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Monthly summary | Investment companies

March 2020

Economic & Political Roundup

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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

It was a sombre month for markets as the Coronavirus (Covid-19) spread briskly beyond China. China's economy effectively ground to a halt and there are now real concerns other large economies will face mass disruption. Government bond yields have tightened as investors see them as relatively safe investments.

Global

Too early to gauge full scale of the impact of Covid-19

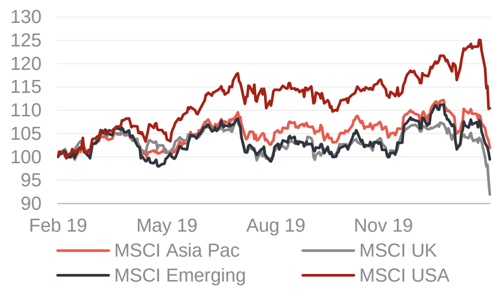
Carolan Dobson, chair of Brunner, said it was impossible to know whether the current outbreak of Covid-19 will remain a human tragedy or also develop into a significant economic problem as global trade becomes disrupted. Herald's manager, Katie Potts, says the technology sector will be significantly affected if manufacturing continues to be disrupted. She also makes the interesting observation that the premiums being paid by private equity companies for quoted companies has had the effect of moving the quoted market to their valuation levels. The managers of JPMorgan Global Growth and Income say they have been using gearing more cautiously, reflecting their view that historical indicators of a recession, including the yield curve, remain somewhat elevated. James Dow and Toby Ross, managers of Scottish American, reflect on the risk of extrapolating past returns. They highlight the underperformance of a number of so-called "dividend aristocrats" over the past 10-15 years.

Exchange Rate	28/02/20	Change on month %
GBP / USD	1.2823	(2.9)
USD / EUR	0.9069	+0.6
USD / JPY	107.89	(0.4)
USD / CHF	0.9649	+0.2
USD / CNY	6.992	+0.79

Source: Bloomberg, Marten & Co

MSCI Indices rebased to 100

Time period 01/03/2019 to 28/02/2020



Source: Bloomberg, Marten & Co

	28/02/20	Change on month %
Oil (Brent)	50.52	(13.1)
Gold	1,585.69	(0.2)
US Tsy 10 yr yield	1.1486	(23.8)
UK Gilt 10 yr yield	0.442	(15.6)
Bund 10 yr yield	-0.609	+39.7

Source: Bloomberg, Marten & Co

UK

Low growth and reduced capital spending persist

Dan Whitestone, the manager of Blackrock Throgmorton, says that strong equity markets during the trust's November 2019 year-end masked increasing levels of volatility and style rotations in market leadership away from growth and into value. Philip Remnant CBE, chairman of City of London says that the end of the UK's political paralysis is likely to lead to improved business and consumer confidence. He adds that there is some limited scope for further interest rate cuts for the UK, but further stimulus to economic growth could come from an expanding fiscal deficit.

Gervais Williams and Martin Turner, managers of Diverse Income, believe that in time, anticipated renewed capital inflows into the UK will flow down the market capitalisation bands from the FTSE 250 stocks into small, and then microcap, stocks given that their valuations are so much lower. They expect many of the best performers to be small and micro caps where their results surprise on the upside.

Henderson Opportunities's managers, James Henderson and Laura Foll, note that the UK economy has been growing at a very modest rate and capital spending is running at low levels. They add that over the last year, it has been the high valuation stocks that have performed the best. When economic growth picks up and some confidence returns, the valuation gap between highly rated shares and much cheaper shares may contract.

Continuing Brexit uncertainty

The management team at Investment Company note that with the finer details of Brexit still to be negotiated, there will undoubtedly be continuing concerns about the UK's long-term relationship with Europe and the progress made in agreeing trade deals with the rest of the world.

Standard Life UK Smaller's manager, Harry Nimmo, says that several big uncertainties have been removed. Most importantly a government with a working majority creates more certainty as to the constitutional future of the UK and its relations with the European Union.

JPMorgan Mid Cap's managers, Georgina Brittain and Katen Patel, say that global investors are slowly revisiting the UK stockmarket, and they still believe that the mid cap arena is not expensive and stands to benefit most from the changed political environment.

Charles Luke and Iain Pyle, managers of Murray Income, note that the new Chancellor of the Exchequer does have the option to stimulate the economy with a programme of fiscal easing and infrastructure spending which has the potential to provide a significant tailwind for future growth.

Finally, Arthur Copple, chairman of Temple Bar, points out that the year did not start well for value investors, with renewed appetite for momentum stocks.

North America

US consumer remains a bright spot though industrial side has displayed hints of a recession

Tony Despirito, Franco Tapia and David Zhao, the managers of Blackrock North American Income, say that their base case for 2020 remains positive, albeit slowing, US growth with the trajectory of corporate earnings being a key litmus test for the durability of this business cycle. The US consumer remains a bright spot and they note that the household savings rate is well above the pre-crisis level seen in 2007 and jobs and wages are growing but not at an untenable pace. The industrial side, meanwhile, is showing hints of recession with purchasing managers' indices slowing globally. They also say that with the benefit of hindsight, 2016 was a classic mid-cycle slowdown.

Japan

After 'three lost decades,' Japan might finally be re-emerging as an attractive destination for international investors

AVI Japan Opportunity's chairman, Norman Crighton, begins by reflecting on three 'lost decades' that have seen global capital repeatedly deployed in the Japanese markets with the promise of revaluations that were going to be inevitable once the attractive valuations and opportunities were recognised. It is the trust's conviction that change - meaningful change - is in the wind in Japan: with the political will to apply pressure through the revised stewardship and governance codes, and the increasing presence of shareholder-conscious institutional investors, a slow-but-sure shift is coming about in Japan Inc.'s attitude to corporate governance. Perhaps things really are different this time.

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Europe

Europe has shown its relative vulnerability to trade disputes, though for now the focus is on containing Covid-19

Alexander Darwall, manager of European Opportunities, compares the performance of European markets and its economy with the US. He says Europe lacks the flexibility and low energy cost policies of the US. Further, its greater vulnerability to trade disputes is reflected in the German GDP growth number, estimated by the IMF at 0.5% in 2019.

Ollie Beckett and Rory Stokes, managers of TR European Growth, say that like everyone else, they do not know how long the impact of Covid-19 will last. They say that it seems reasonably certain that the first half of the calendar year will be weak; understandably leading to ever lower bond yields and a flight to safety. If the health scare can be contained in the coming weeks, we could see a v-shaped recovery.

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Global emerging markets

Emerging and frontier markets remain an 'unloved' asset class. 2019 was the second worst year for frontier market fund flows, despite long-term growth prospects remaining attractive in many markets

Aberdeen Emerging Markets say that emerging market equity is an unloved asset class at present, held back by negative sentiment and low expectations. Anecdotally, they have seen a withdrawal by investors from single country funds and those regions now deemed to be marginal when compared with Asia, which is perceived as the most defensive emerging market region. This has been to the detriment of frontier markets, Latin America and Eastern Europe. They believe the long term prospects in many of these markets are as good, if not better, than those of Asia.

We also hear from Aberdeen Frontier Markets, who note 2019 was the second worst year for frontier market equity fund flows since records began, only beaten by 2015's net outflow of $2.4bn. The manager's report states that an ongoing issue for frontier markets has been the reoccurrence of capital destructive idiosyncratic risk, a theme, this time in Argentina, which was then exacerbated by the evaporating investor confidence witnessed in Lebanon. Looking forward, they believe that Vietnam, Pakistan and Egypt are particularly well positioned today.

The management team Gulf Investment Fund say that with large investments anticipated over the next few years, they expect to see increasing opportunities in banking, infrastructure and industrials. The oil price remains a key risk.

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Biotech and healthcare

Covid-19 is providing a reminder that healthcare needs to evolve to face new challenges

Randeep Grewal, chairman of BB Healthcare, says Covid-19 provides a tragic reminder of the need for healthcare and that healthcare has to continuously evolve to face new challenges. Randeep also discusses the US election later this year.

We also include commentary from the managers of BB Healthcare, Paul Major and Brett Darke. They take us on a detailed journey through the 16 categories they classify healthcare investments into.

