

## 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

Sentiment improved to a degree over September, as equity markets nudged higher. Gold gave back some gains after a bumper summer while long-term government bond yields increased in the UK and US, as capital was taken away, pushing prices lower.

### Global

Managers are increasingly cautious as manufacturing slips and trade tensions add weight to weakening sentiment.

Zehrid Osman, manager of Martin Currie Global, believes that the outcome of trade tensions between the US and several countries are harder to gauge than initially predicted. On the economic front, Zehrid adds that based on looking at leading indicators generally, trends remain mixed with an uncertain direction of travel. The manager of Livermore Investments discusses weakening manufacturing output and subdued investment spending, while the managers of Mid-Wynd International, hold the view that the best growth opportunities in equities will generally be broadly spread and the best value-for-money investments equally widely dispersed. They note that UK 10-year bond yields below 1% represent poor value, incentivising savers to hold equities even when valuations look stretched.

### UK

#### Looking for green shoots from Sterling weakness

In these uncertain times, Michael Hughes, chairman of JPMorgan Mid Cap, believes that now, in particular, is the time when a...

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Exchange Rate	30/09/19	Change on month %
GBP / USD	1.2289	+1.1
USD / EUR	0.9176	+0.8
USD / JPY	108.08	+1.7
USD / CHF	0.9977	+0.7
USD / CNY	7.1483	(0.1)

Source: Bloomberg, Marten & Co

### MSCI Indices rebased to 100

Time period 01/10/2018 to 30/09/2019



Source: Bloomberg, Marten & Co

	30/09/19	Change on month %
Oil (Brent)	60.78	+0.6
Gold	1472.49	(3.1)
US Tsy 10 yr yield	1.6646	+11.3
UK Gilt 10 yr yield	0.488	+1.9
Bund 10 yr yield	-0.573	(18.4)

Source: Bloomberg, Marten & Co

■ UK (continued)

... fundamental stock-picking approach should benefit shareholders. Elsewhere, M. Foster, J. Harrison & J. Dieppe, managers of Investment company, say that, overall, the UK market remains very attractively priced. They believe that, unless a global recession takes hold, historically low yields on government bonds offer little scope for capital appreciation. A resolution to Brexit would remove some uncertainty and in doing so provide international investors with more reason to invest in UK assets. Philip Remnant CBE, chairman of City of London, discusses an upside from sterling's weakness, saying this would be a positive for City of London's portfolio given the predominance of international companies where profits and dividends will increase when translated from overseas currencies into sterling.

The manager of Crystal Amber says that sterling's weakness has created several activist opportunities that are particularly attractive to overseas buyers. David Seligman, chairman of British & American notes that the determination of markets to ignore the growing political and economic headwinds and uncertainties seems to have faltered. Unless several issues globally are resolved, markets are likely to remain below the peaks achieved in 2018, which followed years of stimulus.



■ Japan

Promising signs that corporate Japan is becoming more shareholder friendly

Baillie Gifford Shin Nippon's manager thinks that broad-based uncertainty globally, with Japan no exception, creates an exciting landscape as there are a growing number of fundamentally sound companies with durable strategies that are getting dragged into sell-offs. The manager discusses some of the fund's main theme exposures, including payments, as Japanese society continues the structural shift away from cash. We also hear from Joe Bauernfreund, manager of AVI Japan Opportunity, who believes that Japan's commitment to corporate governance reform is real. AVI discuss the high cash levels corporates hold (payout ratios are low) while providing anecdotes from their form of shareholder activism. Joe believes Japanese companies will start to focus on their balance sheet efficiency and returns on equity and that ultimately running companies in a more shareholder friendly manner will mean that investors have been too pessimistic in the valuations they ascribed to Japanese stocks.



■ India

BJP election win provides footing for growth to accelerate

The manager of Ashoka India Equity sees upside following the re-election of the BJP led NDA government for a second term. The result is business-positive as it removes uncertainty associated with a weak coalition government. The manager thinks there is increased likelihood of further structural reforms over the coming years. With the current electoral numbers, it is expected that in a couple of years, NDA is likely to win a majority in the upper house of the Parliament as well, which should enable the government to pursue the more difficult and long awaited reforms. India Capital Growth's manager makes the point that the BJP's election win represented the first time a party has returned to power with a majority since 1971. There is now a stable footing for an economy that is poised to see an acceleration in growth.



Private equity awash with dry powder

## Private equity

Lorne Abony, CEO of FastForward Innovations, discusses concerns around the block-chain and cryptocurrency space. The fund remains bullish about the opportunities in wellness, longevity and medicinal cannabis investments. Elsewhere, Caroline Foulger, chair of Oakley Capital Investments, says there is an abundance of 'dry powder' in the sector. She also adds that the pool of investable private companies is growing.

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Credit quality has started to decline in the US

## Debt

The manager of M&G Credit Income walks us through the performance of several credit asset classes over the year. Looking ahead, the manager says that rather than chasing yield, in an environment where corporate bond yields have been falling, the fund is likely to take a more defensive approach while maintaining a high level of liquidity in the portfolio (in the form of AAA-rated asset-backed securities) to opportunistically make investments, in the event of a market sell-off. The manager's report for Pollen Street Secured Lending (formerly P2P Global Investments) notes that in the current more competitive mainstream lending environment, it is particularly important to maintain prudence and discipline. In addition, with household borrowing at high levels, and the regulatory framework remaining an ever present factor as consumer credit regulation continues to develop, it is necessary to proceed with caution. We also hear from the manager of Fair Oaks Income, who is cautious about credit quality in the loan market. It is pointed out that average leverage from US large corporates, defined as corporates with EBITDA of more than US\$50m, increased from 5.2x at the end of 2018 to 5.4x in Q2 2019 while interest coverage fell from 3.6x to 3.1x. We also have comments from Honeycomb, GCP Asset Backed Income and Biopharma Credit.

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## Other

We have also included comments on North America from North American Income; Japan from Baillie Gifford Shin Nippon and AVI Japan Opportunity; Vietnam from Vietnam Enterprise Investments; Korea from Weiss Korea Opportunity; global emerging markets from Genesis Emerging Markets; Latin America from BlackRock Latin American; the Gulf region from Gulf Investment fund; global frontier markets from Aberdeen Frontier; Africa from Africa Opportunity Fund; the hedge fund sector from Highbridge Multi-Strategy and EPE Special Opportunities; the leasing sector from Tufton Oceanic and SQN Asset Finance Income; Infrastructure from Infrastructure India, BBGI SICAV S.A. and International Public Partnerships; environmental from Menhaden; European property from Phoenix Spree Deutschland, Aberdeen Standard European Logistics Income, Globalworth Real Estate Investments and Yew Grove; rest of the world property from Ceiba Investments, Aseana Properties and Dolphin Capital Investors; the property debt sector from ICG-Longbow Senior Secured UK Property Debt and Starwood European Real Estate Finance; the renewables sector from Bluefield Solar Income, US Solar Fund and Greencoat Renewables and the commodities sector from Baker Steel Resources.

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## Global

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### Peter Burrows AO, chairman of UIL:

There are two opposing forces at work in global markets at the moment: populist leadership and Central Bank activity. Populist leaders have been elected to challenge the existing "political establishment" while Central Banks have been seeking to move policies back to a more "normal" setting. As the world's economies currently slow down, the Central Banks are in retreat. Most developed economies are seeing interest rates reducing while this should at some point result in inflationary pressures, there is little sign of this today. The populists are looking to deliver policy changes with little regard for more traditional economic forces.

Given that the US Dollar is still the world's reserve currency, the contraction in US Dollars in circulation leads to broad global economic contraction. This has put pressure on other global economies, as has the challenge posed by the emergence of disruptive technology businesses, which dominate local and global markets. Much of the equity market growth has been driven by higher earnings, but higher debt levels across the world's economies have contributed as well. These three factors add to market volatility.

In my statement in last year's report and accounts, I noted that there had been a sharp increase in volatility, and we expect this to continue, driven by the issues outlined above. While market volatility was anticipated, the extent of the market weakness that we have seen in the first half was not. In the six months to 31 December 2018 the China A Share market was down 12.4%, the FTSE All-Share down 11.0% and the US S&P down 7.8%. Since then markets have rebounded in the second half to close largely in positive territory.

In the UK, Brexit has continued to crowd out discussions on most topics as exit concerns have risen. Unsurprisingly, over the year to 30 June 2019, Sterling weakened 3.6% against the US Dollar and 1.2% against the Euro. The Australian economy has also weakened and the Australian Dollar declined 1.5% against Sterling. In the face of weakening demand and over-supply, the oil price has seen a dramatic decrease from USD 79.44 to USD 66.55 per barrel, a decline of 16.2%. Gold rose by 12.5% over the year to 30 June 2019 ending the year at USD 1,409/oz. It is worth noting that, in AUD terms, gold ended at near all-time highs of AUD 2,005/oz, up 18.5% in the year to 30 June 2019. In response to lower interest rates globally and rising political and geopolitical tension we expect gold to go higher.

### Outlook

The world's economies are slowing as reported by the International Monetary Fund. In addition, trade friction is rising as America First, China 2025 and Brexit drive changes in global relationships. All this leaves the board cautious about the outlook for the markets.

Against the above backdrop, stock selection is of increasing importance.

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**Simon Edelsten, Alex Illingworth & Rosanna Burcheri, managers of Mid-Wynd International:**

The last five years have mainly seen strong equity markets, especially abroad. However, our view is that the best growth opportunities will generally be broadly spread and the best value-for-money investments equally widely dispersed. A global equity mandate allows us a full range of choice and the broadest opportunity to diversify.

Yet we do live in unusual times. Current UK 10-year bond yields below 1% seem very poor value for most investors (indeed I never thought I would see such a yield). Savers therefore may have to hold equities even when valuations look historically stretched. With that in mind, we continue to invest in quality growth companies, but we also try to ensure that average valuations across our portfolio have not risen unreasonably. Furthermore, we aim to keep the fund well enough diversified to cope in future scenarios both easily anticipated and unpredictable. With politics, economies, trade, and bond rates all unusual, we maintain a style we believe to be more capital protective than the equity index. High quality companies which have invested for the future and which have reasonable valuations should continue to provide healthy investment returns even in troubled times.

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**Helge Skibeli, Rajesh Tanna and Tim Woodhouse managers of JPMorgan Global Growth & Income:****Volatility isn't going away**

As we review the company's financial year for the 12 months to June 2019, it is notable how much volatility we have come to live with. This volatility is found both in markets and in the geopolitical environment, and we enter the rest of 2019 with the prospect of exogenous factors significantly impacting companies around the world. From Brexit, where a Boris Johnson-led government is threatening the prospect of a hard Brexit, to the US-China trade war - we can't ignore that there is risk associated with the outcomes of these disputes. This unsettling backdrop for equities has of course led to volatility. The significant sell off between October and December 2018 went hand-in-hand with fears of an impending recession. As quickly as these fears manifested themselves, they were then gone. Markets hit new highs in 2019, with the MSCI ACWI index up 15.9% between 1st January and 30th June, although again, not without some bumps along the way.

As we look forward, it is important to remember that markets are more volatile than the economy. The consumer remains in good shape and accounts for double the output of the industrial economy. Unemployment numbers remain low, wage growth is giving consumers more money in their pocket, and willingness to spend is stable. As managers of the company, even when we see volatile markets, we need to remember that being invested long-term brings rich rewards. Any volatility in the market should be embraced - it allows us to buy companies at even more of a discount to their intrinsic value.

**Outlook**

China-US relations is a topic that one could spend hours on, only to find that one tweet changes the situation entirely. At this stage we think it is clear that there is no easy deal to be had. With further tariffs put in place as of 1st September, the market fears things will get worse. We should remember though, that neither side wishes to harm their economy, and that fact should prevent the disagreement from turning into something much worse.



We are seeing data from the industrial companies we research that is less than encouraging, unsurprisingly given the trade tension, but at the same time the consumer remains strong. We have enough precedent to know the consumer doesn't necessarily have to weaken, but the answer to that will determine when we have the next recession. We are watching carefully unemployment and job openings data for signs of weakness.

One important difference between what we thought back in December, and what we think today, is the mindset of central banks. We have just seen the first cut from the US Federal Reserve. Another is expected this month. Policymakers have emphasized they are 'data-dependent'. This loosening of monetary policy is one important tool that could extend the cycle further, and central banks' willingness to use it is an important indicator for markets.

When we bring these dynamics together, there is no clear picture.

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### **Manager's report for New Star Investment Trust:**

#### **Market review**

US monetary policy reached a watershed moment during the company's financial year. Starting in December 2015, the Federal Reserve had tightened monetary policy through successive interest rate increases and some reduction of its swollen balance sheet, culminating in December 2018, when the Fed funds target rate rose to 2.25-2.50%. Global equities fell over the final quarter of 2018, more than erasing the previous quarter's gains because investors feared overly-restrictive monetary policy might choke off economic growth. In a significant volte-face, however, the Fed chairman, Jerome Powell, retreated from earlier hawkish comments that interest rates were "a long way" from neutral, saying rates were "close to" neutral. Confidence returned following the Fed's U-turn, with global equities gaining. US equities outperformed but European and Asian equities underperformed.

Safe-haven assets were in demand as economic prospects deteriorated. The yield on 10-year US treasury bonds fell from 2.85% to 2.20%, with investors looking forward to US interest rate cuts. Gold rose 16.25% in sterling as the decline in bond yields reduced the opportunity cost of holding this nil-yielding commodity and investors sought safety from the potential debasement of some major currencies through monetary easing.

The Fed changed tack because of slowing economic growth and below-target inflation. US gross domestic product (GDP) rose 3.1% in 2018 but the rate slowed to 2.2% in the final quarter as the impact of fiscal stimulus and increased public sector spending faded. In August 2019, the Fed forecast growth of 2.1% for 2019. The narrowing difference between short-dated and long-dated US bond yields led some forecasters to be more pessimistic, fearing a recession might be approaching.

In August, the 10-year US treasury bond yield fell below the two-year yield. This so-called "yield inversion" has preceded every US recession in the last 40 years although some months have typically elapsed between the inversion and the onset of recession. US leading indicators for manufacturing and non-manufacturing sectors weakened in the first eight months of 2019 and the manufacturing leading indicator dipped to a level that implied output might fall. Consumer spending, however, proved resilient as a result of low unemployment. Employment data tend, however, to be lagging indicators. In August, the Sino-US trade dispute escalated as both sides increased tariffs. US tariffs have gained bipartisan support and are likely to become an established feature of US trade policy, reducing the scope for an economic boost if the impasse is resolved.

UK GDP expanded 0.5% quarter-on-quarter in the first quarter of 2019. GDP did, however, fall 0.2% quarter-on-quarter in the second quarter, according to the first estimate, probably as a result of activity having been brought forward into the first quarter ahead of the first Brexit deadline of 29th March. UK household spending continued to grow steadily but leading indicators deteriorated and the potential disruption from a no-deal Brexit may tip the UK into recession. Brexit-risks overshadowed UK equities. UK smaller companies did worse because they tend to be more reliant on domestic earnings than larger companies, whose export and overseas businesses benefitted from sterling weakness. In response to the increased likelihood of a no-deal Brexit, sterling fell.

Eurozone manufacturers suffered from worsening global economic prospects and the impact of trade disputes and tariffs. German GDP fell in the third quarter of 2018 and the second quarter of 2019 as the manufacturing sector contracted. In June, German industrial production fell 1.5% on the previous month, leaving it down 5.20% over 12 months as vehicle production was hit particularly hard.

Over the summer of 2019, investors expected the European Central Bank (ECB) to ease monetary policy later this year. The scope for interest rate cuts may be limited, however, because the ECB's deposit rate ended the company's year at -0.40%. Banks have typically refrained from passing on the negative deposit rate to retail customers, reducing their profits. Further cuts may be no more effective in encouraging bank lending so the ECB may resort to more bond buying, the previous programme having ended in 2018. As a result of recent falls in bond yields, however, many Europe excluding UK sovereign bonds were already trading on negative yields over the summer and the ECB may encounter liquidity constraints.

Chinese economic growth slowed as weak export demand was only partially offset by increased infrastructure spending. Additional policy support may, however, be forthcoming if trade talks stall. After the year-end, the renminbi fell against the dollar, prompting the US to designate China a currency manipulator. Renminbi-weakness generated fears of deflation in August 2015 and January 2016, leading to sharp falls in some risky assets.

Within emerging markets, returns diverged widely. While Chinese equities fell, Indian stocks rose. The prime minister, Narendra Modi, won a second term while the 16.15% oil price fall in sterling terms benefitted India as an oil-importing economy. Russian equities rose as investors' fears of further sanctions proved unfounded for now.

### **Outlook**

Global economic growth slowed over the summer of 2019, affected by US monetary tightening in previous years and the fading of the impact of President Trump's fiscal stimulus. The manufacturing sector was suffering more than services as trade woes exacerbated worsening global economic conditions. In the US, bipartisan support for tariffs aimed at Chinese exports mean there may be no easy resolution of trade disputes as the US seeks to maintain technological supremacy in key sectors such as information technology and communications. The eurozone and some emerging markets were more severely affected because of their dependence on exports while the UK appeared vulnerable to a no-deal Brexit.

The flattening yield curve may imply a recession is approaching. The Federal Reserve and some other major central banks have been seeking to mitigate the impact of slowing growth through monetary easing. These policies may, however, prove less effective than previously after more than a decade of such measures.

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**Zehrid Osman, manager of Martin Currie Global:****Outlook**

On the macroeconomic front, since the publication of our 2019 outlook, the situation has become more uncertain on the outcome of trade tensions between the US and some of its trading partners (not just China, but also Europe, Mexico, Vietnam and others). We believe the outcome of such trade tensions are more difficult to gauge than we initially predicted, notably in relation to the US-China tensions, which have taken on more than just a trade dimension, now becoming political and strategic, with the issues surrounding Huawei, the Chinese telecommunications company, at the heart of the escalation.

The Brexit issue continues to languish, fuelling more uncertainty and continuing to impact the UK economy negatively. The change in political leadership further increases the risks of a disorderly Brexit. We ran a Brexit stress-test on our portfolios at the start of the year and remain comfortable with our current positioning. The situation is fluid and the final outcome highly uncertain both in terms of shape and timing (despite the 31 October 2019 deadline) and is being monitored for further developments. To add to the geopolitical uncertainty of Brexit, conflict between Iran and the US escalated towards the end of the first half of 2019, and again needs careful monitoring.

Global macroeconomic momentum has been weakening, leading central banks to either back-track on their hawkish intentions from late last year (witness the US Federal Reserve turning more dovish at the start of 2019), or to reiterate their dovish stance (as per the European Central Bank or the Bank of Japan). Looking at leading indicators generally, the trends remain mixed and direction of travel uncertain in aggregate. Whilst central bank support is a welcome confirmation for equity markets, it highlights the fact that the economic recovery globally remains fragile and the strong deflationary undercurrents we discussed in previous manager's reviews remain an important risk for investors. Government bond yields remain very low as a result.

The yield curves have inverted across key developed markets which, as we have written in previous reports, has typically been a good lead predictor of a pending recession in the past, which has increased the market fears around the macroeconomic picture. It is important to highlight two things on this topic: (i) equity markets can continue to perform for some time after an initial yield curve inversion, and (ii) there are potentially more technical currents at play pushing yields down into negative territory, which could somewhat muddy the ability of such indicators to predict a recession this time around. In any case, this is something that the market will be spending a lot of time focusing and commenting on.

From our point of view, we believe that we are heading into a slowdown rather than a recession for the time being. In any case, our portfolio is well positioned to weather a recession if one were to happen. The weaker economic backdrop is likely to put pressure on consensus earnings estimates globally, which some short-term investors will be particularly sensitive to. We think the downward revisions to earnings could actually be quite substantial in some more cyclically exposed companies.

