

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

Most stock markets moved higher in January, reversing some of the losses they suffered in December. Emerging markets did well with the exception of India which was affected by a rally in the oil price and worries about economic growth rates. Sterling edged higher but many investors in the UK appear to be sitting on their hands waiting for a resolution of the Brexit negotiations.

Global

Caution advised as volatility returns.

Richard Killingbeck, chairman of Bankers, suggests that we will have to adapt to more normal (higher) levels of volatility, as quantitative easing is unwound, and hopes for a clearer picture in the second half of 2019. The manager of that trust points out that there is an incentive on all sides to resolve trade disputes. The managers of Aberdeen Diversified Income & Growth think that US valuations look high and note that worries persist about slower growth in China. They like the look of emerging markets bonds.

UK

The path to Brexit is as unclear as ever but, perhaps, investors' fears are overdone.

James Henderson and Laura Foll, managers of Henderson Opportunities, draw attention to a gulf between bearish investor sentiment and the more positive results coming through from companies. Andrew Chapman, chairman of River & Mercantile Micro Cap, offers a wide-ranging discourse on 'change' and asks us not to

| Exchange Rate | 31/01/19 | Change on month % |
|------------------|----------|-------------------|
| GBP / USD | 1.3109 | 2.8 |
| USD / EUR | 0.8736 | 0.2 |
| USD / JPY | 108.89 | (0.7) |
| USD / CHF | 0.9942 | 1.2 |
| USD / CNY | 6.6961 | (2.6) |

Source: Bloomberg, Marten & Co

MSCI Indices rebased to 100

Time period 31/01/2018 to 31/01/2019



Source: Bloomberg, Marten & Co

| | 31/01/19 | Change on month % |
|----------------------------|----------|-------------------|
| Oil (Brent) | 61.89 | 15.0 |
| Gold | 1321.25 | 3.0 |
| US Tsy 10 yr yield | 2.6293 | (2.0) |
| UK Gilt 10 yr yield | 1.219 | (4.5) |
| Bund 10 yr yield | 0.148 | (38.1) |

Source: Bloomberg, Marten & Co

United Kingdom (continued)

be fearful of it. Jamie Cayzer-Colvin, chairman of Henderson Smaller Companies, says that outside of the UK there is greater preoccupation with US/Chinese trade disputes, rising interest rates and commodities prices than Brexit. Neil Hermon, manager of that trust, reports that there is an expectation that once there is clarity over Brexit there will be increased interest in UK corporates from abroad. Jonathan Cartwright notes the weakness in UK small cap valuations, in particular, and thinks that they represent attractive value. The managers of Aberforth Split Level Income say that while Brexit may look superficially like it will have a binary impact on the UK, that is oversimplistic and most UK companies may prove resilient regardless of the outcome. They have also canvassed the companies that they invest in about the potential impact of Brexit and we report the results here.

Japan is sensitive to a Chinese slowdown and also faces a hike in consumption taxes

Japan

Harry Wells, chairman of CC Japan Income & Growth, notes that China, as Japan's largest trading partner, has an important influence on business performance, supply chains and investor perception of Japan. There is also a hike in consumption taxes to contend with. The managers are encouraged by Japanese companies' increased willingness to return cash to shareholders through dividends and buybacks, however.

Brexit overshadows the UK property market but niche areas may be less affected

UK Property

Steven Owen, chairman of Primary Healthcare Properties, thinks that the government's commitment to invest more in the NHS and the low correlation between this part of the property market and the economy make primary health centres a good place to invest; other investors agree which is pushing up values. The managers of Drum Income Plus REIT expect Brexit to reduce activity in the UK property market. They continue to favour property in the regions. Safestore takes us through the fundamental drivers of the self-storage market.

Other

We also have comments on the US from Baillie Gifford US Growth; global emerging markets, from Jupiter Emerging and Frontier Income; Russia, from JPMorgan Russian Securities; and resources, from BlackRock Commodities Income.

Contents

| | |
|----|--|
| 5 | Global (thoughts from Bankers and Aberdeen Diversified Income & Growth) |
| 6 | United Kingdom (thoughts from Henderson Opportunities Trust, River & Mercantile Micro Cap, Henderson Smaller Companies and Aberforth Split Level Income) |
| 11 | Japan (thoughts from CC Japan Income & Growth) |
| 12 | United States (thoughts from Baillie Gifford US Growth) |
| 12 | Global emerging markets (thoughts from Jupiter Emerging & Frontier Income) |
| 12 | Russia (thoughts from JPMorgan Russian) |
| 13 | UK Property (thoughts from Primary Healthcare Properties, Drum Income REIT and Safestore) |
| 15 | Resources (thoughts from BlackRock Commodities Income) |

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Global

(compare Global funds [here](#))

Richard Killingbeck, chairman, Bankers: In my view it is too early to become contrarian in regard to market sentiment but it is very tempting to begin to look at markets more positively. The global economy, led by North America, remains solid, and inflationary pressures, whilst higher than a year ago, are stabilising. The recent oil price decline has yet to feed through into inflation numbers and, whilst wage inflation remains a concern, overall inflation could fall in 2019. If such a scenario were to be in evidence then the current momentum in interest rate rises in the US could ease giving markets a welcome boost. Valuations in certain sectors will continue to be a limiting factor, equally investors will need a resolution of the current trade tariff dispute to commit substantial new money to the market. The recent low levels of volatility in markets are a phenomenon that are now likely to be confined to history and a product of quantitative easing used to stabilise markets through the financial crises. Therefore, going forward investors will need to readjust to more historically normal high levels of volatility.