Other

We have also included comments on flexible investment from Ruffer; private equity from Pantheon; debt from Riverstone Credit Opportunities Income; renewable energy infrastructure from Bluefield Solar, Greencoat UK Wind and Renewables Infrastructure Group and commodities and natural resources from Blackrock Energy and Resources Income and Blackrock World Mining.

Contents

Polar Capital Technology Trust plc

Beyond the collection of data

Twenty years after the dawn of the commercial internet, nearly every sector is now being challenged, improved or replaced by disruptive technology. The Polar Capital Technology Trust – managed by a team of dedicated technology specialists – has a proven track record with the ability to spot developing technology trends early on and to invest in those companies best placed to exploit them.

Find out more about how the

Polar Capital Technology Trust

is helping to transform the world bit by bit.

London Stock Exchange Ticker: PCT

Visit **polarcapitaltechnologytrust.co.uk**
Available to purchase through all major platform providers, stockbrokers and/or your financial adviser.

Global

(compare Global funds **here**)

Carolan Dobson, chair of Brunner:

We had thought as some of the uncertainty that plagued global markets through 2019 falls away that economic and corporate growth would pick up or at least there would be a clearer outlook. This would allow companies to plan better for the future and this increased confidence could spur improved corporate spending and growth. However, at the time of writing it is impossible to know whether the current outbreak of the Coronavirus will remain a human tragedy or also develop into a significant economic problem as global trade becomes disrupted. Also, the eventual outcome of the Brexit negotiations remains far from clear.

Equity markets are still attractively valued when compared to bond markets.

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Katie Potts, manager of Herald:

Review

After a year of consolidation in 2018, I was confident that 2019 would be better, but candidly I am surprised by quite how strong the market has been. I was particularly apprehensive in the middle of the year when I was aware how dire liquidity was, particularly in the UK and Europe.

As Woodford's troubles emerged there was a spate of selling as investors tried to reduce holdings in illiquid stocks and the market was scarcely functioning. I feared distressed sellers would deliver a downward dislocation. Fortunately, the Woodford situation occurred against a very strong market background; otherwise, more damage could have been done.

Why, I wonder, has the market been so strong? I believe the main reason is that, while there is a shortage of capital in smaller quoted companies, there is a surplus in the hands of private equity. They are using cheap debt to leverage returns and exploit the anomaly that interest is tax deductible when dividends are not. They continue to pay significant premiums when acquiring quoted companies and gradually the quoted market is moving to their valuation levels. They have gathered assets by performing with leverage, which has worked in an era of declining and very low real interest rates.

From first principles, the ideal environment is for companies to have permanent capital and for investors to have perfect liquidity. That worked in the stock market and for the wider economy as well over extended periods. On the other hand, private equity is temporary capital, with short-term horizons, which while possibly driving markets higher in the short-term, will over time tend to undermine economies as more ownership goes into its hands.

The move to private equity ownership has been helped by the huge increase in costs and distraction from spiralling regulation in public markets, which is particularly onerous for developing businesses. For example, I estimate that of the 131 UK listed investments in the portfolio each has spent an additional £50,000 on investor relations by appointing a joint broker, commissioning independent research or, in extremis, employing an individual to do investor relations. On average Herald owns 4.2% of the outstanding capital of its UK holdings, so the share of those costs borne by our investors is around £275,000. This is a hidden cost not disclosed to investors. At the same time, we now have 17 holdings with no broker coverage, a further 64 with access to only one broker (including our largest US holding Pegasystems) and a further 62 holdings with access to research from only two brokers. This anecdote perhaps explains why MiFID II research payments are so confusing and challenging for us and why some investors and brokers are disappearing from the smaller companies' scene.

Similarly, audit fees are leaping, and it seems too much time is spent counting the blades of grass without intelligently viewing the lawn. We are jealous of the minimal scrutiny of the private equity world, but maybe in time investors will realise that minimal regulation is not ideal either. Wealth managers are facing ever increasing costs, which now have to be paid out of after-tax income when previously more of the cost was ascribed to capital. None but the richest investors can now afford tailor-made advice. When costs were pro-rata to dealing more of the cost was born by big investors and less by small investors.

In recent years the stock markets in the UK and the US have not provided the stable quality ownership that they did in the past and have not supported the UK technology sector. The quality long-term owners of defined benefit pension schemes and insurance companies have disappeared and the ebbs and flows of open-ended funds make them unstable shareholders for small companies. As allocations to quoted UK equities have fallen, investors have too easily accepted takeovers and failed to provide capital for companies to grow.

On a more positive note there is relative value in the smallest companies. Capital is still hard to find where it is needed most, which is for emerging companies who have not yet reached profitability where venture capital has significantly lower cash to deploy compared to leveraged private equity. Furthermore, US investors, appreciating the value in the UK, are beginning to appear on the share registers of the smaller UK quoted companies, which may be the lifeline needed. I am reassured that the SEC has extended the exemption which allows US brokers to sell research to European firms by three years. There are therefore the building blocks in place, of attractive valuations and increasing capital availability, for a positive investment environment.

I remember when I started in the City during Thatcher's reign the atmosphere was "we need small companies to create wealth, added value jobs, taxes and future big companies", and there was an enthusiasm to allocate capital accordingly. It is within the Government's powers to direct UK savings to alleviate the disastrous decisions made over the last twenty years: after all, they provide a subsidy to pensions, ISAs and private equity. Now that we have left the EU, there is an opportunity for government to create a really positive environment for innovation and growth.

Technology sector background

We remain enthusiastic about the outlook for investing in the technology sector. Cloud computing and ubiquitous connectivity will continue to drive disruption across different sectors, creating opportunities for technology companies. Although we expect trade tensions and regulatory concerns to continue to cause short-term volatility, ultimately the sector is among the few which is investing heavily in innovation, creating high value employment and bringing benefits to consumers, enterprises and governments around the world and generating attractive returns in the process.

The concept of IT as a utility has been talked about since the mid-1990s. However, it was with the wide acceptance of opensource software post 2000, the availability of mobile data networks in the mid-2000s, the launch of Amazon's AWS in 2006 and the launch of the Apple App store in 2008 that the pieces of the puzzle were in place for the concept to go mainstream. Today we call that utility model "Cloud Computing."

We are 10+ years into the adoption of Cloud Computing. The size of the market is very large but growth rates remain robust. Gartner Group estimate Public Cloud revenues to grow from $227bn in 2019 to over $350bn in 2022 (source: Gartner). Moreover, we see the adoption of Cloud Computing disrupting about $1tr of the current annual spending on legacy systems.

The move to Cloud Computing is disproportionately beneficial for smaller companies. It gives them access to a global resilient IT infrastructure at arguably less than 1% of cost of having to build it themselves, and the added benefit that they can flexibly scale their businesses up and down efficiently and with low risk. Additionally, this allows small companies to target niche markets around the world efficiently.

In the same way that the internet democratised information flow and we are still grappling with its second and third order effects, Cloud Computing and Ubiquitous Connectivity continue to democratise software development across different end markets with changing second and third order effects.

Investing in technology gives us a front seat to see the ripples and aftershocks of seemingly unconnected small innovations which often combine to create tectonic shifts across different industries. Regardless of the source of the innovations, smaller companies and the entrepreneurs behind them tend to be the first ones to exploit the nascent opportunities throughout global supply chains.

With time and relentlessly excellent execution, leaders emerge to dominate fragmented, newly created markets. This has been the story of most of the tech titans of today, e.g. Microsoft, Apple, TSMC, Google, Facebook, Amazon, ASML and SAP. We have seen this pattern repeated again and again over the last three decades. We do not see any sign of it changing in the foreseeable future.

Coronavirus

The technology sector will be significantly affected if Coronavirus continues to disrupt manufacturing in China. Although the direct exposure to Chinese companies is minimal, the indirect effect could be significant. In particular, a handful of holdings in each region manufacture products there, either with Chinese operations, or through subcontractors and suppliers, and many more companies use PCs and servers which are at least in part manufactured there. However, the knock-on effects will be felt in many sectors if the cessation of production is prolonged, and at this stage that is uncertain.

