

## 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

Equity markets weakened in August as the trade war and Brexit rumbled on. The Chinese have been allowing their currency to slide. Fears about global growth are also weighing on the oil price. Gold is still seen as a safe haven, as are developed market government bonds – helping long-term rates move below short-term ones (an inversion of the yield curve).

### Global

The mood is cautious, based on the distortive effects of monetary policies such as quantitative easing as much as trade wars and weaker economic growth.

Lord Rothschild, outgoing chairman of RIT Capital Partners, questions whether the current high level of corporate profitability is sustainable. Harry Henderson, chairman of Witan, wonders whether the recession-signalling qualities of plunging bond yields are less reliable than in previous cycles given the influence of quantitative easing. Dr Kevin Carter, in his capacity as chairman of Murray International, says these extraordinary monetary policies have created an enormous legacy of indebtedness that remains the Achilles heel for whatever comes next. Dr Sandy Nairn, manager of EP Global Opportunities, thinks we might see inflation emerging, given the strength of labour markets.

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Exchange Rate	31/08/19	Change on month %
<b>GBP / USD</b>	1.2156	0.0
<b>USD / EUR</b>	0.9102	0.8
<b>USD / JPY</b>	106.28	(2.3)
<b>USD / CHF</b>	0.9904	(0.4)
<b>USD / CNY</b>	7.1565	4.0

Source: Bloomberg, Marten & Co

### MSCI Indices rebased to 100

Time period 31/08/2018 to 31/08/2019



Source: Bloomberg, Marten & Co

	31/08/19	Change on month %
<b>Oil (Brent)</b>	60.43	(7.3)
<b>Gold</b>	1520.38	7.5
<b>US Tsy 10 yr yield</b>	1.4961	(25.7)
<b>UK Gilt 10 yr yield</b>	0.479	(21.6)
<b>Bund 10 yr yield</b>	(0.702)	58.8

Source: Bloomberg, Marten & Co

## UK

Brexit still overshadows the UK but unfortunately there is more to worry about. The UK market may be cheap but is likely to be volatile.

Jamie Cayzer-Colvin, chairman of Henderson Smaller Companies, wants a resolution to Brexit, noting that many companies had planned for the March Brexit by increasing their stock, only to find this was a wasted exercise. Neil Hermon, manager of that trust, thinks that, if corporate confidence does not deteriorate, mergers and acquisitions activity will increase. The managers of Diverse Income Trust pose some troubling questions such as whether interest in high profile loss-making growth stocks will be sustained in a downturn and what the effect of a breaking the virtuous spiral of globalisation might be. Returning to Brexit, the chairman of JPMorgan Claverhouse, Andrew Sutch, believes we must be prepared for the UK stock market and sterling to experience significant volatility over the coming months, a sentiment echoed by Allister Langlands, chairman of Standard Life UK Smaller Companies. The managers of JPMorgan Claverhouse note that high yields make UK stocks look attractive but caution that UK dividend growth is slowing.



## North America

Optimism and pessimism in equal measures

The managers of Baillie Gifford US Growth Trust think that there is a good chance that stock markets will be driven by just a handful of stocks. They focus in their report on the prospects for the electric and self-driving car market. The managers of Canadian & General Investments highlight the usual roster of macroeconomic issues overhanging markets. Worryingly, they note that NAFTA (USMCA) has not yet been signed into law by all the signatories, suggesting there is still scope for this to cause problems. Dr Kevin Carter, here in his capacity as chairman of JPMorgan American, points out that this period of US expansion is now the longest in modern times and thinks caution might be needed. The managers of that trust are still looking for 10% earnings growth in 2020.



## Brazil

The Bolsonaro bounce is fading, now eyes are on the progress of reforms

Howard Myles, chairman of JPMorgan Brazil, is buoyed by the prospect of social security reforms in the country and the EU/MERCOSUL trade deal. The managers of the trust talk us through the impact of Bolsonaro's election victory. They also stress the importance of getting social security reforms through parliament on sentiment.

## Commodities and natural resources

Might the aversion that investors seem to have to resource sectors have left stocks attractively valued?

Richard Hayden, chairman of Riverstone Energy, sees opportunities given the scarcity of finance available to energy companies. The managers think merger and acquisition activity might pick up as smaller companies are trading on lower ratings than larger ones. David Cheyne, chairman of BlackRock World Mining, stresses the low valuation of the sector. The managers seem disillusioned by investors' failure to embrace low valuations. They urge investors to look at the true investment case for stocks and not get distracted by media coverage of the macro issues.



Volatility may pick up in the debt sector and investors may be too complacent

## Debt

The managers of NB Global Floating Rate Income are fairly positive, noting that, while leverage rose modestly, interest coverage remains strong and refinancing activity has significantly reduced the amount of loans maturing in the near term. The managers of RM Secured Lending expect that volatility will pick up. The managers of the debt portion of Acorn Income Fund, seem to suggest that investors are complacent of credit risk in particular. The managers of City Merchants High Yield think valuations may not reflect risk levels.

The energy market is changing, creating new opportunities

## Renewable energy infrastructure

Helen Mahy, chairman of The Renewables Infrastructure Group, talks us through the renewable infrastructure market in the UK and Europe and, in particular, how the market can expand without subsidy. John Leggate, chair of Gresham House Energy Storage, outlines how the battery storage market can help the UK adapt to the changing energy market.

## Other

We have also included comments on Asia from Aberdeen Asian Income Fund, Europe from Fidelity European Values, Japan from Fidelity Japan Trust, the environmental sector from Impax Environmental Markets, and technology from Allianz Technology. Sir Michael Bunbury, chairman of BH Global, says that everything points towards future bouts of uncertainty and volatility in markets. DP Aircraft talks us through the prospects for the global airline industry. Empiric Student Property is enthused about the potential for a significant influx of overseas students studying in the UK. We also have commentary on the private equity sector from Apax Global Alpha and BMO Private Equity.

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Global Investors

## Global

(compare Global funds [here](#))

### Lord Rothschild, chairman, RIT Capital Partners:

Valuations are, on many metrics, at the upper end of historical ranges at a time when geopolitical risks abound; credit quality is deteriorating; and global economic growth is weakening.

Of particular concern is whether the current high level of corporate profitability is sustainable. The last decade has seen a confluence of factors which have benefitted companies' earnings to an unprecedented extent. Lower cost of capital, reduced taxes, stagnant wages and the influence of globalisation contributed to record profit margins. These positive factors are, however, unlikely to be sustained. Trade wars, the weakening of economic growth and the risk of recession are of concern, particularly at a time when stock markets have reached all-time highs.

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**Harry Henderson, chairman, Witan:** In most cases, the significant returns enjoyed by equity markets in the first half of 2019 have done little more than reverse the falls seen in 2018. The US is a notable exception, having gained more than 20% over the 18 months since the end of 2017. Elsewhere, there looks to be greater scope for further upside, if investor faith in economic growth can be rekindled.

The prospects for the rest of 2019 and next year depend to some degree on whether the interest rate cuts and other forms of easier policy are viewed as a form of policy insurance to prolong the economic upswing or as emergency treatment for a moribund global economy. With global growth forecasts low but positive, the former looks more likely, in which case the recent fall in bond yields is probably overdone.

A number of risks to global confidence have outcomes which are currently unpredictable. The most pervasive is probably the trade policy of the current US Administration, particularly in relation to China. The consensus assumption is that a deal will be struck which maintains relatively free-flowing trade between them but this seems likely to be on terms less attractive to China than the previous status quo. This may be hard for them to accept, particularly if President Trump's re-election campaigning leads him to trumpet a 'win' over China (and, for that matter, Mexico and the European Union). Although it is hard to see any benefit for the US from a trade war, the path towards a trade 'peace' could be erratic.

The dispute between the US and Iran could become more heated, creating upward pressure on the oil price. However, unless Iran has the will and capacity to engineer a sustained interruption of tanker traffic through the Straits of Hormuz, there seem sufficient supplies to prevent a damaging spike in oil prices, the source of many past economic slowdowns.

Locally, UK politics and business plans are dominated by the question of Brexit - will the EU amend the offered deal, will Parliament approve a new deal (or the existing thrice-rejected one) or will the UK either leave without a deal or hold another in/out vote (which would require a delay in the departure date)? Each possibility would either require one group or another to change its declared views or a change in the parliamentary arithmetic. It promises to be an eventful few months but making investment decisions on the basis on a particular outcome is more than usually speculative.

Given the distorting effects of QE policies, the recession-signalling qualities of plunging bond yields appear less reliable than in previous cycles, particularly at a time when economic excesses are limited and forecasts for economic growth suggest anaemia rather than rigor mortis. Bond yields at record lows (even negative yields in some countries) may be trusting to chance in extrapolating current low inflation rates and monetary policy decades into the future. Despite subdued inflation in recent years, all trends have cycles and with unemployment low in many developed economies a rise in productivity looks necessary to square the circle of an improvement in economic growth without a pick-up in inflation.

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**Kevin Carter, chairman, Murray International:** The pivot undertaken by global policy makers since December last year has clearly provided real support to global equity markets. For many investors, the default path of least resistance is usually viewed as being up, so the prospects of continuing monetary stimulus, notwithstanding clear signs of economic challenges ahead, will likely promote continued confidence. However, the path ahead is likely to become increasingly difficult for the global monetary authorities as they navigate the late cycle nature of this economic expansion. Re-establishing some form of economic orthodoxy in an environment of rising political and market pressure will not be straightforward. The extraordinary monetary policies over the past decade have created an enormous legacy of indebtedness that remains the Achilles heel for whatever comes next.

The sharp decline in global bond yields suggests that weaker global growth is likely to be on the horizon. At this stage of the cycle, not only will interest rate policy become increasingly ineffectual, but also the importance of faltering earnings growth will become progressively more influential. Valuation support, through solid earnings, strong balance sheets and well-covered dividends has been noticeably absent from investor considerations of late, but remains the fundamental prerequisite for capital preservation and growth over the long term..

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**Dr Sandy Nairn, manager, EP Global Opportunities:** The trade dispute between China and the US has continued to impact the economic outlook, with notable declines seen in US business surveys and signs of weakness in Germany's manufacturing sector. With downside risks to the economic outlook, central banks have once again adopted a dovish stance, implying the prospect of further monetary stimulus to boost demand.

Despite a slight lowering of global growth forecasts, labour markets continue to look reasonably robust with wage growth becoming increasingly evident. This would not normally be a backdrop for a loosening of monetary policy. We expect that inflation will start to emerge which should inevitably bring with it a rise in interest rates and a reassessment of equity market valuations.

There has been an extensive period of Value stocks underperforming Growth stocks. In our view, it is a direct result of the cost of money being at and staying close to zero in real terms. We believe this is unsustainable and that we are closer to the point where equity and bond markets will recognise this.

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## United Kingdom

(compare UK funds [here](#))

**Jamie Cayzer-Colvin, chairman, Henderson Smaller Companies:** Populism has never been a more dominant influence in the political leadership of Western countries, and yet economies continue to grow, albeit at a slow pace, and unemployment continues to fall, creating new opportunities for investors. Global markets have responded positively to the latest round of interest rate signals emerging from the US and the expectation now is for lower rates, rather than rate increases, in the world's largest economy. Whilst progress on talks between the US and China on global trade has been mixed, any move forward here is likely to provide further support for investors.