Overall, there are plenty of uncertainties for the market to worry about on the geopolitical, macroeconomic and microeconomic fronts.

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## Manager's report for Livermore Investments:

### Economic & Investment Environment

The first half of 2019 was beset by increased geopolitical noise, trade and tariff uncertainties, and concerns over slowing global economic growth and the ability of central banks to stimulate if hit by a deep slowdown. As the US continues to push to renegotiate longstanding trade treaties and dealings with the rest of the world, the tariffs imposed and resulting uncertainties are slowing business investment down and its effect on the global supply chain has not yet been fully understood. UK's disarray over its orderly or disorderly exit from the European Union has further dampened global trade and investment.

Although, GDP growth in the first quarter picked up worldwide with all large economies recording above-average expansion, manufacturing output again tended to weaken in many countries, accompanied by subdued investment spending and a reduction in global goods trade. At 3.1%, economic growth in the US was considerably stronger in the first quarter than in the previous period. However, this was primarily attributable to volatile components such as inventories. Domestic final demand lost some momentum with slower consumer spending and uncertainty in connection with financial markets volatility. The Euro area also recorded a higher growth rate in the first quarter with Germany leading the way. However, here too momentum was lost with Germany staring at a potential recession later this year.

Signals from the labour markets have remained positive overall. Employment figures in the advanced economies rose again and unemployment has continued to decline. The unemployment rate in the US moved down from 3.9 percent in December to 3.6 percent in May; meanwhile, wage gains remained moderate. The Euro area also saw the unemployment rate decline and is now close to its lowest level since its inception.

Inflation has generally remained muted in most advanced economies. In the US, the personal consumption expenditures price index moved down from over 2% to 1.5% in May. Core inflation also fell, and was 1.6% in May - down from 2% a year ago. In the Euro area, consumer price inflation was little changed in recent months, with core inflation hovering around 1.0%.

To combat a potential slowdown in their respective economies, central banks in the US and Euro area changed their monetary policy stance to allow for additional accommodation. The US Federal Reserve stopped its interest rate hikes and in July voted to reduce the Fed funds rate by 0.25%. The European Central Bank (ECB) has also indicated further easing.

Stock markets initially continued to move higher; however, trade tensions prompted a correction in May. By mid-June, the MSCI World index was back near its mid-March level. Still, the drop in the last quarter of 2018 was deep enough that the S&P 500 generated over 17% return during the first half of this year. Yields on ten-year government bonds in advanced economies declined for the most part with the US 10 year yield dropping from about 2.7% to 2.0% by the end of the first half as investors ratcheted down growth and rate expectations.

With expectations of slower economic growth in the US and a resulting fall in rate expectations, demand for floating rate assets such as US senior secured loans and CLOs waned and there were substantial outflows from retail loan funds. According to S&P Capital IQ, total institutional loan issuance was USD 147bn in the first half of 2019 as compared to USD 271bn during the first half of 2018 as leveraged buyout (LBO) and refinancing activity decreased. Loan spreads were wider as compared to last year and offered good return characteristics to spread buyers. Given the length of the credit cycle certain loan fundamentals have deteriorated and the loan market exposure to Single-B

rated loans is at its highest level. Default rates, however, have continued to stay well below historical levels. The company anticipates default rates to stay below historical average levels as there are few near-term maturities and interest coverage ratios remain healthy. For the six months ended June 30, 2019, the Credit Suisse Leverage Loan index (CSLLI) generated a total return of 5.42%.

### **Senior Secured Loans and CLOs:**

The US senior secured loan market (leveraged loan market) continued to offer good risk adjusted returns in the first half of 2019 with relatively lower volatility and low correlation to the equity market. CLOs are managed portfolios invested into diversified pools of senior secured loans and financed with long term financing pre-fixed at the time of issuance.

After a steep fall in late 2018, US senior secured loans staged a sharp comeback in January. The rally lost steam however, as investors ratcheted down rate expectations and yields tumbled on the back of slower growth expectations and increased trade tensions. Outflows from retail funds were strong and persistent. Nonetheless, the leveraged loan market performed well in the first half of 2019 with the Credit Suisse Leveraged Loan index recording a total return of 5.42%. Credit conditions remained benign with default rates lower than historical averages as there are few near term maturities and interest coverage levels remain healthy.

The soft demand for floating rate paper was also apparent in the CLO market in the first half of 2019 with debt spreads much wider as compared to the same time period last year. This has made refinancing or extending existing CLO reinvestment periods quite difficult. Wider new issue spreads in the loan market and somewhat elevated loan price volatility in the secondary loan market provided most CLO managers opportunities to increase weighted average spreads, build par, and/or reduce risk. The CLO equity market was relatively weak during the first half of 2019 especially for those with short reinvestment periods..

Although management maintains a positive view on the CLO portfolio, mid-long term performance may be negatively impacted by a strong pull back in the US or European economy or geo-political events that could result in a spike in defaults. Despite the overall decent health of the US economy, we acknowledge that the continued trade tensions and below trend growth globally as well as headwinds relating to the political turmoil and geopolitical shocks pose risks to the CLO portfolio.

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### **Manager's report for CIP Merchant Capital:**

#### **Market review**

Public markets are heading to a potential tumultuous second half of 2019, due to a number of threats and increasing tensions at political level. Since the end of June, the European markets have shown signs of weakness due to worries about tariffs the US is threatening to impose on the EU.

#### **Outlook**

The prolonged market uncertainties, especially the Brexit negotiations and trade war between Europe and the US, give us reason to believe that it is prudent to wait, where applicable, until negative news affects the share price of a potential investment instead of investing too early before potential negative macroeconomic impacts are experienced by such targets.

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## United Kingdom

(compare UK funds [here](#))

### Michael Hughes, chairman of JPMorgan Mid Cap:

The market backdrop that I have been reporting on in recent years frustratingly continues. The company is still impacted by the ongoing uncertainties surrounding the UK's exit from the European Union, which continues to keep investors wary of investing in UK equities. The rhetoric now coming from the new leader of the Government that the UK's future, in whatever shape that may take, will be determined by 31st October 2019 has led to heightened uncertainty. It is, however, at times like these when the benefits of active management should materialise.

### Prospects

Political uncertainty and a weakening of the global economy have depressed UK share prices and those of FTSE 250 shares in particular. However, the resulting low valuations relative to the rest of the world seem to be attracting overseas buyers of UK companies, continuing a trend which has been a notable feature of this section of the UK stockmarket over many years. The financial health of UK companies overall is also a reassuring feature which should help restore investor confidence quickly when political uncertainty subsides.

The diversification of investor risk is also a notable feature of the FTSE 250 universe and is particularly relevant during a period of cyclical weakness. Active fund management also provides the ability to adjust positions when economic conditions change over the cycle.

Although the current investment climate appears challenging and perhaps confusing, the steady management of a portfolio of companies which have sound financial credentials and good long term growth prospects, together with an attractive dividend yield, should provide reassurance.

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### Georgina Brittain and Katen Patel, managers of JPMorgan Mid Cap:

### Outlook

For the last three years Brexit has dominated our thinking on the UK outlook, and in particular the outlook for the 50% of the FTSE 250 index which is domestically-oriented. After the initial dramatic market reaction in 2016 post the referendum, both companies and investors became more sanguine and learned to cope with the uncertainty.

This has changed in 2019 as the looming deadline(s) appear, and it is clear that Brexit is currently creating a hiatus in business activity. This, combined with the slowdown in global growth seen this year, makes for a very difficult backdrop for companies to operate in. We believe that now, in particular, is the time when a fundamental stock-picking approach should be able to benefit shareholders, as the discrepancy in performance between the winners and the losers, the well-positioned and those which have lost their strategic way, is only growing.

Over the year we have chosen to rebalance the portfolio to ensure broadly equal exposure to domestic and international earners, since we cannot know or forecast the outcome of the Brexit negotiations. We undertook this repositioning in part due to the extreme valuations of UK-focussed companies and in part to reduce risk, whatever the Brexit outcome. This should leave us well-placed when it finally becomes clear -

hopefully on 31st October 2019, if not before - how Brexit will finally be resolved, and what our country's future position in the world will look like.

In the meantime, valuations currently evidence the lack of investor interest in the UK, and particularly the FTSE 250. While many investors are clearly shunning the UK at this time, others are seeing and seizing the opportunity. According to Dealogic, the value of private equity takeovers in the UK hit £13.6bn for the year to date, the highest since 2007. At the time of writing, there have been five bids for FTSE 250 companies in the last couple of months alone, and we would expect M&A activity to remain a feature.

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**M. Foster, J. Harrison & J. Dieppe, managers of Investment company:**

**Outlook**

Little has changed in the world economic backdrop since our interim report. Both bond and equity markets have continued to respond favourably to dovish sentiment emanating from the Federal Reserve and European Central Bank in response to a slowdown in global growth rates.

Brexit continues to dominate the UK political commentary and its consequential effects on sterling are apparent.

Overall, the UK market remains very attractively priced against the rest of the world. We maintain the view that, unless a global recession takes hold, the historically low yields on government bonds offer very little scope for capital appreciation. A resolution to Brexit in our opinion will remove some uncertainty and in doing so will provide international investors more reason to invest in UK assets.

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**Philip Remnant CBE, chairman of City of London:**

**Outlook**

The record low level of 10 year bond yields, with Japan and several European countries in negative territory, indicates the considerable uncertainty about economic growth prospects. The growth of internet commerce is having a deflationary impact globally. Rising trade tariffs are likely to reduce growth and the outcome of the disputes between the US and its various trading partners is uncertain. While the UK economic growth rate has fallen over the last year, in common with other European countries, there are positive aspects, notably the strength of the labour market with record numbers in work.

The path of the UK's future relationship with the European Union remains unclear but a general election is now imminent. In conjunction with our managers, we have continued to consider the direct practical consequences of Brexit on the operations of City of London and do not consider them to be material. To the extent that concerns about Brexit continue to put pressure on sterling, this would be a positive for City of London's portfolio given the predominance of international companies where profits and dividends will increase when translated from overseas currencies into sterling. On the other hand, a resolution of Brexit could help investment in the UK as businesses and investors gain greater clarity.

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**Neil Rogan, chairman of Murray Income:**

The wall of worry seems as high as ever. Brexit is dominating the UK headlines at the moment but is by no means the only political and economic concern. Even if we knew their resolution, what happens afterwards is still highly uncertain. At times like these it usually pays to focus your attention on where you have an information advantage. For our manager that is in the search for quality companies to include in our portfolio. Quality as an investment style has started to outperform.

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**Manager's report for Crystal Amber:****Outlook**

The fund is increasingly cautious on the outlook for markets. Trade tensions, Brexit uncertainty and political divisiveness have increased. With its focus on UK companies, the fund believes that Sterling's weakness has created several activist opportunities particularly attractive to overseas acquirers.

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**David Seligman, chairman of British & American:****Outlook**

The determination of markets to ignore the growing political and economic headwinds and uncertainties reported in my last statement in April seems to have faltered. Equity markets in the USA and UK retrenched considerably in the second quarter showing increased levels of volatility and this has continued into the third quarter. While the current major unresolved politico-economic issues such as Brexit, the China/USA trade war and looming global economic downturn remain unresolved, markets appear likely to remain below the peaks achieved in 2018 following years of monetary and fiscal stimulus. Without a positive resolution of these issues or a return to substantial monetary intervention by central banks which seems unlikely, markets generally seem to be preparing for a period of underperformance.

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**David Barron, chairman of Dunedin Income Growth:****Outlook**

Equity markets remain surprisingly buoyant given growing concerns over global growth and the continuing escalation of trade conflicts. In the UK, there remains a great deal of uncertainty regarding the outcome of Brexit negotiations with the EU, which combined with the likelihood of further domestic political turmoil and an economy that is increasingly showing the strains of three years of uncertainty, makes us additionally somewhat cautious. Investors, however, are increasingly reliant on the monetary support of central banks to offset these pressures on global economic performance. In such an environment, the manager retains an increasingly cautious outlook and sees little reason to shift from a conservative focus on higher quality businesses with the prospect of better than average dividend growth.

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**Manager's report for Aberdeen Smaller Companies Income:****Overview**

Despite continued macro uncertainty, heightened by political volatility around Brexit, markets have shown a lot of resilience. Having sold off in the latter part of 2018, with concerns around economic growth levels and the prospect of interest rate rises, we started 2019 with a strong market rally. Valuations on the UK market had fallen, and relative to other regions limited growth was being priced in which has helped attract investors back into the UK despite broader high level concerns. What is evident though is that FTSE Small Cap ex investment companies has lagged other markets in the UK, driven by its more domestic focus and the markets concerns about the UK in particular and the outcome of Brexit. FTSE 100 and FTSE 250 have performed stronger so far this year, given their more international exposure, as investors continue to look overseas for what they consider more resilient exposures and perhaps also more defensive and lower risk investments.

The UK market contains a wide and diverse range of companies, sometimes even more so at the smaller end. Through our bottom up stock selection focus we identify businesses which have quality, growth and momentum characteristics, with an income balance. We do not look to take macroeconomic calls or time the cycle, but instead focus on identifying businesses which we believe have the levers and ability to grow in a sustainable manner, despite the external distractions the economy might experience. In difficult market environments and at times when economic growth slows, quality is a characteristic we believe comes into even more focus. Quality businesses with healthy balance sheets, management teams with a strong pedigree, good corporate governance and strong competitive positions have the ability to be resilient through more difficult periods, and even improve their positioning when peers may be struggling.

**Outlook**

Whilst some market concerns such as interest rate rises have eased since late 2018, other areas have come to the fore. Economic growth looks to be slowing, US-China trade tensions remain volatile, the outcome of Brexit remains uncertain, and after many years of bull markets investors are conscious that these can't last forever. These dynamics create a lot of uncertainty and volatility, but despite these the market has remained positive throughout the period. Towards the end of the first half this looks to be coming under some challenge, with tougher sentiment and performance in global markets.

The UK market remains an attractive universe of diverse businesses, an opportunity to access a wide variety of end markets and themes globally, and gain exposure to overseas earnings where that is seen as attractive.

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**Colin Clark, chairman of Merchants Trust:****Outlook**

Although markets have undoubtedly been stronger over the period than in the final months of 2018, the main issues that were prevalent then are still present now and our managers remain cognisant of the potential ramifications of global trade tensions, Brexit and US interest rate policy in particular. That said, as to be expected when following a value based investment philosophy, uncertainty will often reveal opportunities to invest in companies with sound business models and whose share prices have been caught in a wider sentimental draught.

The UK stock market does not solely reflect the UK economy and we believe that this should be borne in mind when looking forward. Brexit is less of a structural risk than might be expected, given exposure to multinational businesses and the benefit of the weakness of sterling on overseas earnings. The fundamentals of much of the UK stock market should remain largely unaffected by Brexit and a fair buffer of pessimism is already priced in. In the near term, our investment manager reports an ongoing polarisation of the UK market due to investors favouring "quality" and "growth" stocks. This is causing a significant distortion of market valuations, and creating opportunities for value investors. The managers expect this polarisation to reverse at some point, although the trigger for that reversal remains uncertain.

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## North America

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

**James Ferguson, chairman of North American Income:**

### Outlook

Following its rate-cut announcement at the end of July, the Fed highlighted the downside risk from weaker global economic growth and trade tensions. Nonetheless, the Fed would not commit to further rate cuts, which frustrated investors. We take comfort that domestic economic data points remain reasonable and corporate earnings have been well received by the market and are still decent for this point in the cycle. As the Fed highlighted in its Federal Open Market Committee statement following its rate announcement, while consumer spending remains robust, there has not been similar strength in business-driven fixed investment. This has been demonstrated by weakening Purchasing managers index (PMI) of manufacturing activity domestically, and China's PMI remaining below 50 (signalling a contraction in manufacturing activity) since earlier this year. Many industrial-exposed companies posting results in July reported revenue weakness that coincides with this softening economic data, but also margin issues in many cases due to tariffs.

Notwithstanding US GDP returning closer to longer-term averages and capital investment being subdued due to trade policy impasses, strong cash flows and capital discipline continue to generate progressive shareholder distributions for our investee companies. Interest rates and inflation remain subdued and thus consumer spending remains robust. However, with the macro environment showing some signs of stress, our manager remains cautiously optimistic.

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## Europe

(compare European funds [here](#))

**Andrew Sutch, chairman of Jupiter European Opportunities:**

There are some worrying headwinds affecting the global economy: slower economic growth, a possible recession in Germany, US/China trade disputes, geo-political developments involving oil producing countries, Brexit and so on. .

However, the investment adviser continues to concentrate on individual stock-picking rather than basing investment decisions on macroeconomic issues. It looks for those

companies with innovative products or strategies and good management; many of these companies will prosper during cyclical economic downturns.

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#### Alexander Darwall, manager of Jupiter European Opportunities:

There has been a slight deterioration in forecasts for economic growth. The IMF has reduced its world forecasts for 2019 over the last eighteen months and now expects a figure of 3.3 per cent, having earlier forecast growth of 3.9 per cent. Most regions of the world are forecast to deliver slightly lower growth rates than previously expected: The Euro Area 1.3 per cent (2.0 per cent previously); the US 2.3 per cent (2.7 per cent); and the UK 1.2 per cent (1.5 per cent previously). Forecasts for Brazil, an important market for many of our companies, point to an improving trend with growth in 2019 building on 2018 and 2020 expected to see a further acceleration in growth. The salient reason for the softness in global growth is weaker world trade, this principally the result of tensions between the US and China. The sharp fall in the oil price - the West Texas Intermediate (WTI) was down by 20.2 per cent to \$53.50 over the period under review - would normally give a strong fillip to economic activity. However, the energy market is greatly distorted by incentives to encourage the move to a low carbon economy. In Europe especially, this has the effect of increasing costs. Two other big constituents of corporate costs, labour and interest rates, are still 'positive' for corporate earnings inasmuch as new digital technologies continue to improve efficiency, and interest rates remain low. The ECB's main refinancing rate remains 0 per cent as it has been for the last three years; and 3 month Euribor was -0.32 per cent at the end of May 2019, almost exactly the same figure as a year earlier. The policy of Quantitative Easing (Q.E.) has inflated asset prices (as reflected in rising stock markets) but not had the desired effect of boosting capital expenditure. European corporate earnings have continued to improve, but at a lower rate than previously forecast. Consensus estimates for the constituents of the MSCI Europe index are that European companies' earnings increased their earnings by 6 per cent in 2018 and forecast only 4.3 per cent progress in 2019. Our companies deliver higher growth rates partly because they are engaged in higher growth businesses and partly because, typically, they have a global coverage thereby tapping into some of the more vibrant economies.

#### Outlook

We identify a few elements in the economic backdrop which give cause for concern: anaemic economic growth rates, high debt levels and protectionism. Moreover, quoted companies are assailed by wider 'stakeholder' interests that challenge business orthodoxy and explain the continuing shift in capital from public to private equity. The value of Initial Public Offerings declined in 2018 whereas Private equity fund raising increased. Notwithstanding these multifarious concerns, it is undoubtedly the case that some businesses will prosper.

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## Japan

(compare Japan funds [here](#))

#### Manager's report for Baillie Gifford Shin Nippon:

During the first half of this year, we witnessed anaemic market conditions driven primarily by macroeconomic concerns. Investors remained cautious due to the ongoing US-China trade war and slowing economic growth across key geographies. Unsurprisingly, Japanese equities remained under pressure during this period. High

growth smaller companies and cyclical businesses with meaningful overseas sales were especially hard hit as investors sought refuge in high yielding sectors with dull growth prospects. Despite these short-term cyclical headwinds, we remain confident that the disruptive, high growth stocks that we own are well positioned to deliver attractive returns over the medium and long term.