Outlook

We remain confident that there is growth in the sector above that of the wider economy and that much of the sector now has non-cyclical spending. In particular, the recurring revenues associated with IT infrastructure and applications, used by corporations, the consumer and governments alike, have the defensive characteristics of utilities without the regulatory issues, which benefit so many companies within our universe. However, the geopolitical uncertainties, the illiquidity associated with smaller companies and valuation levels which will be vulnerable when interest rates rise, means that we prefer to keep higher than normal cash levels to ensure we can exploit buying opportunities, which will inevitably occur. For reassurance, valuations are in general not in bubble territory and the difficulty which central banks have in raising interest rates means there is a good chance that valuations could rise further.

Helge Skibeli, Rajesh Tanna and Tim Woodhouse, managers of JPMorgan Global Growth and Income:

Review

When we cast our minds back to this time last year, writing this report, it's notable how much has changed. The latter part of 2018 brought a market crash, geopolitical tension and rising economic headwinds. The past six months however, have brought rising markets, signs of a trade deal and an improvement in economic momentum since the summer.

It is a sign of the world we live in today that each year brings with it something different to focus on. Four years of President Trump have almost passed, and we face another US election in November. Yet politics has not been a useful guide to market performance.

We expect a return to earnings growth in 2020 as we recover from the manufacturing slump seen in 2019. Central banks also continue to be accommodative, but we remain on the lookout for signs of significant risk or exuberance. One risk we will discuss is that posed by the Covid-19 virus.

Outlook

It is also worth acknowledging the risks posed by the Covid-19 virus to the global economy. We are watching developments carefully, in particular watching for signs that the inevitable slowdown in China is having longer-term repercussions on employment numbers.

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James Dow and Toby Ross, managers of Scottish American:

Outlook

A risk in investing is that you look backwards rather than forwards. One way that dividend investors sometimes do this is by focusing on so-called "Dividend Aristocrats". This is a term that was popularised in the US market and refers to companies that have an unbroken 25-year history of continual dividend increases.

In 2005, Standard & Poor's launched a "Dividend Aristocrats" Index, allowing investors to identify a basket of these companies. Today billions of passive dollars track this index. We recently thought it would be interesting to investigate how many of 2005's founding 'aristocrats' still make the criteria today? We were surprised to find that only half of them did. Over the fifteen years since the index was launched, a few of the original companies were acquired, or reshuffled their businesses, which interrupted their dividend records. But more than 1 in 3 of these blue-chip dividend payers went on to cut their dividends, often drastically. General Electric, for instance, which was once held up as a classic example of a "sure thing" for dividends, has seen its earnings and dividends collapse in recent years. Often the Aristocrats have proved less robust and adaptable than their boards or investors expected, to changes that had not been foreseen.

This highlights the danger for investors of just looking backwards, particularly if they are long-term income investors. Extrapolation tends to be a good way of forecasting what happens tomorrow, but it's a bad way of predicting what will happen in ten years from now.

If anything, we tend to think the risks of gazing in the rear-view mirror are increasing. Competitors are emerging faster, consumer habits changing more rapidly, and concerns over climate change are forcing many businesses to rethink strategies that have historically worked well. Because we are investing for income for decades rather than quarters, we need to look for different pockets of opportunity, rather than just opting for those parts of the market which have historically offered safety; and we need to think critically about how adaptable the businesses we invest in are going to be in a future that is unlikely to offer 'more of the same'.

So what are we doing differently, to avoid extrapolating yesterday's successes?

In 2019, an analyst who had spent two years on our team became one of the initial members of the firm's new research office in Shanghai. Part of his remit is to generate income-growth ideas from the China A-share market for the company. This should be a fertile hunting ground. We estimate that including the A-share market would increase our global 'universe' of dividend-paying companies with a market cap of >£1bn from 4,500 to 5,400 (both numbers much higher than the UK market's universe of 250 companies!).

Simon Barnard, manager of Smithson:

Review

2019 provided very favourable conditions. From the low point in December 2018, global stock markets rallied strongly during the early part of the year. As noted in our interim report, this was likely the result of the pause in interest rate increases, and a subsequent rate decrease by the US Federal Reserve. Markets made little progress during the summer as negative headlines regarding US and China trade negotiations continued to foster uncertainty regarding global trade and future economic growth. However, sentiment picked up again from October to December as global economic data points began to stabilise and market participants started to imagine a possible improvement in economic growth in 2020. It is impossible to know at this stage whether this will actually come to pass, although there is a reasonable chance, given 2019 was the worst year for global economic growth in a decade. The year culminated in a loudly trumpeted US China trade deal in December, although we suspect the actual substance of this deal will likely be immaterial in the context of global trade flows.

2019 was also the third year of the US presidential term, which has historically benefited from a very positive equity performance - an average of 17.8% since 1927 (measured by the S&P500 index). The theory goes that after US midterm elections, which tend to favour the party in opposition (as it did in 2018), the power of the President is stymied to such an extent that stock markets can now rely on US policy 'certainty', given that nothing is now likely to change. Moreover, since presidents like to be re-elected, in the third year of a first term president we can usually expect some focus on policies which will benefit the US economy, like tax cuts, for example. With the globalised nature of stock markets, and the very significant weight the US carries within them, these effects are also likely to impact other regional markets. As the MSCI World Small and Mid-Cap (SMID) Index, our reference index, was up 21.9% for the year, it appears that this theory continues to be of some use.

The obvious question one might now ask, is what does the historic data suggest for equity performance in the fourth and final year of the US Presidential term? This time, the answer is: it depends. A re-elected Republican President, usually considered pro-business, tends to result in above average stock market performance in the fourth year. However, a newly elected Democrat, usually considered pro-regulation, has historically resulted in a lower than average year for equities.

Flexible investment

(compare flexible investment funds **here**)

Manager’s report for Ruffer:

We should not forget how extraordinary current conditions are. In the annual financial report we referred to the large amount of debt trading at negative yields across the world and how this has distorted the prices of many different asset classes. This distortion persists and if there is a lesson to be learned from the last 15 years it is that these things can go on longer than seems logical. Much has been written about what would have happened had the Federal Reserve ('the Fed') not performed a spectacular u-turn 12 months ago. Perhaps the more interesting question will be whether in a decade's time that volte-face will matter, or, as we believe, will simply be seen to have put off the inevitable. However, we also acknowledge that the Fed has masterfully kept the show on the road in recent years and our investment strategy needs to be able to capture some of the benefit should that continue in the short to medium term.

Looking forward we worry about the combination of highly indebted corporates and consumers, a widespread insouciance on inflation and growing concerns about liquidity mismatches in financial markets. 12 months ago no one thought that markets would rise over the following year and now no one thinks that they can fall.

Ashe Windham, chair of Ruffer:

The decisive Conservative election victory has spurred on the UK Equity market, and it seems to me that there is more ground to be made up, since the underperformance of the UK market relative to its global peers since the Brexit vote on 23 June 2016 is stark. The twin threats of a socialist government and the uncertainty over Brexit are receding, leaving the UK as a much more attractive place in which to invest. Regarding the recently emerged COVID-19 coronavirus threat, the board is monitoring its spread and the manager has confirmed that it is in contact with our investee companies about the likely impact.

While continuing to look for attractive opportunities in equity markets, we are ever cognisant of the risks hanging over financial markets. This bull market is now long in the tooth and corporate profits are being maintained by share buybacks and cost cutting, whilst the amount of debt outstanding now dwarfs the position which prevailed in 2008. Interest rates are at all-time lows and thus there is little ammunition left to offset any downturn.

United Kingdom

(compare UK funds **here**)

Dan Whitestone, manager of Blackrock Throgmorton:

Review

Strong equity markets during the period masked increasing levels of volatility and style rotations in market leadership away from growth and into value. Global trade uncertainties continued to create a major headwind, offset by renewed central bank monetary easing in both the US and Europe. The UK's political environment remained turbulent; first with Theresa May's decision to step down as Prime Minister after failing to secure a Brexit deal in Parliament (leading to the UK General Election), which saw Boris Johnson's Conservative Party secure a convincing majority. This political chaos resulted in increased sterling volatility, with the currency touching lows in August, and then rallying in anticipation of the Conservative majority. For all the Brexit-related concerns, there was a notable resurgence in Mergers & Acquisitions activity in the UK market, with a diverse range of targets, particularly from overseas corporates prepared to take advantage of opportunities in the UK, despite the nervousness in the equity market.

Outlook

The Conservative majority in Parliament does remove a tail risk in our view, and more clarity should lead to increased business confidence and corporate spending (something we will look for evidence of this in our interactions with company management teams). This has the potential to create a healthy backdrop of improving corporate profitability both for domestic and global-facing UK PLCs.

