In this respect, we are becoming optimistic about the use of artificial intelligence (AI) in medicine. From a market adoption perspective, we do not think that successful AI products will replace medical professionals. We are looking for companies that have developed products and technology that will adapt to existing workflows, assist medical professionals, increase efficiency and improve outcomes.

Medical imaging is an area where AI could have an important near-term impact. For example, we have seen product developments in the area of foetal ultrasound imaging as well as early cancer detection in colonoscopy - a medical professional still conducts the scan and is responsible for reporting the results but a machine assists in interpretation of the images.

In addition, we are seeing applications of AI in telehealth as well as in new approaches to improving patient compliance and management of chronic conditions.

Technology is Changing the Competitive Landscape for Insurers

Last year, further consolidation of the US health insurance industry seemed to be on the cards. Building scale allows health insurers to spread risk across a larger group of members and then negotiate with healthcare service providers to get lower costs in return for volume. However, at the beginning of 2017, the Federal Trade Commission (FTC) blocked two large proposed mergers - Humana/Aetna and Anthem/Cigna - on competitive grounds.

With major consolidation now less likely, the focus for the large health insurance companies seems to be changing. Most of the major companies are looking at ways that they can use data to drive down costs. For a couple of years, some of the larger companies have been analysing claims data to identify which hospitals may be outliers in terms of medical costs. This has now been extended to determine whether providers are delivering the appropriate standard of care and which service providers are producing the best clinical outcomes.

In addition, we are seeing the development of products and services to try and change the behaviour of members. This started a few years ago with the introduction of high deductible insurance plans, where patients are responsible for a larger proportion of initial medical costs. The use of high deductibles looks set to continue as it is clearly changing consumer behaviour. We estimate that more than a third of commercially insured members will have a high deductible plan next year.

Insurers are also beginning to use new financial incentives to drive member behaviour. This started with simple concepts such as offering discounts on insurance premiums to members who use a wearable device or regularly visit the gym. We are now seeing digital technologies emerging that are intended to drive patient compliance with therapy and help manage chronic diseases more efficiently. We think this is consistent with the trend of consumers taking more responsibility for their own health. Insurers are looking to align incentives by developing products that can help customers reduce medical costs and save money for themselves and the insurer.

New Entrants Threaten Disruption in the Supply Chain

One aspect of the drug pricing debate that has received a lot of attention is who benefits from drug rebates. In a meeting with President Trump last January, leaders of the pharmaceutical industry highlighted the discrepancy between the list price of certain drugs and the actual net price that a drug company receives. The pharmacy benefit managers (PBMs), which develop formularies and negotiate drug pricing with pharmaceutical companies on behalf of insurance companies, make a margin on any rebate or discount on the list price that they can negotiate with the drug company.

We had initially considered this to be just a political risk for PBMs and were concerned that legislation could be framed that would create greater transparency on who benefits in the supply chain. However, a potential new entrant is now looming on the horizon in the shape of Amazon. While Amazon has yet to detail its plans to enter the healthcare market there are significant investor concerns that Amazon will disrupt both the distributor, pharmacy and PBM business models by creating greater transparency and taking market share.

In many ways, Amazon looming on the horizon validates our view that the healthcare industry has begun a process of major structural change. As with many other industries that have been disrupted by technology, the incumbents in healthcare may

face competitive challenges not only from small start-ups but also from non-traditional, new entrants to the market.

Outlook

The process of structural change will create opportunities and risks for investors in healthcare.

The intention to 'repeal and replace' Obamacare has been high on the political agenda in the US since President Trump's inauguration but we think the political focus will change in the run up to the mid-term elections in 2018. The Republicans seem keen to pass legislation on tax reform before the elections and this is likely to be the political focus.

For healthcare companies, tax reform looks likely to be a big positive for domestic companies, such as hospitals or health insurers, who would benefit from a big cut in corporation tax. For companies with overseas operations, especially those that have placed intellectual property in lower tax jurisdictions, the situation may be more complicated depending on how the rules for taxing overseas profits and repatriation of foreign earnings are framed.

Within the medical technology sector, a number of large companies are beginning to deliver on the innovation front with new product cycles that should drive good top- and bottom-line growth.