Although the Japanese market remained sluggish, sterling-based investors benefitted from currency weakness against the Japanese Yen.

Global markets are currently experiencing high levels of uncertainty and Japan is no exception. The slowdown in economic growth across many large economies is being exacerbated by the ongoing trade war between the US and China. It is natural to expect market weakness in these conditions as investors adopt a cautious approach towards equities in general. However, for us as long-term growth investors, the current environment is giving rise to numerous exciting investment opportunities. Many high quality and rapid growth companies are seeing sharp declines in share prices that appear to be divorced from the fundamental long-term attractions of these businesses. Contrary to the prevailing pessimistic sentiment, we are excited at the prospect of investing in these businesses.

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#### **Joe Bauernfreund, manager of AVI Japan Opportunity:**

Institutional shareholders in Japan are coming under scrutiny from the Stewardship Code to vote their shares in a coherent manner and to engage proactively with management. Foreign shareholders have also become more forthright in their engagements with companies. AVI is playing its part in this, and we have been pleasantly surprised at how receptive managements have been to our form of shareholder activism. We are convinced that a respectful, constructive and patient dialogue with company directors will ultimately result in vastly improved policies relating to the use of surplus cash and the independence of company boards.

In the aftermath of the bursting of the Japanese asset bubble in 1989/90, companies embarked on an exercise to store up cash for a rainy day. The companies we have invested in operate successful businesses across a wide range of industries and sectors. However, they have built up substantial cash piles on their balance sheets. The combination of low pay-out ratios and cashflow-generating businesses means that these cash piles grow each year. Over 50% of the market cap of the companies we hold by the company is covered by excess cash. It is this cash that Prime Minister Abe wants to move off balance sheets and put to use working to boost the Japanese economy. The third arrow of Abenomics is all about corporate reform and at its heart is the challenge to put idle cash to efficient use and to get company management to start focusing on shareholder returns and the share price.

We see an increasing number of companies starting to address the inefficiencies that have plagued the Japanese stock market for years. The ultimate proof of how undervalued companies are occurs when a third party makes a bid to take the company private. With the growing presence of private equity investors actively looking to invest in Japan, we think more and more transactions of this nature will occur in coming years.

Japanese share prices have been held back for many years. Indeed, the valuation metrics we are finding in Japan today have existed for several years. We think Japan is changing. We believe that the commitment to corporate governance reform is real, and the result will be that Japanese companies will start to focus on their balance sheet efficiency and returns on equity. Investors will come to recognise that they have been too pessimistic in their valuations of many companies in Japan.

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## Vietnam

(compare Country Specialist: Asia Pacific ex Japan funds [here](#))

### Stanley Chou, chair of Vietnam Enterprise Investments:

Continuing the positive trends of 2018, Vietnam's economy remained solid in the first half of 2019 with leading indicators performing in line with Government forecasts. Vietnam continues to grow and have a greater footprint in international trade and while there may be some concerns regarding global geopolitics, we believe this progress emphasises there is limited risk towards Vietnam.

The figures for Vietnam were encouraging given weaker global demand and the high level of trade to GDP. GDP growth reached 6.8% in the first half of 2019 while average inflation came in at 2.6% year-on-year (y-o-y), the lowest level in three years. The industrial sector was the main growth driver, posting an 11.2% y-o-y rise in the first half. In contrast, the agricultural sector lagged behind, rising just 1.3% y-o-y due to African Swine Fever, which caused a 4.7% decline in pig production. Other performance factors include the El Niño effect which resulted in a lack of water for irrigation, adversely impacting farm productivity.

As for trade, Vietnam posted a trade surplus of US\$1.59bn in the first half which was softer than the previous US\$3.26bn achieved in the same period last year. Vietnam's total export value reached US\$122.53bn, an increase of 7.2%, while the import value nationwide hit US\$120.94bn, up 8.9%. It's important to note that import demand often surges substantially in May while exports often peak in June-August, thus the net export surplus is expected to increase in the second half. In addition, FDI built on its strong 2018 performance with total disbursement growing 8.1% to US\$9.1bn in the first half. New registration totalled US\$18.5bn in the first half of 2019 vs. full year 2018 registration of US\$35.5bn. From a currency perspective, the Vietnamese Dong (VND) depreciated by 1% in the first half and an expected weaker US\$ following the Federal Open Market Committee's June meeting implies less pressure on the VND vs. the US\$ in the second half. As outlined, although the country is clearly a beneficiary of the trade war between the US and China, it will come at the cost of unwanted attention from the US.

The Vietnam stock market gained 10.1% in the first quarter of 2019, with strong inflows from foreign investors driving the market, before falling for three consecutive months. This resulted in a total year-to-date performance increase of 6.8%. Further evidence of the concerns of a continued trade war between the US and China are evident in the average stock market liquidity for the first half of 2019 which was US\$188m, below the US\$250-300m average daily turnover of 2018. However, foreign inflows remained strong and continued to impress with net foreign inflows of US\$424m. In market development, derivatives products within VN30 index Futures have proved to be attractive as the daily traded value increased from just a few US\$m when first introduced in July 2017 to almost US\$400m by the end of June 2019. Covered warrants started trading on the Ho Chi Minh Stock Exchange on 28 June 2019 attracting high demand from investors. Covered warrants are indicative of market access improvement as they offer a way for investors to get exposure to foreign-constrained names like MWG, FPT and PNJ.

We remain positive on Vietnam's outlook for the second half of 2019. There are some international trade concerns given US President Trump's rhetoric on countries abusing trade practices. This was followed by the implementation of 400% tariffs on certain Vietnamese steel products, however, Hanoi has taken immediate steps to mitigate the situation by imposing tariffs on certain products coming from other Asian nations in

order to deter transshipment. At the same time, Vietnam is expected to increase imports from the US, including food products, gas/fuels, and civilian aircrafts. We believe the risk of a trade war with the US is low, as the US will seek allies in Asia to pivot against China. Trade aside, a number of key metrics favour strong domestic performance; 2019 GDP growth is expected to reach 6.7%, inflation is anticipated to remain 4.0% and the local currency remains stable thanks to both the trade surplus and high foreign reserves.

Vietnam is less expensive compared to regional peers such as Thailand, The Philippines, Malaysia and Indonesia.

## Korea

(compare Country Specialist: Asia Pacific ex Japan funds [here](#))

### Manager's report for Weiss Korea Opportunity:

The manager continues to believe that an analytically focused and disciplined investment approach in Korea will generate attractive long-term returns for investors. It is puzzling to us that large inefficiencies and dislocations in the Korean preference shares space remain in a yield compression environment. These dislocations persist in the face of positive catalysts, growing dividends, and cannot be explained away by typical financial factors.

## Asia

(compare Asian funds [here](#))

### Jean Matterson, chairman of Pacific Horizon:

There are currently an increasing number of global political, social and economic issues to worry investors, but there are also a large number of companies in our universe that continue to grow successfully and can be bought at reasonable valuations. The most pertinent issue for our markets is the disagreement between the USA and China regarding tariffs on goods in and out of the region. China is not giving in and is now using the Renminbi exchange rate to offset some of the rising costs to Chinese exporters. A more localised issue is the political disturbance in Hong Kong and whether it can be resolved to the satisfaction of all parties.

### Robin Parbrook and King Fuei Lee, managers of Schroder Asian Total Return:

#### Review

After a volatile and generally poor end to 2018, most Asian equity markets posted strong gains in the first half of 2019. Key to the reversal in sentiment was the shift in policy stance from the US Federal Reserve and Chinese authorities. Both moved towards a more accommodative monetary position as the global economic outlook darkened. After heightened trade tensions caused a sell-off in global stockmarkets in the second half of 2018, a beginning of the year barrage of Presidential tweets led a greater optimism among investors about the prospects for a trade deal between the US and China. However, this relief proved temporary as it became clear in May that no real

resolution was in sight and further tariffs were likely to be imposed. The threat of a full blown China/US trade war remains a major overhang for stockmarkets in Asia.

The period ended with rumbling tensions in Hong Kong SAR due to Chief Executive Carrie Lam's proposed extradition bill, which has the potential to undermine Hong Kong's separate legal system. At the time of writing, these demonstrations have escalated into full blown and sometimes violent protests. The underlying cause of the protests are multiple whether it be lack of accountability of those at the top, inequality in society, sky-high housing prices and lack of opportunity for the young. This means the situation has the potential to be prolonged and will be difficult to resolve. We currently believe cooler heads will ultimately prevail, provided that the Hong Kong Government agrees to drop the extradition bill permanently and is responsive to some of the concerns that have led an estimated one in five people in Hong Kong to march in the streets. Whilst a risk, we think direct military intervention from China is unlikely unless the protests become more violent, given this would have the potential to seriously undermine Hong Kong which still remains the mainland's financial window on the world.

With markets rising whilst earnings prospects are generally deteriorating given the challenging macro backdrop, the managers have turned more cautious and added additional capital preservation in June to protect against the risks of a sharper than expected slowdown in China.

### **Outlook**

The widely anticipated cut in interest rates by the Federal Reserve has finally arrived. While some market participants were disappointed with the size of the cut, it is clear to the managers that the global policy easing cycle has now been firmly set in motion, with a number of countries in Asia having already started cutting their policy rates since the April Federal Reserve move. While the resumption of trade talks provided a temporary boost to the market, the more recent re-escalation of tension following President Trump's announcement to slap an additional 10% tariffs on the remaining \$300bn of Chinese imports by 1 September and subsequent labelling of China as a currency manipulator showed that no real resolution to the underlying issues is in sight.

Ongoing trade tensions are likely to weigh on corporate and consumer confidence across the world. Higher tariffs will raise many end-product prices for consumers in both countries which will likely dampen demand and reduce trade volumes. Heightened uncertainty will also likely deter corporate investment, undermining any optimism that was building with regard to the growth outlook in the second half of 2019.

Meanwhile, amidst the challenging external environment, we continue to see signs of economic deceleration in China. During our recent visit to China, the companies we saw, particularly the hotel and travel-related businesses, painted a similar picture of a slowdown, albeit not a collapse, in demand with business travel being weak and leisure/mass consumption generally holding up. This was also confirmed by retailers and mall operators where the picture was relatively resilient, especially for high-end fashion and athleisure. Visits to companies selling bigger ticket items like white goods and autos, however, were much more downbeat with no companies expressing any optimism for a turnaround in the second half of the year.

So, what do we expect in China going forward? Probably more of the same or effectively continued "muddling through". We do not expect any recovery in trade, and expect exports from China to remain structurally weak, both due to weak end-demand and trade tensions, as well as the clear move by many to diversify production out of China.

We think hopes of China stimulus measures, particularly more infrastructure spending, will disappoint. We expect Chinese investment to structurally fall from here and

continue to avoid anything directly related to Chinese real estate, construction and state-directed domestic investment within the portfolio. With investment remaining at extraordinarily high levels in China and, given this has been funded by a massive build-up in bank debt that the authorities are keen not to further inflate, large infrastructure stimulus is unlikely. With overcapacity in China causing persistent deflation, the authorities are unlikely to want to exacerbate deflationary pressures by further overbuilding, particularly given how stressed the smaller banks have become (deflation being the death knell of weak banks as the Germans know).

Which brings us on to the Chinese banks themselves. The company continues to avoid all exposure to Chinese banks and remains extremely cautious on banks generally (a visit to Ant Financial - Alibaba's finance arm - reminded us that disruption in the financial sector is very real and the internet start-ups in Asia are well-funded, very aggressive and not interested in making money). However, with the recent collapse of Baoshang Bank in China, is this a precursor to major systemic problems in China and a much greater economic slowdown? At the moment we continue to think the problems can be contained, albeit we are monitoring the situation closely.

On a positive note this doesn't mean a Chinese "Minsky Moment" is around the corner or inevitable as China's interbank funding is pretty "plain vanilla" and unlike in previous Asian banking crises there are no foreign (and fickle) liabilities in the system. The problem should thus be containable assuming strong PBOC oversight and stable interbank funding. We do, however, view this situation as one that needs watching and we assume that large banks will be considered part of the solution to bailing out the smaller insolvent banks. This, along with persistent deflation which will pressure bank margins, and fintech players like Ant Financial and Tenpay which will pressure fee income, is why we continue to avoid all exposure to Chinese banks. In fact, given our view that deflation trends and fintech disruption are universal to the broader banking sector (not only in China), we are very selective in our bank exposure in the portfolio, despite prima facie attractive yields and low valuations.

So, what do we want to own in China? We remain very focused on Chinese domestic consumption and upgrading plays. The good companies we meet in China continue to upgrade product quality rapidly, whether it be manufacturers of injection-moulding machines (PIMMs) or hydraulic systems which continue to gain market share globally. Whilst the Chinese workforce is shrinking, it is increasingly well-educated and we believe productivity growth can remain strong, supporting income levels and economic growth over the long term. With savings rates set to fall as China matures we think consumption will be the driver of growth moving forward. Our key exposures in China are to companies playing to the country's comparative advantages in areas such as medical research outsourcing, diversified textile production, insurance, internet and consumption names. Our recent trip to China reaffirmed our view that China's transition from an investment, export-driven economy to a slower but consumption-driven economy remains on track, but we need to watch both the financial system and currency closely for signs of stress.

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## India

(compare India funds [here](#))

### Manager's report for Ashoka India Equity:

#### Outlook

In our opinion, the opportunity to make sizeable returns from stock selection alpha has always been and continues to remain the most attractive aspect of the investment case for India. From this perspective the outlook remains as positive as in the past. Having said that, there are several factors that might be worth considering as investors formulate their view of the market.

The re-election of the BJP led NDA government for a second term provides a positive backdrop for business sentiment by removing the uncertainty associated with a weak coalition government. There is an increased likelihood of further structural reforms over the coming years, continuing what we have seen during the first five year term of this government. With the current electoral numbers, it is expected that in a couple of years, NDA is likely to win a majority in the upper house of the Parliament as well, which should enable the government to pursue the more difficult and long awaited reforms.

At the same time, signs of moderation in growth have emerged in certain pockets of the economy over the past few months. Automobiles and rural consumption have in particular seen softness in demand partly due to reduced lending activity on account of liquidity constraints faced by many NBFCs, as well as due to weak rural income growth. Consensus earnings growth expectations for the fiscal year 2020 have been moderating over the year from circa 20% down to a current low to mid-teens level. If the demand weakness persists beyond a few months, it may lead to a further reduction in consensus earnings estimates. However, despite this risk, that level of earnings growth would still be higher than the mid-single digit earnings growth that corporate India has experienced over the last ten years.

One of the factors that is contributing to the continued growth of corporate earnings is the normalization of profitability for corporate lenders, both government owned and private. Over the last few years, the return on equity of several corporate lenders collapsed from the mid-teens to low single digits due to rising bad debts and related write-offs resulting in a material headwind to earnings growth. With the implementation of the Insolvency and Bankruptcy Code and the resultant resolution of several non-performing assets, debt quality problems at corporate banks are rapidly improving with each passing quarter as mentioned above. Whilst the corporate banking sector may represent a modest part of the total market, the sharp recovery in this segment is expected to contribute approximately ten percentage points to overall index earnings growth.

Amongst the near-term risks, as explained earlier, there has been a tightening of liquidity within the non-banking financials space since September 2018. Consequently, the rapid growth witnessed in the segment in prior years has slowed down since then. The stress continues to remain confined to a few entities, and any systemic risk to the financial system seems minimal. However, the situation needs to be monitored over the coming months.

Another prevailing risk relates to the ongoing global trade tensions, although India remains relatively insulated given that it is predominantly a domestic driven economy unlike China and many emerging markets.

On the macro front, most indicators remain stable. Consumer price inflation has been at the lower end of the historical range at three to four per cent. Fiscal and current account deficits are at or below recent averages and remain within manageable levels. This benign macroeconomic environment allows the Reserve Bank of India room to stay accommodative, if required, to support economic growth or ease liquidity constraints.

India's journey as an emerging economy can be traced back to the landmark economic liberalization of 1991 aimed at making the economy more market oriented and expanding the role of private and foreign investment. More than 25 years later, at a GDP of \$2.6 trillion, India has emerged as the sixth largest and the fastest growing major economy in the world. It is riding on demographics, productivity catch-up, domestic consumption and an aspirational middle class against the backdrop of a mature democratic framework. Concurrently, a slew of structural reforms aimed at improving capital allocation and economy wide productivity are underway.

We continue to believe that the structural growth drivers of the Indian economy are deep rooted and, near-term challenges notwithstanding, India today offers a multi-faceted, multi-generational investment opportunity.

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### Manager's report for India Capital Growth:

#### Manager's report

The period witnessed a wide divergence in performance between the large cap and mid cap stocks, a trend which has continued since 2018. This is best reflected in the performance of the BSE Sensex TR index which was up 9.9% while BSE Mid Cap TR index was down 3.7% (INR). Select large caps have performed well on the back of healthy Foreign Institutional Investors (FII) net equity inflows of US\$11bn while the correction has been more evident in the small and mid-cap equities which took the brunt of selling pressure (this could be partly explained by Domestic Institution net outflows of US\$1bn, more severe earnings cuts and lower liquidity leading to more pronounced price movements) as investors continued to seek refuge in a limited number of large caps.

The first event to discuss is the BJP's win in the general election that took place in May. Consensus expectations were that the BJP would win fewer seats than it won in 2014 but still have a workable mandate with its coalition partners. As a positive surprise, the BJP not just won an absolute majority, but actually increased its seat share. This is the first time a party has returned to power with a majority since 1971. This brought relief as it ensured policy continuity and a belief that, with key structural reforms having been passed, there is now a stable footing for an economy that is poised to see an acceleration in growth.

However, since the election results, sentiment has actually deteriorated. One of the main reasons is the slowdown in growth momentum, particularly in the consumption space. GDP growth in the March 2019 quarter slowed down to 5.8%, a significant fall from the 6.6% delivered in the December 2018 quarter. If one recalls, India's 7% GDP growth was largely being sustained by strong investments in infrastructure by the Government and strong consumption demand. The drag was from weak private sector capex investment due to overcapacity. This too was expected to improve as capacity utilisation levels had touched 78%, with interest rates coming down and a positive election result assuaging concerns over a return to policy uncertainty. However, we are witnessing a sharp slowdown in consumption in urban and rural India. Automobile sales have turned negative across commercial vehicles, passenger vehicles and even two wheelers. Even the FMCG sector growth has almost halved to 4-5%. A sharper fall has

happened in rural demand, which was growing at twice the rate of urban demand and has now come down to parity. Our discussion with several companies in the consumer discretionary space all indicate a similar trend. Banks too are consciously going slow on their unsecured loan segment. In this backdrop, it looks like a re-ignition of the corporate sector capex cycle will be delayed further.

There are many other reasons being attributed to the sudden change in sentiments. One is the elections itself. There are typically three months of campaigning and voting in the run up to an election result, during which the Government machinery slows down as new tender activity stops, the pace of implementation of projects on the ground slows down and even Government payments get delayed. Moreover, cash in the system gets diverted to election funding. In rural India, the slowdown is being attributed to weak rural incomes caused by two years of weak monsoons compounded by falling food prices. This is also a result of the Government's focus on reigning in inflation of which food is a core component.