Philip Remnant CBE, chairman of City of London:

The end of the UK's political paralysis is likely to lead to improved business and consumer confidence. While Brexit is settled with the UK having left the European Union, the future trading relationship is unclear and this uncertainty might be a brake on investment intentions and the more optimistic outlook.

There is some limited scope for further interest rate cuts for the UK, but further stimulus to economic growth could come from an expanding fiscal deficit, especially given pledges made in the Conservative election manifesto. Globally, growth could continue to be lacklustre, partly because of tensions over tariffs and the spread of the Coronavirus. In addition, monetary policy has probably reached the limits of its effectiveness given historically low interest rates in many countries.

While UK equities have performed well in 2019, this only recovers the losses from 2018. In our view, the UK equity market's valuation is supportive, with its dividend yield better than that of most other leading equity markets, yields in most areas of fixed interest and bank deposit rates.

Gervais Williams and Martin Turner, managers of Diverse Income:

What market trends can be expected when the UK transitions out of the EU?

Three stock market changes occurred after the result of the EU referendum was first announced in June 2016.

The UK exchange rate fell abruptly. This boosted the value of profits generated overseas and increased the Sterling profits of multinational stocks. Hence the FTSE 100 Index actually ended up rising after the Brexit vote.

The share prices of mainstream cyclical stocks such as banks, housebuilders and retailers fell sharply on the assumption that domestic growth prospects were going to be less buoyant.

Small cap stocks were all lumped together with domestics and their share prices were marked down sharply, rather like the cyclicals. After a few months with many small caps reporting upbeat results, their share prices staged a recovery.

Following the General Election result, there is evidence that capital allocations to the UK stock market are now rising as the uncertainty of the Brexit transition falls away. Alongside, the recent UK stock market trends are also reversing.

The UK exchange rate has already started to appreciate, and is a headwind for multinational stocks and the FTSE 100 Index specifically. The best performing sector of the stock market has been the FTSE 250 Index stocks for now.

Specifically, much of these renewed capital flows have been directed towards mainstream cyclicals, such as banks, housebuilders and retailers. However, in spite of the greater confidence, we do not expect the growth of the UK to greatly outpace many others.

In time, we expect the renewed capital inflows into the UK to flow down the market capitalisation bands from the FTSE 250 stocks into small, and then microcap, stocks given that their valuations are so much lower. We expect many of the best performers to be small and micro caps where their results surprise on the upside.

Importantly, the UK is distinctive in its vibrant community of quoted small and micro caps, and there are few other markets where investors can participate in all the advantages these stocks offer.

Outlook

Since 2008, a key driver of global growth has been Chinese infrastructure investment. Our collective problem is that after a decade of Chinese infrastructure spend, many of their current projects do not generate enough cash to fund the repayment of their debt. Therefore, the Chinese have found it harder to borrow over recent years, and this has led to a marked slowdown in Chinese growth, and that of the world economy.

As larger companies rarely grow much faster than their host economies, the slowdown in world growth suggests that most mainstream companies will not grow much in future. It also implies stock market returns could turn out to be quite modest. Indeed, the fact that government debt is now standing on ultra-low interest rates also implies that returns on most asset classes are likely to be very modest in future.

Diverse was set up with these challenges in mind. The wide-ranging nature of the multi cap strategy means that the portfolio can pick more of the quoted companies that are able to sustain dividend growth even when the wider economy is not growing. During globalisation and the years of plentiful growth, this differential has not been particularly relevant. However, now that globalisation has evolved into nationalism and global growth has died away, small caps could be important. We would argue that this is the moment when all investors will become more interested in diversifying risk and including more companies with scope to buck the wider economic constraints.

Overall, during the long period of Brexit uncertainty, the valuation of the UK stock market has fallen behind others. Small and micro caps are even more overlooked than mainstream stocks, so we believe that they have potential for an even greater performance catch-up in future.

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James Henderson and Laura Foll, managers of Henderson Opportunities:

Background

The UK economy has been growing at a very modest rate. Capital spending is running at low levels. This is not an easy background for investment. Sales growth and investment in new capital lies behind profit growth. Therefore there have been a larger than usual number of profit disappointments from UK smaller companies. The reaction these sometimes modest profit downgrades have met in share price terms has often been severe, with the share price falling a considerable amount. This is a result of general shareholder nervousness.

The companies that worried shareholders like to hold are predictable businesses with very solid profiles that they believe will have no operational problems. Companies that are thought to have these attributes have moved onto very high valuations while those that are thought to be in any way challenged have seen their valuations fall. The problem with this approach is that in a fast moving world the business model that works well today can easily be out of date in the near future. The life cycle of companies is getting shorter as early strong growth can give way to maturity and decline faster than in the past. The speed of information flow exposes companies to faster, often global, competition. Very few have 'a moat' round them and this is why there are inherent dangers in investing in high valuation companies. However, over the last year it has been the high valuation stocks that have performed the best. When economic growth picks up and some confidence returns, the valuation gap between highly rated shares and much cheaper shares may contract.

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M. Foster, J. Harrison and J Dieppe, managers of Investment Company:

Fears of a global recession have eased somewhat with better economic data from the UK and US. In response, bond yields have backed off from their lows. Notwithstanding geo-political risks, the backdrop is generally supportive for equity markets although investors have become more discriminating in their evaluation of growth company ratings. This has led to a better period of performance for more value oriented stocks.

With the UK General Election now decided, the political uncertainty has been largely removed. However, the finer details of Brexit still need to be negotiated and there will undoubtedly be continuing concerns about the UK's long-term relationship with Europe and the progress made in agreeing trade deals with the rest of the world. With the Conservatives having such a large working majority, the major risk to the UK economy would appear to be a hard or no deal Brexit. This will no doubt be reflected in how Sterling moves against other currencies over the coming year.

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

What a tumultuous year! While the global backdrop was one of continuing Middle Eastern agitation, ongoing although slowly de-escalating trade wars between China and the USA, and slowing global growth notably in Europe, caused by those trade wars, the main story for the UK stockmarket was all political. We saw Theresa May leave Downing Street, Boris Johnson replace her, the 31st October Brexit cliff-hanger, and then the December 2019 Election. The outcome of the Election with its decisive victory and significant majority for the Conservatives, and the disappearance of the key risk of a Corbyn-led Labour government, provided a level of certainty to UK politics that had been lacking for several years.

Outlook

The UK has endured a protracted period of uncertainty since the Referendum in June 2016, which affected businesses, consumers and the economy. Post the Election and parliamentary approval of the Withdrawal Agreement from the EU, the outlook for the UK both politically and economically is clearer than it has been for several years. While the Brexit negotiations are not over, the strength of the Conservative majority means they should no longer dominate all other considerations.

We now have a pro-growth, pro-investment Government in place, and already we have seen real Government spending accelerating at its fastest pace in a decade. The most recent economic data has seen improving CBI surveys, a sharp pick up in the important Purchasing Manager Indices and an improvement in consumer confidence, helped by the very recent strengthening of the housing market. The labour market remains strong, and very low inflation (CPI of 1.3% in December 2019) is a boon to disposable income.

The progress of post Brexit trade talks this year, not only with the EU but also with the USA, Japan and other countries, will be important to the maintenance of this more positive outlook. One year ago, we wrote in our half year report that if the Government was able to negotiate its way out of the existing impasse, then we should see sterling rise, inflation fall further and consumer confidence rebound, all of which would be very positive for the share prices of UK domestic-facing companies. So far, all of this has come to pass. While we are clearly cognisant of the risks that still exist (both in the UK and globally), we feel much more confident about the outlook. We have significantly increased our exposure to domestic companies in the FTSE 250, and gearing at 31st December 2019 was 9.3%. Global investors are slowly revisiting the UK stockmarket, adding to the impetus, and while valuations have clearly risen from their lows, we still believe that the Mid Cap arena is not expensive and stands to benefit most from the changed political environment.

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Charles Luke and Iain Pyle, managers of Murray Income:

The UK equity market rose by 5.5% on a total return basis over the six month period. This completed a remarkably strong calendar year for the market with the index increasing by 19.2%. Despite worries around the impact of trade wars and protectionism resulting in anaemic global growth, political concerns regarding Brexit and a potential market-unfriendly Labour government, investors took comfort from the prospect of easier fiscal and monetary policy. In addition, the weakness of sterling in the first half of the year buoyed overseas earners and the strength of domestically-oriented companies in the last quarter of the calendar year provided a further fillip for the market.