The uncertainty in the UK will remain and will be dominated by Brexit issues well beyond the end of March 2019. Consumer and business sentiment remain as critical indicators in the year ahead for the country and for confidence to return to the UK from international investors in particular. The UK market therefore will likely have another dull year. Yet the valuation argument is becoming more compelling especially for some companies in more traditional defensive sectors with strong balance sheets and well covered dividends. Currency markets may surprise in 2019.

Thus I fear caution remains the key watch word for global equity markets, at least for the first half of 2019. The direction of US interest rates, the outcome of Brexit with its range of economic implications and the wider inflationary picture should all be clearer by this time. If corporate earnings growth remains positive then valuations may become compelling, despite the late stage in the cycle in which we find ourselves.

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Alex Crooke, manager, Bankers: As I look forward I suspect that the future will not turn out as bad as many predict. The world does not appear on the verge of a sharp recession but clearly growth is slowing and share prices have begun to price this in. There is an incentive on all sides to get trade discussions concluded and I expect a better picture to emerge as the year develops. By the summer many of the uncertainties will have resolved themselves in one form or another and we should have a clearer outlook. Valuations have fallen significantly in recent months and we have an opportunity to invest cash at very favourable dividend yields. An element of caution still seems sensible. It looks like a year of two halves lies ahead of us.

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Mike Brooks and Tony Foster, managers, Aberdeen Diversified Income & Growth: A year ago, we were broadly optimistic about the global economic outlook. Since then, the US economy has performed especially well. However, America's more belligerent policy on trade and its tightening of monetary policy have been reflected in growth disappointments in a number of economies outside the US. This has led us to reduce modestly our forecast of global GDP growth to 3.4% in 2019 and 3.2% in 2020. In the UK, we expect growth of around 1.4% in each year, assuming a smooth exit from the European Union. We expect short term interest rates to rise to around 3% in the US in 2020 and to 1.5% in the UK. With inflation forecast to be just over 3% globally and

around 2% domestically for the next 2 - 3 years, the economic backdrop appears fairly benign.

The company's year ended with US equity markets at an all-time high amid newspaper reports of "the longest bull market in history". It is nearly ten years since the end of the global financial crisis and it is therefore not surprising that many investment commentators regularly advise caution. Indeed, a year ago, US / North Korean tensions were deemed worthy of a mention in this report and, over the short term, investment market sentiment is often led by such events and news flow. Over the year ahead, the UK's exit from the European Union will undoubtedly keep our economists and strategists busy.

Valuations in the US market, which accounts for over 60% of global equities, now seem stretched. Profit margins have most likely reached their cycle peak and more sluggish earnings growth should be expected. A slower but still solid global growth outlook may provide support for equities in the near term, but worries persist about risks resulting from tighter monetary policy and slower growth in China, as well as political uncertainties and threats of trade wars.

If investors are cautious on the outlook for equities, then traditional safe havens, such as developed market bonds and investment grade credit, may not provide attractive alternatives. Government bond yields remain near historical lows in developed markets, with the exception of the US. Low starting yields make for low long-term bond returns: the Manager's 10-year forecast is just under 1% per annum in the UK, and no better in Europe and Japan. Much better value is on offer from less familiar forms of credit such as asset-backed securities and emerging market government bonds. The former benefits from any increase in short term interest rates and offers higher returns than high yield bonds. Emerging market government bonds have experienced a difficult year. The recent crises in Turkey and Argentina have deterred many investors but markets already reflect the negative news flow. Emerging market currencies have depreciated sharply over recent years and so the combination of high yields and cheap currencies means that this asset class offers good value for long-term investors.

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United Kingdom

(compare UK funds [here](#))

James Henderson and Laura Foll, managers, Henderson Opportunities Trust:

There is a convergence of reasons for making investor sentiment bearish. Actual company announcements do not correspond with the degree of macro gloom. The cautious will say this is because the companies have not yet caught up with the economic problems but that they will in time. There is a general attempt to impose generalities onto what is actually a very diverse picture of industrial activity. Some businesses are moving forward and some moving back, with the quoted company sector maybe doing better than general UK Plc because of overseas earnings and more exports in their turnover. They therefore should be helped by Sterling weakness.