Against this background, it is critical that the Brexit process is concluded, one way or another, and that there is some clarity around the UK's trading position with Europe and the rest of the world. This will help to remove any lingering uncertainty. Many companies had planned for the March Brexit by increasing their stock, only to find this was a wasted exercise; we shouldn't make companies do so again. I really hope that next year I shall be commenting on post-Brexit events.

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**Neil Hermon, manager, Henderson Smaller Companies:** The UK economy is showing anaemic growth. Brexit deliberations stumble on, with intermittent progress. 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 and that Boris Johnson has replaced Theresa May as Prime Minister. The battle to replace her and the Summer Parliamentary recess accounts for a significant proportion of the time before we are due to leave the EU. This political uncertainty is likely to weigh on consumer and business confidence and delay and postpone investment and purchasing decisions, further dampening economic growth.

Outside the UK, economic conditions are robust, but slowing. Europe, in particular, is showing signs of economic slowdown. Escalating trade tensions are providing additional negative commentary and after what seemed to be good progress between the US and China, recent rhetoric and actions have seen an increase in volatility of relations between the two countries. The rise in US interest rates in 2018 flagged to investors that loose global monetary conditions were reversing. However, commentary from the Federal Reserve has softened recently and the expectation is that there will be cuts in US rates in 2019.

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 come from overseas, even among smaller companies, and should be boosted by the relative weakness of Sterling.

In terms of valuations, the equity market is now trading below long-term averages. Mergers and acquisitions ("M&A") remains a supportive feature for smaller companies. If corporate confidence does not deteriorate, M&A will increase, especially as little or no return can currently be generated from cash and the cost of debt is historically low. We have seen interest in UK corporates from abroad and from private equity and, given the relatively low valuation of UK equities and a weak currency, we expect this trend to continue. However, a return to a more vibrant M&A market depends on a Brexit resolution and clarity around the UK's trading position with Europe and the rest of the world.

The smaller companies market continues to throw up exciting growth opportunities..

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**Gervais Williams and Martin Turner, managers, Diverse Income Trust:**

### **Questions posed by globalisation and nationalism**

Over the last decade, stock markets have risen as bond yields have fallen to ultra-low levels and as market liquidity has been plentiful, possibly as a result of many years of quantitative easing. Economic growth may have been patchy, but fortunately the Chinese economy has bucked the wider trend and this has provided some positive impetus.

Over recent years, global equity markets appear to have become more unsettled. Note the correlated setback of nearly all stock markets during the second and fourth quarter of 2018. Furthermore, government borrowing costs in some territories, such as Europe, have fallen into negative territory recently. Ultra-low or negative bond yields have been a feature of Japanese markets for decades and experience implies that these can be a sign of corporate stagnation. They imply an absence of the vibrancy needed to generate future growth. Ultimately, negative bond yields may sap their economies of an ability to put capital to work productively.

The big question is whether the recent wide-ranging reduction of bond yields into negative territory necessarily implies that the decades of supernormal growth of China are now past. The prior trend of easy market liquidity could be becoming more sporadic as well. If either, or both, of these conclusions are correct, then stocks carrying elevated risk metrics could get caught out. During downturns, those with too much debt or those that are persistently loss-making can suffer disproportionately. Interest in high-profile, loss-making growth stocks can work both ways. For example, the share prices of "dot.coms" fell back precipitously after investor interest peaked out.

Meanwhile, a large percentage of stock market dividend income in the UK has become more reliant on a relatively limited number of mainstream companies that operate in an even more narrowly based range of sectors. After years of squeezing dividend cover lower, some mainstream UK stocks have now reached the point where the only way forward involves a dividend cut.

The nature of the problem is that the past virtuous spiral of globalisation could turn a little vicious.

The risks are often most acute for those with substantial debt, especially should it become due for repayment during a geo-political crisis. In such cases, excessive debt can precipitate additional emergency fund raisings, dividend cuts, or even a rise in corporate bond defaults.

Furthermore, many mainstream quoted businesses still have major pension liabilities from the past. These have been tolerable at times when asset prices are rising, but additional corporate bond defaults or prospective dividend cuts could destabilise the delicate balance that currently exists. Even a minor mismatch in the projected returns on pension fund assets would lead to much greater pension deficits. Since the Pension Regulator is not likely to take a soft line on this, it too could lead to yet more emergency fund raisings and dividend cuts.

Lastly, one of the adverse side effects of three decades globalisation is that it has happened everywhere. For example, whilst the UK stock market dividend income is dominated by several very successful oil and pharmaceutical majors, these types of

companies have also been successful elsewhere. This suggests it may be harder to diversify sector specific risk after globalisation.

We believe that investors may need to adjust the mix of assets within their portfolios. It appears that investing in a number of stock market index funds might generate lesser capital gains than in the past and, at times of market setbacks, many mainstream stock market indices could prove to be uncomfortably correlated. This logic implies that there may be real advantages in considering more selective strategies in future.

Overall, it appears that a major valuation gap has opened up between UK and US listed companies, which we expect to narrow once the detail of Brexit is known. In part, this may be due to renewed capital allocations to UK quoted companies. We also anticipate that there will be more takeovers of UK quoted companies. Either way, we expect the UK stock market to outperform others and anticipate that the greatest upside potential often lies in small and microcaps.

### Prospects

In recent years, the absence of productivity improvement and wage growth has led to a seismic change in the political and economic agenda. With the substantial change in the market environment, we believe that the agile and well capitalised will generate disproportionate returns.

On top of this, there is scope for three past headwinds to reverse:

Firstly, when the uncertainty over the detail of the UK's withdrawal from the EU is known, it is expected that investors will step up their allocation to UK listed companies generally, helping the UK stock market to outperform others.

Secondly, anxiety ahead of Brexit has been particularly acute amongst the share prices of UK microcap stocks and hence their valuations have fallen well behind those of the mainstream UK listed stocks. Therefore, we believe that UK microcaps have greater upside potential than the UK stock market itself.

Thirdly, we look forward to the time when regular companies, generating good and growing dividends, especially those standing on undemanding valuations, resume their prior long-term trend of outperformance.

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**Andrew Sutch, chairman, JPMorgan Claverhouse:** Having lived with the issue of Brexit for over three years there are many who would just like it to go away. It does now look as though we are entering the endgame of the UK's plan to leave the European Union ('EU'). What is still uncertain is what will be the short and long term effects of Brexit on the UK economy, markets and livelihoods. Notwithstanding strong equity markets, I believe that we must be prepared for the UK stockmarket and sterling to experience significant volatility over the coming months.

Appetite amongst investors for UK equities has been damaged by the Brexit uncertainty, with significant redemptions over recent months from UK equity open-ended funds and discounts widening in the UK equity investment trust sector.

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**William Meadon and Callum Abbot, managers, JPMorgan Claverhouse:**

Relative global valuations strongly favour equities over bonds and within this, the high yielding UK equity market looks particularly good value. But UK dividend growth is slowing as a number of blue chip companies have recently cut their pay-outs to

shareholders. Moreover, the uncertainty over the timing and nature of our departure from the EU continues to weigh heavily on both consumer and company confidence, the effect of which is seen in a moribund housing market, subdued corporate investment and a falling pound.

The new Prime Minister, Boris Johnson, is pledging 'do or die' to take the UK out of the EU by 31st October 2019. However, the EU has reiterated that many of the matters which Mr. Johnson thinks are still up for negotiation are in, their minds, definitely not. So, if the Prime Minister is to keep his pledge, then a 31st October departure is likely to be without a deal with the EU. In such a scenario, we would expect both the UK economy and sterling to suffer significant setbacks, at least in the short term. However, international companies and exporters (which make up the bulk of the portfolio) would benefit from a weakening of sterling.

These are very uncertain times and the economic and political stakes could not be much higher. With such a volatile and rapidly changing political UK and European backdrop it would be wrong (and dangerous) of us to be too prescriptive as to how events will unfold.

Whilst UK equities are likely to be more volatile in the second half of the year, our belief is that they continue to represent good value for the medium term investor, especially if interest rates stay low and sterling remains at these very competitive levels.

Encouragingly, the global economy remains reasonably strong but not so robust as to change our view that interest rates will remain very low in the developed world for the foreseeable future.

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**Allister Langlands, chairman, Standard Life UK Smaller Companies:** It seems as though we are stuck in a form of Groundhog Day. This time last year I referred to how the Brexit negotiations and the decisions of Donald Trump continue to influence market movements and the geopolitical backdrop. I think that everyone expected that there would be more clarity with regard to the Brexit position, but as the date of the UK's expected departure from the EU has been moved to 31 October 2019, that has not happened. Mr Trump continues to influence short-term market sentiment, with frequent pronouncements on changes to tariffs with China being the most significant.

Brexit remains at the forefront of our minds; the succession of Boris Johnson as Prime Minister appears to have changed the tone of the conversation that the UK is looking to conduct with the EU, but it remains to be seen whether it has any impact on the EU's stance, which has been very clear and consistent to date. Mr Johnson also needs to manage the House of Commons and there remains a potential disconnect between the position of the majority of MPs and the country at large, as evidenced by the referendum in 2016.

This is not a comfortable backdrop for investors and we saw in October 2018 how sensitive markets can be to changing circumstances.

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**Harry Nimmo, manager, Standard Life UK Smaller Companies:** It is pleasing that the new issues market in the UK is still producing strong companies.

The two over-arching "macro" issues going forward remain Brexit and the threat of trade wars. Bad outcomes in both cases could cause mayhem far beyond the realm of UK smaller companies. Investors thus should continue to favour better quality, growing companies with strong business momentum.

Smaller company investing should be viewed as a long term investment and we have no doubt that patient investors will be rewarded in the longer term.

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## Asia

(compare Asian Pacific funds [here](#))

**Charles Clarke, chairman, Aberdeen Asian Income Fund:** After a strong start to the year, Asian stock markets have pulled back somewhat as trade tensions, primarily but not solely between the US and China, are compounding fears about a slowing global economy. Falling trade volumes, subdued business sentiment and weakening economic data from China could all put pressure on regional corporate earnings. In addition, the recent unrest in Hong Kong heightens concerns. Against this backdrop, there are some silver linings. For one, domestic consumption - in China and other parts of Asia - remains relatively resilient. Furthermore, with lower rates leading to deteriorating bond yields, dividend-focused stocks now appear more attractive to investors.

From the longer-term perspective, Asia remains the world's fastest-growing region and is expected to dominate global growth in the next decade. The rise of the Asian consumer, fuelled by higher household incomes and a burgeoning middle class, is set to continue.

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## Europe

(compare European funds [here](#))

**Fidelity European Values:** Little was resolved in terms of what had been worrying markets in the latter part of 2018. Trade threats rumbled on, political uncertainty remained high and the Brexit "can" was kicked down the road. However, the key turning point for investors has been the growing expectation, confirmed as the period progressed, that central banks would loosen monetary policy if evidence began to mount that the global economy was slowing. In the US, the Federal Reserve Chairman, Jerome Powell, indicated a change in direction from monetary tightening to monetary easing. Towards the end of the review period, the outgoing head of the European Central Bank, Mario Draghi, added his own commitment by pledging again, to do effectively "whatever it takes" and highlighting some arrows in his quiver, including further reductions in interest rates, more dovish forward guidance and perhaps a resumption of bond purchases. To date these are mostly words and not actions, but the market has been comforted by the expectation that central bankers stand ready to provide more liquidity to keep this long cycle going. Investors have seen this before and know that increased liquidity buoys all asset markets, including continental European equities, even if the benefit to the global economy is more questionable.