Over the six month period in question at a sector level, the more defensive areas of the market such healthcare and utilities outperformed while the more economically sensitive areas such oil & gas and mining underperformed. The Mid Cap Index (with its greater exposure to domestic earnings) increased by 13.1% on a total return basis outperforming the FTSE 100 Index which increased by 2.7%.

UK GDP increased by 0.3% in the third quarter of 2019 and the first estimate for the fourth quarter of 2019 suggests flat growth. Although business investment and exports have been weak household consumption has remained robust. The result of the General Election should provide a greater degree of certainty and a number of surveys in the post-election period have confirmed an increase in confidence for both consumers and companies - we wait to see whether this will translate into an improvement in activity, remaining cognisant that downside risks include that trading arrangements remain uncertain and global growth is not particularly supportive. Throughout the period the Monetary Policy Committee (MPC) voted to maintain base rate at 0.75% although in December two members voted to reduce interest rates on the basis that the economy was softer than expected, core inflation remain subdued and employment growth had slowed. Since the period end the MPC has voted to maintain the base rate at 0.75%.

Overseas, recent data has suggested a stabilisation in the global economy helped by central banks loosening monetary policy and early signs of a thaw in the US-China trade war, as well as a reduction in the likelihood of a Brexit dislocation. Having cut interest rates three times during period, the US Federal Reserve has signalled that it has no plans to change rates during 2020. Although US consumer activity has remained robust helped by a solid labour market backdrop, manufacturing data, business investment and exports were weak over the period prompting the reduction in interest rates. Eurozone economic activity has also been weak with measures of industrial activity, business confidence and trade volumes depressed. The main emerging markets have demonstrated somewhat differing trends over the period with a slowdown in growth in China, despite efforts to stimulate the economy, and a similar picture in India with weakness in the consumer sector. In Brazil and Russia activity has stabilised following the slowdown earlier in the calendar year.

In the shorter term, the impact of the emerging coronavirus is uncertain. However, looking further forward, the United States' presidential election has the potential to offer the American electorate a broad spectrum of candidates with differing economic visions and will influence the future direction of US trade policy with China. For the UK, future trading relationships will be dependent on the outcome of negotiations with the US and EU but reaching agreements for these are likely to be fraught with difficulty. The new Chancellor of the Exchequer does have the option to stimulate the economy with a programme of fiscal easing and infrastructure spending which has the potential to provide a significant tailwind for future growth - the extent that he wishes to pursue this will become clearer in the Budget next month.

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Harry Nimmo, manager of Standard Life UK Smaller:

Several big uncertainties have been removed. Most importantly a government with a working majority creates more certainty as to the constitutional future of the UK and its relations with the European Union. The US and world economies look in better shape following Federal Reserve easing and some semblance of a rapprochement on trade between the USA and China.

The other unknown is the progress of the Coronavirus, the ultimate impact is as yet difficult to quantify.

The deadline for the negotiation on the actual terms of Britain's departure from the EU at the 31st December 2020 looks tight and could present a considerable challenge to negotiators.

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Arthur Copple, chairman of Temple Bar:

The current year has not started well for value investors, with January seeing a return of investors' appetite for momentum stocks. Time will tell whether this situation will continue for an extended period.

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North America

(compare North American funds **here**)

Tony Despirito, Franco Tapia and David Zhao, managers of Blackrock North American Income:

Review

For the year ended 31 October 2019, U.S. large cap stocks, as represented by the S&P 500 Index, advanced by 14.3% in US dollar terms. The S&P 500 Index concluded calendar year 2018 in a different manner than the previous nine calendar years, with negative returns. Throughout the majority of 2018, equity market optimism had been supported by broadly positive economic fundamentals and continued strength in corporate earnings. Equity market strength had persisted through the start of 2018, but a number of underlying factors contributed to a different experience through the final quarter of the year and the first two months of the company's financial year. While U.S. economic fundamentals continued to confirm the narrative of a healthy and expanding domestic economy, investors struggled to weigh a constructive economic environment against a growing list of headline risks. After broad-based sell-offs in October and December, stocks regained their footing at the start of 2019 before May and August presented a risk-off environment for U.S. equities. Although the U.S. equity market ended the calendar year having produced very strong returns, 2019 has not been the 'smooth ride' that investors experienced earlier in this cycle. Macro influences such as monetary, fiscal and trade policy have dominated recent financial news. We reject the short-termism embedded within the 24 hour news cycle and the resulting ebb and flow of investor sentiment. Our base case for 2020 remains unchanged and on track –

positive, albeit slowing, U.S. growth with the trajectory of corporate earnings being a key litmus test for the durability of this business cycle. We remain risk-on but believe higher valuations and an economic cycle approaching late stage argue for a focus on quality and selectivity in pursuit of portfolio resilience. Trade tensions and a looming U.S. election cycle are two factors we anticipate contributing to bouts of higher volatility in the months ahead.

Outlook

Our read on market fundamentals is a story in two parts. The U.S. consumer remains a bright spot. We expect the positive tone to continue: the household savings rate is well above the pre-crisis level seen in 2007 and jobs and wages are growing but not at an untenable pace. The industrial side, meanwhile, is showing hints of recession. Purchasing managers' indices are slowing globally, partly as a result of the trade war. North American industrial demand figures are softening, with some categories recording negative growth for the first time since the last industrial recession in 2015 to 2016. In hindsight, 2016 was a classic mid-cycle slowdown. Today shows many parallels and we believe stocks can grind on, supported by a strong U.S. consumer. We concede this time could be riskier, however, as the cycle is older and the economy has less slack to offer a buffer.

Our largest exposures are in the financials, health care and energy sectors.

Japan

(compare Japan funds here)

Norman Crighton, chairman of AVI Japan Opportunity:

Japan has a long and unenviable history of disappointing investors. Over three 'lost decades' global capital has repeatedly been deployed in the Japanese markets with the promise of revaluations that were going to be inevitable once the attractive valuations and opportunities were recognised. The performance of our portfolio since launch has been highly satisfactory so at the risk of sounding overly guarded, it is still worth injecting a word of caution: it is early days and any company's true accomplishments can only be measured across the medium to long-term. Change in Japan is arduous (as it is in any culture) and the timing of inflection points, together with the consequent outsized returns, is difficult to predict. However, it is our conviction that change - meaningful change - is in the wind in Japan: with the political will to apply pressure through the revised Stewardship and Governance Codes, and the increasing presence of shareholder-conscious institutional investors, a slow-but-sure shift is coming about in Japan Inc.'s attitude to corporate governance. Perhaps things really are different this time. The companies we invest in continue to operate attractive businesses and boast high and growing levels of cash and realisable securities, all the while trading at valuations not available in other developed markets today. The opportunity set remains rich and continues to hold out the offer of highly attractive risk-adjusted returns.

ESG

There has rightly been a marked increase in the attention paid to ESG factors in investments all over the world. I want to give an historical overview of how the ESG environment in Japan has developed to differ from the western world. Some of our portfolio companies are involved in activities that traditional ESG funds may seek to avoid. AJOT is not an ESG fund; the basis for making investment decisions is different.

However, no responsible citizen, whether private or corporate, can or should ignore the growing calls for everyone to work together for the benefit of all.

The history of caring for the environment in Japan is a long one, having its foundations in a deep-rooted cultural connection to nature. According to Shinto folklore, the islands that make up the nation owe their very existence to the ocean surrounding them, when the gods Izanami and Izanagi dipped their swords into the sea and the salty water droplets turned into land. Thus, when the air and water supplies suffered severe and tangible pollution during the period of rapid industrialisation in the 1950s, the Japanese people's response was visceral. The government was galvanised into crafting what now seems a very forward-looking framework placing heavy responsibilities on corporations not only to do no harm to the environment, but to take steps to improve it. The recycling of household waste has been commonplace for over twenty years, while as early as 1990, the business group Keidanren published detailed guidelines that required Japanese companies to review their activities from the viewpoint of reducing the burden on the environment and specifically integrating precautions and protections into their operations. More recently, the response to the nuclear accident in Fukushima in 2011 focussed the world's attention on an effective way to ensure that any damage to the environment is rectified immediately and those responsible be dealt with appropriately.