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Andrew Chapman, chairman, River & Mercantile Micro Cap:

Nothing is permanent except change (Heraclitus)

The ancient philosopher Heraclitus of Ephesus is one of the most important thinkers in history. Heraclitus' views on change and flow stand in stark contradiction to the picture of the static universe presented by his predecessor, Parmenides, and fed into the work of untold philosophers from Marcus Aurelius to Friedrich Nietzsche. Heraclitus maintained that change is the only reality in nature. We have all made changes in our lives, both good and bad, expected and unexpected. Employment, relationships, circumstances, and feelings inevitably change.

Nobody or no individual thing is ever exactly the same in each precise moment. Heraclitus' philosophy is a good starting point for anyone concerned with change in life or these underlying circumstances. Heraclitus said that life is like a river, the peaks and troughs, pits and swirls, are all part of the ride... life's rich tapestry... but are all the unplanned and unexpected changes bad? What if all changes were good by default? Now that's an interesting philosophical debate and one that is more pertinent in today's complex political financial and military environment.

Of all the myriad changes that we face at this particular juncture, I am fascinated by our ever-changing strategic relationship with Russia. This is of particular note at the moment as this nation state continues to strive to understand its role in a modern world. Russia has always strived to project its power and we should not be surprised by its appetite to exert some form of influence over its citizens, lapsed or otherwise, both within and outside its natural borders. However, the UK's relationship with Russia has been a constant factor through history, a relationship whose positive undertones have waxed and waned. Few may remember that, even in its darkest historical moments, Russia has relied on its global relationships to ensure its ultimate survival. Britain's relationship with Russia is complex and has been in a period of almost permanent change. We seem to be at a low point in terms of Russia's desire for normalised and healthy relationships with its global partners. Strategic culture in the Russian case is very much influenced by political culture. How this political culture is defined, acquired, legitimised, and used in the execution of its foreign policy, and by its underlying economic culture, are a source of influence. Its strategic culture arises from the intersection of political, foreign policy, military, and economic culture, and these influences can and do flow in both directions. We can be assured that the evolving relationship we have with "Mother Russia" will continue to undergo fundamental change, and this will have an impact on all of our lives, social, economic and cultural.

I think that we can all agree that change can be a force for good; however, the determining factors of whether the outcome for an organisation is a positive cultural one are driven by the continuity of belief in the importance of integrity and values.

We have also seen a year in which continued change in our core market place is continuing to impact behaviour. The most dramatic of these has been the highly contentious implementation of the latest piece of EU derived regulation called MiFID II. The Markets in Financial Instruments Directive ("MiFID") is the EU legislation that regulates firms which provide services to clients linked to 'financial instruments' (shares, bonds, units in collective investment schemes and derivatives), and the venues where those instruments are traded. A revamped version of this legislation is designed to offer greater protection for investors and inject more transparency into all asset classes: from equities to fixed income, exchange traded funds and foreign exchange. This extensive piece of legislation, seven years in the making has, like most politically driven legislation, focused on delivering change in one theatre, but caused a range of unintended consequences in others. An example of the latter is the effect on mid, small and micro cap quoted companies where we are seeing a reduction in the

quality and volume of research written about them, which is in turn impacting their visibility in the market. This will ultimately restrict liquidity in their shares, which may hinder their ability to access capital for future growth. However, as my mother was always inclined to state, “every cloud has a silver lining” and in this case it is the potential that these modern day research deserts provide to a disciplined and fundamental investor. We have all read the many articles that have been written forecasting the rise of the passive and the demise of active management. Like most journalism there is a desire to report the dramatic and downplay the mundane. The growth of so called index funds has converted most investors into “asset pickers” instead of “stock pickers”, yet the indexing community has tried to sell indexing as though it is something totally different from stock picking. The reality is that we are all discretionary decision makers in our portfolios, as the choice to allocate according to a formula is still a discretionary decision.

The increase in index approaches has had the benefit of creating bifurcation in the availability of investment options. The active managers delivering index “plus a little” strategies have been largely eradicated and this has created a clear ground for investors who want either to invest in a solution that will guarantee an index “minus a little” return (net of all costs) or a genuinely active solution.

An important consequence of the significant rise in the use of index strategies, in all of their forms, is the balance between formulaic strategies and judgemental approaches shifts in favour of the former. While this has the benefit of lower fees for investors using index strategies, it does at the margin improve the ability for those using judgemental approaches to succeed. The fewer people that are applying judgement, the greater the potential return will be from its application.

The rise of the passive community will also have a direct and positive impact on micro-cap and other smaller companies as they grow in size and liquidity. The index funds will be required to purchase these stocks when they enter the index; and this provides a potentially significant return for the active investor that holds these fast growing and exciting stocks. I hope that we can agree that we should not always be fearful of change, as often the change presents opportunities for those that choose to embrace it.