Across the broader healthcare services sub-sector, certain companies, such as drug distributors and PBMs, are facing some significant headwinds. However, we can find healthcare service companies that face no major headwinds with respect to reimbursement and, more importantly, look set to deliver growth in a value-based environment.

Within the pharmaceutical space, we think it is important to focus on company fundamentals and to regularly evaluate the risk/reward profile of stocks. The competitive dynamics within certain therapeutic areas, especially areas like oncology, are moving very rapidly as new clinical trial data are reported. In the biotechnology sector, we are more optimistic on some of the smaller names that are targeting areas of unmet medical need. We continue to believe that large companies will look to acquire small, innovative companies but also would not be surprised to see one or two major M&A transactions over the next year.

In summary, we remain positive on the outlook for healthcare as valuations seem reasonable, both on a relative and absolute basis, and we can see many investment opportunities arising from the ongoing structural change.

Commodities and natural resources

(compare commodities and natural resources funds here)

Robert Crayfourd and Keith Watson, managers, Geiger Counter:

Swing producer drives rebalance

The most significant influence on the sector was the mid-January announcement by the Kazakh state-owned uranium mining company, Kazatomprom, that it would cut production during the calendar year 2017 and that it was willing to make further cuts if necessary to rebalance the market. We believe this telling shift to a more commercially minded value over volume strategy by the world's lowest cost producer, with a market share of approximately 40%, represents a fundamental turning point to allow the oversupplied market to rebalance.

The news from Kazatomprom provided strong initial impetus to the uranium spot price which rose from a low of approximately US$18/lb in December 2016 to over US$26/lb in Q1 2017 though the move was viewed as insufficient by market participants and spot price gains subsequently unwound, retracing to around US$20/lb at the end of September.

However, the decline drew a further more pronounced response from Kazatomprom and also from Cameco. In November Cameco announced plans to mothball its largest McArthur River mine, removing around 14Mlb of forecast output in 2018 (equivalent to 8% of global production). Cameco also stated that the operations would only be reopened when it was able to sign higher priced contracts, a level we would infer to be around US$40/lb. Kazakhstan then announced, in early December, that it would extend its production cuts to over 11Mlbs pa (approximately 20%) for a sustained three-year period commencing January 2018. Following these supply reductions, the market is now projected to be in deficit. As a result, the spot uranium price at the time of writing has risen 31% to US$26.55/lb, above the previous peak achieved earlier in the year.

Policy shifts improve demand outlook

Kazatomprom's behaviour is particularly important given the sluggish pace of Japanese reactor restarts since the Fukushima accident in 2011. Latterly, however, news from Japan has been encouraging and momentum for restarts in the region is improving. Notwithstanding the re-election of pro-nuclear Abe government price increases for Asian LNG, a preferred substitute for out of favour nuclear generation, have had accelerated rising over 50% since summer. The rise in LNG input costs for gas fired power improves the competitive position of nuclear in the region and provides further incentive for the country to switch reactors back on.

Prior to Abe's re-appointment Japan's Atomic Energy Commission expressed support for retaining nuclear power as a significant contributor to the nation's grid. The Commission issued a report calling for nuclear power to supply at least 20% of Japan's electricity by 2030, which compares to a 30% market share prior to 2011. Abe's success, against anti-nuclear opposition, indicates Japan's electorate may be well attuned to the advantages of restarting it's installed nuclear capacity rather than relying on developing more costly alternatives such as LNG.

This should help reduce industry uncertainty and in the near-term Japanese utilities Kansai Electric Power Company and Kyushu Electric Power Company each expect to restart two units during the first half of 2018, increasing the number of operating reactors to 9, of the 42 operable facilities post Fukushima. The restart of Japanese

reactors should also help reduce spare uranium enrichment capacity which indirectly supplies over 20Mlb pa of U3O8 into the market.