The price of crude oil has increased over 30% since the December low. The combination of looser global liquidity conditions, collapsing Venezuelan shipments and deeper than projected Saudi production cuts will likely keep prices inflated if not rising further. Tensions with Iran have been increasing, following incidents in the Straits of

Hormuz, also contributing to higher oil prices. A sustained higher oil price could negatively impact demand and push up inflation above the Federal Reserve's 2% target.

Fundamental progress in continental Europe has been lacklustre. The Italian economy went into recession causing much doubt that the populist government will be able to prevent the government budget deficit from flouting EU guidelines. The German economy is sluggish, partly due to the slowdown in global automobile markets, particularly in China. Concerns around the knock-on effects of a possible "no deal Brexit" continue to plague certain stocks and sectors that have a relatively high exposure to the UK. The earnings growth of continental European companies has been steadily revised down from close to double-digits at the start of the year to a mid-single digit figure.

The direction of interest rates and long bond yields has been a major determinant of sector returns during this period. Bond-like sectors such as utilities, which enjoy steady revenues and profits, have benefited. The banking sector, however, continues to be a laggard in European markets. Lower or negative interest rates would put further pressure on net interest income, which often makes up much of the revenue of European banks. In addition, some of the Scandinavian banks which have generally performed better than their peers since the great financial crisis, have recently become embroiled in money-laundering scandals dating from that period.

### Outlook

All asset classes have risen handsomely this year in anticipation of easier monetary policy. There is a risk therefore that investors will be disappointed by the scale of monetary easing in the months ahead. Or perhaps the greater risk is that easier policy fails to kick-start global economic and corporate earnings growth. The yield curve inversion in the US, with three-month interest rates moving above ten-year rates, and the narrowing of equity leadership, with very large companies outperforming, both suggest that this long economic and stock-market upturn may be nearing its end. The conundrum is that the market already seems to be anticipating this given the growing dispersion in valuation between companies. Investors already appear to be very sceptical of the sustainability of earnings in more cyclical sectors.

Geopolitical risks continue to beset investors, with no clear end in sight. When it comes to the trans-Pacific trade dispute, it is likely that some European industries may in fact benefit by picking up business lost to their US and Chinese competitors on the back of worsening tensions; with some examples being aerospace, technology and telecommunications.

Conversely, these benefits will most likely be neutralised by the potential impact of trade wars on overall market returns, via a negative impact on sentiment and global growth. European industries with higher exposure to Chinese consumption growth, for example consumer discretionary and industrial stocks, might underperform in the short term.

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## Japan

(compare Japan funds [here](#))

**Nicholas Price, manager, Fidelity Japan Trust:** Japanese stocks have lagged their global peers so far this year, as uncertainty over US-China trade frictions and the

impact on the global economy have clouded the outlook for corporate earnings. The consensus of analyst forecasts is that the market appears to have bottomed out and earnings trends should stabilise in the coming quarters. However, share prices are likely to remain volatile amid a steady stream of political newsflow.

While not immune to external headwinds, the Japanese economy remains stable. Confidence among Japanese manufacturers has clearly weakened, but sentiment in the non-manufacturing sector is holding up. Employment conditions remain tight, with the job-offers-to-applicants ratio at record levels. Capital expenditure plans are supported by non-cyclical factors such as investment in labour saving technology and research and development. The Bank of Japan remains highly accommodative and extensive counter measures will be deployed to mitigate the effects of the October 2019 consumption tax hike from 8% to 10%.

From a valuation perspective, Japanese stocks priced in a significant level of risk in late 2018 and continue to look undervalued at around 12x forward earnings. With valuations testing historical lows in some parts of the market, there are opportunities to capitalise on disconnects between near term sentiment and mid term fundamentals..

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## North America

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

**Baillie Gifford US Growth Trust:** Academic studies have clearly shown that, over the very long term, most of the net excess return for the market is attributable to a small number of companies that do exceptionally well.

We are of the view that the pattern of returns that we have seen historically may turn out to be even more pronounced in future, given the pace of change affecting many industries. In other words, the gaps between the winners and losers are more likely to widen than shrink. The disruption enabled by the emergence of new technologies started in a few select industries, such as retail and advertising, but it is spreading more broadly. We are now seeing digital, mobile and machine learning technologies applied in insurance, banking and the healthcare sector.

Another part of the global economy where we expect to see significant transformation over the next decade is the transportation sector. It is an area which has seen little change since the Ford Model T started rolling off the production line over 110 years ago. People still buy cars, fill them up with petrol, and then drive them from A to B. But there are some major problems with this model. Firstly, petrol is a hydrocarbon, and it is probably not in society's best interests that we keep burning hydrocarbons at the rate we have been doing historically. Secondly, car ownership is inefficient with the average car being used only about 5% of the time. Given that Americans collectively spend around US\$1 trillion per year on their cars this low capacity utilisation represents a huge waste of resources. Finally, humans are fallible - we are easily distracted, which leads to accidents. Tragically, 1.4 million people are killed every year on roads around the world, making road traffic injuries one of the ten leading causes of death across all age groups and the leading cause of death in young people between the ages of 5 and 29 years.

These challenges are not insurmountable, however. There are three important and parallel technology-driven shifts underway right now which could reshape the transportation sector over the coming decades. These are: (1) the transition from petrol

engines to electric vehicles ('EVs'); (2) the shift from car ownership to ride-sharing; and (3) the move from human-driven cars to autonomous vehicles. The exact slope of the adoption curve for each of these new products is currently unknown, but the arguments for their mainstream adoption in the long term are compelling.

Whilst all three of these technology-led evolutions are currently at a nascent stage, the first - the shift from petrol to EVs - is most advanced. It sounds strange to say it now, but it was not so long ago that electric cars were undesirable. Tesla has, pretty much single-handedly, made electric cars cool. EVs are fast, safe, clean and increasingly affordable. Whilst true plug-in EVs still represent a small proportion of annual car sales in the US and globally, the trends are indicative of a major shift underway. In the US, EVs made up just over 2% of new car sales in 2018 representing an almost doubling of market share year over year. In California, arguably a leading indicator for the adoption of new technologies, EVs comprised almost 8% of new vehicle sales last year. The astonishing fact that the Tesla Model 3 was the best-selling car in the US by revenue based on the last four quarters, coming in ahead of the Toyota Camry, perhaps marks a major milestone on the coming transformation of the car industry and the end of our reliance on a major finite resource.

The second of the major technology-led shifts in the transportation sector, that from car ownership to ride-sharing, is also gathering momentum, as anyone who has used the services of Uber or Lyft will attest. What we may be seeing with these services is the beginning of a major change in mindset amongst consumers. For so called digital-natives, on-demand services such as Airbnb and ride-sharing are the new normal. The changing attitudes towards driving are strikingly evident in the UK, where the proportion of 17 to 20 year olds with a driving licence has plummeted from almost half in the early 90s to under one-third in 2014.

Last year fewer than 1% of miles driven in the US were on the ride-share networks which serves to highlight the scale of the opportunity. We invested in Lyft for the Company in the middle of 2018 when it was still private. Our work has led us to conclude that Lyft is a company with a strong social purpose and genuinely distinctive culture. These softer points, whilst admittedly intangible and difficult to measure, may add up to a significant source of edge. The fact that Lyft has risen from a very distant position in the US market to challenge Uber highlights the importance of factors like culture in consumer-facing businesses.

If Lyft does succeed in weaning consumers off car ownership it could act as a catalyst for much bigger societal changes. Many US cities have been optimised for cars rather than people. If more trips are taken on the ride-sharing networks then fewer parking structures will be required, freeing up room for more green spaces or perhaps even denser cities, with more people living closer to where they work. There is potentially scope for ride-sharing to be a substitute for a significant proportion of car ownership in its current form, perhaps 5% -10% of miles driven. This is still a very meaningful market opportunity for Lyft. However, for ride-sharing to reach a much greater penetration figure will require the cost of ride-sharing to come down substantially, and for that we need autonomy.

The third technology-led shift, the move from human-driven cars to autonomous-vehicles, is arguably the least mature but the impact of its adoption could be truly transformational across several different domains. A decade and a half ago progress in autonomous driving technology was being led by a select number of academic institutions like Stanford and Carnegie Mellon. However, the centre of gravity has shifted to the commercial space with Alphabet's Waymo, Tesla and Aurora arguably leading the way, albeit with quite different approaches. We believe broad exposure to this area is appropriate given the potential scale of its impact. There is no consensus on when true autonomy will become mainstream which is not surprising given the



enormous range of edge cases that any system will have to deal with (e.g. roadworks, snow), but most would agree that the remaining problems are solvable, and it will not be that long until we are being driven around by computers.

Ride-sharing is still quite expensive on a per-mile basis. Around two-thirds of the total cost is attributable to the driver. By incorporating autonomous technology into ride-share networks, it is possible that costs would fall to a level where it would be almost inconceivable that anyone would want to own a car for practical purposes. In addition, autonomous software, when deployed at scale, ought to have the potential to be orders of magnitude safer than human drivers, leading to a drastic reduction in road fatalities and injuries. It will also free up time that would otherwise have been spent driving for productive work and save consumers considerable money. Lyft is investing significant capital in the development of its own ride-sharing capabilities and is also working closely with Waymo to trial autonomous Waymo vehicles on the Lyft network in a small area just outside of Phoenix, Arizona.

The three major shifts outlined above are likely to lead to a complete redrawing of the landscape in the multi-trillion-dollar global transportation industry over the next decade. This will lead to dislocation not only within transportation but across a whole host of industries which support the current status quo. What will come of the traditional car companies and their supply chains and distribution and support networks? What about the oil companies? Or the car insurers? These businesses make up a substantial proportion of market indices. Fortunately, disruption also brings opportunities.

The above is just a snapshot of the technology led change which is underway in society. We believe that we will come to view these times on a par with the industrial revolution.

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**Canadian & General Investments:** About the only forward-looking comment that could be made at this time, unfortunately is that the future is beset with uncertainty. Many of the markets' influential and overriding concerns have been around for a while now and still remain unresolved. In the case of NAFTA (USMCA), even though the successful conclusion of negotiations for the next version provided some relief in the North American context, the approval process required to pass it into law keeps getting extended and opens up the possibility of renewed political involvement before the United States and Canada can finalize the agreement. Fortunately, one of the participants, Mexico, has taken the lead and has passed the document into law. But until it's over, it's not over and, although relegated to the backburner for now, this issue remains in play as a low probability disruptor.

As the Brexit issue keeps getting pushed further along the calendar, it remains a mystery. It has thrown the U.K. political scene into turmoil which adds uncertainty and though distant and indirectly connected to North America, Brexit has the potential to impact all markets.

However, the overwhelming cloud over stock markets for months has been trade tensions between China and the United States. Indeed, after months of seemingly productive advancements towards something, meetings were abruptly halted, additional and retaliatory tariffs were put in place and a ratcheting up of threats and hostilities ensued.

Investors were hoping that meetings between the two countries' leaders at the G-20 at the end of June could restart negotiations and begin to relieve some of the fallout that had arisen as a result of the tradewar and arrest further deterioration. Fortunately, an announcement by China and the U.S. at the event that, at least for now, a cease-fire agreement had been agreed to and the stalled trade talks would resume. Once again,

financial markets were calmed short term, but doubts persist about the two nations' willingness to compromise on a long-term solution.