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Jamie Cayzer-Colvin, chairman, Henderson Smaller Companies: At the time of our AGM in May, I said that rarely a day goes by without Brexit and Trump commanding the news. Well, roll on six months and Brexit is still all that occupies the British press and a large majority of the British population has fallen into a catatonic state of boredom. When travelling in Asia or North America, the business communities only mention Brexit out of a sense of politeness when they realise that a Brit is amongst them. They are far more concerned with an escalation of the US and China trade hostilities, rising interest rates or falling commodities prices. However, we should not feel too glum and side-lined; many of those Asian and American businesses I speak to say that the impact of Brexit will be short-term because whatever the outcome, Britain is a creative and adaptable country that has the best commercial law in the world and, most importantly, an incorruptible judiciary. In short, the global commercial world likes doing business in Britain.

Nevertheless, the continuing uncertain outlook on the prospects for global trade and the recent interest rate rises by the US Federal Reserve have caused global markets to weaken in the last few months and the UK has not been immune.

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Neil Hermon, manager, Henderson Smaller Companies: The UK economy is showing anaemic growth. Brexit deliberations stumble on, with intermittent progress. The date for the UK leaving the European Union is looming into view. There is clearly a range of outcomes, but what deal, if any, the UK will end up with is, at this point, unclear. Extra complication is added by the weak position of the minority Conservative Government led by Theresa May, who is struggling to deal with the conflicting demands of her MPs on Brexit.

This political uncertainty has made UK consumers cautious. Although unemployment is historically low, net disposable income growth has been constrained by the rising cost of living. Weakness in consumer spending and low consumer confidence is demonstrated by a moribund second-hand housing market and weak sales of high-ticket items such as cars, carpets and double glazing.

Outside the UK, economic conditions are robust, particularly in the US. However, there is mounting evidence of a slowdown, particularly in Europe. Escalating trade tensions are providing additional negative commentary. The rise in US interest rates has served as a reminder to investors that loose global monetary conditions are reversing.

In the corporate sector, conditions are intrinsically stronger than they were during the financial crisis of 2008-9. Balance sheets are more robust and dividends are growing. In addition, a large proportion of UK corporate earnings comes from overseas, even among smaller companies. This would provide some degree of diversification in the event of a 'hard' Brexit, especially if Sterling were to weaken further.

In terms of valuations, the equity market is now trading below long-term averages. M&A remains a supportive feature for smaller companies. Although M&A has been subdued in 2018, there is an expectation that once there is clarity over Brexit there will be increased interest in UK corporates from abroad, given the relatively low valuation of UK equities and a weak currency.

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Jonathan Cartwright, chairman, Aberforth Split Level Income: The last six months have been challenging for equities generally and for small UK quoted companies in particular, which is a salutary reminder, if ever it were needed, that equity investment requires a long term perspective. Whilst it would be remiss to suggest that there is no more pain to come, the managers are of the view that, although there are current uncertainties including those surrounding Brexit, small UK quoted companies represent attractive value.

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Aberforth Partners LLP, managers, Aberforth Split Level Income: The uncertainties surrounding the UK's departure from the EU have clearly been a fundamental influence on the UK stock market over the past year and, with the matter yet to be resolved, it continues to affect the valuation opportunities described above. It is tempting, as many have done, to portray investment in small UK quoted companies as binary at the current time.

- In the event of a hard Brexit, the economy would be vulnerable to a further slowdown and, given presently low rates of growth, recession. Dividend cuts would follow and renewed monetary stimulus would be likely. It is possible that the risks of a downturn and further uncertainty would prove not to have been fully reflected in share prices and in sterling. Weaker sterling would insulate the overseas earners, but businesses reliant on the domestic economy would come under renewed pressure.

- A softer Brexit, along the lines of the prime minister's withdrawal agreement, would avoid a near term downturn and, through the removal of uncertainty, might see an acceleration in the economy as businesses increase investment. Sterling would plausibly recover at least some of its losses since the referendum and the outflow from UK assets would start to reverse. Some of the current headwinds facing the profits of domestic businesses would presumably turn to tailwinds, with the opposite being the case for the overseas earners.

However, this feels rather short term. On the one side, it ignores the likelihood that political uncertainty will continue to beset the UK even if an immediate hard Brexit is avoided. On the other, it implies something close to Doomsday for small companies, whereas the events of ten years ago in the financial crisis proved their resilience. Good management and the support of the equity markets in the refinancing of 2009 allowed businesses to recover and grow. From its previous peak in May 2007 to the end of 2018, the NSCI (XIC) doubled in total return terms. The Managers therefore suspect that, after the inevitable short term adjustment to a hard Brexit, a degree of clarity would return to allow small companies to resume their well established habit of creating wealth for their shareholders.

The binary view also risks ignoring economic and financial developments in the rest of the world, which, as the events of the fourth quarter demonstrate, will affect perceptions of and future returns from UK equities. Notably, there is potential for a normalisation of US monetary policy to upset the established investment strategies since the financial crisis. This is not to argue that the valuations of growth stocks cannot move even higher or that the path to a normal cost of money will be short and without setbacks. However, to judge by the portfolio profiles of investment and unit trusts investing in small UK quoted companies, the desire to own growth stocks is extreme, while value investing remains very much out of fashion.