Favourable government policy changes in the US are also encouraging for the nuclear power industry. Of note, Federal regulators have been requested to make allowances to struggling nuclear and coal base load power stations in recognition of their zero carbon emissions and benefits to grid stability, particularly against subsidised renewable sources that produce more variable power output. Also, helpful to the outlook for the region's nuclear industry, the head of the US Environmental Protection Agency stated that tax incentives for the wind industry should be eliminated and that they should "stand on their own and compete against coal and natural gas". As with Japanese government policy, we believe these initiatives provide recognition of the inherent value of the installed nuclear generating capacity for developed economies more broadly. This seemingly rational behaviour offers an alternative path to the politically expedient approach taken by Germany and France to prematurely close nuclear facilities. Indeed, France's attitude to early reactor closures has softened with the target date for reducing nuclear power's share of the country's generating capacity from the 75% currently to 50% by 2025 being delayed. Reasons cited for the delay include increased vulnerability to electricity shortages and higher greenhouse gas emissions.

Elsewhere, China's focus on air quality remains a key long-term driver for uranium demand, as a meaningful source of zero carbon base load power. China's initial drive on closing inefficient coal power stations and metal smelters to reduce chronic air pollution emissions is likely to be a multi decade theme extended by an emerging middle class seeking better health and quality of life. Given the population's sensitivity to this issue political impetus to the industry's expansion is likely to remain high. Importantly, in addition to the political motivation to develop nuclear generating capacity, China's replicable reactor design provides significant potential to reduce operating costs comparable to coal fired power stations fitted with scrubbers and flue gas desulphurisation to reduce emissions. This is will provide an important competitive foundation for China's future domestic and international expansion plans.

China currently has 36 operating reactors, 21 in construction and more expected to start construction shortly and remains the primary growth driver for nuclear power. China expects to generate 58GWe by 2020-21 and 150GWe by 2030, with 6-8 reactors being approved for construction each year. These are predominantly going to incorporate latest Generation III technology that have longer lives and improved security features relative to previous reactor models that make up the majority of the current global reactor fleet. In addition, China is seeking to establish international export credentials for its sector capability. For example, China National Nuclear Corporation has now signed contracts to build reactors in Pakistan, Argentina and the UK.

Debt

(compare debt funds **here**)

Donald Adamson, chairman, Invesco Perpetual Enhanced Income: 2017 has proven to be a year of mixed fortunes in the bond markets. The market overall still remains sensitive to price fluctuations. Low yields in the high yield bond markets and central banks shifting toward normalising monetary policy provide a challenging

backdrop for next year. The impact of duration on a bond portfolio is a factor that the portfolio managers must contend with.

With the Bank of England raising UK interest rates and the European Central Bank considering tapering its asset purchase programme, a period in which monetary policy is tightened is an important factor for the portfolio managers to consider in 2018.

The current elevated valuation of the high yield market provides challenges in the short and medium term.

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Paul Read, Paul Causer and Rhys Davies, managers, Invesco Perpetual Enhanced Income: Our view on the high yield market remains cautious. Yields are exceptionally low and credit spreads are relatively tight. However, default rates remain low, and all else being equal, we would expect the default outlook to remain benign in the months ahead.

The focus of our markets has now switched to the tapering of the European Central Bank's asset purchase programme. Discussion around this will be an important factor for markets and could cause yields to rise. Meanwhile other risks have reduced. Politics in Europe is now supportive of markets and the Eurozone economy continues to show signs of strength. Furthermore, the rescue of troubled banks in Italy, Spain and the UK has taken some of the risk out of the banking sector.

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Robert Jennings, chairman, Sequoia Economic Infrastructure: Much of the market turbulence has abated, and the credit markets in general are currently characterised by low volatility and historically tight lending margins and bond spreads. To a certain extent the infrastructure debt markets have been included in this trend, with some sectors such as social infrastructure, core renewables (e.g. onshore wind and ground-mounted solar) and European toll roads now being funded at very low interest rates. This is primarily the result of institutional investors such as insurance companies becoming more active in infrastructure debt, as they look to improve upon the yields that are available in the corporate bond market. However, this is far from uniformly the story across the infrastructure debt market with, in particular, the US markets, the mezzanine lending market, and some industry sectors continuing to offer excellent risk-adjusted returns.

Over the course of 2017, infrastructure finance in the UK through the PFI or PPP model has become increasingly politicised, with the Labour Party threatening nationalisation.