Markets have absorbed many of the negative issues quite well, having shown great resilience in spite of these trade tensions and a slowing global economy.

Perhaps investors have so far been encouraged with a supportive low interest rate environment and retain hope that those who are in positions of responsibility are committed and determined to remedy the outstanding ailments before there is an acceleration of further economic damage on the global scene.

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**Dr Kevin Carter, chair, JPMorgan American:** As 2019 began the US Federal Reserve performed an about turn on its expectations for short term interest rates, reversing its proposed increases in 2019, to expected cuts. This provided considerable cheer to the stock market which rose strongly in the first quarter. During the period under review the US entered its longest period of economic expansion - 121 months of GDP growth, eclipsing the 120 months from 1991 to 2001.

The length of this economic expansion coupled with an inverted interest rate yield curve in which short rates are higher than longer term rates, suggests at least a material slowdown or possible recession lie ahead. Presumably this is what the Federal Reserve is now weighing more highly in its policy outlook, along with lingering global trade issues, and some festering geopolitical concerns.

Stock market investors need to balance the still healthy corporate sector with these time honoured signals for caution.

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**Timothy Parton and Jonathan Simon, managers, JPMorgan American:** Our analysts' estimate for S&P 500 earnings currently projects 3% growth for 2019 and 10% growth for 2020. While subject to revision, this forecast reflects our expectations for modest expansion in the underlying economy and includes our best analysis of earnings expectations for this year. However developments in global trade will remain key to investor sentiment and so will likely continue to contribute to market uncertainty.

While continued earnings growth should provide support to the equity market, we are monitoring the incremental risks that could represent future headwinds for U.S. stocks. In particular, we continue to watch closely the state of trade relations, movements in global economic growth, and the implications of Fed policy, all of which have the potential to heighten volatility.

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## Latin America

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

**Howard Myles, chairman, JPMorgan Brazil:** GDP growth in Brazil over the medium and longer term is mainly dependent on the extent of reforms to social security, taxation, labour markets and education, as well as continuation of the privatisation programme. The initial votes in the lower house of Congress on the Social Security Reforms, as noted above, in a greater amount and by a much wider margin than

expected, augur well for their final approval in both houses of Congress, which is currently expected before the year end. If the Social Security Reforms obtain this final approval, the momentum will exist for the government to move on to the other reforms mentioned above with tax reform likely to be the priority. If passed, these additional reforms will raise the long-run sustainable rate of growth of the Brazilian economy substantially. In addition, the recent conclusion of negotiations for a free trade agreement between MERCOSUL, of which Brazil is the leading member, and the European Union augurs well for the future as this is expected to have a positive impact on many of the key sectors in the Brazilian economy.

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**Luis Carrillo and Sophie Bosch de Hood, managers, JPMorgan Brazil:**

#### **Market background: before and after the 'Bolsonaro Bounce'**

Brazil's presidential election at the end of October was the pivotal political event of the period under review, impacting both business sentiment and equity markets' performance before and after. Trepidation in the run-up to the election was followed by euphoria and then, latterly, reality. The remarkable political rise of right-wing congressman Jair Bolsonaro of the Social Liberal Party resulted in his landmark victory over left-wing Fernando Haddad of the Workers' Party, with Bolsonaro winning 55% of the vote in the process.

Before the Bolsonaro victory [*there*] was a period of considerable volatility, with politics, inflation worries and market sentiment at home and abroad all weighing heavily on the country's economic prospects. As well as a general increase in concerns over emerging markets, Brazil's own economy was further burdened by election fears as well as by the much-publicised truckers' strike, which brought the country to its knees; it triggered supply shortages, stalled production and a fall in household spending. Industrial production in Brazil plummeted by 10.9% in May 2018, one of the biggest monthly declines in recent decades. Both economic growth and inflation forecasts were revised downwards and expectations for company earnings were lowered. Away from Brazil, fears of slowing global growth and the ongoing tit-for-tat trade dispute between the United States and China created fears for the global economy and precipitated worsening market conditions around the world.

Brazilian markets stabilised in September when the clouds of uncertainty about the likely election outcome lifted. Indeed, post-election, there was an extremely positive market reaction to Bolsonaro's victory which shielded Brazilian stocks from the global market sell-off in October. Markets rallied in comparison with other emerging markets, reflecting high hopes and investor confidence in the Bolsonaro government's commitment towards fiscal and structural reform, particularly its highly anticipated plans for a major pensions system overhaul.

The reform plans are ambitious, requiring considerable political cooperation not yet in evidence. Getting the plans through Congress will be an uphill battle and a sense of realism has replaced the post-election euphoria. By April, equities were struggling as the pension reforms moved forward at a snail's pace and economic data disappointed. The lack of discernible progress spooked investors and weakened both consumer confidence and economic activity.

#### **Outlook: uncertainty brings opportunity**

At least in the short term, market uncertainty and fragile business sentiment are likely to prevail.

Globally, economic momentum has faltered, and the US-China trade spat that has dominated the business and economic news continues to linger. In Brazil itself, projections for economic growth have been reduced to 1.7% and the road to economic recovery will depend very much on the progress of fiscal reforms, so badly needed to alleviate the government's structural expenses and plug the gaping budget deficit. The scale and success of these reforms will determine the country's future economic growth trajectory. Although we believe the government is resolute on delivering these reforms, the administration's progress has been laboured so far and confidence in its ability to do so has plummeted. Opposition to the reform process remains formidable and future battles could seriously jeopardise the ability of the reforms to tackle the budget deficit. Failure could have harsh consequences for the Brazilian economy, pushing it back into recession.

There are positives: privatisations are planned for several state-owned entities and the Bolsonaro government's more pro-business stance should fuel growth. The Brazilian currency is cheaper than it was in effective terms and we expect it to strengthen from here, increasing the sterling value of Brazilian company earnings and valuations. Historically low interest rates (and a benign outlook for rates), low inflation, high earnings growth expectations and a recent marginal improvement in unemployment figures also provide cause for cautious optimism.

We believe the financial and operational leverage of the economy will come through in due course and that, this time, the domestic names that we favour should outshine those in the materials and energy sectors that benefitted from currency rates and commodities strength last year.

Credit growth to both individuals and companies turned positive in 2018 and we expect this trend to continue, supporting future economic activity. However, in the short term, all eyes will remain fixed on the progress of pensions reform; this will be the key determinant of economic growth which we expect to remain muted until tangible progress is evident.

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## Commodities and natural resources

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

**Richard Hayden, chairman, Riverstone Energy:** After an especially turbulent fourth quarter last year, crude oil prices modestly recovered during the first half of 2019. Though the WTI price continued to fluctuate, it ended the period at \$58 per barrel, compared to \$45 per barrel at the end of 2018. WTI continued to be acutely influenced by developments in the geopolitical environment, notably the shifting dynamics of the U.S.- China trade discussions and concerns around slowing economic growth.

The challenging oil price backdrop has continued to impact energy equities, particularly within E&P. While energy equities dropped in tandem with WTI price decreases late last year, they have been much slower to recover as oil prices have trended upwards this year. WTI increased by 29 per cent. through 30 June 2019 compared to the end of 2018. However, the S&P Oil & Gas E&P Index only recovered by 3 per cent. and the Canadian S&P TSX Oil & Gas E&P Index dropped by 1 per cent. during the same period. This dynamic is reflective of the enduring wariness of public institutional investors towards the sector, given the lengthy nature of the current downturn which started five years ago.

Despite turbulence in commodity prices and the public markets, the current market environment presents unique investment opportunities for private capital as public financing sources for energy companies remain scarce.

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**Riverstone Energy:** Oil prices continued to experience significant fluctuations through the first half of 2019. Following the \$45 per barrel WTI pricing at the end of 2018, prices rebounded as sanctions on Venezuela and Iran tightened and U.S. supply growth appeared to be slowing. As U.S.-China trade discussions were tabled and inventories were building, spot oil prices exhibited volatility. However, they have since stabilised as trade discussions have resumed and OPEC announced extended production cuts.

Although energy companies have focussed on capital discipline and commodity spot prices have recovered moderately, North American energy valuations remain at muted levels. Despite the gains in near-term prices, the forward oil prices supporting valuations have been anchored in the low-to-mid \$50 per barrel range. Meanwhile, public energy equities continue to underperform the broader market and have recovered materially less than spot prices as investor sentiment towards the industry remains weak. As a result, trading multiples have continued to compress, furthering the downward trend that has persisted over the last three years. These factors, combined with public investors' demands for capital discipline, have also limited capital markets and M&A activity. In the E&P sector, consolidation could potentially be on the horizon as the "majors" have begun to trade significantly above their smaller peers and there appears to be a need for smaller producers to gain scale, lower their cost structures and diversify their asset bases in order to be competitive in a lower commodity price environment. Chevron's bid for Anadarko Petroleum, which eventually lost to a bid by Occidental Petroleum, was the first major transaction to be announced, though subsequent M&A activity has been somewhat limited.

Several factors which will meaningfully affect inventory balance have the potential to improve market sentiment and support a sector recovery. First, a stable geopolitical environment will be critical. Recent developments including OPEC's extension of their production cuts through the first quarter of 2020 and continued dialogue in U.S.-China trade discussions following the G20 Summit are encouraging signals. Tensions between the U.S. and Iran will also be an important issue to monitor as hostility has risen between the two major oil producing nations recently. Recent seizures of oil tankers in the Strait of Hormuz by Iran have continued to create uncertainty in the oil markets and could lead to supply constraints. Secondly, there will be a considerable focus on U.S. producers' ability to grow volumes with limited access to capital markets, reduced capital budgets and declining quality inventory. Investor sentiment is expected to improve if producers are able to generate free cash flow sustainably and return value to shareholders.

Despite a challenging backdrop for E&P, REL believes that the energy investment landscape is still quite attractive, especially across subsectors. The need for critical infrastructure in key basins continues to provide compelling investment opportunities within midstream. Meanwhile, secular trends indicate that the long-term demand for power and electricity will increase immensely and outpace the rate of growth for hydrocarbons. This dynamic, along with the shorter-term cyclical troughs that certain power markets are facing, create a constructive market environment.

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**David Cheyne, chairman, BlackRock World Mining:** Current low valuations in the sector appear to reflect investor caution about the outlook for global growth and therefore scepticism about current pricing. This sees the sector trading at a significant valuation discount to world markets, despite the improvement in balance sheets across the sector, strong levels of cash generation, and the scope to use surplus cash flow to enhance earnings per share through buy backs.

Our Portfolio Managers believe that, notwithstanding the duration of the current economic cycle, there remains scope for economic growth to continue. With high and well covered dividend yields, the major diversified mining companies offer an attractive return from their dividend income alone, enhanced by the scope for capital appreciation when the strength and flexibility of their free cash flow becomes better appreciated by the market.

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**Evy Hambro and Olivia Markham, managers, BlackRock World Mining:** The year 2019 has so far been a year in which unforeseen events have impacted the performance of the mining sector more than in recent years. Despite global markets continuing to grow, the gyrations in both political and financial factors have largely dictated returns. In addition, the tragic tailings dam collapse in Brazil has completely altered the iron ore market, which in turn significantly shifted the outlook for iron ore producers around the world.

Another area of frustration has been the ongoing derating of resources companies, as multiples have continued to contract versus prior periods. The obvious value that is available in the equity market today is encouraging, but the fact that it has been around so long leaves us wondering when the sector is going to be able to command the multiples it used to enjoy.