Our own belief is that the main trigger behind the slowdown is tight liquidity in the system. The genesis is the default by IL&FS, an AAA rated unlisted Non-Bank Finance company (which happened in September 2018 and something we wrote about extensively last year). Virtually all mutual funds and banks were lenders to IL&FS. Since its default, most mutual funds have seen redemptions in their debt schemes and have been pulling out money from any business they see as risky. Likewise, even well capitalised banks have turned risk averse and are consciously restricting credit growth. This is having a domino effect with the real pain being felt in the non-banking finance sector (NBFC) which relies on wholesale liabilities (mainly from banks and mutual funds) to fund asset growth. The NBFCs have been the large lenders to the Small and Medium Enterprises (SMEs) as well as to retail borrowers as they are able to provide small ticket loans, filling in gaps left by the banking sector. Moreover, they are also the principal lenders to the real estate sector. With funding drying up for even the well capitalised NBFCs, it is having a direct impact on liquidity across the system. This is seeing itself manifest in various forms:

- Behaviour patterns are changing. Conserving working capital has become the buzz word. Most dealers and distributors are focusing on reducing inventories. At the same time many businesses are sacrificing growth if they find their counterparty does not have a strong enough balance sheet.
- Many promoter families of strong cash rich companies had other business interests, funding for which was obtained by raising debt by pledging shares of the existing business. With refinance proving difficult for these businesses, these families are being forced to top up the pledges (as share prices are falling) and in some cases being forced to sell stakes in their crown jewels or face liquidation by creditors.
- There are also rising cases of corporate defaults by companies with leveraged balance sheets or cashflow mismatches. This is because the refinancing of working capital is drying up. Consequently, there are sharp downgrades in credit ratings, leading to a further hit on the balance sheet of banks and mutual funds.

The above factors have created nervousness in the business environment. There are concerns of the liquidity crunch leading to defaults in areas such as the real estate sector. In this environment, any negative news on a company is leading to sharp stock prices corrections corresponding with the flight to "mega-cap safety". What has surprised us is the stand taken by the Government. Both the Government and the Central Bank have repeatedly stated that they are on top of the situation, that the problem is restricted to just four or five entities and there are no systemic issues. The Central Bank has been infusing liquidity in the system and claims that there is actually

a surplus in liquidity. If this is the case it is clear that it is not reaching the intended target.

It was widely anticipated in the budget, which was presented in the first week of July, that the Government would try to kick-start the economy by going easy on its fiscal deficit target. Instead it remained on the path of fiscal consolidation, with the fiscal deficit targeted to come down to 3.3%, from 3.4% in the previous year. The Government's viewpoint is that with structural reforms over the past five years in place and further supply-side measures planned, it is more prudent to follow a path of long-term sustainable growth over any short term fix.

The Budget did however open the window for the Government to source up to 10% of its borrowing requirements through sovereign debt issued to the offshore market. This has not been done before and attempts to address concerns of liquidity being sucked up by the Government borrowing at the expense of the private sector. This was a bold move and has already led to 10-year bond yields correcting by almost 40bps. It is anticipated that over the next twelve months, interest rates could see a further drop of about 50-75bps, following the 75bps fall already seen over the last six months. The Government has set a target of growing India into a US\$5 trillion economy by 2025 from US\$2.7 trillion on the back of higher investment, savings and exports in the way China's growth was propelled. Infrastructure expenditure target has been put at US\$1.5trn during this period. However, with no concrete measures announced, it remained a disappointment. There were however measures to tackle the current liquidity crisis. This included further capital infusion into public sector banks. Also, the Government will give a 10% first loss guarantee to banks for the next 6 months, on high-rated pooled assets that they purchase from "sound" NBFCs up to a total limit of INRs1trn.

The Government's attempt at raising additional revenues by increasing tax surcharges on super high-income individuals spooked the market. An unintended fallout was that foreign portfolio investors (FPI) registered as trusts and associations would also come under this surcharge. This covers roughly 40% of FPIs registered in India and implies a jump in their capital gains tax outflow. With net FII outflows of almost US\$2bn in July, we did expect the Government to have a rethink and as we write, the Government has indicated that they would begin an exercise of meeting with different industry bodies over the next month to understand the issues they are facing on how to address them. We believe this is the first recognition of the fact that there is a slowdown in the growth momentum.

While markets have come off, it has also been accompanied by downgrades in earnings. For FY19, the Nifty 50 index earning growth was a modest 9%, compared to a consensus forecast of 25% at the beginning of the previous year. The portfolio itself saw earnings growth diminish largely driven by some of the financials exposure increasing provisioning in the event of NPAs and cement companies, which suffered from low pricing. Both sectors should however see a bounce back in earnings as current short term challenges facing the economy wash through.

While we do remain optimistic on the long term given the structural reforms already in place, forecasting earnings in the short term is proving to be challenging. This is also because of the global uncertainty led by the US-China trade wars, which has a bearing on some of our portfolio companies, particularly in the IT and auto-ancillary space. We believe sentiment needs to improve and for this we need some trigger factors. A potential resolution of one or two stressed companies in the housing finance space could help as it would provide confidence that there is no systemic issue and there are buyers for these assets. Likewise, quick resolutions to one or two large assets which have got stuck in legal issues during bankruptcy proceedings could also be a trigger for the banking sector to see a revival in lending.

In terms of valuations companies are more reasonably priced. After the recent price correction and earnings downgrades, valuations are now below their historical averages. The BSE Mid Cap TR index is trading at a PE of 16x for FY21 (against its 4yr average of 17x) whilst the large cap Sensex index is trading at PE of 17x FY21 (against its 4yr average of 15.6x).

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## Latin America

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

### Carolyn Dobson, chair of BlackRock Latin American:

#### Overview

Latin American stock markets were strong in the first half of the year and the MSCI EM Latin America index (Net Return) rose by 12.6%.

The progress towards social security reform in Brazil boosted investor sentiment and the Brazilian stock market produced a net return of 16.0% over the period.

Markets in Argentina were invigorated by the country's inclusion in the MSCI Emerging Markets index, ending the first half of 2019 up by 29.2% (net return). Whilst the Mexican stock market rose less strongly over the period, it still produced a positive net return of 6.8%, as investors were encouraged by the new government displaying a more austere approach to public spending in order to maintain a prudent fiscal surplus. Chile was the only stock market that fell in the period (net return down by 0.9%) driven by currency and macroeconomic weakness.

However, since the period end, there has been a marked deterioration in market sentiment towards the Latin American region.

The unexpected primary election results in Argentina in August suggest a change of government in October and this has worried investors, creating a currency crisis and sharp falls in equity prices. In Brazil (which comprises over 60% of the company's benchmark index) the reports of fires for land-clearing in parts of the Amazon rainforest have sparked public outrage and developed into a politicised topic on a global level.

#### Outlook

Some countries in Latin America appear poised for recovery and growth, notably Brazil, where social security reform and increased fiscal stability should bode well for the economy. The outlook towards the Mexican economy is still weighed by a deceleration in growth expectations, offset by lower inflation that should allow the central bank to reduce interest rates. One year following President Andres Manuel Lopez Obrador's election, the market's worst fears over his presidency have not been realised and his government's pragmatic approach towards the private sector has been viewed positively. The equity market is trading at cheap valuation multiples relative to history (at the time of this report) which gives the portfolio managers a constructive outlook on the Mexican equity market. While the Peruvian economy slowed further in the second quarter of 2019, interest rate cuts should stimulate private investment. Given underperformance in the first half of the year, Chilean equities are looking increasingly attractive due to discounted valuations. Despite the portfolio managers' guarded optimism for most of the region, uncertainty has been generated in recent months, particularly by events in Argentina and Brazil. Volatility is a constant feature of Latin American markets; the company's investment manager is strongly focused on risk

management as an important element of portfolio construction and remains confident in the current investment approach which has contributed positively to the company's performance over time, and continues to identify interesting opportunities in the region.

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## Gulf region

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

### Manager's report for Gulf Investment Fund:

After positive gains in 1Q19, regional markets tracked by the S&P GCC Composite index (S&P GCC) exhibited volatility in 2Q19 as geopolitical events kept investors on tenterhooks.

The standoff between the US and Iran hardened after Iran shot down a US drone. The event was the first direct Iranian-claimed attack on US military assets. This was the latest in an escalating series of incidents in the Gulf since mid-May this year, including suspected attacks on six tankers, and has prompted international concern that the standoff could escalate into an open confrontation

S&P GCC index was up, led by Saudi Arabia, which rose on much-anticipated inclusion into the FTSE and MSCI EM indices. Kuwait market also rose supported by favorable stock re-weightings by the FTSE in March. Markets also reacted positively to the news of Kuwait's MSCI EM inclusion expected to take place in 2020.

Oil prices rose 23.7 per cent YTD 2019 led by decreasing US inventories, US imposed sanctions on Venezuela and OPEC+ decision to continue production cut. However, trade tensions dampened the demand outlook, limiting further upside.

During 2H18, a steep decline in oil prices (Brent oil price was down 32.3 per cent) led to a mixed performance for GCC markets.

### Economic Outlook

Economic reforms and infrastructure spending by regional governments has started yielding positive results for GCC economies, which can be seen in a pickup in non-oil growth for most countries.

Saudi Arabia's fiscal, labour and capital market reforms, undertaken over the past few years, have started bearing fruit. Non-oil growth has picked-up, female participation in the labour force has increased, the introduction of VAT has underpinned an increase in non-oil tax revenues, while energy price reforms have helped reduce per capita consumption of gasoline and electricity. Measures have also been introduced to shield lower and middle-income households from higher costs resulting from these reforms. Reforms to the capital markets, legal framework, and business environment are also progressing well.

During the period, Saudi Aramco sold US\$12bn of international bonds across five tranches, in one of the most oversubscribed debt issuances of all time.

Saudi Arabia Purchasing Managers' index (PMI) improved to a 19-month high of 57.4 in June from 57.3 in May, as Saudi Arabian firms reported rising output and new orders. Meanwhile, the unemployment rate among Saudi nationals fell for the third consecutive quarter in the first quarter of 2019 to 12.5 per cent.

The UAE economy continued to adjust in 2018, when non-oil growth slowed to 1.3 per cent, while the overall economy grew 1.7 per cent, benefiting from increased oil production. The economy is now at a turning point, supported by public spending. A substantial amount of Expo 2020 investment should be completed by end-year, while some government related businesses are embarking on investment plans. This is expected to raise the growth rate to over 2 per cent this year and to nearly 3 per cent in 2020-21.

The stimulus plan for Dubai is directed at technology entrepreneurship, including waiving property registration fines for 60 days, freezing school fees and scrapping 19 fees related to the aviation industry. The Abu Dhabi economic stimulus plan aims to create at least 10,000 jobs for Emiratis in the private and public sectors over the next five years, as well as boosting the competitiveness of SMEs.

The Abu Dhabi government continued its efforts to open the economy, announcing plans to permit the sale of land and property in investment areas to foreigners on a freehold basis - previously limited to Emiratis and other GCC citizens. This should help boost property demand and ultimately prices. UAE also announced plans to issue permanent 'Golden Card' residency visas to high-net-worth individuals and highly skilled workers, in a bid to support foreign investment and retain exceptional talent.

Around 6,800 individuals with a combined worth of about US\$27bn are currently eligible for the visa.

The UAE PMI rose to a four-year high of 59.4 in May from 57.6 in April, led by gains in new orders and output, which rose to multi-year highs.

Abu Dhabi Commercial Bank, Union National Bank and Al Hilal Bank merged and with combined assets of US\$115bn became the third largest lender in the UAE. The merger comes amid ongoing consolidation efforts in the UAE banking industry to strengthen profit margins.

Qatar's overall GDP growth is projected to reach 2.6 per cent in 2019 from 2.2 per cent in 2018, supported by a recovery in hydrocarbon output and robust growth of the non-hydrocarbon sector. The projected non-hydrocarbon growth for 2019 reflects the persistent multiplier effects of continued increases in capital expenditure in recent years, the gradual pace of fiscal consolidation, ample liquidity, and increased private sector activity. Medium-term growth will be supported by increased gas production from the Barzan field and a planned increase in LNG production capacity.

Qatar's banking system remains well capitalised and asset quality is strong. Liquidity pressures that emerged following the blockade in June 2017 have waned, and foreign exchange reserves have recovered to pre-blockade levels.

In Kuwait growth has resumed, with hydrocarbon output rising by 1.2 percent in 2018 after contracting a year earlier. Buoyed by a rebound in confidence and government spending, non-oil growth has accelerated to 2.5 per cent. After the first deficit in more than two decades in 2016, the current account shifted back into surplus in 2017 and reached an estimated surplus of 12.7 per cent of GDP in 2018.

Overall growth in Kuwait is expected to strengthen. The recent OPEC+ (the grouping of OPEC members plus Russia and other oil producers) decision to cut production is expected to limit oil output growth to 2 per cent in 2019, which should rebound to 2.5 per cent in 2020 given the spare capacity. Non-oil growth is projected to increase to 3 per cent in 2019 and 3.5 per cent in 2020, driven by accelerated capital project execution. Once the headwinds from new taxes wear off, non-oil growth could reach 4 per cent. As growth strengthens, and capital projects come on stream, credit growth

should pick up, aided by bank liquidity and the recent easing of lending limits on personal loans.

Oman is reportedly preparing for an international debt issue (US\$2bn) in a bid to help finance its budget deficit (estimated at 7 per cent of GDP in 2019). This comes after recent downgrades that have left its credit rating at non-investment grade. Early this year the government announced that it plans to finance 86 per cent of its deficit with foreign and domestic borrowing and the rest from its reserves.

Additionally, the Oman government plans to make changes to FDI laws to encourage investment inflows. The changes include granting foreign firms 100 per cent ownership and lowering minimum capital requirements. These laws are expected to be passed by the end of this year. Also, to boost non-oil revenues, in June the government implemented an excise tax of 100 per cent on selected goods, including sugary drinks and tobacco. A 5 per cent VAT originally planned for 2018 is likely to follow in 2020.

### Other Recent Developments

In February 2019, Saudi Crown Prince Mohammed bin Salman visited China, India and Pakistan, where he signed multibillion investment contracts. This is part of the Kingdom's plan to strengthen ties with Asian countries to fuel its economic transformation programme.

In 1Q19, Saudi Arabia closed six privatisation deals worth SAR13.3bn in the Water, Healthcare and Transportation sectors. A further 23 privatization projects, due for completion in 2022, are in the pipeline. Saudi Arabia has begun the construction of residential units in the US\$500bn Neom city project with phase 1 expected to complete in 2020. Saudi also announced the "Employment Subsidy Program for Upskilling" to encourage local nationals to work in the private sector with a subsidy equivalent to 30 per cent of their salaries for their first year.

In a bid to lure more investment to the real estate sector, Qatar plans to open further its property market to foreign investors. In line with this decision, ten locations have been identified allowing 100 per cent foreign ownership.

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## Global frontier markets

(compare global frontier market funds [here](#))

### Manager's report for Aberdeen Frontier Markets:

#### Market environment

The twelve months to 30 June 2019 was another challenging period for frontier market equities. While the MSCI Frontier Markets index achieved a gain during the period, this gain was largely attributable to surging Gulf markets, namely those of Kuwait and Bahrain. Without their contribution, the index would have registered a decline.

Indeed, outside of the Gulf and Vietnam, most other frontier markets displayed continued weak momentum, which we believe is primarily due to ongoing negative foreign fund flows and declining investor activity, specifically falling average daily traded volume (ADTV). Figures from EPFR Global show that 2018 witnessed circa US\$1,600m of net outflows from frontier market mutual funds, while the five months to the end of May 2019 has shown a further US\$900m in net outflows. Many smaller



frontier markets have seen declines in ADTVs of 50% or more since 2014 in US dollar terms, meanwhile smaller emerging markets, such as Egypt and Pakistan, which fall within our definition of investable markets for the company, have suffered worse, with declines of 70% plus. In terms of valuations, the index trades on a forward price-to-earnings ratio of just 9.6x if one excludes Kuwait and Vietnam from the calculation, 10% below its five-year average.

A variety of global concerns continue to weigh on investor appetite for more risky asset classes, not least the poor state of US-China relations in trade and other strategic areas. But appetite for frontier markets has remained elusive even as the Federal Reserve (the Fed) has shifted to a more accommodative monetary policy stance this year, which is somewhat surprising. The softening of the monetary policy outlook might have been expected to weigh on the US dollar and provide frontier economies with the flexibility to reduce local rates, not to mention trigger an uptick in foreign investor interest, but this has not played out to any meaningful extent.

Some sceptics point to late-cycle risks to momentum in respect of the world's largest economies, above all that of the US, as cause for ambivalence towards riskier assets. Others contend that this more accommodative monetary stance has underwritten a further late-cycle advance of US equities, which remains the preferred equity exposure for most global portfolios. Whilst recognising such unknowns exist, the fact that most frontier markets are being given such a wide berth seemingly regardless of events in developed economies exemplifies just how out-of-favour this asset class has been.

We repeat the point made previously that the low correlation of frontier markets with global equities, as well as relatively weak trade linkages with the developed world, should imbue the asset class with certain defensive qualities should global equity markets actually lose their footing, especially given the very low valuations that most of our markets now stand at. The month of May was a case in point as global equity markets briefly tumbled on growth concerns, whilst most frontier markets performed somewhat better. Early August has again seen such volatility amid global concerns over China's attempt to counter further US tariff hikes with a weakening of its currency.

Turning to some specific markets, Vietnam remains a high-conviction exposure given excellent corporate earnings delivery within the backdrop of a robust economy, which has been underpinned by rapid investment-led industrialisation. Offshoring from China seems to be a secular prospect given the continuing US-China trade tensions as well as Chinese wage inflation, but there is also a risk that the US turns its attention towards Vietnam's own large trade surplus, which is the US's fifth-largest trade deficit relationship.

Elsewhere, the Nigerian economy continues to struggle within a framework of government policy continuity that is largely absent of reforms that will meaningfully address structural constraints to growth. Tight monetary policy and a focus on maintaining the naira peg to the dollar has provided an aura of stability, but at the cost of growth, with real GDP expected to advance no more than 2.0% this year, which is a lower rate than the expansion of the population.

In Pakistan, the Pakistan Tehreek-e-Insaf (PTI) government led by Imran Khan took several months to define key policies after its election, and almost a year to reach an agreement with the International Monetary Fund (IMF). The government was cajoled by the IMF to concede on several important areas of economic policy, including allowing a major adjustment of the currency, maintaining a suitably positive real interest rate and devising a strategy to reign in the country's fiscal deficit. These remedies were never avoidable, but the quantum of adjustment ballooned with the extended delay in implementation. Facing the prospect of a 12-24 month engineered slowdown, the local equity market retreated to decade lows. By the end of June the Karachi All Share index

traded on 6.4x the current year's earnings, despite depressed corporate profits. With a now inexpensive currency and credible reform effort in place, we believe the worst is behind the market.

Egypt, in the third year of its IMF-supported programme, saw real GDP growth accelerate to 5.7%, a solid number that is expected to be maintained in the medium term given falling inflation, lower interest rates, recovering tourism, returning consumer confidence and what is expected to be a recovery in capital investment.

Indeed, most of our markets outside Argentina and Pakistan are enjoying stable or accelerating economic activity at this juncture, which is in contrast to a peaking economic cycle in the developed world. The outlook for developed economies appears more fragile than it has been for some time in many ways, but given our region's relatively weak linkages with the global economy, idiosyncratic drivers such as the timing of various IMF supported programmes and moderating interest rate expectations, we see reasons to remain bullish about the prospects for a frontier market recovery over the coming quarters.

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### Market outlook

While news flow continues to be mixed and liquidity conditions an ongoing challenge, we see reason to be optimistic about the near future. Firstly, from an economic as well as political point of view, many of our core markets continue to progress various structural reforms, several under the direct auspices of the IMF, which is very encouraging. This provides an element of policy clarity to the cyclical recovery that is underway across a number of our markets. Pakistan is the latest to join this group, which bodes well for the future of that economy. Secondly, while foreign investor participation in most of our markets has fallen to extremely low levels, such a lack of engagement we believe will revert in due course and in the meantime valuations are at highly attractive levels in absolute terms, underpinned by a still reasonable corporate earnings outlook.