There is therefore a case to be made that Japan Inc. already benefits from high levels of corporate environmental awareness and responsibility. This is likely to take on increasing relevance to global investors as the interpretation of ESG develops over time. Even dedicated ESG funds are now starting to take a more nuanced approach - no longer just bluntly investing in businesses that are sustainable and avoiding others that cause harm - but also seeking out companies that perform traditionally harmful activities in innovative and less harmful ways, thereby starving the less responsible actors of investment. Under these criteria, the universe of companies that AJOT looks at is likely to outperform their non-Japanese counterparts.

In terms of benefits to society, Japan built its post-war prosperity on a slightly different model to the west, one that places a strong emphasis on societal advantage. Here again, history has a lesson to teach. During the Edo period (1603-1868) when the eponymous city, since renamed Tokyo, was the largest city in Asia and its most prosperous commercial hub, the merchants and traders coined a dictum: sanpo yoshi. Literally meaning "tripartite contentment", every transaction was thought to have three parties: the buyer, the seller and society. And only if all three parties were satisfied should any deal be concluded. Implicitly or explicitly, this is a dictum that has continued to be followed to this day. Lifetime employment, the paucity of opportunities for outsized personal enrichment, consensus-based decision making, seniority based pay - many of the components of what western commentators have seized on as the essence of what is considered the 'Japanese way' owe their origins to sanpo yoshi. This does not mean that Japan doesn't have more improvements to make - the slow progress on gender equality is a very visible failing.

Europe

(compare Europe funds **here**)

Alexander Darwall, manager of European Opportunities:

The MSCI World Index, sterling adjusted, improved by 10.6% during the period under review. The S&P 500 was the principal driver of this performance, rising by 12.6%, a reflection of the vibrant US economy. While trade disputes capture much attention, the US economy is performing well, exemplified by high employment levels, and 'onshoring' driven by deregulation and lower energy costs. US GDP grew at 2.4% in 2019, admittedly below the 'world' GDP growth forecast of 3.0% for 2019, but better than the European Union's 1.5%. Europe lacks the flexibility and low energy cost policies of the US. Further, its greater vulnerability to trade disputes is reflected in the German GDP growth number, estimated by the IMF at 0.5% in 2019. Indeed, the World Trade Organization (WTO) estimates that global trade in 2019 increased between 0.5% and 1.6%, a lower figure than global growth. Of this trade growth, the WTO estimates that Europe's growth is lower still. These challenges were reflected in European corporate earnings which, according to consensus industry forecasts, dipped in 2019; a rebound is expected in 2020. Interest rates in Europe remain at historically low levels. The ECB Main Refinancing rate is 0%; the benchmark 3-month Euribor rate was -0.401% at the period end, lower than a year earlier. The low interest rate policy (a consequence of Quantitative Easing) has had the effect of driving asset prices. It has also led to an increase in household debt, but the policy has not succeeded in driving fixed capital formation.

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Ollie Beckett and Rory Stokes, managers of TR European Growth:

Going into 2020 we had anticipated neither a global economic recession or a dynamic recovery, but instead a period of anaemic global growth. At the time of writing, the Coronavirus has created huge uncertainty for the global economy. Like everyone else, we are unsure how long the impact will last. It seems reasonably certain that the first half of the calendar year will be weak; understandably leading to ever lower bond yields and a flight to safety. If the health scare can be contained in the coming weeks, we might see a v-shaped recovery and a rapid reversal in market leadership. This would be helpful for the performance of European smaller companies as Europe remains heavily geared to global growth.

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Global emerging markets

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

Manager's report for Aberdeen Emerging Markets:

Market review

The year under review was a positive one for investors in emerging market equities, with the MSCI Emerging Markets Index gaining 10.3% in total return terms. Volatility was a regular feature, with three significant market retractions over the year as investors reacted to developments in the US-China trade war, weakening global economic data and the direction of monetary policy. While emerging markets outperformed developed markets for much of the year, the overall return was very similar, with the MSCI World Index up 11.2% over the period.

Asia was the best performing region, gaining 11.2% as China, India and Taiwan all delivered double digit returns. Chinese equities gained 11.4%, with market direction correlating closely with developments in the trade dispute with the US. After several false dawns, the outline of a "Phase One" deal was agreed in October 2019. China also benefitted from index provider MSCI's decision to increase the weighting of domestically traded A-Shares in local and regional indices during the period. Indian equities rose by 15.9%. The key event in that market was the general election, which saw the incumbent BJP deliver a resounding victory in May that helped the market shrug off a somewhat lacklustre economic outlook. Taiwan was a prime beneficiary of the improved news flow on the trade war in the final weeks of the period and a more optimistic demand outlook for the technology components sector which dominates that market.

The Europe, Middle East and Africa regional index rose by 9.7%. Russia was responsible for a significant part of that gain as its market appreciated by 32.5%, benefitting from its relative immunity from trade war concerns, depressed valuations and a sharp rally in Gazprom's share price after a surprise doubling of its dividend in May. Turkey endured a volatile year with domestic politics and concerns about the direction of monetary policy impacting the value of the Turkish Lira. The market declined sharply in the final month of the period following Turkey's incursion into Syria and the US imposition of sanctions in response, although it still posted a gain of 7.9% for the overall period. South African equities rose by 6.9% despite a weak economic picture amidst ongoing electricity outages and financial uncertainty at power utility Eskom.

Latin America was the weakest region, gaining just 6.3% despite a strong recovery in Brazil, the largest regional market, which rose by 11.7%. This was largely a consequence of a change in political direction as President Bolsonaro took office in January with a policy agenda pledging to tackle political corruption, clamp down on crime and deliver social security and tax reform. A significant pension reform bill was approved by the senate in October. Mexico delivered a return of 5.7% despite concerns about the policy direction under President López Obrador's administration and a somewhat testing relationship with the US over migration. Elsewhere in the region, Chile fell sharply in the final weeks of the year to post a return of -16.8% amidst a wave of anti-government protests over equality, pensions, healthcare and education. Argentina had an eventful year, rejoining the emerging markets index at the end of May (alongside Saudi Arabia) but falling sharply as opposition leader Alberto Fernandez's victory in October's presidential election led investors to fear that a return to left wing populist policies may be imminent. Over the year as a whole the Argentinian market declined 35.2%.

Outlook

Despite the emerging markets index posting a gain of 10.3%, the investment backdrop became more challenging over the course of the year with investors increasingly focused on concerns about the outlook for global growth and trade war uncertainties. Corporate earnings and economic growth forecasts across the emerging world were generally revised down as the period progressed.

While the global economy is weaker than historical averages, growth remains respectable, with the IMF, OECD and World Bank forecasting real growth in 2020 in the range of 2.8% to 3.4% and a generally improving trend through 2021. Although there are risks to these forecasts we feel they are reasonable given the accommodative stance of central banks and signs of a truce in the trade war between the US and China following the recent signing of the "Phase one" trade deal and, as a result, the US suspending previously announced tariff increases. China will significantly increase its purchase of US agricultural products over the next two years. China has also indicated that it will accelerate the opening of its financial sector. Nonetheless, we will need to watch the tone of further negotiations closely, particularly as the US presidential election campaign develops and candidates potentially vie to be "tough on China".

While 2019 was undoubtedly a poor year for corporate earnings in emerging markets, with persistent downward revisions throughout the period, the coming year may well offer a better environment. Consensus expectations of 15.1% growth for 2020 appear somewhat high but double digit growth may well be achievable if the economic outlook and trade war truce can be sustained. As for valuations, while emerging markets are not outstandingly cheap compared with their history, they are trading on undemanding multiples (12.2 times forward earnings at the time of writing) relative to developed markets as a whole.

Emerging market equity is an unloved asset class at present, held back by negative sentiment and low expectations. The average global investor remains significantly underweight and over the course of 2019 global and regional emerging market equity funds saw only modest inflows of US$4.1bn, much of which came in the final weeks of the year. Anecdotally, we see a withdrawal by investors from single country funds and those regions now deemed to be marginal when compared with Asia, which is perceived as the most defensive emerging market region. This has been to the detriment of frontier markets, Latin America and Eastern Europe. We believe the long term prospects in many of these markets are as good, if not better, than those of Asia. This is reflected in the company's current asset allocation.