It is very pleasing to see the sector returning to positive territory. In last year's Annual Report we mentioned how disappointing it was to see companies doing the right thing but not being rewarded by the market. This confusing trend continues today as generalist investors remain on the side-lines, still nervous about increasing exposure to the miners. It is easy to have sympathy with their caution due to the ongoing US/China trade discussions, slowing global growth, political battles in Europe, as well as Brexit, reversal of US interest rate policy, heightened tensions in the Middle East and North Korea once again testing missiles. Despite all of this, we feel that it is important for investors to look through the headlines and search for the detail behind the companies to look at the true investment case and not get distracted by media coverage of the macro issues.

The mining sector today is in a very different place to that of prior decades and cycles. The lessons that have been learnt from these earlier periods have shifted strategy away from growth at any cost to a more shareholder friendly approach. We describe the potential for the last few years and those in the near term to be called the 'Era of the Shareholder'.

In this period we have seen a number of things play out. It started in 2016 when companies went through a process of right sizing the debt burden by deleveraging balance sheets. Assets were sold, cash flows were used to repay debt and management outlined a disciplined approach to capital allocation. The culmination of these actions left the large diversified mining companies looking very different to prior periods. Today all of them have conservative balance sheets with some close to having zero net debt. Capital expenditure levels remain low as projects go through tougher approval processes and reinvestment decisions are reviewed versus returns to shareholders. New supply is also looked at in the context of its impact on existing supply

and therefore pricing to see what it might do to the profitability of existing production (iron ore markets being the best example of this). Dividends are no longer progressive but based on payout ratios and many companies are reducing their equity base by buying back shares. All of this should boost interest in the sector, but for the reasons mentioned earlier it seems that the attractive characteristics on display are not yet enough to tempt people back into the sector when viewed in the context of macro risks.

This year has been a tragic period for the mining sector following the collapse of the Brumadinho tailings dam in Brazil. The complete collapse of the retaining wall caused vast amounts of inert mine waste to flow downstream and this resulted in a huge loss of life. Vale, the Brazilian mining company, and local authorities are still working out the exact cause of the event and we expect clarity later this year but for the time being it has had a material impact on iron ore markets. Vale's production of iron ore has been severely impacted with iron ore production estimated to be approximately 60Mts lower versus the prior year. On its own, this represents close to 4.0% of the seaborne iron ore market, but more importantly it resulted in huge volatility in iron ore price premiums for ore qualities and supply into the pellet production market.

Outside of Brazil, iron ore supply has also been impacted by problems in Australia where cyclones and production issues have taken additional supply out of the market. In total we estimate that close to 93Mts has been lost from the market this year and it is unlikely that much of this, if any, can be replaced with higher production during the remainder of the year. The fact that this has happened when steel production rates in China are at record levels, currently annualising at over 1 billion tonnes of production, means that inventories of iron ore at Chinese ports have fallen sharply, leaving the market tight going into the seasonally weaker summer months and boding well for the ongoing profitability of iron ore producers in the near term.

Base metal prices have generally been weaker as fears of slowing growth have cooled estimates for demand. Copper in particular has been surprisingly weak given the elevated level of supply disruptions in South America, Indonesia and Africa. Nickel markets remain hostage to the rapidly growing supply of highly profitable integrated stainless steel being produced in Indonesia.

Precious metals, particularly gold and palladium, have performed well with the former benefiting from the shift in monetary policy in the US and expectations of rate cuts and a weaker dollar. The latter has seen supply tightness and strong demand result in prices moving to high levels and, despite expectations for this only to be temporary, the palladium price has remained strong.

The reform agenda in China continues to play a key role on commodity markets, especially with the increased global focus on the environment.

During 2016 and 2017 the primary focus for the sector was strengthening balance sheets and since 2018 we have seen companies look to step up returns to shareholders via dividends and in some cases buybacks.

As we look into the second half of the year, we continue to remain positive on the outlook for dividends particularly for the iron ore exposed diversified miners given the rally in the iron ore price and the resulting 'windfall profits' year-to-date. We increasingly see dividends and buybacks as an important component of total shareholder return given the low level of reinvestment into growth across the sector.

### **Shareholder returns**

With dividends across the sector underpinned by record balance sheet strength, we find it perplexing that the sector continues to trade at an elevated dividend yield. There are numerous factors cited to explain this such as dividend volatility following the move

to pay-out ratios and the risk of dividend cuts if commodity prices weaken. Despite this, we struggle to see why the mining sector does not increasingly appeal to traditional UK income investors with a number of the UK dividend stalwarts increasingly coming under pressure to cut dividends.

A common criticism of the mining sector is the perceived lack of growth. Whilst this is largely correct if we look at volume growth across the sector on an absolute basis, it is not the case if we look at growth on a per share basis. Some interesting analysis from Citigroup highlights that the major mining companies have meaningful growth on a per share basis if they use 50% of their free cash flows to buyback shares at the current share price. Under this scenario we see 15% to 30% copper equivalent volume growth on a per share basis over the next two years for the UK diversified miners, in addition to the dividend pay-out policies they have committed to. Given the low execution risk of this growth and the compounding benefits of reducing shares through time, we believe the sector should consider this strategy more aggressively.

### **Growth and resource replenishment**

In addition to volume growth, companies that have successfully invested in exploration through the cycle and have sufficient asset quality to replenish reserves and resources, we believe will be strong outperformers in this next phase of the cycle. This is particularly prevalent amongst the gold companies given their shorter mine lives and greater need for reinvestment.

### **China supply-side reform and increasing environmental standards**

Over the last couple of years we have discussed the impact of China's supply-side reform agenda and efforts to improve environmental standards in the country. This has had a significant impact on the steel, aluminium and coal industry with pollutive and loss-making capacity closed and any new capacity limited to high quality efficient operations. China's efforts to combat pollution have been relaxed this year, as it has increased steel production to support the domestic economy. Despite this, the longer-term goal of reducing pollution remains clear. This should support demand and, in turn, price premiums for high quality product such as high grade iron ore, high calorific value thermal coal and ethically sourced cobalt.

Another key development in this area has been China's move to ban waste imports from 2017. This is a wide ranging policy with China, previously the world's largest importer of waste, banning 24 types of scrap from being processed in the country in 2018. In the metals space, the most significant impact has been in the copper scrap market with China banning the import of category-7 copper scrap. The plastic and packaging market has also been significantly impacted, with developed countries no longer able to rely on China to deal with their waste problem. This is a profound issue which we expect will continue to gain traction through time. As we look forward, we expect environmental measures to continue to be at the forefront of Chinese Government policy which will increase the demand for electric vehicles, renewable energy and recycling.

Today the metals recycling industry remains fragmented, but we expect to see significant growth over time, particularly as China begins to recycle steel.

### **Battery materials**

The rise of the electric vehicle (EV) has continued this year, led by growth in sales of electric vehicles in China which grew 41% compared with the equivalent six months in the prior year (Source: CAAM). Sales have been incentivised by significant subsidies in China; however, the subsidies have been so successful they are now no longer required to meet government targets. As such these subsidies will halve in the second



half of 2019 before being removed in 2020 and we expect this to be a headwind to near-term EV sales in China. We have seen the industry destock ahead of the normalisation of demand and sentiment for growth decline. The raw materials that go into the battery - cobalt and lithium - have been hit by the tempering of expectations after strong price increases in 2017 and 2018; however, it is important to note that the absolute tonnage demand continues to grow strongly.

Cobalt prices have continued to decline, due to a large increase in refined supply. A key driver here has been production from the Democratic Republic of Congo where both Chinese and artisanal producers responded with surprising speed to the very high cobalt price in the first half of 2018. Another headwind for the cobalt price has been the mix of different metals used in the battery, with technological advances resulting in the increased thrifting of cobalt; however, this is unlikely to completely offset the volume growth required to meet electric vehicle demand.

Prices for lithium have continued to move lower in the first six months of 2019, down 18.2%. As well as the tempered growth outlook, prices have been hit by bottlenecks in the battery supply chain, with some Australian miners being unable to sell their lithium spodumene concentrate due to processing capacity builds being delayed.

Another major battery metal is nickel where demand is expected to benefit from the increased penetration of electric vehicles and thus demand for lithium batteries. However, today the number one use of nickel driving near term demand is stainless steel production. Not all nickel production is created equal when it comes to suitability for different end-uses, and for battery cathodes the most efficient nickel is nickel sulphide, whilst for stainless steel ferronickel is the most cost effective.

2019 has seen large volume growth from Indonesia in ferronickel, as well as stainless steel. Outside of ferronickel there has been a lack of supply for nickel, with production shrinking for the last three years and this may cause an eventual divergence in pricing of the nickel market.

### Outlook

Unlike the last two years, 2019 to date has delivered a strong period of returns despite the ongoing macro headwinds on trade, monetary policy and political risks. Whilst we do not expect these issues to be resolved in the short term, we remain very confident on the underlying fundamentals of the companies in the sector. Management continue to be disciplined, balance sheets are generally very strong, free cash flow yields are high, cost inflation is low and shareholders continue to be rewarded with rising dividends.

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## Environmental

(compare environmental funds [here](#))

**John Scott, chairman, Impax Environmental Markets:** Over the first six months of 2019, global equity markets rallied strongly following a volatile and difficult end to 2018. The fourth quarter of last year saw a sharp sell-off in response to growing fears of a US-China trade war and interest rate rises, with a disproportionate impact on small-caps, a sector to which we are significantly exposed. We were confident that last year's sell-off in small-cap stocks generally, and environmental markets names in particular,

was overdone and we were proved right. Indeed, sentiment improved significantly as the year turned.

While improving macro-economic sentiment is part of the story, continuing and growing public concern about environmental issues provided support. June brought a heatwave across continental Europe, with temperature records set in France, Germany, Poland, Spain and the Czech Republic. In North America, California-based utility PG&E announced it was temporarily shutting off power to some communities to avoid a repeat of last year's fires, resulting in lawsuits which have forced it to seek bankruptcy protection. Meanwhile, in India the reservoirs feeding Chennai ran dry in June, leaving the population of India's sixth largest city dependent on water tankers.

The increasingly evident physical impacts of climate change are fuelling this growing concern, which in turn is likely to stimulate bolder policies to mitigate climate change. By mid 2019, France and the United Kingdom had introduced legislation requiring economy-wide net-zero carbon emissions by 2050; the adoption of an EU-wide net-zero target came surprisingly close to adoption by European Union member states in June. Similar legislation was passed by New York State in the same month.

Climate impacts are also creating impetus for greater public and private sector spending on adjusting to the new reality of a warmer world. Worsening water shortages in India, South Africa and rich countries such as France are underscoring the need to invest further in water infrastructure, while the effects of extreme weather events - not to mention managed outages to reduce wildfire risk - create demand for back-up power generation capacity and off-grid renewables. A reinvigorated push to reduce emissions will support our renewable energy and energy efficiency themes, while accelerating investments in adaptation will benefit water, distributed energy and sustainable food stocks.

In addition, efforts to build a more 'circular' global economy are intensifying. The war on plastics triggered by the BBC's Blue Planet series is continuing, with a growing number of countries introducing partial bans on single-use plastics and deposit schemes, while retailers and food companies are looking for alternatives to plastics. Attention is also turning to textiles, for which recycling solutions remain elusive, despite the environmental impacts inherent in their production.