As discussed above, uncertainty with regard to the outlook of developed economies, matched by increasing dovish tones from central banks, could provide a more conducive environment for frontier markets as investors seek uncorrelated and absolute return opportunities. In time we expect the frontier region to be rediscovered as global investors recognise the attractiveness of the asset class's idiosyncratic drivers, cyclical positioning and attractively valued markets.

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## Africa

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

### Manager's report for Africa Opportunity Fund:

The single biggest factor on the negative front is an underlying macro-economic pattern in several African countries. Governments in countries like Ghana, South Africa, Zambia, and Zimbabwe have incurred large amounts of debt in recent years to pay for heavier salary and interest-servicing obligations, and climbing contingent liabilities. Each government faces doubts about its resolve and ability to reduce sharply its recurrent expenditure ratios. Consequently, in those countries with shallow savings pools, high domestic real interest rates (20% in the case of Zambia, for example, and 10% in the case of Ghana) exert immense downward pressure on local stock exchanges, regardless of whether listed companies report growing profits.

## Growth capital

(compare growth capital funds [here](#))

### Neil Woodford, manager of Woodford Patient Capital:

I remain as passionate for the early-stage asset class as I have ever been. I have often said a long-term "patient capital" approach can deliver extremely successful outcomes, help businesses to fulfil their potential, while also helping to develop the UK's knowledge economy, and support economic rebalancing.

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## Private equity

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

### Lorne Abony, CEO of FastForward Innovations:

The macro-economic and political environment both in the UK and globally is creating volatility in many different markets. Notably, the continuing uncertainty around regulation of crypto-currencies and the price volatility in those markets has impacted the operations and attractiveness of [*two portfolio companies*] since our latest investment into each last year.

The nature of investing in early stage venture capital investments is that success will be variable and will generate correspondingly variable returns.

At the time of writing, we are concerned with the block-chain and cryptocurrency space and the effect the market has on our investments in these areas, but equally are bullish about the opportunities in the wellness, longevity and medicinal cannabis investments we hold.

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### Caroline Foulger, chair of Oakley Capital Investments:

There is concern around the abundance of dry powder within PE funds, increasing valuations and the dangers of high leverage. However, we believe that the industry's superior returns and ability to deploy capital are currently sustainable, thanks to the increasing pool of investable private companies, in contrast to continued public market consolidation.

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### Clive Spears, chairman of EPE Special Opportunities:

The economic outlook for the UK remains subject to significant headwinds, both with regard to the outcome of the EU exit process and the possibility of a change of government during the coming period. Underlying economic performance has been mixed; UK annual GDP growth has been muted, with the 1.8 per cent growth recorded in Q1 2019 expected to soften. The labour market has remained resilient however, with unemployment at multi-decade lows and real wage growth strong.

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## Debt

(compare debt funds [here](#))

### Manager's report for M&G Credit Income:

The company was launched on 14 November 2018 amid volatile market conditions with market moves dominated by geopolitical events and macroeconomic uncertainty. UK economic growth slowed at the end of 2018, mainly reflecting softer global conditions and the wider Brexit uncertainties.

Increased risk aversion and volatility amid continuing trade tensions between China and the US increased investors' appetite for safe haven assets. As a result, government bond yields compressed whilst credit spreads widened.

These circumstances created some attractive opportunities. Banks, property companies and insurers had all widened significantly at the start of the deployment programme.

At the end of 2018, the largest sectoral investment by the company was in asset-backed securities (ABS) and comprised mostly AAA and some AA-rated mortgage-backed floating rate bonds. These had widened to attractive levels and were ideal interim investments being very low risk and easily tradeable.

Global markets recorded a strong start to 2019, recovering from their disappointing performance in the previous quarter. The bulk of the gains were recorded in the first two months of the year, with January particularly strong as worries about faltering global economic growth dominated once again. US job creation came to a near halt, with non-farm payrolls for the month of February recording its weakest gain in more than a year, while in Europe manufacturing activity across the eurozone was the worst in five years. This slowdown in economic growth and generally muted inflation led to dovish commentary by many central banks alluding that interest rates would remain on hold for the time being. This, combined with better than expected earnings for many companies in the final quarter of 2018, drove market sentiment.

The second quarter of 2019 was also positive for public bond markets, rounding off a very strong start to the first half of the year. This was despite significant volatility during May, caused by renewed trade war concerns after US President Trump escalated disputes with China and Mexico. Nervous investors sought safety in core government bonds with yields decline meaningfully. This flight to safety, together with the prospect of lower interest rates saw asset prices appreciate considerably as global bond markets powered higher. Consequently, yields on 10-year government bonds in Japan and Germany fell well below zero into negative territory and in the US, 10-year yields returned to 2%, having traded at over 3% less than a year ago. UK corporate bonds also delivered steady returns over the period, notwithstanding spells of volatility in UK credit markets amid the ongoing political uncertainty relating to Brexit.

### Outlook

With public corporate bond yields falling further, rather than chasing yield, our inclination currently is to be defensive, and we have continued to sell more of our longer dated fixed rate corporates to fund new shorter dated floating investments.

The global outlook remains uncertain and the UK, in particular, could be subject to considerable economic and political turbulence around its prospective exit from the EU later this year.

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**Manager's report for Pollen Street Secured Lending (formerly P2P Global Investments):****Outlook**

There exists a substantial opportunity for non-bank capital to earn attractive risk adjusted returns by targeting under-served specialist asset classes with high quality products that meet customer needs.

To date, there has been minimal impact from the UK referendum vote to leave the European Union. However, looking ahead, the situation will continue to be monitored to address the economic challenges and opportunities that may arise as the long-term effects of Brexit become clearer. In the current more competitive mainstream lending environment it is particularly important to maintain prudence and discipline. In addition, with household borrowing at high levels, and the regulatory framework remaining an ever present factor as consumer credit regulation continues to develop, it is intended to proceed with caution.

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**Manager's report for Fair Oaks Income:****Loan Market Update**

The spread of the Credit Suisse Leveraged Loan index fell from Libor+5.50% as at 31 December 2018 to Libor+4.60% as at 28 June 2019 while the spread of the BB rated loans (a more appropriate proxy for CLO's higher average credit quality holdings), fell from Libor+4.14% to Libor+2.90% in the same period. We continue to be cautious about credit quality in the loan market. Average leverage from US large corporates, defined as corporates with EBITDA of more than US\$50m, increased from 5.2x at the end of 2018 to 5.4x in Q2 2019 while interest coverage fell from 3.6x to 3.1x.

The rolling twelve-month default rate increased to 1.34% as of 28 June 2019. A total of fourteen loan issuers tracked by the US S&P/LSTA index have defaulted this year with Retail, being the largest contributor by number with three defaults, followed by Energy: Oil and Gas, Services: Business and Telecommunications.

According to a quarterly survey published by S&P Global Intelligence in June 2019, loan managers expect the default rate to increase to 2.04% in June 2020. Sentiment however is positive from six months ago, where from the same survey loan managers predicted a higher default rate for June 2020 at 2.48%.

The market's low default expectations are also supported by the very limited amount of loans set to mature over the next three years. The notional of loans maturing in 2020-2022 has fallen from US\$260bn as of 28 June 2018 to US\$173bn as of 28 June 2019.

Despite falling loan spreads and wider CLO liabilities (primary CLO AAA liabilities in the US rose from Libor+1.12% in June 2018 to a high of Libor+1.42% in March 2019) H1 2019 CLO new issuance in the US was strong, at US\$65.1bn, down only 6% from the same period in 2018.

Challenging primary CLO arbitrage in the US may result in an increasing focus on secondary market and European CLO opportunities.

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**Robert Sharpe, chairman of Honeycomb:****Outlook**

We believe that the retrenchment of mainstream lenders from our target markets continues to present attractive opportunities.

We continue to closely monitor the political and economic uncertainty created by the continuing Brexit process. While the UK economic performance has remained resilient as a predominantly UK focused fund, our performance and lending growth will broadly reflect its economy. In addition, were there to be a general election, the company may also face new risks as a result of a change in government policy. Although current market conditions remain benign, the longer-term economic outlook and impact of Brexit on our customers and wider markets continues to remain uncertain.

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**Alex Ohlsson, chairman of GCP Asset Backed Income:****Overview and outlook**

Market conditions remain supportive, with the company seeing a strong pipeline of attractive asset backed financing opportunities.

The growing concerns over the absence of a negotiated Brexit deal and resultant political uncertainties continue to be a principal concern for economic stability in the UK. However, uncertainty can often create opportunities for those willing to commit the time and resource in areas where mainstream lenders have become less active.

Yields continue to contract in a number of investment areas, due to the limited supply of investments and the low interest rate environment.

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**Pedro Gonzalez de Cosio, CEO of Pharmakon (the manager), Biopharma Credit:****Outlook**

The life sciences industry is expected to continue to have substantial capital needs during the coming years as the number of products undergoing clinical trials continues to grow. All else being equal, companies seeking to raise capital are generally more receptive to straight debt financing alternatives at times when equity markets are soft, increasing the number and size of fixed-income investment opportunities for the company, and will be more inclined to issue equity or convertible bonds at times when equity markets are strong. A good indicator of the life sciences equity market is the New York Stock Exchange Biotechnology index (BTK index) While 2018 was a volatile year, with the BTK index essentially at the same levels as it started the year, the first six months of 2019 were stronger with the BTK index rising by 13%.

Global equity issuance by life sciences companies during the first six months of 2019 was \$32.1bn, a 16.1 per cent. increase from the \$27.7bn issued during the first six months of 2018. We anticipate an increased appetite for fixed-income as a source of capital in 2019.

Acquisition financing is an important driver of capital needs in the life sciences industry in general and a source of investment opportunities. An active M&A market helps drive opportunities for investors such as the company, as acquiring companies need capital to fund acquisitions. Global life sciences M&A volume during the first half of 2019 was \$38.5bn, 84.7 per cent. less than the \$251.2bn witnessed during the first half of 2018. It is widely believed that the high M&A activity in 2018 was caused by US tax reform in

December 2017. We are encouraged by the number of M&A opportunities that are starting to build up and should lead to a more active market over the coming year.

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## Leasing

(compare leasing funds [here](#))

### Manager's report for Tufton Oceanic:

The ongoing vessel supply correction in the shipping market continues to support higher charter rates. However, a slowdown in global GDP growth and the trade war have resulted in lower demand growth than previously expected. As per Clarksons Research:

- Global seaborne trade is projected to grow by 2.3% (tonne-miles) in 2019, down from 3.1% in 2018
- Fleet expansion is continuing to slow; the global fleet is expected to grow by 2.8% for the full year 2019 compared to 5.3% p.a. (2008-2018)
- The global order book (forward supply growth) is now equivalent to only 9.8% of the fleet, compared to over 50% in 2008
- Newbuild deliveries were up by 9% y-o-y in 1H19, with newbuild ordering volumes down 54% y-o-y
- Secondhand transaction volumes in the first half of the year were in line with the average since 2009, with their Secondhand Price index down 4% y-o-y compared to the end of 1H18
- The weighted average of ship earnings (as defined by Clarksons Research) across shipping segments was up 8% y-o-y in 1H19. There has been considerable anxiety about the impact on trade demand of the tariffs between the United States and China. Per Clarksons, the total tariffed trade is limited to 1.7% of global seaborne trade.

Meanwhile, other bilateral and multilateral trade agreements like the Transpacific Partnership and the North American Free Trade Agreement are also being renegotiated. The net impact of these is mitigated by trade flow substitution. Clarksons Research revised down their tonne-mile trade demand growth estimate for 2019 from 3.4% (in January 2019) to 2.3% but expect demand growth to rebound back to 4.1% in 2020, in part driven by expected positive trends in oil and gas trades although economic risks remain.

In addition to the developments above noted by Clarksons Research on the mainstream shipping markets and the shipbuilding market, we believe:

- Bank lending for ship acquisition continues to be very limited other than to the largest shipping companies
- Public equity and public debt markets continue to be of limited scope for smaller companies as a source of funds for acquisitions
- Sale and leasebacks, often in industrial segments of shipping such as chemical tankers or general cargo ships, will continue to be excellent opportunities. These are often less fragmented market segments where operators have long-term contracts to move cargo, giving us visibility over a significant portion of their cash flow
- Increased regulation is a positive for well-capitalised asset owners (such as the company) and operators, as marginal ships and operators may have little choice but to leave the market through scrapping, asset sales or mergers.

## Outlook

We believe the recovery in shipping markets will continue. As of mid-2019, the IMF forecasts global GDP growth of 3.2% in 2019 with potential pickup to 3.5% in 2020. While these forecasts have been revised down, they still reflect supportive levels for global trade growth in the historic context. Clarksons Research forecast moderate demand growth for shipping in 2019 (2% tonnes, 2.3% tonne-miles) and 2020 (3.2% tonnes, 4.1% tonne-miles). On the supply side, shipping benefits from slowing fleet expansion. The sector is capital constrained and we believe bank lending continues to be very limited other than to the largest shipping companies while public equity and public debt markets continue to be of limited scope. The financial stresses in shipping, traditional ship lenders and shipbuilders, which are still somewhat a result of the excesses of 2005-2008, continue to create a very attractive risk return profile. Secondhand prices in many segments continue to be significantly below Depreciated Replacement Cost (DRC). The supply side recovery is continuing and driven by:

- Continued lack of capital availability for shipping
- Vessel orderbook (forward supply growth) near a 20-year low
- Low levels of new orders, leading to shipyard capacity reductions

We believe that DRC will increase in the medium term due to shipyard consolidation. Clarksons Research newbuild price index has been steady in 2019 and up 5% since the start of 2018

As of 1 January 2020, the International Maritime Organization (IMO) mandates that ships are required to burn fuel with a sulphur content of no more than 0.5% unless fitted with an exhaust gas emissions cleaner (scrubber) capable of reducing sulphur emissions to 0.5% or less. Compliance will be possible by either switching the ship to low sulphur, compliant fuel (distillates or LNG) or by installing an exhaust gas scrubber. We expect the regulatory change could accelerate the supply side adjustment in shipping by three means. Firstly, with most of the global fleet using more expensive fuel, we expect the average fleet speed will be reduced. Further, there will be increased scrapping of less efficient ships and many of the remaining ships will be taken out of service to prepare for fuel transition. Finally, as the sector remains capital constrained, higher newbuild costs and changing regulations may discourage large investments in new vessels for the next few years.

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## Manager's report for SQN Asset Finance Income:

### Outlook

In the five years since the group was launched, a large number of lenders have entered the market. Equipment leasing and asset finance, once a speciality product, has now become part of the offerings of financial institutions with broader mandates and greater flexibility than the group. Equipment leasing and asset finance specialists who rely on bank borrowings or capital markets have benefited from lower rates which has made them more dominant in their niche markets. This has created a more competitive environment and has shifted the risk profile of opportunities in the yield range required by the group.

In the medium term, as a result of the changing market conditions set out above, reinvestment yields are expected to come under pressure while the universe of appropriate transactions available to fit the group's narrow requirements diminishes. Based on the managers' experience, this is not expected to be the long-term reality but will take several years to revert to the norm which will only happen after a credit market correction.



It is an increasingly common market perception that the end of the credit cycle is approaching.

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## Infrastructure

(compare infrastructure funds [here](#))

### **Tom Tribone & Sonny Lulla, chairman and chief executive of Infrastructure India:**

In the *[Indian]* logistics sector, increased containerisation of cargo has led to a sharp rise in container traffic growth. This growth has highlighted the importance of inland container terminals in the export-import value chain. Inland terminals with rail connectivity play an important role in decongesting container traffic at ports thereby enhancing supply chain efficiency. They also cater to significant hinterland cargo traffic.

Further cargo growth is expected following India's relaxation of cabotage rules. This move is seen as a way of levelling the playing field between foreign and domestic shipping lines and should lead to a reduction in overall freight rates, making Indian trade more competitive. Growth is also evident in warehousing, which recorded an overall space take-up of over 24m square feet in 2018, a 40% increase from 2017. Implementation of the Goods and Services Tax (GST) has been a driver of centralised warehousing.

On the wider macroeconomic front, there has been little impact so far from the trade war between the US and China, and DLI management do not currently foresee significant headwinds for the Indian logistics sector.

The government of India's emphasis on increasing manufacturing and exports has made logistics a key consideration in achieving sustained growth. The Ministry of Commerce and Industry has proposed a separate department for trade facilitation and logistics to better coordinate government departments responsible for railway, customs, roads and shipping. Considerable steps have been taken to create a reliable and predictable national supply chain, including significant investment in the transport network, improving customs and facilitation, and the implementation of GST. Although more is needed to address certain regulatory bottlenecks, the government focus on developing a well-connected economy is good news for the sector and those that operate in it.

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### **Colin Maltby, chairman of BBGI SICAV S.A.:**

#### **Outlook**

In 2019 to date, there have been no material changes to the official policy governing the infrastructure markets in which we invest. Governments and procuring authorities in our priority markets continue to support the role of responsible private capital to finance the infrastructure assets that citizens rely on every day to keep local economies moving.

The global diversification of the company's portfolio is a natural hedge to political uncertainty. Whilst political risk remains most evident in the UK as the Labour Party's policy agenda evolves, we continue there and elsewhere to demonstrate the long-term value which we provide to our public sector clients, contributing positively to the communities and environments in which we operate.

**Mike Gerrard, chairman of International Public Partnerships:**

We continue to be optimistic about new investment opportunities - in particular within Germany and North America, although not to the exclusion of other jurisdictions. In the U.K., the Company recognises the continued uncertainty of the current political landscape, both in regard to Brexit and the emerging policies of the Labour Party relating to the use of private capital in certain infrastructure sectors. The Company also believes that the best counter argument to adverse political policy developments is to continuously demonstrate, to the end-users of its assets, governments and other key stakeholders, the value for money that our investments deliver to the societies that they serve.

The infrastructure investment sector worldwide remains highly active and diverse, and the pipeline for the types of assets in which the company invests remains strong and evolving. Moreover, across the geographical areas in which the company invests, the general policy and regulatory environments continue to support long-term investment of private capital into public infrastructure. Notwithstanding my earlier comments about current uncertainties within the U.K., it is encouraging to note that HM Treasury and the Infrastructure and Projects Authority ('IPA') recently consulted on the development of mechanisms for the continued delivery of private capital into infrastructure investment.

While headwinds exist in terms of the nearer-term investment opportunities in the U.K., we remain very positive about the pipeline in the other jurisdictions in which the company is active.

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## Environmental

(compare Environmental funds [here](#))

**Sir Ian Cheshire, chairman of Menhaden:****Outlook**

Global growth continues to slow and geopolitical, environmental and technological risks continue to cause uncertainty and volatility in stock markets. However, there has been a notably improved focus on tackling the global climate crisis and the investment community is well placed to engage with sustainability issues and achieve a real impact.

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## Property - UK

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

**Steve Smith, chairman of AEW UK Long Lease REIT:****Outlook**

In spite of continuing political uncertainty and the potential for global trade dislocation, the fundamentals for UK real estate remain, selectively, sound. Selectively, because there are clearly segments of the market which are subject to disruption, whether that is the drive for supply chain efficiency that is affecting all retail (and some logistics) property or the impact of new technology on office buildings.

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**Manager's report for AEW UK Long Lease REIT:****UK Economic Outlook**

In the first half of 2019 inflation slowed to 2% per annum with headline inflation marginally higher than core inflation. The inflation rate is expected to keep in line with the Bank of England (BOE) inflation target rate for the next couple of years.