Finally, the binary characterisation is essentially the consensus view. This in itself does not mean that the view is wrong, but history suggests that a strong consensus can often lead to opportunities within financial markets, such as in 1981 when 364 economists penned a poorly timed letter criticising government policy. The strength of the consensus against the majority of small UK quoted companies is evident in their unusually depressed valuations. The Managers believe that, with sentiment towards UK equities, small companies and value investment so negative, [they are] well placed to generate good returns in the future.

Brexit survey

To gain a different perspective on the ubiquitous Brexit debate, in September the Managers undertook a survey of the 93 companies held within Aberforth funds. The questions focused on the companies' reactions to the referendum and on potential future actions. The response rate was 94%, which represents a useful cross-section of the small cap universe.

The overall impression was of frustration with the politics, the Brexit process and lingering uncertainty. The lengthiest and most detailed responses tended to come from businesses oriented towards the domestic economy. This is unsurprising, though to an extent reassuring, since it is these companies that have been most affected by the decision to leave the EU. The survey identified three principal areas of concern.

- Employment: executives are worried about the availability of relatively cheap and skilful labour from the EU against the background of the rising national living wage.
- Sterling: there is an overwhelming assumption that sterling would weaken further in the event of a hard Brexit, which would be to the disadvantage of domestic businesses but to the benefit of overseas-oriented businesses.

- Supply chain: there is concern that a deal-less Brexit would complicate the movement of goods into and out of the UK at least in the short term. Contingency planning for several companies involves pre-emptive inventory building ahead of March.

The results of the survey need to be considered in the context of the continuing uncertainty about the Brexit process and outcome: company executives are having to operate with limited information and little guidance to date from government. Nevertheless, the survey did suggest that the companies are not complacent: money and time are being spent on preparations. This cannot, however, guarantee that the businesses will emerge unscathed, despite the commendable resilience displayed since the referendum in 2016.

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Japan

(compare Japanese funds [here](#))

Harry Wells, chairman, CC Japan Income & Growth: The immediate economic prospects for Japan are heavily dependent on the dynamics of the global economy. This has not changed in recent years. The greatest dependence is on the US economy both through its direct trading relationship and also the secondary impact on international trade. China, as Japan's largest trading partner also has an important influence on the business performance, supply chains and investor perception of Japan and many individual companies.

The domestic economy has benefited from not only global economic recovery but also, notably from Abenomics. Prime Minister Abe recently won an unprecedented third term as leader of the ruling Liberal Democratic Party which leaves him set to remain as Prime Minister until 2021 and thereby to become modern Japan's longest serving elected leader. This political stability is in stark contrast to Japan's own recent history and the current international stage. Notwithstanding tensions over the Korean peninsula, Russian meddling in the Kuril islands, China's expanding footprint in the South China Sea and throughout the Pacific, the domestic political backdrop should be considered positive for Japanese equities. As signs emerge of an end to deflation, the focus of debate has shifted to how and when the Bank of Japan removes its easy monetary policy. However, the main topic for the Government in 2019 may be the looming proposal to introduce a consumption tax hike in October 2019. The Prime Minister has been a strong advocate of an increase from 8% to 10% and time will tell whether other policy initiatives expected to soften its impact will be successful in averting the downturns that have followed previous adjustments to the consumption tax. For instance, the 2020 Olympics should provide some additional stimulus.

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Richard Aston, manager, CC Japan Income & Growth: Aggregate distributions from Japanese companies are set to achieve another all-time high in the fiscal year ending March 2019. Despite this very apparent improvement in recent years, the potential for further positive developments is evident from the steady rise in cash accumulated on corporate balance sheets and the high dividend cover in Japan. We are also encouraged by the flexible approach to share buybacks promoted by many corporate leaders as an important component in their efforts to boost capital efficiency. As a result we believe that these steady improvements are set to continue regardless of the near

term economic trends and these positive trends will continue to be more broadly recognised by both domestic and international investors.

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United States

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

Tom Burnett, chairman, Baillie Gifford US Growth: We remain convinced that these are exciting times for growth investors. The world is going through a period of almost unprecedented change, driven by the convergence of a multitude of technologies such as the internet, mobile devices and machine learning. The associated disruption was initially concentrated in a couple of big and important sectors, like retail and advertising, but it seems to be speeding up and broadening out. There will be huge value creation and destruction on either side of this change. Political and macro considerations are unlikely to have a significant influence on the magnitude or trajectory.

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Global emerging markets

(compare global emerging markets funds [here](#))

Ross Teverson and Charles Sunnucks, Jupiter Emerging & Frontier Income: The recent sharp falls in the Argentinian peso and Turkish lira, and the knock-on effect on other emerging market currencies, have spooked markets. Global economic factors have had a significant impact on emerging market returns this year; however, these factors are often difficult if not impossible to predict.