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Angus MacPherson, chairman, Henderson Diversified Income: The market's continued appetite for yield [*is*] pushing up prices for income producing assets. It is now difficult to argue bonds are cheap. If fairly valued, reflecting the current market environment of low volatility, low defaults, low inflation and modest global growth, then we can look forward to yields settling at this lower level for the immediate future.

There are obvious, potentially disruptive, political and economic threats. To date these have not upset this equilibrium. However, these risks will persist in 2018 and may yet trigger more volatile conditions.

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John Pattullo and Jenna Barnard, managers, Henderson Diversified Income: Unless there are signs of a pick-up in inflation or default rates, neither of which we expect, it is hard to see yields on corporate bonds or loans rising materially in the short term. This is a most unusual economic cycle stymied as it is by a combination of the disinflationary forces of an aging population, some private sector deleveraging and technological disruption. The low interest rate and low growth environment may be with us for many years to come.

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Environmental

(compare environmental funds **here**)

Michael Naylor, chairman, Jupiter Green: President Trump's decision to withdraw the US from the 2015 Paris climate agreement has widely been viewed as a step back for the country and was condemned both at home and abroad. California's Governor Jerry Brown was one of the most vocal critics of Trump's decision, suggesting that many states will maintain their commitments to the agreement, while government leaders in the EU and China underscored their commitment to the Paris climate deal.

More meaningfully from an investment perspective was the uninterrupted progress made by a number of environmental solutions industries. Developments this year in the markets for electric vehicles, renewable energy and energy efficiency, in terms of technological innovation and cost competitiveness, speak volumes about how important these solutions have now become to the global economy. While headwinds from the White House have the potential to unsettle this progress, the disruptive power appears to side firmly with the innovators who continue to seek cost effective and profitable solutions to the world's most pressing environmental problems. In our view, the long-term opportunity to invest in environmental solutions remain compelling.

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Charlie Thomas, manager, Jupiter Green: We remain mindful that market valuations are looking stretched on some measures, and we continue to monitor a number of potential risks. These include ongoing tensions between the US and North Korea, uncertainty around the UK's Brexit negotiations, and the prospect of tighter central bank policy, which can have a dampening effect on equity markets.

President Trump's decision to withdraw the US from the 2015 Paris climate agreement was disappointing. Since the announcement, there has been widespread condemnation of the move by a number of politicians and businesses in the US, most notably by California Governor Jerry Brown who suggested Trump has a weak hand in the face of determination at US state-level to continue towards the pathway set in Paris. He said: "President Trump can't command science...in fact he is fostering more activism, more effort and more collaboration on the opposite side...we are going to intensify our efforts whether it be for electric cars, renewable energy, the whole radical shift to a decarbonised future". In the same vein, both the EU and China at their annual summit meeting reconfirmed their commitment to the goals set out in the Paris climate deal. It is worth highlighting that a number of the portfolio's key themes have made excellent progress this year, including areas such as sustainable transport and the wind power sector. To our minds, the progress being achieved by these areas is a clear signal of the growing importance of environmental and sustainable

technologies in the global economy, despite the lack of support from the Trump Administration, and speaks of the long-term opportunity presented by the wider investment theme.

Infrastructure

(compare infrastructure funds **here**)

Ian Reeves CBE, chairman, GCP Infrastructure: In the context of the significant infrastructure and renewable energy development of the last decade, recent government policy has been less supportive of new projects. PFI and PF2 are now seemingly largely out of favour across the political spectrum and the support mechanisms for core renewables sectors have either been withdrawn or materially reduced. The Government has recently channelled support for low carbon technologies through CfDs, although the next projects to receive such support will have to wait until 2019.

These policies were largely reinforced by the Chancellor in his November 2017 Autumn Statement. There was positive sounding commentary regarding train links, the development of five garden towns and the roll-out of electric vehicle charging infrastructure, but limited details about scale, timetable and the investment structures that would be available for private sector capital.

It remains to be seen how the overall contribution of renewable sources to the UK's energy mix, which in the second quarter of 2017 stood at a record 30%, will develop over the next few years. It does seem that the UK is successfully weaning itself off fossil fuels, with 21 April 2017 marking the first day without coal power since the industrial revolution.