Economic growth in the UK for Q2 2019 is expected to remain flat, down from 0.5% in Q1 2019. This brings the full year 2019 growth estimate to 1.3 %, down from 1.4% in 2018. GDP growth is still forecast to rebound to just below 2% in 2022, implicitly assuming a successful and orderly EU exit transition. However, this outlook seems more unlikely given recent Brexit developments. The new Prime Minister is aiming for a departure on the 31 October, raising the possibility of a "no-deal" scenario, which could have unappealing consequences for consumers and business alike.

The UK labour market remains strong despite the uncertain environment with unemployment remaining at a more than 40-year low of 3.8% in August 2019. The tightening labour market has finally lifted annual pay growth and provides room for some real pay improvement as inflation remains at 2%. Despite real wage growth, consumer spending is expected to slow to 0.9% in 2019 from 1.5% for 2018.

**UK Real Estate Outlook**

The UK property market continues to deliver healthy spreads over 10 year government bond yields, both in absolute terms and relative to other markets. Amid fears of an economic slowdown, the past six months have seen central banks begin to change views on future interest rate trajectories and keep interest rates lower for longer. Despite this, we expect yield widening in traditional property sectors going forward and therefore a lower yield premium amid bond yield normalisation, albeit not in the short-run.

The long income property sector continues to benefit from strong competition amongst investors looking to buy into long-let inflation-linked income and assets that are akin to social infrastructure. Returns from long income property outperformed traditional commercial real estate in the first half of 2019 and show a total return of 8.2% in the 12 months to June 2019 vs 3.9% from all property. We have seen this first-hand when acquiring properties as well as in our own portfolio.

Consensus forecasts over the coming three years show an average of 2.8% for RPI, as compared to 0.6% for all property over this period.

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**Manager's report for PRS REIT:****Market overview**

An interim report of a study investigating housing supply requirement by Herriot-Watt University published in May 2018 suggested that the estimate of an additional 300,000 new homes per annum to rebalance supply in England understated the problem. The report suggests that the total level of new housebuilding required is around 340,000 per annum for England (and 380,000 for Great Britain) until 2031, which represents a total requirement of over 4m new homes.

Against that wider picture of undersupply, demand for rental homes is growing, fuelled by restricted access to other tenures, with affordability and mortgage availability limiting owner occupation and social rented funding constraining development and supply. After tax changes introduced in 2016 and 2017, there has been an exodus of typically

small individual landlords from the buy-to-let sector, and the estimated resultant outflow of properties from the rental market over the last two years is put at 120,000.

The build-to-rent market is growing steadily and investment in PRS in 2018 increased by 11% on the previous year to £2.6bn. By the end of the first quarter of 2019, there were approximately 30,000 completed PRS homes in the UK. About half of this output was concentrated in London and almost all of the development comprised apartments. A similar number of PRS homes is currently under construction and a further 70,000 or so homes are in planning. The vast majority of this delivery remains apartment schemes in urban centres. To place the scale of this PRS activity in context, it accounts for under 1% of the total value of the rental stock in the UK. By comparison, in more mature PRS markets, such as the United States, institutionally-owned properties represent nearly 50% of the total rental market.

According to Savills, at full maturity, the UK PRS market could be worth around £550bn and encompass more than 1.7m households. This indicates the scale of opportunity available to market participants, including the PRS REIT.

### Outlook

The growth opportunity available to the PRS REIT remains substantial, driven by the strong underlying supply and demand fundamentals in the housing market. We also believe that PRS housing (at scale) can play a part in accelerating the overall delivery of new homes, a key agenda with local authorities.

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### Vikram Lall, chairman of BMO Real Estate Investments:

#### Market overview

The UK commercial property market delivered a total return of 3.3 per cent as measured by the MSCI UK Quarterly Property Universe ('MSCI') for all assets in the year to 30 June 2019. Total return performance was positive throughout the year, but the pace slowed when compared with the previous year. The annual all-property income return was 4.4 per cent and capital values fell by 1.1 per cent in the year, hit by weakness in the retail segment.

Performance was again driven by Industrial and Distribution property with south east industrials out-performing within that sector. Although the all-property return was depressed by the negative performance from retail, all sectors recorded a slowing in total returns compared with the previous year. In the year to 30 June 2019, open market rental value growth at the all-property level was -0.1 per cent, with falls in the retail sector offsetting a positive performance elsewhere in the market. Investment activity was lower, and that trend intensified in the latter part of the year, moving beyond retail to affect all sectors. Initial yields edged slightly higher over the year as higher retail yields were counterbalanced by yield compression in parts of the office and industrial markets.

#### Outlook

The outlook continues to be dominated by the stresses in the retail sector and the Brexit process, with its political and economic ramifications. A slowdown in global growth offers additional challenges, with a period of muted rental growth now likely to be the outcome and meaningful differences in the prospect for the underlying property sectors. However, with fiscal policy potentially easing and the market expecting interest rates to remain at low levels by past standards, property market performance may receive some support once there is greater clarity on political sentiment.

Property continues to deliver an attractive income return. Prime property in established locations and emerging hubs is expected to out-perform. The Industrial and Distribution market should continue to be a major driver of performance, benefiting from the continued growth of online sales but perhaps to a lesser degree as supply increases. The retail sector is facing structural issues which will take time to resolve and this will continue to impact sentiment for much of the sector. Repurposing and repricing of property is underway, and the market is predicted to re-balance in due course albeit with significant casualties at the secondary end of the market and at lower rents for a majority. Alternatives are expected to continue to grow in importance as investors seek long-term contracted income. A period of positive single-digit total returns is in prospect, underpinned by the income return.

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### **Malcolm Naish, chairman of Target Healthcare REIT:**

#### **Outlook**

Prospects for the macroeconomic environment are more bearish than when I last wrote. The political outlook heightens uncertainty at home rather than reducing it, impacting our closest trading partners; there exists the potential for global trade wars to escalate in a manner which appears to be unconstructive; and, growth rates in the larger developing economies are slowing. We are also seeing a more unpredictable approach to world leadership than we have been accustomed to, which does little to provide clarity - relations with Russia and North Korea, and the UK/EU resolution of Brexit being prime examples.

No surprise then that with this uncertainty, and its associated impact on the confidence levels of those who may otherwise be investing for growth, that consensus economic forecasts for growth and interest rates have continued their trend to "lower for longer".

Careful investment in the UK care home property market, which can offer attractive returns significantly above prevailing interest rates, and at lower risk levels than some might expect, is therefore in demand. We continue to see our shares trade at a premium, in contrast to many of the traditional property sectors, and the asset class we invest in sees continued yield stability with some modest tightening.

Residential care for the elderly and infirm is needs-based, with demographic trends suggesting demand is only going to increase. The need to adequately fund the nation's infrastructure for care services to ensure it is fit-for-purpose is well-documented and very much a talking point, however funding of the NHS is still gaining more political attention and policy initiatives - perhaps social care will follow.

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### **Manager's report for GCP Student Living:**

The UK continues to attract substantial numbers of international students, with acceptances to full-time courses for the 2018/19 academic year up 4.4% year-on-year.

#### **The UK student accommodation market**

The UK remains a global leader in the provision of higher education, with some of the highest ranking universities in the world, including three in the top ten in 2019<sup>1</sup>, making it attractive to both domestic and international students, for whom the UK is the second most popular destination for further education after the USA.

### **Student numbers supportive of occupancy and growth**

UCAS data for the 2018/19 academic year shows total acceptances to full-time education in the UK remains broadly consistent with prior years, with the number of students applying to higher education continuing to substantially exceed the number of places available, resulting in nearly one in four of all applicants unable to secure a place in higher education, equating to c.162,000 applicants.

The UK continues to attract substantial numbers of international students, with acceptances to full-time courses for the 2018/19 academic year up 4.4% year-on-year. The total number of EU and non-EU international students accepted to courses in the UK is at the highest level ever seen.

Non-EU student numbers have increased by 4.9% year-on-year, with acceptances of EU students increasing 3.8% and to levels above those seen prior to the EU referendum in 2016. Initial data published by UCAS indicates that applications by EU students and non-EU students for the 2019/20 year have increased by 1.0% and 7.9% respectively on the previous year.

The number of acceptances for UK students has shown a modest year-on-year decline of 0.8% for the 2018/19 academic year. This decrease has been widely attributed to the decline in the population of 18 year-olds in the UK, which is forecast to reverse after 2020. This should be considered in the wider context of entry rates for higher education which represent the proportion of the population who are placed in higher education and which, for UK 18 year-olds, has increased by 0.4 percentage points to 33% in 2018/19.<sup>3</sup>

Whilst total acceptances to full-time higher education in the UK for the 2018/19 academic year remain broadly consistent with prior years, a combination of the cost of tuition and the removal of student number controls continues to benefit the top ranked universities most, suggesting a flight to quality as students increasingly view their choice of university in terms of expected future earnings.

Demand for full-time higher education is not evenly distributed across the UK, with certain locations attracting greater demand for places from domestic and international students alike. Demand for courses in London remains strong. London is home to 23 universities, with more universities ranked in the top 40 by The Times Higher Education World University Rankings than any other city in the world. Approximately one-third of the 2.3m students in the UK study in London and the south east of England<sup>1</sup>.

International students favour London as a destination for higher education; a quarter of all international students in the UK choose to study in London. With 87% of the company's portfolio located in and around London and 77% of its tenants being international students, current market dynamics are strongly supportive of the company's investment objective and underpin its continued ability to deliver fully occupied assets with long-term rental growth prospects. These demand dynamics are also in play in the Brighton market, which is home to both the University of Sussex (a UK top 20 university) and the University of Brighton, with in aggregate c.32,000 students, including c.8,000 international students. The city is also home to two of the largest English language foundation course providers in the UK.

### **Strong supply-side barriers**

The supply of private student accommodation varies substantially across the UK, with increasing divergence of investment returns between those cities with an undersupply of student housing resulting from restrictive planning and/or limited land availability, and those with less restrictive planning regulations.

Severe undersupply in London, driven by high land values and a challenging planning environment, means that it remains more restricted than the UK average in terms of the number of beds per student. Brighton, like London, also remains severely undersupplied, primarily due to a restrictive planning environment which means that currently only c.700 beds have been consented for private development in Brighton, excluding the company's Scape Brighton and Circus Street properties.

Based on current provision rates, London is undersupplied by circa 35,000 beds. Further, modern student accommodation is in short supply, with an estimated two-thirds of existing university beds in London being more than 17 years old.

The extent of undersupply is likely to be compounded by the slowing pace of the delivery of new student accommodation developments in London. The number of beds delivered in London in 2017/18 represented the lowest rate of growth for more than a decade. In addition, the development pipeline for new schemes remains constrained, with the development pipeline having decreased by 41% in the last three years and increasingly focused on developments outside central London, as illustrated by the decrease in the percentage of pipeline developments located in London Zone 1 from 36% in 2014/15 to only 12% in 2017/18.

### Outlook

The manager believes investment demand is increasingly selective, with the weight of institutional capital focusing on the supply of 'core' locations with attractive supply and demand characteristics. This is illustrated by the substantial yield differential between private student residential accommodation assets in and around London and in super prime regional locations such as Brighton as compared to those located in secondary and tertiary regional locations. It is the manager's belief that this trend is likely to continue, particularly in those locations where local government policy may further limit the development in future of private student accommodation.

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### Will Fulton, manager of UK Commercial Property REIT:

#### Outlook

The UK economy continues to be affected by political and macroeconomic uncertainty which looks likely to persist in the near term, holding back growth. We have revised our GDP growth expectations downwards to 1.4% in both 2019 and 2020 in its base case, although downside risks exist and leading indicators have weakened in recent months.

Occupier markets are, overall, holding up relatively well with office demand being supported by the rapid expansion of flexible office providers and, in the regions, by corporate and public sector consolidation. The polarisation of retail is an ongoing trend and weaker locations are under increasing pressure, however, the twin engines of urbanisation and the rise of e-commerce continue to propel the industrial sector.

Whilst the investment market has slowed this year, and with political uncertainty causing many to adopt a cautious approach to investment, there remains considerable capital with potential for deployment attracted to UK real estate's income yield and, retail sector aside, good occupational fundamentals.

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**Robert Peto, chairman of Standard Life Investments Property Income:****Background**

In what has been the theme for over three years, the UK continues to be gripped by political uncertainty. The Conservative Party election of a new leader, and therefore Prime Minister, and his promise to leave the European Union by 31 October 2019 may at least clarify matters one way or another. However, there remains uncertainty as to how this situation will evolve.

Despite all of the uncertainty, the economy has proved remarkably resilient through this period but the holding back of planned investment until the political situation becomes clearer, combined with headwinds caused by the US/China trade dispute, has resulted in an economy that is now stagnating and on the verge of technical recession.

Against this background, UK commercial real estate, even with a continuing fall in investment volumes, has held up well producing positive returns over the first half of 2019. The company's benchmark (Quarterly version of MSCI IPD Monthly index Funds) produced a total return of 0.9% over this six month period as declining capital values of 1.3% were more than offset by the attractive income returns of 2.3% that the UK commercial real estate market continues to generate. The polarisation of the industrial and retail sectors continued apace with industrials producing a total return of 3.3% compared to the retail total return of -2.5%. Offices also produced a positive total return of 1.9% underpinned by take up from flexible office providers.

**Outlook**

The UK economy continues to be affected by political and macroeconomic uncertainty centred around Brexit, which looks likely to persist in the near term, holding back investment and therefore growth. The company's manager is forecasting GDP growth of 1.4% in both 2019 and 2020 in its base case, although it should be highlighted that downside risks exist and leading indicators have weakened in recent months.

Overall, the UK commercial property market is holding up well with positive total returns still forecast. The investment market has been, and will continue to be, muted in 2019 until progress is made on the Brexit conundrum. However, occupier markets are generally faring well, apart from the retail sector which is under severe pressure as the growth in e-commerce continues which, inversely, is boosting the industrial sector. The property market also continues to be underpinned by strong fundamentals—relatively high yields in an environment where there is a suggestion of interest rate cuts, limited development and high occupancy rates.

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**Martin Moore, chairman of BMO Commercial Property:**

The property market continues to deliver positive total return, but the pace has slowed and investment activity has weakened. The market is likely to encounter continued headwinds related to Brexit and its political and economic ramifications. Slower economic growth and political uncertainties internationally are also affecting sentiment. However, post Brexit, if there is some easing in fiscal policy and interest rates are kept low, as the market expects, then this should provide some support for property, particularly from investors seeking a higher-yielding alternative to gilts.

Total returns are expected to be low single-digit and will be driven by income, with well-specified and well-let assets in established locations likely to out-perform.

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**Kevin McGrath, chairman of Regional REIT:****Market Environment**

At £20.0bn, investment volumes in the first half of 2019 were 29% below the same period in 2018 and 26% below average. This was attributed to the continued uncertainty caused by the six-month extension to the Brexit deadline, which has now been extended until the end of October 2019. However, there is evidence that the UK regions performed better than London in Q2 2019. Despite investment volumes for single assets in the UK regions falling 25% below the five-year quarterly average at £3.7 bn in Q2 2019, London volumes dropped to the lowest level since Q4 2011 at £4.0 bn - 37% below the five-year average.

Research from CBRE indicates that regional offices have outperformed in comparison to central London offices, delivering superior returns of 10.8% in the 12 months ending July 2019 in comparison to central London office returns of 4.9% - a trend that has been witnessed over the last three years.

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**Max Shenkman, head of investment, Triple Point Social Housing:****Market Review**

A significant theme of the last six months has been the series of regulatory notices and judgements published by the Regulator of Social Housing. In February, the Regulator published its Regulatory Judgement on Inclusion Housing C.I.C., an Approved Provider that as at 30 June 2019 the group had 75 assets leased to (21.1% of the group's contracted rental income), giving it a non-compliant G3, V3 rating. In April, Encircle Housing, which the group had two assets leased to (as at 30 June 2019), received a non-compliant rating, and in May, Bespoke Supportive Tenancies Limited, which the group had five assets leased to (as at 30 June 2019), likewise received a non-compliant rating. Because Encircle and Bespoke Supportive Tenancies had fewer than 1,000 units under management at the time of the Regulator's investigations, neither received a formal governance or viability rating though they were deemed non-compliant. The reasons for these non-compliant judgements varied, but they centre on the under-developed governance functions and relatively small balance sheets of these Registered Providers. The Regulator has pointed to specific issues for Encircle and BeST, primarily based around risk management. Westmoreland's judgement, published on 30 November 2018, likewise highlighted specific issues with its reporting processes, property maintenance and reliance on third-parties. By contrast, Inclusion's judgement focused on the general implications of the lease model rather than anything specific to its operations.

Beyond these specific regulatory judgements in April 2019, the Regulator published an addendum to its 2018 Sector Risk Profile. The addendum looked at providers of specialised Supported Housing which have a model of leasing, rather than owning, properties which are owned by public or private funds. The addendum acknowledges the important role played by private investment in supporting much-needed growth and sustainable development in this sector as well as identifying the risks that should be borne in mind by both Registered Providers and investors into the sector. The report highlighted the fact that in some of the small Supported Housing Registered Providers there had been material governance shortcomings and that Registered Providers should not enter into long-term leases without first analysing, understanding and reporting on the financial implications of, and risks associated with, long-term financial commitments. The addendum states that the boards of Registered Providers have

strengthened over time, but that the Regulator intends to work with them to discuss the leasing model and how its concerns can be addressed.

Taken together, these publications make clear that the Regulator is serious about improving the governance and financial positions of lease-based Registered Providers. The Regulator has rightly identified shortcomings that need to be remedied to avoid operational difficulties and, as manager for the group, we support what the Regulator is seeking to achieve. Like all fast-growing sectors, this one is undergoing growing pains that need to be worked through promptly and efficiently. It is important that Registered Providers have the infrastructure to provide cyclical and responsive housing services to the vulnerable residents in properties in different geographical areas. It is vital Registered Providers manage their financial positions prudently as they take advantage of this financing structure. Above all, Registered Providers must have strong, independent boards whose governance will help them to understand the nature of the leases they enter and to prevent any risks to health and safety, or financial viability. Although we do not fall under the jurisdiction of the Regulator, as a stakeholder in this model we are committed to working with the Regulator and all other market participants to ensure that any Registered Providers using leases to grow are doing so in a considered, risk-averse manner that safeguards their residents and their financial position through the development of proper governance functions.

Nonetheless it is important to remember that this sector has grown fast for good reason: the fundamentals are strong. Beyond the housing crisis in the general residential market, the demand for new Supported Housing remains as compelling as ever - something reflected by our pipeline of close to £400m. As we deploy the group's funds on the ground, we hear, on an almost daily basis, commissioners in all parts of the UK calling for more Supported Housing. It is perhaps no coincidence that during the last six months the group invested for the first time in Scotland, forward funding the new-build scheme in Edinburgh strongly supported by the City Council described above. It is likewise important to note that the Regulatory commentary and judgements has had no impact on the valuation of the group's assets, which have in fact continued to appreciate in value in line with market dynamics.

Indeed, commissioners continue to push for this type of housing because the proportion of people with high needs is growing as a percentage of the population and the government continues its policy of moving people out of institutions and into community-based homes set in motion by the 2015 Transforming Care programme.<sup>1</sup> The government chose the policy of pursuing Supported Housing because it has been shown to not only provide better social and health outcomes for residents by giving them the dignity of a home and the independence that comes with that, but also because it saves the government considerable amounts of money. Research demonstrates that someone in specialised Supported Housing saves the government around £200 a week compared to them being in residential care and around £2,000 a week compared to them being in a hospital.<sup>3</sup> Multiplied across all the units in the market it is clear that the financial benefits are considerable, particularly at a time when government grant funding is limited and Local Authorities struggle with rising costs.