The recent market volatility has highlighted the importance of being selective when seeking out investment opportunities. Some large companies, most notably those that are widely perceived to be high quality, continue to be very highly valued by the market, even after the recent falls.

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Russia

(compare European single country funds [here](#))

Gill Nott, chairman, JPMorgan Russian: There are undoubtedly political risks to investing in Russia and heightened sensitivities to possible significant changes to sanctions, however, there are attractive investment opportunities if the right stocks are selected. We continue to believe that market in Russia provides a good long term investment opportunity, particularly if sentiment towards Russia becomes more positive. Dividend payments from Russian companies are currently expected to remain strong, offering another positive dimension to the market, although recent significant falls in the price of oil may challenge these positive forecasts. For those investors

prepared to take the risk, the long term potential on investing in Russia remains attractive.

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Oleg I. Biryulyov and Habib Saikaly, managers, JPMorgan Russian: We continue to see fundamental support for Russia at the country and company level, with the following factors all supportive:

- Interest rates are a powerful monetary tool and we expect them to fall further in 2019. Lower interest rates, together with lower inflation, should drive domestic consumption higher;
- The Central Bank will aim to keep the rouble relatively weak, which is good for exports; and
- Russian stocks are paying (and expected to continue paying) relatively high dividend yields which provides valuation support and which we expect markets will appreciate over the coming months.

We think the market is attractively valued, with stock valuations reflecting this level of risk.

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UK Property

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

Steven Owen, chairman, Primary Healthcare Properties: Whatever the final outcome and consequences of Brexit for the UK it is unlikely to have a direct impact on the primary health centres we invest in, which perform a vital role in the provision of healthcare across the UK and Ireland. Demand is driven by demographics and in particular populations that are growing, ageing and suffering from more instances of chronic illness.

Despite the continued volatility in the economic and political environment and the prolonged era of low, albeit increasing, interest rates, there continues to be an unrelenting search for income yield across most sectors. Primary healthcare, with its strong fundamental characteristics and government-backed income, has been a significant beneficiary. The UK market for primary healthcare property investment continues to be highly competitive with strong yields and prices being paid by investors for assets in the sector and we have continued to see yields compress further during 2018 although at a slower rate than that witnessed in 2017.

Primary healthcare performs a critical function, providing a key part of the NHS's Five-Year Forward View ("FYFV"), operating as most patients' first point of call when unwell. The primary care estate has faced underinvestment over the last decade, with approximately 50% of the 8,000 GP surgeries in England and Wales now considered by medical professionals to be unfit for purpose. Building on the FYFV, the follow-up "Next Steps on the Five-Year Forward View", published in March 2017, reiterated that shift, setting out targets for growth in the primary care workforce, expansion of access to general practice and the need for improved primary care premises.

In January 2018, the Government published a response to the Naylor review, which acknowledged the importance of land and property to the transformation of the health system and how the NHS will be able to supplement public capital with other sources

of finance from the private sector. The response also confirms that the use of private finance has been particularly effective as a source of investment and innovation in primary and community care in the past and will still be used in the future where it represents good value for money. Demand for healthcare is driven by demographics and the NHS is supported on a cross-party basis in the UK.

We welcome recent announcements made this year by the Government to increase funding for the NHS and how the £20.5bn budget settlement, announced on its 70th anniversary, will be spent over the next five years. The new NHS Long Term Plan, announced in January 2019, sets out how the NHS plans to improve the quality of patient care and health outcomes. The plan also includes measures to improve out-of-hospital care, supporting primary medical and community health services, and investment in these services will grow faster than the overall NHS budget, worth an extra £4.5bn a year in real terms by 2023/24 with the aim of reducing pressure on emergency hospital services. These additional resources may in time lead to increased activity in the building of new facilities and the modernisation of existing primary care premises and we look forward to helping deliver the modernisation of the estate by actively pursuing attractive investment opportunities of both existing assets and developments.

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Drum Income Plus REIT: Looking ahead to 2019 we believe that there might be a reduction in activity as investors adopt a 'wait-and-see' position with regards to Brexit. There is no consensus view as to what will happen, but the Investment Advisor believes it is likely that there will be a pause and more subdued property market activity. This occurred immediately after the EU referendum in 2016, when investors and tenants alike took time to consider where the market was heading. Central London offices remain the most vulnerable but it is likely that all sectors will be impacted in some way. Meanwhile the occupational market in the regions remains short of supply which continues to support rental growth in office and industrial markets. Secondary retail is also worrying the market and we may see further asset sales with falling values to match. We also expect a clearer picture to emerge as to which retail assets are in demand by occupiers which, in turn, might start to allay investors' fears in this sector.