### Outlook

We expect market conditions to remain volatile over the months to come. Growth is slowing, with the global economy facing challenges on a number of fronts. Foremost among these are continuing US-China trade tensions, the unravelling of the Iran nuclear deal, with possible implications for the oil price, and the risk posed by a disorderly Brexit to the UK and EU-27 economies.

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**Manager, Impax Environmental Markets:** Key developments and drivers for environmental markets.

### Climate change

Global emissions from energy use rose to a record high in 2018, climbing in the US, China and India, driven by a strong economy and higher heating and cooling demand. They grew at the fastest rate since 2011, according to BP, showing a growing gulf between the pace of progress in addressing climate change and a growing public clamour for action.

Extreme weather events linked to climate change are becoming more frequent and more severe, with the UN warning that climate-linked natural disasters are now occurring at the rate of one a week.

These events are prompting governments to set more aggressive medium- and long-term mitigation targets. The UK passed legislation in June to increase the ambition of its 2050 carbon target from 80% below 1990 levels to 'net-zero emissions' by that date. It followed the publication of a report from the Climate Change Committee, a government advisory body, that a net-zero target would be no more expensive than the earlier goal, given the falling costs of technology. France approved similar legislation, while a proposal for the EU to adopt a bloc-wide net-zero goal came close to passing at the June 2019 meeting of the European Council.

The increasing severity of climate impacts is accelerating policies to promote adaptation, including in the developed world. For example, France has announced plans to reduce water consumption by 25% within 15 years, in response to studies that suggest its rivers and streams could shrink by up to 40%. The plans involve investment of EUR5 billion by 2024 to protect water sources and reduce agricultural water use. The EU, meanwhile, is considering regulations to encourage the re-use of waste water by the sector.

#### **Integration of renewables, storage and standby generation**

Mitigating climate change will require the full decarbonisation of the power sector. Given the intermittency of wind and solar generation, this will require the integration of large-scale storage into electricity systems. While this process is at its early stages, a number of utility-scale renewable energy projects are coming online with associated storage technologies, taking advantage of falling technology costs as well as local markets for grid-balancing services, which provide additional revenue streams.

#### **Textiles and the circular economy**

We believe that, in the wake of the war on plastic, a new front is opening in the campaign to create a circular economy. Textiles are highly resource intensive, requiring large amounts of water and land leading to considerable pollution. The growth of fast fashion has contributed to a doubling of clothing production over the last 15 years, and a loss of value of US\$500 billion each year from under-utilised clothing and a lack of recycling, according to the Ellen MacArthur Foundation. The European Environment Agency (EEA) estimates that textiles represent the fourth biggest source of pollution after housing, mobility and food, and are Europe's fourth largest consumer of primary materials. Currently, three-quarters of textiles are sent to landfill or incinerated.

Policymakers are responding: the EEA is due to produce a pioneering study on the subject in October which is likely to build pressure for regulation to promote recyclability, better labelling and producer responsibility. We believe that policy and public concern will impact the entire textiles value chain. Opportunities exist in new materials, such as the substitution of cotton or fossil fuel-derived fibres with less resource-intensive materials.

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## Technology and media

(compare technology and media funds [here](#))

**Walter Price, manager, Allianz Technology:** In our view, the technology sector continues to benefit from strong tailwinds which should continue to drive attractive long term appreciation. The digital transformation is the top priority for many companies across the economy, as these technologies are increasingly becoming critical drivers of growth, productivity, and competitive positioning. If IT budgets must be cut in an economic slowdown, management teams are reporting that the budget for the digital transformation will be the last to be reduced. This transition is a multi-year process, and we believe we are still in the fairly early stages. For the semiconductors and hardware segments, we expect the environment to remain mixed as companies work through production and inventory adjustments amid the trade conflict between the US and China. From a fundamental perspective, these companies are much stronger after years of consolidation, and we expect growth to reaccelerate in 2020. We maintain exposure to companies that we believe will benefit from secular growth themes. Despite periods of volatility driven by geopolitical uncertainty, we expect the broad technology sector to see attractive growth in the future.

We continue to believe the technology sector can provide some of the best absolute and relative return opportunities in the equity markets - especially for bottom-up stock pickers. The growth in technology is coming from the creation of new markets, rather than simply GDP growth.

Investors need to find companies generating organic growth by creating new markets or effecting significant change on old markets. Industries such as automobiles, advertising, security, retail, and manufacturing are all being shaped and transformed by advances in technology. We are seeing an ongoing wave of innovation in the sector that we believe has the potential to produce attractive returns for companies with best-in-class solutions.

Despite high valuations for some high growth companies, we continue to see massive addressable markets much larger than the revenue today. However, we have consolidated our exposure to these areas in select companies having the most compelling solutions and whose business models demonstrate a discernible path to deliver strong earnings and cash flow growth over the next few years.

We are also finding excellent investment opportunities among more attractively valued areas of technology. In particular, certain technology incumbents are making compelling progress on their "as-a-service" offerings. Artificial Intelligence (AI) is also becoming a significant trend. From consumer goods, such as the Amazon Echo, to autonomous driving, practical applications of AI are emerging. We expect AI will increasingly be used to make our lives more convenient.

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## Debt

(compare debt funds [here](#))

**Neuberger Berman Investment Advisers LLC/Neuberger Berman Europe Limited, NB Global Floating rate Income:**

### Market Environment

Market sentiment in 1st quarter 2019 rebounded following a dovish pivot by central banks, and coupled with reasonable economic data, gave investors comfort that a soft landing was materializing. However, sentiment deteriorated over the 2nd quarter due to uncertainty surrounding both global trade and sustained global growth. That being said, market fundamentals have remained stable, and while leverage rose modestly, interest coverage remains strong, and refinancing activity has significantly reduced the amount of loans maturing in the near term. These positive trends more than offset the more aggressive metrics coming out of the new issue market during 2018. Despite this positive fundamental backdrop, retail investors continued to move away from the asset class due to a preference for longer duration asset classes based on the Fed's dovish pivot, leading to withdrawals of \$20 billion from retail loan funds year to date, per J.P Morgan. The loan market has not fully recovered from the drawdown in 4th quarter 2018.

In the U.S., demand for loans was robust year to date, with over \$68 billion of new collateralized loan obligation ("CLO") creation more than offsetting the \$20 billion of outflows from retail funds. These figures do not take into account demand from pensions, endowments and other institutional investors in separate account format. For comparison, the first half of 2018 saw \$70 billion of CLO creation; however, demand from retail funds was very strong with \$12 billion of inflows. Although down 46% from the first half of 2018, institutional loan issuance of \$146 billion kept the market in balance from a supply/demand perspective. The mix of issuance was materially different from 2018, as Mergers & Acquisitions ("M&A")/Leveraged Buyout ("LBO") decreased 57% year over year. The loan market continues to grow, however, ending the period at \$1.15 trillion versus \$1.0 trillion one year ago. The average bid ended the period at a healthy 96.79 while the trailing 12-month U.S. default rate was 1.34%, well below its long-term average of approximately 3%.

In Europe, demand for loans continued to be strong and CLO issuance totalled EUR14.7 billion for the period. The par amount outstanding of the ELLI ended the period at EUR193 billion, an increase from EUR157 billion one year ago. By principal amount, the trailing twelve-month default was 0.0% at the end of period, down from 0.11% at the end of 2018.

Importantly, aggressive issuance from lower rated, higher levered issuers slowed in 2019. We view fundamental weakness to be primarily concentrated in new deals that were issued in 2018, and therefore represent a relatively small portion of the overall loan market, which is now \$1.15 trillion in size. Seasoned loan issuers have demonstrated solid financial performance and improved credit metrics and these issuers have relatively conservative credit agreements.

We believe that loans continue to offer an attractive yield with limited duration risk

### Outlook

We continue to believe fundamentals and valuations are compensating investors for a benign default environment and that the current yield investors receive from the loan market is attractive versus other asset classes. While new issuance leverage and

assumptions were aggressively marketed in 2018, operating performance of legacy loan issuers has been stable, revenue and EBITDA growth remain in positive territory. While leverage rose modestly, interest coverage remains strong, and refinancing activity has significantly reduced the amount of loans maturing in the near term. Economic growth is expected to slow; however, the Fed continues to push a more dovish narrative, thus leading to an expectation for even fewer recessionary pressures in the U.S. All told, we believe prices could continue to rise over the near term. However, risks remain, including uncertainty around global growth expectations, government disruptions, trade policy and the overall regulatory environment, which could lead to periods of price volatility.

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### **RM Funds, manager, RM Secured Lending:**

#### **Improved market environment but macro uncertainty remains**

The global equity and credit markets have had a solid first six months. The market weakness experienced over Q4 2018 reached its nadir in December 2018 but since January 2019 equities, government bonds and credit have all performed well, with global equities touching their years' highs during the second quarter of 2019. The most notable market move has been the global rally in government bond markets. Weak global data and the belief that inflation will not feed through as strongly as expected, particularly in the US, has seen a global rally across fixed income markets. Current expectations that central banks will be more accommodative for growth thus keeping interest rates lower for longer has been beneficial for equities as investors seek yield. The Investment Manager remains cautious as its attention is drawn to the 3 month/10 year US yield curve, which inverted during the quarter to June 2019. It has been widely reported that the yield curve between the US 3-month and 10-year bond has been negative before each recession for the past 50 years. In addition, the commentary and market noise surrounding the trade wars have reduced over the quarter, but the risk remains that policy mistakes with unintended consequences could damage global growth.

RM's expectation is for volatility to pick up especially as we move through the deal/no deal Brexit date at the end of October. Equities and credit seem priced to perfection and any change in sentiment to a risk-off mode could see significant price moves lower - although government bonds despite their eye-wateringly low yields seem to have their valuations underpinned by all of this uncertainty.

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**Paul Smith, Chun Lee and Robin Willis, managers, Acorn Income Fund:** Year to date, Government bonds have rallied strongly with yields falling in some cases, to record lows. Central banks have begun to posture more dovishly in response to the softening economic data being witnessed globally whilst trade tensions threaten to cut activity and confidence further.

With trillions of dollars of global debt now trading on negative yields many bond buyers are effectively paying governments to have their money. But alongside this, risk assets such as equities and corporate bonds have also been rallying. Trying to make sense of these conflicting moves might lead to the conclusion that markets are preparing for a scenario whereby central banks will ease quickly and effectively enough to offset the slowdown meaning global economies escape unscathed. However positioning strongly for central bank's magical ability to fine-tune policy seems highly complacent. Historically this has not been the case and when business cycles turn, risk assets have

tended to see declines, even as central banks are easing aggressively as cuts struggle to provide support instantaneously.

As it has been since the financial crisis, perceived market wisdom is if the central banks are accommodating, then investors should immediately add risk. We find this hard to justify in bonds given very expensive valuations and the scope for markets to be surprised, especially on the downside in terms of credit risk, should company earnings weaken materially. We therefore believe it is still prudent to stay focussed on shorter dated corporate bonds where visibility and predictability of returns is stronger and also like selective instruments where issuers are incentivised to buy back bonds ahead of maturity, improving the risk-return profile.

Trying to identify idiosyncratic opportunities within credit markets is getting trickier but is still possible.