It is in the knowledge of specialised Supported Housing's dual-benefit - of improving the lives of some of the most vulnerable people in society at the same time as saving the government money - that we continue to support the efforts of the Regulator to ensure that their concerns around Registered Providers are addressed. Only by continuing to improve the quality of Registered Providers operating in this sector can we unlock the full benefits of the Supported Housing sector by enabling these providers to take on the management of new Supported Housing assets thereby bringing new social housing stock to market. Every one of the units leased by Registered Providers

is helping achieve the government's policy of giving more people the opportunity to move out of expensive, often-ageing institutional care properties into newly-refurbished or purpose-built homes for life in the community, with all that this entails for resident outcomes and the government purse.

To continue achieving these benefits, we need to ensure that the risks associated with this sector continue to reduce and standards continue to rise. We have already started to roll out a change in law clause that gives Registered Providers the opportunity to re-negotiate leases in the unlikely event that changes in national rent regulations cause a material drop in the amount of housing benefit that Registered Providers can receive. Similarly, we have been introducing to our leases a call option that allows Registered Providers to extend the term of their leases, giving them more control of their housing stock and addressing the Regulator's concern over social housing not remaining social housing in perpetuity.

More generally, we have seen the growth strategies of smaller Registered Providers begin to mature as intended. Beyond general improvements in their financial position, Registered Providers are beginning to use surpluses to not only invest in new staff and reporting software, but also to diversify into freehold stock (rather than simply leasing all properties), creating fixed asset bases for them to draw upon. Governance has improved at the same time. More process policies are being designed and implemented, and new members are being appointed to boards of directors. This is all part of the wider process of high-quality operators in this sector squeezing out operators who cannot meet the rising standards of the Supported Housing sector as it matures.

In light of all this, it is clear that regulatory scrutiny has been successful in helping the Regulator achieve one of its objectives, which is proper standards of governance and financial viability for Registered Providers. We welcome this engagement and will continue our ongoing dialogue with the Regulator and other stakeholders to continue the process of improvement. Over time, however, we hope the cumulative impact of these improvements will allow the Regulator to achieve its other, important objective of encouraging the investment of private finance into social housing. Because it is only through investing private capital in this under-funded sector that we can facilitate Registered Providers bringing new stock to market in order to achieve the benefit of improving government finances at the same time as improving the lives of some of the most vulnerable people in our society.

### **Outlook**

Ongoing regulatory engagement is providing a welcome opportunity for all stakeholders in this sector to improve due diligence processes, financial positions and governance arrangements. We anticipate that this engagement will continue through the rest of this year and into 2020 and beyond.

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### **Martin Moore, chairman of Secure Income REIT:**

#### **Outlook**

Volatility has returned to equity markets as investors' attention has swung back to the twin threats of geo-political risks and slowing global growth. The resultant flight to safety has had a dramatic impact on the pricing of government bonds with 30 year US Treasury yields falling below 2% for the first time in history. In much of the developed world a government bond yield of 2% has become the stuff of dreams with all German and Swiss bonds across the entire maturity spectrum offering negative yields. In Japan and France bond yields only turn positive at durations over 16 years whilst in the UK 10 year gilts offer less than 0.5%. Inflation protection via long-dated index-linked gilts

has been expensive for several years but investors now face an even steeper bill as yields have plummeted to minus 2.2%, pushing up their price by as much as 10% over the last month and 20% compared to six months ago. In contrast, the yields offered by well-let property with index-linked uplifts continue to be much more generous.

Political uncertainty is reaching a crescendo in the UK as the probability of a no-deal Brexit has risen significantly. Regrettably, uncertainty is also likely to continue into 2020 and quite possibly beyond. Any of the following: a disorderly Brexit, the prospects of an imminent general election or a far-left Labour government is likely to sustain demand for lower-risk inflation-protected investments. Continued Sterling weakness should also contribute to attracting overseas capital into these assets, especially if global economic concerns continue to suppress government bond yields across the world. The £347m sale of our non-core hospitals at a 16% premium to valuation to a US healthcare REIT is an illustration of this trend. The fact that these assets delivered an unlevered total return of over 100% during the five years of our ownership as a quoted REIT demonstrates how ostensibly "boring" assets that churn out highly predictable income streams can deliver exciting returns.

The UK REIT market has become bifurcated with the ratings between the best and worst performing sectors at an all-time high. Shopping centre REIT share prices have collapsed as landlords have lost pricing power to their retail tenants whilst CVAs drive vacancy rates inexorably upwards. At the other end of the spectrum those parts of the alternatives and warehouse markets still judged to retain their capacity to deliver sustainably growing income streams are being rewarded with premium ratings.

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### **Manager's report for Impact Healthcare REIT:**

#### **Market drivers**

A number of drivers influence demand for, and provision of, care for older people. This makes it an attractive investment market for well-capitalised asset owners working in partnership with well-managed operators, who are committed to providing high standards of care.

#### 1: Growing demand

People aged over 85, the age group most likely to need care, are the fastest growing segment of the UK population. According to the Office for National Statistics, the number of people over 85 years old in the UK is forecast to double by 2041, from 1.6m in 2016 to 3.2m. At the moment, around 15% of those over 85 require a level of care which can only be provided in either a hospital or a care home.

#### 2: Capacity has shrunk from its peak

The number of available residential and nursing home beds in the UK rose rapidly in the 1970s and 1980s, reaching a peak of 563,100 in 1996. It has since declined by 17% from that level, to 464,800 in 2018. This decline is the result of obsolete homes withdrawing from the market, homes being sold for change of use and the amount of new development activity coming to completion. In the years to March 2016 and March 2017, the number of available beds fell by 1,700 and 4,300 respectively. However, in the year to March 2018 there was a small net increase of 900 beds.

#### 3: Severe pressure on the NHS

In the 12 months to May 2019, the NHS in England lost 1,650,875 bed days through delayed transfers. Pressure on the NHS remains severe with Simon Stevens, the CEO of NHS England, estimating that patients who stay in hospitals for more than three

weeks, most of them elderly, occupy one in five hospital beds or the equivalent of 36 hospitals.

Acute hospitals are not only more expensive than other care settings, they do not always offer the best environment for the care of elderly people with multiple, long-term chronic medical conditions.

#### 4: Growing calls for major reforms of the system

Funding to adult social care (which includes care for working age adults and care at home, as well as money spent on residential care for the elderly). According to research by the House of Commons Library, local authorities will have access to an additional £10bn in social care funding between 2017/18 and 2019/20.

There is widespread recognition that more needs to be done to find a long-term funding solution for the challenges and opportunities presented by an ageing population. Reports published in 2019 by The House of Lords Economic Affairs Committee, The King's Fund, The Institute for Public Policy Research and Policy Exchange have all suggested that the best solution would be to make personal care for the elderly free at the point of delivery, just as medical care provided by the NHS is free. The new government formed by Boris Johnson in July has committed to develop a long-term solution for social care. However, any structural reforms requiring legislation seem unlikely in the short-term given the government's focus on Brexit.

#### 5 A growing market

Despite this lack of clarity in long-term government policy, as a result of increasing demand and a shift from government provision to independent providers, the independent sector has seen sustained and above-inflation growth. Since 2005, the revenues of for-profit independent providers have increased by 4.2% per annum, and for non-profit independent providers by 4.3% per annum.

## Property – Europe

(compare property – Europe funds [here](#))

### **Robert Hingley, chairman of Phoenix Spree Deutschland:**

The rent controls proposed by the Berlin Senate (the "Mietendeckel") have created significant uncertainty. This has been reflected in PSD's share price and has resulted in the shares trading at 34% discount to EPRA Net Asset Value as at 30 June 2019. The share price weakness and valuation discount are in line with Berlin-focussed listed peers.

The principal aim of the Mietendeckel is to prevent rents for private non-subsidised rental properties being set at free market levels, despite the fact that Germany and Berlin already have in place tenant protections which rank amongst the strongest in the Western world.

The first draft of these proposals was presented to the Berlin Senate at the end of August and the consultative process, involving experts, owners and trade associations, is ongoing. A Berlin Senate resolution on the final draft is currently scheduled to take place in mid-October, with implementation of the new rules by Berlin's parliament expected during January 2020, with retrospective effect to 18 June 2019.

There remains considerable uncertainty surrounding the content, timing, legality and implementation of the new rental proposals. PSD, and its legal advisors remain firmly of the opinion that the rent proposals are unconstitutional and that State law cannot supersede Federal law. We expect a number of legal challenges should the Berlin Senate pass the bill into law.

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### Manager's report for Phoenix Spree Deutschland:

#### Backdrop

During the past decade, Berlin's economy has flourished and this economic renaissance has been supported by high levels of net inward migration. Between 2013 and 2017, the number of inhabitants grew by between 40,000 and 60,000 per year, increasing by a further 31,000 in 2018. Currently, the City of Berlin estimates the requirement for new housing will be 194,000 units by 2030, and that over 20,000 new housing units will need to be constructed annually to satisfy demand. However, in recent years, the number of building permits and completions has fallen well short of this target and it remains the case that the cost of new-build generally exceeds the cost of acquiring existing rental stock.

It is against this demographic backdrop that the new Berlin rental laws have been proposed. These rules seek to address the effects of housing shortage rather than addressing the cause. PSD believes that the long-term solution to the housing shortage and rent-price inflation lies with incentivising increased supply, which the current proposals fail to address.

#### Outlook

Changes to rental regulations are not a new phenomenon but the Mietendeckel proposals have very wide-ranging implications.

The new proposals will be legally challenged and PSD believes they are likely to be proven to be unlawful. However, in the near term the uncertainty surrounding the current proposals will inevitably affect market dynamics as owners prepare for the new regulatory environment. Notwithstanding the fact that there was no discernible slowdown in market transactions in the first six months of 2019, there has been a reduction in transaction activity in the second half as investors wait for more clarity on potential investment returns. Equity markets have also placed a significant discount on the valuations of listed Berlin residential businesses, reflecting current uncertainty, much of which should be removed in the event that the new rules are successfully challenged.

Pending finalisation and implementation of the proposed new rent proposals, the industry-wide response of property owners and tenants remains uncertain. However, although further growth in rental income will be difficult to achieve, PSD considers it unlikely that there will be a material adverse impact on total rental income in 2020.

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### Tony Roper, chairman of Aberdeen Standard European Logistics Income:

#### Outlook

The logistics market is sizeable and continues to grow as the sector benefits from the rapid take-up of logistics facilities, largely helped by the growth in e-commerce, and the long inflation-linked leases that quality tenants are prepared to sign up to in many parts of Europe. This strategy which is focused on investments on the Continent with

attractive pricing, indexation of leases as standard and lower financing costs underpins our investment policy.

As supply chain management gains importance due to growing e-commerce and ongoing urbanisation, prime logistics space may become scarce. The market has started to reflect this with increased pricing and lower yields which underpins valuations. However, with vacancy rates at historic low levels, rising construction costs and strong demand for modern warehouses, it is anticipated that rental growth will become an important driver for future capital growth in supply constrained areas.

Asset selection, price and tenant quality are key considerations and our manager has continuously sought to add to and improve the portfolio with this in mind. As the company seeks to deploy the recently raised funds these factors will be imperative in determining the shape of the portfolio.

The European logistics sector continues to grow with the increasing demand from market participants for newer quality warehousing driven by their demand for increased space and the rise in ecommerce operations.

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#### **Ioannis Papalekas, CEO of Globalworth Real Estate Investments:**

Our activities continue to benefit from a supportive economic environment and healthy real estate fundamentals in both Poland and Romania. With ongoing expansionary demand from multinational companies attracted to the region, we believe we are well positioned with our strategy of offering high quality, well located space, with a long-term tenant orientated approach and with a strong focus on localised management.

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#### **Barry O'Dowd, chairman of Yew Grove:**

##### **Market review**

In our chosen markets (institutional grade office and industrial buildings outside of the traditional Dublin Central Business District (Dublin 2 and 4, CBD)) the first half of 2019 was notable for demand from tenants for large, Grade A floorplates (Source: Cushman & Wakefield Dublin Office research Q2 & Q1). In Dublin, the markets in and around the North Docks (Dublin 1, 3 and 7) (Core+) dominated this activity in quarter one 2019 (Q1) and accounted for over 63% of the city centre take up, as demand for mega leases (100,000+ sq ft) from the central bank and technology companies meant that the take up of new leases was approximately twice the size of that in the traditional CBD. In the first half of the year net vacancy (after taking account of pre lets and reservations) fell to 5.4% in the traditional city centre and 3.9% across the expanded city centre (admittedly affected by the very low vacancy rates in the IFSC). Vacancy rates across the rest of our markets are also healthy and shrinking; sitting at 6.8% in suburban Dublin, at a low of 4.1% in Galway, 5.98% in Cork and only in Limerick where there is a real overhang of older, smaller buildings is the vacancy in double digits, at 12.3% (Source: Cushman & Wakefield research Q2 for Dublin & Cork, Q1 for Limerick & Galway). This increase in tenant demand linked to low vacancy rates especially in larger more modern buildings has led to increased construction activity, especially in Dublin and Cork, increases in planning applications across the country and the beginning of construction in Galway. The low level of available good quality space despite existing construction activity and the continued pressure from tenants suggests that rents in the traditional CBD for Grade A space will stabilise or may edge up. Good quality larger buildings in Dublin fringes, the South Docks and good suburban locations should continue to rise. Across the rest of the country rents are now reaching a level where most over rental has been eliminated and especially in those locations which are

popular with expanding foreign direct investors (FDIs) (principally software, and in the broader pharmaceutical markets) we are seeing upward pressure on rents feed through in reviews and new lettings.

Despite this increased demand from tenants the first quarter was relatively quiet from a transaction perspective. Sales activity picked up in quarter two 2019 (Q2") with a total of €770m in office transactions of over €1m in the first half of the year (Source: CBRE market view Dublin Office, Q2 2019). The market expectation is that the second half of 2019 will be much healthier and this is also reflected in our pipeline of potential investments. Market sentiment was mixed at the beginning of the year with the ongoing Brexit debate driving increased demand from new and prospective tenants but casting a pall over the general economic outlook and dampening investment transaction activity.

The industrial market is also principally about tenant take up. Here demand is mostly from e-commerce, logistics, pharmaceuticals and food (Source: CBRE mid-year review of outlook 2019). What little development activity there has been (principally Cork and Dublin) is largely driven by specific demand and generally there is little vacancy in good quality, larger (40,000+ sq ft) buildings. Rents in this segment have been one of the best performing asset classes in Irish commercial property over the past few years and that is expected to continue. Despite or perhaps because of this, there is little sales activity other than in older, smaller buildings (1,000-2,500 sq. ft) (Source: Cushman and Wakefield Industrial market snapshot, Q1 2019) driven by owner occupiers and a few buildings built to investor specifications. Construction costs are rising and allied to the continued demand for larger, more modern buildings we expect this to produce continued upward pressure on rents.

### Outlook

Despite headwinds in the Irish property market there is continued growth and opportunity within it. The evidence in our markets suggests that we are in a rising market, with demand for properties outstripping supply and tenants with robust businesses in expansion mode; a backdrop supportive of continued improvements to rents, take up and vacancy.

Against this, there is continued risks in the macro environment, most newsworthy of these is the increasing possibility of a 'no deal' Brexit. The UK Government has actively briefed the markets about the potentially disastrous effect a 'no deal' Brexit would have on the Irish economy. That has led to a fall in the share prices of a number of Irish companies, and a fall in investor optimism. Whilst a 'no deal' Brexit is not good for Ireland, it is far from clear that it would be as bad as is currently suggested and it is still unclear that it would affect the Irish office/industrial commercial property market negatively. Ireland is much more dependent on the US and wider European markets for exports of goods and services that are minimally dependant on, or exposed to, the UK.

Perhaps more significantly there are macro-economic signals increasingly suggesting the global boom driven by the post-global financial crisis recovery may have ended or is coming to an end. If so global economic growth is expected to slow, and the implications for Ireland (an open economy with significant exposure to the US and European economies) will be reflected in its GDP. One implication would be a slowing of demand for Irish property by Foreign Direct Investors. However, given the country has little excess capacity for the existing demand for offices or industrial buildings, and no overhang of suitable space we do not see this as the precursor to a collapse in the commercial property market.



From an investment perspective a cooling global and European economy means that the era of low interest rates is likely to persist for some time and as such, property, especially property that yields a significant premium to base rates, will continue to be a popular investment.

In summary, the short-term outlook is likely to see significant volatility as Brexit and its various contortions continues to roil the markets. It is likely that this may have a dampening effect on investors, and for a time prices and values. The medium-term outlook is still good, although perhaps a little less optimistic than at this time 12 months ago.

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## Property – rest of the world

(compare property – rest of the world funds [here](#))

### **Sebastian A.C. Berger, manager of Ceiba Investments:**

The economic and political environment in which the group operates has continued to deteriorate over the period under review, driven primarily by the adoption of aggressive new measures by the United States Government against the Cuban economy. This has led to a significant reduction in the number of tourists visiting the island and to a further decline of the oil trade between Venezuela and Cuba on favorable economic terms involving the exchange of services for oil. These external factors have contributed to a notable deterioration of the overall liquidity position of the country, resulting in numerous reported shortages of fuel and basic food supplies across the island, as well as sporadic reports of delays in international payments. The new economic measures adopted by the Trump administration include:

- the adoption of new restrictions aimed at limiting U.S. travel to Cuba (the removal of the "people-to-people" category of approved travel and the cancellation of cruise ship travel to the island);
- the coming into force of Title III of the Helms-Burton Act; and
- the announcement of further rollbacks of Obama-era normalisation measures in the banking and other areas.

The coming into force of Title III of the Helms-Burton Act (a controversial law previously suspended by all U.S. presidents since it was adopted in 1996) has resulted in the launch by Cuban American plaintiffs of a limited number of lawsuits in U.S. courts against certain Cuban as well as foreign companies doing business in Cuba who are accused of "trafficking in confiscated property". These lawsuits are likely to take some time to work their way through the court processes. However, the law remains highly controversial and has been strongly condemned by the European Union, Canada, Mexico and other allies of the United States who trade with and invest in Cuba. In a departure from past policy towards U.S. legal actions against it, the Cuban government has hired U.S. lawyers to defend the interests of Cuban state companies in at least one of the Title III lawsuits.

This renewed hostility towards Cuba on the part of the United States would seem to form part of the more general U.S. policy of pressuring the Maduro government in Venezuela with a view to encouraging regime-change there, and specifically targets some of the leading sources of Cuban hard currency income: tourism revenues relating to U.S. travel to Cuba, subsidised oil imports from Venezuela and new foreign investment transactions. The new travel measures have already had a negative impact on U.S. travel to the island, with a corresponding fall in tourism arrivals and receipts

(the Cuban government has recently adjusted downwards its projected arrival numbers for the full year, from 5.1m to 4.3m), and the initiation of lawsuits against foreign companies under Title III of the Helms-Burton Act has begun to have the clearly-intended chilling effect on the foreign investment climate more generally, as well as on the willingness of international banks and other financial institutions to deal with Cuba.

The recent political developments are monitored closely but we do not believe that they undermine the long-term investment case or value of the company's assets, although it is expected that the short-term operational context will remain very challenging for at least the remainder of the year and it is unclear when the general situation will start to improve.

### Outlook

Management expects that the tough economic and political headwinds faced by Cuba in recent months will persist into the second half of 2019, and that the local market conditions in which the group operates will remain very challenging. In addition, fuel shortages and other logistics problems, if they continue or worsen, may have a more pronounced impact on the pace of construction of our projects.