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Safestore: The self-storage market in the UK and France remains relatively immature compared to geographies such as the USA and Australia. The Self-Storage Association ("SSA") Annual Survey (May 2018) confirmed that self-storage capacity stands at 0.67 square feet per head of population in the UK and 0.16 square feet per capita in France. Whilst the Paris market density is greater than France, we estimate it to be significantly lower than the UK at around 0.36 square feet per inhabitant. This compares with 7.3 square feet per inhabitant in the USA and 2.0 square feet in Australia. In the UK, in order to reach the US density of supply would require the addition of around another circa 12,000 stores as compared to circa 1,150 currently operating. In the Paris region, it would require circa 1,800 new facilities versus circa 90 currently opened.

While capacity increased significantly between 2007 and 2010 with respondents to the survey opening an average of 32 stores per annum, new additions have been limited to an average of 19 stores per annum between 2011 and 2016 (including container storage openings).

The SSA 2018 Survey reported 70 stores as having been opened across the industry in 2017. However, our own analysis of these openings shows that many were container-based operators. The SSA 2018 Survey also reported that operators have become more conservative since 2017 in terms of new store openings and site acquisitions. For

2019, operators have revised their new store predictions down from 52 to 47 and their site acquisitions down from 46 to 31. Traditionally, operators have opened or acquired far fewer stores than originally estimated. For 2017, the survey group had predicted in the previous year that it would open 47 stores and only 26 were in fact opened by the operators in the survey group. For 2020, around 42 new developments are predicted. Based on these estimates, and adjusting for historical inaccuracy, we estimate that around 30 stores per annum will be developed over the coming years.

New supply in London and Paris is likely to continue to be limited in the short and medium term as a result of planning restrictions and the availability of suitable land.

The supply in the UK market, according to the SSA survey, remains relatively fragmented.

Consumer awareness of self-storage is increasing but remains relatively low, providing an opportunity for future industry growth. The SSA survey indicated that 54% (58% in 2017) of consumers either knew nothing about the service offered by self-storage operators or had not heard of self-storage at all. The opportunity to grow awareness, combined with limited new industry supply makes for an attractive industry backdrop.

Self-storage is a brand-blind product. 61% of respondents were unable to name a self-storage business in their local area. The lack of relevance of brand in the process of purchasing a self-storage product emphasises the need for operators to have a strong online presence. This requirement for a strong online presence was also reiterated by the SSA survey where 67% of those surveyed (71% in 2017) confirmed that an internet search would be their chosen means of finding a self-storage unit to contact, whilst knowledge of a physical location of a store as reason for enquiry was c.23% of respondents (c.23% in 2017).

There are numerous drivers of self-storage growth. Most private and business customers need storage either temporarily or permanently for different reasons at any point in the economic cycle, resulting in a market depth that is, in our view, the reason for its exceptional resilience. The growth of the market is driven both by the fluctuation of economic conditions, which has an impact on the mix of demand, and by growing awareness of the product.

Safestore's domestic customers' need for storage is often driven by life events such as births, marriages, bereavements, divorces or by the housing market, including house moves and developments and moves between rental properties. Safestore has estimated that UK owner-occupied housing transactions drive around 10-15% of the Group's new lets. This is consistent with the SSA 2018 Survey which reported that only 22.5% of the industry's customer base use self-storage as temporary storage whilst moving house which includes both the rental and the owner occupier market.

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Resources

(compare resources funds [here](#))

Ed Warner, chairman, BlackRock Commodities Income: In the energy sector, structural shifts away from carbon-based energy supplies towards alternative and renewable energy sources will have fundamental and long-term consequences and be likely to cause permanent change in demand for these fuels. Whilst there remain good opportunities for investment in the traditional sectors of the industry, the Board is

increasingly mindful of the growing use of renewable sources of power in electricity generation and the rapid development of energy technology. The shift to electricity to power cars will drive growth across a wide range of industries including lithium miners, battery cathode manufacturers and a wealth of companies involved in the electrification of transport.

In the mining sector, future prospects depend to a large extent on the outlook for economic growth in China. If this can be sustained, most mining companies continue to be well positioned, having paid down debt and been disciplined in their approach to capital spending in recent years.

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Olivia Markham and Tom Holl, managers, BlackRock Commodities Income:

Energy

Until the last two months, it had been a rather uneventful year for the oil market. Crude oil (WTI, US\$) had traded around \$65-75 per barrel for much of the year with demand and supply relatively well balanced and the oil forward curve in backwardation. We mentioned this in the 2017 annual report and noted that the near-term oil price being higher than the price further in the future was a sign of a strong oil market. However, towards the end of 2018, the curve moved from backwardation to contango – a sign that the market was becoming looser/oversupplied. This was a significant catalyst in causing the oil price to decline sharply. This was caused by continued supply growth from the US, Saudi Arabia increasing production to over 11 million barrels per day and, critically, Donald Trump giving waivers to certain nations on the Iranian crude oil sanctions. This was completely unexpected by the market and meant there were around 800,000 barrels per day of additional supply in the market. The moves in the physical market were exacerbated by financial market players selling their oil exposure with the net length in crude oil futures falling by over 67% from the end of September to the end of November.