John McDonnell, the Shadow Chancellor, stated at the Labour conference in September 2017 that a Labour government would "bring existing PFI contracts back in-house". Given the lack of details as to what this would precisely entail legally, commercially and on what scale, we believe it is difficult to draw useful conclusions as to a theoretical impact of such a policy.

The sustained period of low interest rates in the UK continues to drive demand for infrastructure assets from investors seeking dependable and predictable income.

Property

(compare UK property funds **here**)

DREIM, managers of Drum Income Plus REIT: While the investment market appears to have become more competitive, in large part this is being matched by a strengthening occupational market. This, combined with a dearth of modern vacant space, is leading to rental growth in most office and industrial markets with reducing vacancy rates on the High Street driving a return to rental growth in many retail centres.

DREIM anticipate occupational demand, combined with a limited supply of new development, will drive further rental growth across regional markets

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Mike Adams, chief executive officer, Octopus Healthcare, manager, MedicX: The demand for new modern primary care infrastructure continues to be in both the UK and Republic of Ireland as the population ages and a wider range of clinical services is sought to be delivered over longer hours by GPs in their local communities.

United Kingdom

The long awaited independent report on NHS Property and Estates by Sir Robert Naylor was published in early 2017. It made a number of recommendations focussed on supporting the vision of the NHS Five Year Forward View and the 44 new Sustainability Transformation Plans ("STPs") across England, creating an affordable and efficient NHS estate, and selling surplus land for new housing development. The report highlights the importance of the private sector and how it can play an instrumental role in driving forward the strategic aims of the Forward View. The Department of Health's response is awaited.

An additional GBP325 million was given to the NHS in the 2017 Spring Budget to support the 15 strongest STPs. Cross-party support for increased NHS spending remains in place since the UK general election. In the recent Autumn Budget, the UK government has pledged to increase funding on frontline NHS services and upgrades to NHS buildings and facilities by a further GBP6.3 billion (above the GBP10 billion more per year pledged for the NHS by 2020-21) including GBP3.5 billion for capital investment for the NHS in England by 2022-23.

There continues to be a move towards formation of Accountable Care Organisations ("ACOs") to create locally integrated health systems spanning primary, secondary and social care. These are likely to need new premises solutions to deliver cost savings. Final funding allocations will be made upon business cases being successfully approved and will depend on robust wider estates and capital strategies.

As well as rising clinical demand and transformation from the UK government and the NHS, it has been well publicised that pressure on GPs continues to mount from increased regulation, rising numbers of consultations and recruitment challenges. Practices are continuing the move towards more collaborative working either through federations, super practices or the emerging ACOs.

Republic of Ireland ("RoI")

In the RoI there are similar demographic pressures requiring new primary care infrastructure and the Irish government continues to support their Primary Care Centre strategy delivering modern purpose-built centres serving the local community.

Pricing and rents

The primary care investment sector has continued to see further yield compression during the year due to investor demand, reinforcing the attractiveness of the asset class. Market rental growth remains challenging for the sector due to a lack of new schemes to set new rental evidence but there is increasing acknowledgement from District Valuers that rising land costs and build costs are supporting higher rents for new schemes. In addition, UK RPI inflation increased to 3.9% over the twelve months to 30 September 2017 providing another strong indication of upward pressure on market rents.

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European property

(compare European property funds **here**)

Schroder Real Estate Investment Management Limited, manager, Schroder European Real Estate: Economic momentum in the Eurozone has increased and growth forecasts continue to be upgraded. While growth forecasts for the Eurozone for 2017 and 2018 had been at 1.4% and 1.5% respectively at the start of this calendar year, the September consensus forecasts have been upgraded to 2.1% and 1.8%. Following key elections in Europe political uncertainty has eased. Growth continues to beat expectations while structural reforms, debt restructuring and labour market reforms are taking effect. Unemployment has started to decrease and economic sentiment remains at record highs. Core inflation remains stable around 1% and, while the European Central Bank ("ECB") is likely to reduce its bond buying program, the Investment Manager expects the ECB to leave its refi rate at zero until 2019.

Offices

This economic activity is generating demand in the office markets. In many European cities, jobs in the IT, media and professional services sectors are growing year-on-year and net take-up of office space is positive. Vacancy, particularly for modern flexible space, has decreased and the supply pipeline for the next 2-3 years remains muted. We expect to see a broad-based increase in office rents across continental Europe over the next 3-4 years, dominated by growth cities.