A prerequisite for emerging markets to begin delivering relative outperformance of developed markets again is a weakening, or at least a consolidation, of the US dollar. The last year has shown tentative signs that this is possible, although these signs have not been sufficiently strong to prompt any meaningful rotation in investor allocations.

At the time of writing, investors remain focused on the developing Coronavirus situation to the exclusion of other factors. While the situation is still evolving, our expectation is that it will be short-lived and the effects of this unfortunate event will have no lasting impact on either economic activity or stock markets. We will of course continue to assess the situation as it develops and remain ready to act as necessary.

Manager’s report for Aberdeen Frontier Markets:

Market review

While the period under review was volatile for a small handful of markets in our investment universe, and the asset class continued to suffer ongoing withdrawals by international investors, there have been pockets of solid progress as well, and the majority of the portfolio continues to display good corporate earnings growth.

The MSCI Frontier Markets Index, which shareholders will remember is heavily skewed towards its largest country constituent, Kuwait (which, at the end of December, was a 37.9% weighting in the Index), achieved a 5.5% total return in US dollars, albeit this was largely attributable to the ongoing liquidity-driven bull market in Kuwaiti bank stocks in anticipation of the market's upgrade to Emerging Market status by MSCI at the end of this coming May. Without the support of Kuwait, the Index's return would have been much lower.

In terms of asset class fund flows, figures provided by EPFR Global indicate that the second half of 2019 witnessed slightly over 1.0bn US dollars of net outflows from dedicated frontier market equity funds. This follows an equally difficult first half, which delivered slightly under 1.0bn US dollars of net outflows. Thus, 2019 was the second worst year for frontier market equity fund flows since records began, only beaten by 2015's net outflow of 2.4bn US dollars.

An ongoing issue for frontier markets has been the reoccurrence of capital destructive idiosyncratic risk, a theme that again reared its ugly head in the period under review, this time in the form of spiralling risk in Argentina, which was then exacerbated by the evaporating investor confidence witnessed in Lebanon. Argentina's lurch back to Peronism briefly shook risk assets globally, but the impact was most felt in Argentina itself whose market suffered the second worst stock market collapse ever known - the S&P MERVAL Index lost 48.3% in US dollar terms on 12 August 2019. The new government has since re-introduced exchange controls and commenced talks with the IMF to restructure the largest loan programme in the IMF's history. Lebanon's descent into the economic quagmire was less spectacular, but nonetheless costly, with the MSCI Lebanon Index losing 45.9% in US dollar terms over the course of last year. Lebanon is now struggling to form a new government whose primary purpose will be to tackle the fiscal deficit and stabilise the country's public debt.

It is nonetheless noteworthy that both the asset class and the portfolio delivered positive returns last year despite these pockets of volatility. Frontier markets' intrinsic diversification, as well as low intra-market correlations, meant heightened volatility in Argentina and Lebanon was largely contained to those markets. Meanwhile, other jurisdictions, such as Kenya and Pakistan, enjoyed a substantial improvement in economic prospects as well as investor sentiment.

With regard to Pakistan, the market seemed to have turned a corner in August, following the central bank's implementation of a market-driven exchange rate policy. This was a condition stipulated under the terms of the lending programme agreed by the IMF in June 2019. The outcome of this, as well as supporting policy moves on the fiscal side, have so far exceeded expectations, and underscored the credibility of Pakistan's recently appointed economic policymakers. The rupee's final downward adjustment in June, backed by aggressive hikes of the central bank's policy rate to 13.25%, cemented a severe but necessary contraction of imports that resulted in a 73% year-on-year decline of the current account deficit during the first five months of the local fiscal year to June 2020. Policy credibility has been restored, in our view, which is indicated by a dramatic influx of foreign investment into local currency treasury bills; approximately US$2.0bn in the second half of 2019 alone. With the sovereign bond yield now on a downward trajectory, local investors have piled back into the equity market, driving a 27.9% positive return in US dollar terms during the period. We expect foreign investors will return to the equity market in due course, supporting further market appreciation.

Egypt has also achieved a more balanced growth trajectory, with a serious economic reform programme underpinned by funding from the IMF. Real GDP growth is expected to accelerate to 5.9% in 2020, driven by falling inflation, easing monetary policy, rising real incomes and expansion of consumption. Steady growth of remittances and rising domestic gas production, as well as a recovery in tourism, have kept the current account in balance and in conjunction with still elevated interest rates have supported a steady appreciation of the Egyptian pound. The corporate earnings cycle is yet to fully play out in Egypt but we believe it will do so over the next two to three years.

Turning to Vietnam, the economy continues to chart a steady course despite the global trade headwinds, benefiting from large scale foreign direct investment (FDI) into manufacturing and assembly. Indeed Vietnam has been a beneficiary of US-China trade tensions as manufacturers look for geographic diversification of their supply chains. That said, management of the Vietnamese dong will remain a balancing act for policy-makers, as the country will want to minimise appreciation against the US dollar given regional competitiveness concerns, whilst cognisant of too much depreciation given the USA's sensitivity to this. FDI (which reached US$20.4bn in 2019) and private consumption (which registered +11.8% year-on-year in 2019) should continue to support economic expansion, which is projected at 6.5% in 2020 by the IMF.

Outlook

Vietnam, Pakistan and Egypt are particularly well positioned today from a cyclical perspective, buttressed by credible and orthodox policymaking as well as loosening monetary policy in the western world.

While investor confidence in the asset class has taken a knock, and institutional appetite remains subdued, economic and political progress on the ground remains plain to see in the vast majority of our markets as we witness on our regular country visits, and the corporate earnings backdrop is generally very supportive.

The switch in US Federal Reserve policy from tightening to easing reflects late cycle concerns about the US economic cycle, and in normal circumstances this should herald an uptick of investor interest in riskier asset classes, of which frontier markets is perceived to be one. Indeed, at the very least, monetary easing should cap strength in the US dollar and allow frontier market central banks breathing space to moderate their own interest rates if they feel appropriate. All this should be supportive of our asset class over the coming months.

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Hélène Ploix, chair of Genesis Emerging Markets:

While the recent Coronavirus outbreak in China has introduced heightened levels of volatility and uncertainty in markets, we remain optimistic on the longer-term outlook for Emerging Markets.

We expect continued growth from rising working age populations in Emerging Markets, and continuing convergence with higher income countries. We also remain of the view that Emerging Market equities are less efficiently priced than their Developed Markets counterparts

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Manager's report for Gulf Investment Fund:

GCC Budget and Economic Outlook 2020

Economic growth in the GCC slowed in 2019 with aggregate growth projected at 0.7 per cent, down significantly from 2.0 per cent in 2018. A subdued Oil sector (-1.4 per cent) was the major contributor to this fall amid restricted oil production activity in line with the OPEC+ agreement. However, the non-oil sector continued to report steady growth, signalling the continued results of diversification initiatives.

Overall GCC growth in 2020 is expected to rebound to 2.5 per cent, primarily driven by recovery in oil sector on rising oil and gas output. Oil Real GDP is expected to grow 1.9 per cent in 2020. Meanwhile, the non-oil sector is expected to report growth of 2.8 percent in 2020, up from 2.4 per cent in 2019. Kuwait and the UAE will receive boosts in tourism from their respective Expo 2020. Qatar will continue its preparations towards hosting the 2022 World Cup.

Moreover, recent improvements by GCC nations in the World Bank's Ease of Doing Business ranking confirm that continued efforts towards structural reform are being effectively implemented. Saudi Arabia, Bahrain and Kuwait ranked among top 10 global improvers in the World Bank's assessment. Separately, most GCC economies have cut their interest rates in line with the Fed' rate policy in 2H19. This should support business activity and assist in lowering debt servicing costs.

Saudi Arabia approved a US$272.0bn budget for 2020, marginally lower than the expected expenditure of 2019. This budget underlines the significance of the economic transformation being sought with the nation's National Vision 2030. Government revenues are estimated at US$222.1bn and the budget deficit is US$50bn or 6.5 per cent of GDP. Actual spending for 2019 is expected to reach US$279bn, and the total actual government revenue is anticipated to be US$245bn, with a deficit of US$35bn or 4.7 per cent of the GDP.