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### Gerald Ong, chairman of Aseana Properties:

The global economy experienced sluggish growth for the first six months of 2019. Growing trade tension between the US and China as well as prolonged uncertainty on Brexit continues to be the dominant factor for global market uncertainty.

Malaysia registered a slower GDP growth of 4.7% in the first half of 2019 compared to 4.9% in the same period last year. Although Malaysian economy is expected to remain healthy from the continuous support of steady domestic demand, challenges persist due to uncertain external factors. On the Malaysian property front, the market continued to soften in the first half of 2019 due to various factors including macroeconomic uncertainties and weak domestic consumer sentiment. Challenges such as stringent lending policies, a development approval freeze by the Government on selected commercial and high-end residential developments, property oversupply and price unaffordability continue to dampen the property market. In May 2019, Bank Negara Malaysia reduced the Overnight Policy Rate by 25-basis points to 3.0% which has managed to ease borrowing for potential home buyers. Sabah experienced a slight increase in the number of tourists in the first six months of 2019 compared to the same period in 2018. Total arrivals to Sabah for the first six months was 2.02m, with visitors from China being the largest group at 0.32m. However, eastern Sabah is still affected by adverse travel advisory notices from countries including Australia, New Zealand, Canada, United States of America and the United Kingdom.

Despite a softer global economy, Vietnam maintained strong second quarter GDP growth of 6.7%. On the back of a GDP growth of 7.1% in 2018, Vietnam sustained its economic growth with extensive market-oriented and outward-looking economic policies. Vietnam has emerged as one of the fastest growing countries in Asia over the last decade. Ongoing trade tariffs imposed on China by the United States will continue to dampen global economic growth. However, Vietnam will likely benefit from the ongoing trade tensions as firms are moving manufacturing from China to countries such as Vietnam, to avoid tariffs.

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**Manager's report for Dolphin Capital Investors:****Market Dynamics:****Greece**

Following the completion of the country's 3rd bailout program in August 2018 and the formation of a stable single-party government as a result of the general elections held on 7 July, Greece appears to be back on track to recover from a prolonged financial crisis. Although the country still needs to continue adopting measures to address the sources or potential sources of economic and financial difficulties and implement structural reforms to support robust and sustainable economic growth, the first signs of a stabilized economy are now clearly visible.

The Greek economy expanded by 1.9% year-on-year in Q2 2019, driven by a positive trade balance contribution with exports growing by 5.4% over for the same period last year and yet another strong tourism season. During the first six months of 2019 travel receipts were up 15.3%, while a 15.9% rise in average expenditure per trip was registered, according to the provisional data released by the Bank of Greece.

**Cyprus**

According to the European Commission's projections, GDP growth of 2.9% is expected for the Cypriot economy in 2019. Foreign direct investment has also increased during the first six months and bank lending was steady. Notwithstanding the above, tourism revenues are expected to be marginally lower on a year-on-year basis. After three record years, tourist arrivals in Cyprus for the first seven months of 2019 totalled 2.2m recording a decrease of 0.1% for the same period last year, due to Brexit uncertainty and the re-emergence of competitive neighbouring markets.

Despite the slow-down of tourism growth, the real estate industry is showing robust activity and enjoys strong demand from foreign buyers, predominantly due to the country's visa and citizenship incentive programmes. During the first half of 2019 property sales rose by 24.4% and building permits were up by 6.4% compared to the same period of 2018.

**Croatia**

In the first half of 2019, 6.9m tourists visited Croatia, an increase of 6% compared to the same period last year. These translated into 26.3m overnight stays, up 3% on the year, according to the Ministry of Tourism. Focusing on the coastal regions, Istria recorded the maximum overnight stays (7.6m) followed by Split-Dalmatia County (4.7m), where the company's Livka Bay project is located.

**Turkey**

Following a major economic crisis, tourism revenue has become significant for Turkey as it seeks to enhance the returns from tourism to help offset an economic downturn. Tourism has experienced a record year with numbers up by 13% in the first six months and tourism income increased by 10% according to the Turkish Statistical Institute. The number of real estate properties sold in Turkey decreased by 21.7% year-on-year in the first half of 2019 with around 500,000 properties sold in the first six months.

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## Property - debt

(compare property - debt funds [here](#))

### Manager's report for ICG-Longbow Senior Secured UK Property Debt:

#### Economy and Financial Market Update

The UK economy had a stronger than expected start to the period, with GDP rising by 0.5% in Q1 2019, albeit this partially reversed with a fall of 0.2% in Q2 2019, the first such fall in six and a half years. Whilst service sector growth (which comprises circa 80% of the economy) was nominally positive at 0.1%, this was insufficient to offset weakness in production and manufacturing, which contracted by 1.4% as the Brexit stockpiling seen during Q1 was essentially reversed. With the new Boris Johnson-led Government explicitly committed to leaving the EU with or without a deal on 31 October 2019; the prospect of weaker growth has been reflected in interest rates where the benchmark 10-year gilt fell markedly during August, in particular, and at one point stood below 0.5% before recovering.

More positively, the labour market continues to go from strength to strength with the employment rate of 76.1% as of June 2019 at a record high, according to the ONS. Wage growth at 4% in cash terms is at a decade high, and real wage growth of over 2% is the highest in four years. The public finances are also entering this period of uncertainty from a position of relative health, with the budget deficit modest at circa 1.2% of GDP and the debt-to-GDP ratio below all other advanced economies save for Germany. The new Chancellor, Sajid Javid, has publicly stated that he is looking at taking advantage of low borrowing rates to fund investment, and that in the event of a no-deal Brexit, a Government-led "significant economic package" would be the likely response.

#### Occupational Demand/Supply

The occupational markets have fared relatively well despite the ongoing economic uncertainty. In Central London, H1 take up of 5.8m sq. ft. was down 9% on H1 2018, according to CBRE. This was largely a function of a slow Q1, with a pick-up in activity in Q2 reducing market vacancy rates modestly to 4.2%. Space under offer, at 4.1m sq. ft., is ahead of the 10-year average which points to a robust start to H2.

Take-up has been strong across the 'Big Nine' regional office markets. Q2 activity was 10% up on the long-term average, bringing the half year total to 4.3m sq. ft. Activity was led by several large city centre deals, combined with record levels of activity in the flexible workspace sector. Q2 alone saw over 600,000 sq. ft. of flexible workspace deals, which is already in line with annual totals from the previous two years.

On the supply side, Bristol, Cardiff and Edinburgh all have vacancy rates below 6%, according to Cushman & Wakefield, with relatively limited supply pipelines suggestive of rental growth prospects. By contrast Birmingham, Manchester and Glasgow each have over 1m sq. ft. under construction, and the latter two already have reasonable availability of supply, with vacancy rates of 8.9% and 10.6% respectively.

Industrial take-up totalled 16.1m sq. ft. for H1 2019, up 28% on the long-term average. Although vacancy rates have increased slightly from 5.3% to 6.6% this is in line with a supply increase from 31.4m sq. ft. to 34.1m sq. ft., rather than a reduction in demand, which is highly driven by e-commerce, manufacturing and logistics companies. Overall, the market remains resilient with average industrial rental values increasing by 3.3% in the 12 months to June, according to the MSCI Monthly index. In our view, this new

supply together with ongoing levels of speculative development is likely to moderate rental growth in the medium term.

Retail (in which the group has minimal exposure) continues to struggle as prime rents in Q2 2019 fell by 1.1% compounding on the fall of 1.0% in Q1 2019. Further CVAs during the period, most notably the controversial Arcadia group arrangement, have added to pressure on town centres. According to research from PwC and the Local Data company, a net 1,234 stores closed during H1 2019. Despite this, consumer confidence has risen to an eight-month high, the labour market remains in good shape and real wages are rising strongly, hence we do not expect retail sales to collapse. Despite these positive indicators, Brexit uncertainty combined with structural changes resulting from the rise of e-commerce, business rates and rising wages are all continuing to negatively impact the sector.

### Property Investment Market

Weakening economic sentiment and political uncertainty contributed to a slowdown in real estate transactions during the last two quarters. Investment volumes were circa £19bn during H1 2019, down 32% compared to H1 2018. The negative sentiment towards the retail investment market has deepened with annual transactions down circa 50% on the five-year average.

All-property equivalent yields have begun to drift upwards - to 5.9% in June 2019, compared to 5.8% a year ago. Average yields have increased the most in the retail sector, by over 0.3% according to the MSCI Monthly index. Annualised average capital value growth for all-property also turned negative (-1.2%) in the year to June 2019. This is predominantly driven by the sharp falls in the retail sector (-9.5%) as growth remains positive for the industrial and office sectors at 5.8% and 1% respectively. Looking forward, the latest August 2019 IPF consensus forecasts suggest capital value falls of 3.6% in 2019 calendar year, and a further 1.8% in 2020, again largely driven by retail.

With Brexit risks looming, we do not anticipate any recovery in investment volumes in the second half, but equally we do not foresee any heavy selling of property investments following October, even in a disruptive no-deal scenario, with a wait-and-see approach more likely. Given the strong labour market fundamentals underpinning occupational markets, a relative lack of supply, and the strong yield premium currently over gilts, the challenge for real estate will likely be dealing with thin transaction volumes and consequently a degree of valuation uncertainty.

### Finance Markets

In the finance markets, Cass Business School published its annual review of UK property market lending conditions for Y/E 2018 during the period, based on a survey of 74 lenders with loan books totalling circa £195bn. The data show CRE lending volumes of £49.6bn during the year (a 12% increase from 2017) but total loan books up only 5%, reflecting what Cass describe as a period of extraordinary stability in both loan volumes and market structure since 2014. This reflects our own experience where, outside of retail, there is reasonable liquidity in the debt markets for most LTVs and asset classes, but without the depth of competition seen prior to the GFC which pushed pricing and lending covenants to nonsensical levels. In our view, lenders in general are continuing to invest prudently.

The period was also notable for the first UK loan priced using the SONIA reference interest rate, as an alternative to Sterling LIBOR. Issued by NatWest to National Express, we expect to see similar loans introduced into the real estate lending market in the medium term, prior to the eventual phasing out of LIBOR in 2021.

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**Manager's report for Starwood European Real Estate Finance:**

2019 has seen slower volumes in the commercial real estate market in Europe. According to BNP Real Estate total investment volumes for the first half of 2019 were EUR101.7 billion which is 13 per cent lower than in the same period in 2018. The average hides different situations across the different cities. In London, Brexit uncertainties have brought volumes down by more than the average at 39 per cent lower than last year with less stock being brought to market. Germany's big markets outside of Berlin were down significantly with Munich, Frankfurt and Hamburg down 46 per cent, 34 per cent and 49 per cent respectively. Hot markets included Milan, Berlin and Madrid, where investors are anticipating tight markets and strong rental growth potential, were up 56 per cent, 104 per cent and 67 per cent respectively.

Increased expectations of further rate cuts and quantitative easing has driven asset pricing across the board. Investors were already expecting the ECB to supply fresh monetary stimulus to help alleviate the ongoing economic stress within the region and the nomination of the International Monetary Fund's Christine Lagarde to be the next ECB president has raised expectations of continued loosening monetary policy. The EUR interest rate curve has significantly flattened so now the 5-year swap is lower than 3-month EURIBOR at -63 basis points in the middle of August. Government bond yields have continued to push down with all European 2-year sovereign debt now yielding negative returns and with German 10-year bonds having yielded as low as -0.7 per cent in August. Even peripheral European debt such as Portugal and Greece is trading at significantly lower yields than in recent years. Greek 10-year bonds have priced almost as tight as at 2 per cent having been almost 20 per cent in 2016 and Portugal has traded at 0.1 per cent at points during August versus over 4.4 per cent just 18 months ago.

With low asset yields we have seen increased formation of lower priced debt funds and direct investing by insurance companies and pension funds in more vanilla senior commercial real estate debt as an alternative for sovereign and corporate bonds. Insurance companies such as Axa and Allianz have been expanding their senior commercial real estate lending strategies and we are seeing some new players with similar mandates emerging. We have also seen good pricing on the two recent CMBS issuances with Morgan Stanley's Eos (European Loan Conduit No. 35) pricing at a blended 137 bps over EURIBOR for a 58.7 per cent Note to Value (NTV) and Goldman and CA-CIB's cold storage securitisation pricing at 184 bps over LIBOR for a 65.2 per cent NTV.

For other types of alternate lenders there have been a mixed bag of results. Lendy, a peer to peer lender making small property loans was put into administration in May after issues on its loan book including a reported 66 per cent of loans past due as of late 2018. Funding Circle, which makes small business loans, recently reported the tougher lending criteria it was imposing would halve its expected revenue growth for 2019. The FCA has increased regulation in the space with investors no longer be able to put more than 10 per cent of their investable assets into peer to peer lending and another part of the new rules is the introduction of an appropriateness test for investors that considers a client's knowledge and experience of peer to peer lending. In better news, Lendinvest which provides a variety of property finance has successfully completed its first securitisation. We have also seen varied fortunes for the challenger banks. Oaknorth appears to be doing well having grown its total loan book 160 per cent in a year to £2.2bn and with new commercial development loans as large as £60m reported. Meanwhile fellow challenger bank Metro has had issues with its loan book having announced it had been miscategorising the risk-weightings for a large number of its loans when working out how much capital it needed to protect against losses, which has led to reports of weakened investor and customer confidence and to a new capital raise in May.

On the UK residential side, London peaked in 2014 and according to Savills as a whole the prime central London market has fallen 19.4 per cent in sterling terms between June 2014 and the end of the first quarter of 2019. The second quarter saw a return to positive house price appreciation in London with the Nationwide reporting a 0.6 per cent quarter on quarter growth. Across the UK market as a whole, the RICs residential survey is reporting a more stable picture. In July the survey reported the second consecutive month of increased new buyer enquiries, however, sales volumes are down slightly in July, having been up slightly in June. For the parts of the market that attract high proportions of international buyers the continued devaluation of sterling means that foreign buyers denominated in USD, EUR and RMB currencies are viewing the all-in discount from peak as especially attractive in their domestic currency.

As we have commented in recent factsheets, the market for UK retail debt is yet to settle. The refinancing of the £750m Westfield Stratford CMBS has gone well given the quality of the asset and a low LTV and high debt yield. The new bonds were issued in July and priced at Gilts+100bps. According to Debtwire the market may be tested again soon with Intu reported to be looking at a refinancing of £1bn of debt secured by the Trafford Centre and a potential CMBS of a £150m Deutsche bank loan secured by the Intu Derby shopping centre. It will be an interesting test of sentiment to the sector to follow the progress of the refinancing of these very high profile assets over the coming months.

The UK continues to suffer from Brexit uncertainties with a clear message from Boris Johnson around his intention to come out of Europe on the 31st October 2019 with or without a deal which raises the probability of an intentional or unintentional no deal Brexit. This outcome would no doubt create increased challenges and uncertainties around many aspects of the UK market including real estate and real estate debt. In a down market for real estate, real estate credit will benefit from the equity cushion between starting values of the underlying collateral and the lending basis..

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## Renewable energy infrastructure

(compare renewable energy infrastructure funds [here](#))

### **John Rennocks, chairman of Bluefield Solar Income:**

#### **Non-Subsidised Solar**

The subsidy free market in the UK is now with us. This new market puts a higher emphasis on the management of the power revenues as all the revenues will be derived from the sale of electricity, with no regulated revenues. We believe the conditions are in place for this market to be scalable in the coming years.

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### **Gill Nott, chair of US Solar Fund:**

The US solar market remains a very attractive investment opportunity as evidenced by its continued and rapid growth. During April, the aggregate capacity of renewable energy sources - hydro, wind, solar, biomass, and geothermal - exceeded coal for the first time and renewable energy generated more energy than coal. During the first quarter of this year, 1.6 gigawatts (GWDC) of utility-scale solar was installed, representing a 22% increase compared to Q1 2018 and an 86% increase compared to five years prior. The US utility-scale solar market (5 MWDC and above) now has an

installed capacity of 39 GWDC, approximately seven times the size of the UK utility-scale solar market.

This growth has been driven by a combination of factors including the economic competitiveness of solar which has consistently strengthened due to the continued cost declines of solar equipment; the steady progress of state legislative changes across the US encouraging the use of renewables; and a growing number of corporations pledging to use 100% renewable power. All of these strong drivers make US solar an exciting investment opportunity.

The steady and attractive yields from UK solar assets have been recognized by UK investors for some time. However, the board believes that US solar assets are also attractive given the large areas of the country that are climatically well suited to solar power and availability of space to build larger plants giving rise to economies of scale.

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### Manager's report for US Solar Fund:

The US solar sector and broader renewables market achieved considerable growth and milestones in the first half of 2019. During April, the aggregate capacity of renewable energy sources - hydro, wind, solar, biomass, and geothermal - exceeded coal for the first time and renewable energy generated more energy than coal.

During Q1 2019, 1.6 GWDC of utility-scale solar was installed, representing:

- a 22% increase compared to Q1 2018;
- an 86% increase compared to five years prior, and;
- the strongest Q1 in the history of US utility-scale solar Photovoltaic (PV).

The US utility-scale solar market now has an installed capacity of 39 GWDC, approximately seven times the size of the UK utility-scale solar market. As depicted, utility-scale solar PV has and will continue to account for the largest share of annual installations in the US solar market, with 49 GWDC of utility-scale solar installations forecast between 2019 and 2023.

The economic competitiveness of solar has consistently strengthened due to the continued cost declines of solar equipment. This is evidenced by the fact that most utility-scale solar PV projects are being procured as the lowest cost form of energy generation or as a hedge against the rising price of natural gas rather than being driven by any state mandates. Voluntary (non-mandated) procurement of utility-scale solar PV has continued to be the primary driver of solar development; accounting for 73% of utility-scale solar capacity additions in 2019.

Legislative changes towards favourable state renewable policies continue to expand across the US. Of the 50 states, 35 have implemented either a renewable portfolio standard or a voluntary renewable target, including six states - California, Hawaii, New Mexico, Washington, Nevada, and Maine - which have committed to 100% renewable or clean energy targets. Many states are expected to continue to improve their existing policies as their renewable portfolios approach near term benchmarks. Since January 2018, eight states have increased their existing targets.

Globally, corporations signed 8.6GW of clean energy PPAs in 2019 through July (2019 YTD), up from 7.2GW for the same period last year. This has been driven largely by the US with US corporations accounting for 69% of global PPA volume in 2019 YTD.

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**Rónán Murphy, chairman of Greencoat Renewables:**

The Irish wind market remains a very attractive jurisdiction for investment with both a stable and supportive regulatory regime and broad public support. In the first half of 2019, wind generation delivered approximately 32% of the country's electricity, and will remain the dominant renewable technology as Ireland continues towards achieving its target of 40% renewable electricity generation by 2020.

Beyond 2020, The Irish Government's recently announced Climate Action Policy committed the country to generating 70% of electricity from renewables by 2030. This is expected to create more than €12bn of further investment opportunities and it is expected that the majority of this new capacity will be delivered under the new RESS, a competitive auction structure for CFD support, with such auctions expected to commence in 2020 and run until 2026. The board continue to view the Irish wind market as an attractive market for further investment.

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## Commodities and natural resources

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

**Howard Myles, chairman of Baker Steel Resources:**

There remains significant uncertainty around the outlook for the global economy, any deterioration in which could reduce the demand for most metals. In these circumstances the manager will seek further investments in projects which have the potential to be in the lower quartile of operating costs and therefore be sufficiently robust to survive any downturn. In doing so it will seek to structure transactions in such a way as to protect against downside risk whilst retaining the upside potential.

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