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**Carador Income Fund:** Following a volatile end to 2018, the US corporate credit markets rallied in the first half of 2019. The snapback in the second quarter of 2019 slowed for loans as rate cut expectations worked against the bullish sentiment in the credit markets. Loans returned 5.4% year-to-date as of 30 June 2019. This represents the best first half-year performance in ten years, as lower levels of new issue loan supply offset the headwind of continued outflows from mutual funds and ETFs. High yield returned 9.9% year-to-date as of 30 June as the dovish tone from the Fed and the European Central Bank, coupled with de-escalation of the US/China trade conflict, propelled relatively strong performance over the quarter. May represented the only negative returning month for high yield bonds in 2019, with a return of -1.4%, largely due to the broader risk-off sentiment as retail investors exited the asset class driving \$6 billion of outflows. This sentiment quickly reversed in June following accommodative statements by Fed Chairman Powell, which drove high yield fund inflows totalling \$3.7 billion and a monthly return of 2.4%, the second highest returning month in 2019.

Higher quality loans outperformed the lower quality segment of the market during the first half of 2019, with the upper and middle tier loans within the Credit Suisse Leveraged Loan Index returning 5.8% and 5.5%, respectively, compared to lower tier loans, which returned just 3.3%. In contrast, high yield bond returns during the first half of 2019 were more consistent across credit quality. Upper tier high yield bonds within the Credit Suisse High Yield Index returned 10.2%, middle tier bonds returned 10.0%, and lower tier bonds returned 8.2% year-to-date as of 30 June 2019.

As of 30 June 2019, loan default rates had lowered compared to year-end 2018 levels. Per JP Morgan, the par-weighted loan default rate for the last-twelve-month ("LTM") period ending 30 June 2019 was 1.30%, which is down 42bp since the end of 2018 and down 69bp year-over-year. JP Morgan continues to expect 2019 year-end default rates of just 1.5% and 2020 default rates of 2.0%, which is below the long-term average for loans. Lower default rate expectations are supported by robust interest coverage, expected continuance of US GDP growth, and limited near-term US loan maturities.

### CLO Market Overview

Despite the ultimate favourable regulatory ruling from the Japanese FSA during 2Q 2019, Japanese AAA CLO buyers were slow to return to the CLO market following scrutiny regarding the scale of investments. As the year progressed, a wave of existing and new US AAA buyers emerged to fill the void and changed the CLO landscape to include more syndicated AAA transactions versus the traditional anchored deal approach. This dynamic created opportunities for domestic buyers to increase their

AAA exposure to top-tier managers and increase levels of risk tiering by manager, portfolio, and strength of document.

As a result, US CLO issuance lagged slightly year-over-year with \$65 billion issued through 30 June 2019, compared to \$69 billion over the same period last year. JP Morgan estimates that US CLO issuance will total \$115-\$125 billion by year-end, which would represent a decline of approximately 8-12% year-over-year. CLO refinancing and resetting activities have also been muted so far during 2019, with only \$23.1 billion of US CLOs refinanced or reset versus \$83.9 billion in the first half of 2018.

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**Rhys Davies, Paul Read and Paul Causer, managers, City Merchants High Yield:**

The dovish shift by central banks has re-ignited the search for yield and investor demand for new issues is very strong. That said, credit spreads and the overall level of yield have fallen back below their five-year averages. In aggregate they are now at levels where we feel less comfortable that they are appropriate for the risk, although we are still able to find bonds to buy.

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## Hedge funds

(compare listed hedge funds [here](#))

**Sir Michael Bunbury, chairman, BH Global:** The financial and political worlds continue to be very uncertain. In most developed countries interest rates, both nominal and real, continue at what historically have been almost unprecedentedly low levels. The exception until recently has been the United States, although even there rises in interest rates have now moved into reverse gear despite an economy which has experienced robust growth in recent years. Meanwhile the geo-political scene continues to demonstrate considerable potential risk and the domestic political scene in many countries, particularly at present in the United Kingdom, is highly uncertain. Indeed, the only certainty looking forward is a continuation of uncertainty which will surely lead to further volatility in many asset markets.

Easy monetary conditions since the global financial crisis have driven up the valuation of many asset classes, much to the benefit of the owners of those assets and to those that track indices rather than seek to generate alpha. However, looking forward it feels as if fundamentals are re-asserting themselves as the primary valuation driver.

Everything points towards future bouts of uncertainty and volatility in markets.

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## Leasing

(compare leasing funds [here](#))

**Jon Bridel, chairman, DP Aircraft:** The outlook for the airline industry for 2019 remains positive, with it being expected to be the tenth year in a row of airline profits according to the International Air Transport Association. However, the organisation



downgraded its expectations of global net profits from US\$ 35.5 billion to US\$ 28 billion in 2019. This was largely as a result of slower growth in world trade as well as increasing costs, particularly in fuel, labour and infrastructure. Yields continue to remain under pressure, although constant compared to 2018. Unit costs, excluding fuel, are anticipated to increase by 7.4% whereas overall revenues are expected to grow by 6.5%. Passenger numbers are expected to increase from 4.4 billion to 4.6 billion.

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#### **DP Aircraft:** The Aviation Market - Overview and Development

2019 is expected to be the tenth year in a row of airline profits according to the International Air Transport Association (IATA). However, the organisation downgraded its expectations of global net profits from USD 35.5 billion to USD 28.0 billion in 2019. The IATA also re-stated the 2018 global net profit estimate to USD 30.0 billion (previous assumption USD 32.3 billion). The change mainly results from slower growth in world trade as well as increasing costs, particularly of fuel but also of labour and infrastructure. For 2019, yields continue to remain under pressure but constant compared to 2018. The continuing trade war between the U.S. and China might further weaken global trade resulting in a stagnation in cargo volume. Overall costs are anticipated to increase by 7.4 per cent whereas overall revenues are expected to grow by 6.5 per cent. Passenger numbers are expected to increase from 4.4 billion to 4.6 billion.

Airlines' ancillary revenues are anticipated to be USD 92.9 billion in 2018, which is an increase of 312 per cent since 2010. Once a crucial revenue stream in the business model of low-cost carriers, legacy carriers' profitability has become more and more dependent on ancillary revenues too, especially in an environment of fierce competition. Besides traditional ancillary revenues such as seat reservations, baggage fees or fast-track access, additional offered products are accommodation arrangements, car hire or special pet care services. Low-cost airlines generally have leaner corporate structures and are able to respond faster to changes in customer needs and preferences. Legacy carriers generally have a more complex ticket distribution process in place, and consequently ancillary products atop the traditional ones, can partly only be sold via their website but not by travel agents or third-party websites. However, different initiatives have been launched and digital services are available to support airlines to move from selling tickets to selling a travel experience via various distribution channels. According to IATA many people enjoy highly digitised life experiences and are therefore willing to share personal information, as they believe they may get targeted offers in return.

In 2019, European carriers are expected to generate a total net profit of USD 8.1 billion compared to USD 9.4 billion in 2018. Break-even load factors are the highest amongst all regions and are anticipated to be 70.2 per cent on average. Capacity is assumed to increase by 5.6 per cent, whereas demand is anticipated to increase by only 4.9 per cent. Carriers of the Asia-Pacific region are anticipated to deliver a total net profit of USD 6.0 billion compared to USD 7.7 billion in 2018. Demand is assumed to increase by 6.3 per cent, being the strongest growth amongst all regions, and to outperform capacity growth of 5.7 per cent.

The recently published Boeing Outlook (Current Market Outlook 2019-2038) expects deliveries of 44,040 aircraft with a market value of USD 6,810 billion within the next 20 years. Widebody aircraft and freighter deliveries will account for more than 40 per cent of the total market value. 17,390 aircraft deliveries are expected to be for airlines in the Asia Pacific region and 8,990 deliveries for European airlines. Annual global fleet growth is anticipated to be 3.4 per cent on average. Both Boeing and Airbus (Global Market Forecast 2018-2037) forecast that the global passenger and freighter fleet will

double within the next 20 years. According to Airbus the total fleet will grow by 2.3 times within the next 20 years. In 2019, 1,770 new aircraft will be delivered with a value of USD 80 billion according to IATA. About half of these deliveries will replace older, less fuel-efficient aircraft. The global fleet would consequently increase by 3.6 per cent to more than 30,500 commercial aircraft until year's end.

Discussions regarding climate change intensified recently in some European countries. Aviation accounts for about two per cent of global CO2 emission. The airline industry, represented by IATA, agreed on three main objectives to minimise CO2 emissions: to improve fuel efficiency from 2019 to 2020 by 1.5 per cent, stabilise CO2 emission on 2020 level (carbon neutral growth) and to reduce CO2 emission to 2005 levels by 2050. In 2016, the Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA) had been adopted by the UN specialised agency ICAO (International Civil Aviation Organization), which is based in Montreal (Canada). Consequently, aviation is the first single industry agreeing to a global market-based measure in the climate change field. The objective of CORSIA is not to slow down any technological, operational or infrastructural progress but to provide additional support to mitigate CO2 emissions and to freeze them at 2020 levels. Since 1 January 2019, all airline operators are obliged to report emissions for international flights. From 2021 on, all flights between countries which are volunteering to take part, and from 2027 on, all international flights (there exist some exceptions such as for example, small island developing states) will become subject to the offsetting requirements.

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## Property – UK

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

**Empiric Student Property:** The UK higher education sector continues to both grow and polarise. There is strong demand for education at top tier universities, but the bottom tier are struggling to attract more students. This means selectivity of location is key when student accommodation providers are considering their growth plans.

There were two notable developments in Government policy during the period, both of which are positive for Empiric. In March 2019, the Departments for Education and International Trade published a plan to increase the number of international students studying in the UK by more than 30%. The UK currently hosts around 460,000 international higher education students and the education sector generates approximately GBP20 billion per year through education exports and transactional activity. The Government strategy sets out an ambition to grow the total number of international students to 600,000 and generate GBP35 billion by 2030 - a rise of 75%.

In May 2019, the Report of the Augur Review of higher education suggested a reduction in tuition fees from the current GBP9,250 a year to GBP7,500, balanced by extending repayment periods from 30 to 40 years. It also called for the return of maintenance grants for poorer students. The proposals, if adopted, should help to bolster the number of applicants and the reduction in revenue for universities could incentivise them to further increase their student numbers. However, until it becomes clear if the Government will adopt the proposals, it is difficult to understand the full impact.

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## Private equity

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

### Apax Global Alpha:

#### 1H19 market review

After the doom and gloom of 4Q18, public markets around the globe rebounded in two waves over the past six months. This ascent was temporarily interrupted in April by a breakdown in US-China trade negotiations. But with a "truce" reached in Osaka, the first half of the year finished on a very positive note. Many public market equity indices showed double-digit gains in 1H19. Because of these increases, North American public market indices are at, or close to, their all-time highs. Europe and the Emerging Markets regained their losses from last year but have not developed as strongly as the US markets. This appears to be reflective of macro economic growth rates and their outlook. While the US continues to grow quickly, a GDP slowdown is measurable in Europe and in Asia, notably in China. In addition, some leading indicators of economic activity point to a further worsening of trends. Manufacturing Purchasing Managers' Indices ("PMI") in the major economies have clearly declined substantially over the past 12 months, and a few European and Asian PMIs are now deep in contraction territory (with sub-50 values). A manufacturing recession in Europe is under way.

If trade talks do not have a positive conclusion, a more pronounced slowdown in the world economy seems inevitable. That said, macro economic indicators such as unemployment rates and short and mid-term GDP model forecasts, for example from the ECB for Europe, remain satisfactory. However, these may need to be revised soon in light of the economic trends described. Overall, central banks are flagging a more dovish stance on both sides of the Atlantic and markets are clearly taking some comfort from that.