[When] OPEC held its December meeting. Members announced a production cut of 800,000 barrels per day in conjunction with non-OPEC members agreeing to cut 400,000 barrels per day (the majority of this burden being shouldered by Russia). This was a larger cut than expected, and the oil price rallied but this was short lived with the oil price relinquishing most of the gain within a few days.

One of the most notable features of the oil market during 2018 was the emergence of a number of constraints to US shale production. The usual anecdotes of a lack of skilled labour and rapidly rising wages for truck drivers were perhaps not critical, but the lack of available infrastructure certainly was. There is currently not enough capacity in pipelines from the Permian Basin (the key US shale producing region), and this has resulted in producers in the region having to sell their product at a deep discount to the widely referenced WTI oil price. Looking into 2019 there should be some relief towards the end of the year when over two million barrels per day of new pipeline capacity is due to come online.

Whilst the pipeline constraints discussed above have had a negative impact on certain US E&P's, it has been a tailwind for refinery operators. This has benefited both dedicated refining companies and of course the larger integrated companies who also have significant trading operations. The outperformance of the integrated companies during 2018 is therefore something we believe to have been driven by fundamentals rather than a wider market trend of investments seeking dividend focused companies (integrated) over growth companies (E&P's).

Mining

It was a strong start to the year for the mining sector with 2018 set to be another year of stable synchronous growth. This positive backdrop was further supported by a strong reporting season with companies delivering growth in earnings, dividends and free cash flow year-on-year. The increased focus on shareholder value creation with deleveraging, dividends and buybacks prioritised ahead of growth in recent years, sees the sector generating close to record levels of free cash flow underpinned by exceptionally strong balance sheets. Through a combination of dividends and buybacks, the large-cap diversified miners are forecast to deliver a 5-10% return in 2019, a high hurdle for mid-cap companies to compete against.

China's influence on the mining sector remained at the forefront of investors' minds from both a demand and supply perspective in 2018. China's supply-side reform programme which commenced at the end of 2016 has continued to see supply exit and commodity markets tighten quicker than anticipated. In addition China's "war on pollution", an initiative expected to continue into the future, has resulted in increasing premiums for high quality products and widening discounts for lower quality products. This has been a very notable feature of the iron ore market with high grade 65% iron ore trading at close to double the level of lower grade 58% iron ore in the middle of the year.

From a demand perspective, physical demand conditions remained reasonably solid throughout the first half of the year despite increasingly negative sentiment centred on the impact of the US/China trade war, cracks began to emerge in the second half of the year. Credit tightening measures put in place by the Chinese Government at the end of last year have resulted in a material slowdown in infrastructure spending in the country and while the Chinese Government has recently boosted infrastructure spending and is looking at various fiscal measures to support the economy, the outlook for demand in China remains an area of uncertainty for the market as we enter 2019.

The second half of 2018 was a tough period for resource investors with weaker than expected demand in China and higher than expected oil supply each undermining supply and demand fundamentals in their respective markets. Sentiment towards the sector was also negative with headlines around the US – China trade war being perceived as a key risk to the outlook for global trade, growth and subsequently the resources sector.

Whilst the major mining companies can no longer be seen as the growth companies that they were in the 2000s, they have transformed into dividend and free cash flow machines. Management and boards have embedded a strong bias to returning cash to shareholders rather than reinvesting and this combined with exceptionally strong balance sheets, makes the large-cap mining companies attractive investments. It is challenging for mid-cap companies to compete given their higher level of risk and volatility of cash flow.

Our 2019 outlook for oil is that from December's price (\$53.8 per barrel for Brent Oil at 31 December 2018), there is a greater probability of a higher oil price than a lower one given OPEC's willingness to defend this oil price with the recent larger than expected production cuts. However, we struggle to see upside beyond \$70 per barrel as demand destruction, notably in countries such as India, begins to occur above this level of price and shale activity becomes heavily incentivised. As we move towards 2020, the infrastructure constraints on shale production will begin to ease with pipeline capacity being added so we would expect shale supply to respond more readily to higher prices. In this type of environment we see the integrated oil companies as best positioned. The emerging cost pressures in the shale industry will likely disproportionately impact the lesser operators and those without tier one assets and we do not see the lower quality

companies trading cheaply enough relative to the highest quality companies to justify investment at this point in time.

The increasing use of renewable sources of power in electricity generation has been underway for many years now and offers some attractive investment opportunities in well established companies. Looking at the consumption of energy, the shift from internal combustion engines in cars to electric power is one we believe is going to happen more rapidly than consensus expectations. This is fuelling growth across a wide range of industries from metals such as lithium, battery cathode manufacturers and the vast array of automobile suppliers and technology companies involved in the electrification and, down the line, automation of transport.

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QuotedData

QuotedData is a trading name of Marten & Co, which is authorised and regulated by the Financial Conduct Authority
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