Retail

Strong consumer spending continues to support the wider retail sector, though this growth is mainly being driven by on-line spending. This is impacting the demand for physical retail space. Demand, and rental levels, for high street units/flagship stores in core city centre locations remains resilient and dominant shopping centres with a retail, leisure and food offer also continue to perform well. Secondary high streets and small to mid-sized shopping centres remain under pressure with changing consumer patterns reducing physical shopping time and spend. Supermarkets, convenience stores and out-of-town retail warehouses are expected to be more resilient to online encroachment, as consumers still prefer the physical aspect of goods such as food, furniture, DIY and homewares. Additionally, these stores typically have car parking and are convenient for click and collect sales. Vacancy rates here are also lower as these formats have less of a mid-market fashion offer, the part of the market most severely impacted, whilst the recovery in European housing markets has led consumers to spend more on home improvements.

Logistics/industrial

The rapid growth of e-commerce is driving retailers and other logistics operators to restructure their networks and introduce modern technology to their units. Vacancy levels have been falling across Europe and rents are beginning to grow. Demand remains strong for well-located, modern units to be used for parcel delivery and fulfilment centres, especially urban logistics assets. These are benefiting from the growth in "last mile" deliveries and returned items, as consumers become increasingly demanding and place ever more emphasis on speed of delivery, located in built up areas where new supply is constrained and which offer longer-term mixed-use potential.

Investment market

The favourable outlook for rental growth and the significant gap between real estate and 10-year government bond yields means that there is a large amount of capital allocated towards real estate in Continental Europe. Investment activity remains at high levels and the market is competitive. Asian capital has become more active. European investors are active throughout the region. The most sought-after market remains Germany, but activity is also high in France, the Nordics, Spain and the Netherlands. Values for prime assets are close to the high, assuming that investors will now start to factor in an increase in bond yields over the medium term. However, even if bond yields rise, we expect that real estate yields will probably be relatively stable, given the prospects for rental growth, particularly in winning cities.

Utilities

(compare utilities funds **here**)

Ecofin Limited, manager, Ecofin Global Utilities & Infrastructure: Although volatility has been very low in equity markets for many months, there continues to be enough movement and value in our sectors for stock selection. In equity markets where valuations are becoming more demanding, the defensiveness of utilities and infrastructure businesses and their good prospects for growth and dividend progression, usually from an existing good base, makes them attractive in our view. We recognise that significant increases in long-term interest rates in North America or Europe would impact our sectors in the short-term, especially if economic growth were meaningfully stronger, as momentum would favour other areas of the markets. The diversity of business models, however, limits the portfolio's actual correlation with bond yields, and a little inflation and growth would benefit the regulated business models and infrastructure companies in our investment universe.

Beyond the improving fundamentals of the investment universe, we see an opportunity as long as stock markets undervalue these types of long-term assets and business models. Private equity operators offer significant premiums to listed valuations in takeover transactions. In May, a consortium of investors acquired the U.K. company Affinity Water at a premium to its regulated asset value of close to 50% while its listed peers currently trade at a mere 10-15% premium to regulated asset value. The deal did serve to highlight the continuing interest in U.K. infrastructure assets and the appeal of business models with stable long-term returns based upon regulated revenues.

In our view, valuations continue to suggest there is significant value in our sectors. The spreads between dividend yields for utilities and long-term (10 year) bond yields are currently high compared with historical standards: In the U.S., the spread is 1.2% (versus a spread since 2005 which has averaged about 1.0%); in the UK the spread is currently 4.3% (versus an average of circa 2% since 2005); and on the Continent, the spread is 4.4% (versus a historical average of closer to 2.9%). Another simple valuation metric is the share price/earnings (P/E) ratio of the utilities sector relative to that of the broad market. During the last 20 years in Europe, utilities have traded at a P/E ratio relative to the market that has moved in a range between 90% and 115%; currently the relative P/E ratio is at the bottom end of that range. In the U.S., there is a similar picture with the relative P/E for the utilities sector still sitting just below the long-term average.

QuotedData

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