Credit markets in particular were influenced by the recent US central bank repositioning. Sovereign, investment grade and non-investment grade yields across the risk spectrum reversed gear and significantly contracted in 1H19. This resulted in the US dollar dipping relative to the euro in June; however, it later quickly recovered given the stronger GDP trends in the US.

North American private equity activity remained high in 1H19 with deal-making volumes close to their already elevated 2018 benchmarks; meanwhile in Europe, the pace was substantially slower. Valuation levels seemed somewhat lower than last year as the public market correction in 4Q18 provided some relief. Given the public market rebound this will likely be a short respite.

#### 2019 to 2020 outlook

A number of significant geopolitical issues keep lingering, with a wide range of possible outcomes: the current US-China and the future US-EU trade situations, Brexit, as well as a possible crisis with Iran appear to be the most pertinent. Each of these is highly uncertain and at the same time powerful enough to possibly shake the world economy or at least the economy of one or more large geographies. As such, the macro economic picture and markets appear more dependent on political decision-making than ever before. This makes an economic and investment forecast extremely difficult. So far in 2019, the capital markets seem to be discounting the associated risks - recent sentiment is very positive despite this geopolitical overhang. Whether this sentiment persists into autumn is unclear to us.

With regard to deal making in alternative assets, the markets are widely open for now. One of the more visible trends is the increasing willingness of corporates to scrutinise their business portfolios and divest what is no longer deemed as core. As a consequence, the corporate carve-out is a private equity deal type we expect to see more of in the next 18 months. The situation for public-to-privates is a bit more ambiguous. Markets in 2H18 were quite conducive to these deals; their decision-making cycle let many of them drag into 1H19. However, the more recent stock market rallies could shut down this trend for the second half of the year.

From a credit perspective, markets have recovered substantially during 1H19. Contracting yields and spreads, coupled with the aforementioned economic and geopolitical uncertainty, create a difficult-to-navigate "late-cycle" environment for credit investments. As a reaction to central banks becoming more dovish again, a number of investors have started to reduce exposure to floating rate loans and increase exposure to fixed rate high yield instruments. We believe that in the current environment more focus than ever on the credit quality of the underlying business is the more relevant factor for making a new investment.

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**Hamish Mair, manager, BMO Private Equity:** The economic and political background has deteriorated over the last few months with a resolution to the Brexit impasse appearing no nearer and the threat of 'no deal', or something close to it, rising in probability. Both the UK and German economies appear to be at real risk of dipping into recession and similar trends are seen elsewhere in Europe. Notwithstanding these challenges there is a very healthy amount of activity within the private equity market internationally.

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## Renewable infrastructure

(compare renewables funds [here](#))

**Helen Mahy, chairman, The Renewables Infrastructure Group:**

Although the political landscape in the UK remains subject to uncertainty, the fundamentals for growth in UK renewables remain. Over the coming years we expect most new asset development in the UK to be in offshore wind. Market supply for onshore wind has been tightening and only a limited number of new solar projects have been commissioned in the past three years.

Renewable assets are now being developed without reliance on subsidies within Europe, especially in regions where either wind resource or irradiation are high - such as Scandinavia for wind development and Southern Europe for solar development. Our managers are increasingly seeing attractive investment opportunities in mainland Europe.

The UK has seen a marked slowdown in the development of onshore wind since subsidies for new developments ceased. The UK only added approximately 600MW of onshore wind in 2018 (1,100MW in 2016). Similarly, solar installations in the UK continue to be subdued, with only approximately 200MW of utility scale solar added in total in 2018 as subsidies for utility scale solar have also ceased.

This is in contrast to offshore wind, which is continuing to grow significantly with 2,100MW added in 2018 (2,039MW in 2017). We observe that this has resulted in what we believe is scarcity premia arising in the UK onshore wind and solar markets compared with some European markets where deal flow is being maintained.

### German Offshore Wind

Germany represents the second largest offshore wind market in the world, with sites concentrated in the German North Sea and Baltic Sea. Forecasters estimate the German offshore wind market will grow by over five times to 30GW by 2035. The popularity of the German onshore wind and solar markets with smaller domestic investors has meant that historically these asset classes have proved to offer relatively unattractive returns. However, offshore wind, given the scale of the projects, remain the preserve of institutional investors and provides an attractive access point into the important, large and stable German renewables market. Offshore wind in Germany is still a far smaller industry than onshore wind.

### Significant Growth in Solar Expected

Whilst solar installations have slowed across Europe in recent years compared to the high deployment rates of 2010-2012, this is expected to change over the next five years. This is particularly the case for Southern Europe where levels of irradiation are strong. This has led to solar being increasingly developed without reliance on state subsidies - for example in Spain, some 3.5GW of solar capacity is expected to be developed by the end of 2019 without any subsidies.

2018 saw European governments release targets for solar capacity growth as part of draft National Energy and Climate Plans to 2030. In particular, France and Spain have ambitious growth targets. France plans 45GW of solar capacity by 2030, up from 8GW in 2018, whilst Spain targets reaching 77GW of solar capacity by 2030, up from 4.82GW in 2018.

### UK Macro Economic Risks

Political risk in the UK remains at elevated levels, with the outcome of the negotiations between the UK and the European Union, yet to become clear. There is heightened risk of an early general election being called, and an uncertain economic outlook for the UK.

If a general election resulted in a change of government, there would be an increase of the risk of nationalisation of key UK industries, as pledged by the main opposition party. The grid infrastructure has specifically been targeted for nationalisation but electricity generation does not appear as a target. With the pressing climate change agenda and widespread public support, we believe a decision from government that could jeopardise investment in renewables is unlikely.

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**John S Leggate CBE FREng, chair, Gresham House Energy Storage:** A central aim of the UK government is to achieve a low-carbon future, and recently this commitment has stepped up from an 80% reduction in carbon emissions by 2050 to a 100% reduction, as recommended by the Committee on Climate Change (CCC).

Central to the transition to a zero-carbon economy is increasing year-on-year deployment of renewable electricity generation the growth of which has already been impressive.

The next stage in this evolution of the electricity industry's infrastructure requires more dynamic management of the grid to accompany the growth in renewables in order to

make the transition cost effective. Of all types of flexible generation that are available, grid-scale energy storage is the most impactful. Batteries are needed because renewables, as a class of power generation, are intermittent and are a non-dispatchable source. The UK electricity system has declining levels of baseload generation, and at high levels of output, renewables have the potential to wreak havoc on the stability of the electricity system by constantly over- or under-generating relative to demand as the system has much reduced intrinsic inertia. We believe the events of 9 August 2019, when there were outages across much of Great Britain, are a stark illustration of lack of system inertia to deal with intermittent supply and the sort of challenge the grid will experience increasingly. Battery systems deployed at scale will be essential for the future stable operations of the National Grid.

In 2018, CO<sub>2</sub> emissions from electricity generation fell by 7.3%, resulting in a cumulative reduction of 51.8% since 2000. We would not be surprised to see a further significant drop this year given the continued rapid rate of renewable deployment.

Demand has fallen in the UK over the last ten years due mostly to the more efficient use of electricity. The champion is the humble LED bulb which is up to 95% more efficient than the humble tungsten-filament incandescent bulb, but white goods and other products have played a part where a common aspect to many of them is oftentimes a more efficient electric motor. All this has magnified the impact of renewables and has accelerated the demise of the legacy fossil fuel baseload electricity generation base. In time, of course, we do see the electrification of domestic heating and fully electric cars, buses, etc. driving up electricity consumption, at the expense of gas and oil consumption respectively; another key feature of the CCC's recommendations.

The mix of energy sources for electricity generation has changed drastically over the years, as the relative cost of different generation technologies has shifted, often influenced by regulatory regimes, which in turn have been driven by energy security concerns or the low-carbon agenda.

As such, renewable energy has risen, with the significant impetus from subsidies in the early years, and now represent c.40% of total electricity generation. Looking forward, rapidly falling costs now mean that they are now at grid parity and can compete without support, fuelling further rapid deployment.

However, the overall decline of coal and gas-fired plants has been slowed down by the Capacity Mechanism established by the UK government in 2014 to ensure sufficient base capacity when renewables are not available.

Within the baseload generation mix, coal, which historically has been more competitive than gas has been marginalised by another regulatory regime, the UK's Carbon Price Support, as well as by the EU Exchange Traded System (EU ETS), adding significantly to the cost of generation of coal as it emits the most CO<sub>2</sub> per unit of electrical energy generated. This has resulted in an extraordinary situation; coal-fired generation, from a market share of 42% of total electricity generation in 2012, has since been almost completely removed from the grid.

Thanks to gas-fired generation, there is still a great deal of fossil fuel-fired generation in operation today. However, this is set to fall quickly as renewables deployment marches on for the reasons covered above.

Load factors have evolved for coal and gas-fired generation. Coal, as discussed, is almost all gone. Meanwhile, the c.29GW of gas-fired capacity saw its load factor peak almost three years ago.

In the next year alone, another c.2GW of offshore wind generation and c.1GW of solar and onshore wind generation is expected to be commissioned. This will increase renewable generation by c.10% and add around four percentage points to renewables' market share of electricity generation, taking a further chunk out of gas-fired generation's market share.

Gas-fired generation already operates at an average load factor below 40%, a challenging level. Compounding gas-fired generation's problems is the fact that renewable generation is intermittent, meaning gas-fired power plants can only run when renewable generation is weak. This on-off generation profile drives up both operational and maintenance costs. This combination of factors is likely to become too challenging economically for some plants before too long.

Gas-fired generation, which has a middling marginal cost compared with renewables (c.GBP0/MWh) or flexible generation (>GBP70/MWh), happens to set the price of electricity much of the time. Thus, the falling use of gas creates more dispersion in intraday low and high price points - these spreads increase the profits available to energy storage projects.

With the rising share of renewables in electricity generation, the routinely used grid management tool is curtailment (temporary shutting down) of renewable sources. Curtailment is an expensive solution and costs the consumer GBP162 million per annum. Over 6% of all wind output is curtailed and this is set to rise until there are sufficient batteries system to stabilise the grid.

Batteries are also needed to support the grid in real time. Firm Frequency Response (FFR) Services are the first line of defence, adding or removing power from the grid if the electrical frequency varies by as little as +/-0.05Hz, all in order to keep the frequency within a band from 49.5Hz - 50.5Hz, in line with National Grid's license requirements.

It was this line of defence that 'saved the day' during the blackouts of 9 August by avoiding a far worse outcome. However, they failed in aggregate to completely avoid a short-duration blackout as the supply of back-up power from batteries and other fast-acting generators could not compensate for the size of the system's loss of load.

It is interesting to trace the grid frequency over the last few years, including the now infamous events of 9 August, the day of the recent blackouts across parts of Great Britain. Our technical team had already observed falling 'inertia' on the system in recent months evidenced by increasingly common low-frequency events when there was a drop-in load on the system. We believe, this is due to the recent absence of coal and other heavy rotating turbines which can physically absorb such shocks, tempering the decline in system frequencies.

We therefore feel fully justified in our optimism that this new world of a low inertia National Grid will require the development of more battery capacity, which would benefit battery projects such as ours.

Without doubt, the UK needs more grid-scale batteries. The growth in renewables demands this and recent events provide confirmatory evidence that batteries can make a difference.

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# QuotedData

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