Qatar announced its 2020 budget with spending at US$57.8bn, the largest in the last five years. Major projects have received the largest share (43 per cent), reflecting the country's commitment to complete projects in sectors including healthcare, education, and transportation, as well as those related to the hosting of the FIFA World Cup in 2022. Government revenue for 2020 is projected at US$58.0bn based on an assumed oil price of US$55/barrel generating a surplus of US$137m.

The UAE Cabinet approved a balanced budget of US$16.7bn for the 2020 year, which is 1.8 per cent higher than in 2019 and the nation's highest on record. The Dubai government has also announced an expansionary budget for 2020 with the largest ever spending at US$18.1bn. The budget aims to make Dubai one of the most livable counties in the world by focusing on key sectors such as social services, health, education, and housing.

Kuwait has charted a budget of US$74.5bn for the fiscal year starting April 2020, unchanged over current year. Revenues are estimated at US$49.0bn, 6.5 per cent lower than estimated revenues for current year. The budget assumes an oil price of US$55 a barrel and expected to report a deficit of US$25.5bn (before deducting the sovereign wealth fund's share).

Oman has announced a budget of US$34.3bn for 2020, an increase of 2.3 per cent over 2019. Revenue for 2020 is projected at US$27.8bn, predicated on an oil price assumption of US$58/barrel, resulting in a deficit of US$6.5bn, 10.7 per cent lower than 2019.

GCC Economic Update 2H19

Saudi Arabia PMI fell to 56.9 in December but persisted steadily over 50 indicating MoM improvement in non-oil private activity. Saudi unemployment continued to trend down, with the rate falling from 12.3 per cent in 2Q19 to 12 per cent in 3Q19, the fifth consecutive quarterly improvement.

Saudi Arabia decided to waive fees on expatriate workers borne by companies in the industrial sector, after businesses voiced concern over higher operating costs, though fees on expatriate dependents will continue. Moreover, Saudi Arabia is expected to end the use of expatriate workers in its hospitality sector by year-end.

Qatari authorities revealed that North Field gas has almost double the reserves than its earlier estimates (as large as 1,760 tcf). As a result, Qatar is planning to build two more LNG mega trains by 2027, which would boost LNG output by 64 per cent to 126m tonnes.

The UAE and China signed a series of strategic agreements in a bid to strengthen economic ties. The agreements included a partnership between the Abu Dhabi National Oil Company (ADNOC) and China National Offshore Oil Company (CNOOC) in relation to upstream exploration and development, oil refining and LNG trade.

The UAE will start applying excise tax of 100 per cent and 50 per cent on electronic smoking products and sweetened drinks respectively, starting January 2020.

Dubai's government issued 38,377 new business licenses in 2019, up 90 per cent YoY. Government's decision to allow 100 per cent foreign ownership in certain sectors aided the increase in new business licenses. Moreover, the emirates preparations ahead of the Expo 2020 have attracted companies in the sectors like Hospitality and Logistic & Supply chain.

This highlight Dubai's economic competitiveness and its ability to attract investors to grow and expand their businesses.

Abu Dhabi issued US$10bn in bonds, the first issuance in two years, which took advantage of low rates.

Bahrain marked its return to the international debt markets during the period, raising US$2bn from a US$1bn sukuk due in 2027 with a yield of 4.5 per cent and a US$1bn conventional bond maturing in 2031 at 5.625 per cent.

S&P updated Bahrain's rating outlook to positive from stable, on account of the country's progress on its fiscal consolidation program. Although the sovereign is rated non-investment grade (B+), the upgrade in outlook should boost investor confidence.

Outlook

The IMF expects growth in the region rise to 2.5 per cent in 2020, up from 0.7 per cent in 2019. Gradual recovery in oil prices and continued infrastructure spending will likely boost economic activity in the medium term. Rising oil output in Kuwait and Saudi Arabia, and gas output in Qatar and Oman, should support growth in the hydrocarbon sector.

With large investments anticipated over the next few years, the manager expects to see increasing opportunities in banking, infrastructure and industrials. The oil price remains a key risk. Further decreases in oil prices would lead to GCC governments limiting spending. Despite this, the Investment Adviser remains optimistic on the regional growth prospects, buoyed by planned infrastructure projects and positive momentum in economic and social reforms.

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Maria Luisa Cicognani, chair of Mobius:

At the time of writing the world is dealing with the outbreak of the Coronavirus. This episode is a reminder of how volatile the global investment climate can turn over night. Notwithstanding these circumstances the economic backdrop has improved and I believe we might be at a turning point for Emerging Markets. The IMF in its latest forecast has predicted growth for emerging and developing economies to remain high at 4.4% in 2020 (vs. 2% for the US and 1.3% for Europe), China and the US have signed a phase one trade deal, the US Federal Reserve seems committed to low interest rates and investors are returning to emerging markets. In a 2019 survey of 200 asset owners conducted by State Street Global Advisors, 75% of respondents were expecting their institutions to increase their allocation to emerging market equities over the next two years.

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Private equity

(compare private equity funds **here**)

Manager’s report for Pantheon:

High entry valuations

As with all equity investments, valuations are high in private equity, across all developed markets. We believe that we are unlikely to see a material and sustained re-rating in valuation multiples outside of a broader economic downturn.

Our managers are responding to this and mitigating valuation multiples by employing buy-and-build strategies, implementing operational improvements to maximise the growth potential in the underlying businesses and specialising in more complex transactions for which many strategic buyers may not have the expertise or resources.

Rising debt levels

Leverage levels are high in private equity, however the risk may be reduced by better affordability and lighter covenants, which allow GPs some flexibility if companies underperform. In addition, many of our managers have learned the lessons from the Global Financial Crisis and many GPs have in-house debt teams to ensure that they are taking a disciplined, consistent approach across the portfolio, and making the best use of the leverage available to them.

Primary market

Towards the end of 2019, global fundraising was back to record levels mainly driven by large buyout funds. New deal activity has continued to be strong with both the number and value of deals steadily increasing over time across all investment stages.

The amount of dry powder (capital raised and available to invest but not yet deployed) has increased, however new investment appears to be keeping pace with fundraising, resulting in a ratio of deal activity to dry powder that has been steady over the past few years. Although dry powder continues to grow, it is dominated by the large and mega buyout segment of the market.

Pantheon focuses more on the small/ mid-market buyout segment, where we frequently see more reasonable entry valuations, greater growth potential in the underlying businesses and more routes to exit. Our small/mid-market buyout managers may choose to sell assets to larger managers, who can then take those businesses forward into their next stages of development.

Secondary market

While still relatively small as a proportion of the overall global private equity market, the secondary market is becoming more established, and 2019 was another record year with total volume transacted of US$88 bn1, an increase of 19% from 2018.

The sources of deal flow continue to be broadly diversified due to:

- Institutional investors adjusting their portfolios and using the secondary market as a portfolio management tool
- The growing number of "manager-led" transactions and, within this, single-asset deals now taking up a larger portion of the overall secondaries market.

When structured properly, manager-led deals have the potential to benefit all stakeholders. Experienced secondary markets investors such as Pantheon seek to understand the motivation of the private equity manager to realise certain assets, aiming to invest in good assets, and avoiding problem companies that the manager is finding hard to sell.

The scale of transactions has expanded while pricing has fallen slightly, perhaps driven by a higher proportion of older vintage funds with less upside potential coming to the market as well as being a sign of decreased risk appetite.

Debt

(compare debt funds **here**)

Reuben Jeffery, III, chairman of Riverstone Credit Opportunities Income:

Over the past five years, the energy industry has faced one of most severe and prolonged downturns in recent history due to sharp declines and volatility in commodity prices. This macro environment has considerably impacted the traditional bank lending market as well as the capital markets, which have become virtually inaccessible to energy-related companies. Public debt issuance in 2019 was at the lowest level seen

in several years despite an over $20bn offering completed by Occidental to fund its acquisition of Anadarko, while public equity issuance was at the lowest volumes experienced in two decades. Even though companies of all sizes have been affected by these difficult conditions, small to middle-market energy issuers have faced an especially pronounced tightening of capital availability. This dynamic has proven to be particularly challenging for these companies due to the high capital requirements to fund growth and support cash flow generation.

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Biotech and healthcare

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

Randeep Grewal, chairman of BB Healthcare:

As I write this the newspaper headlines are filled with coverage of the coronavirus (2019-nCoV). Even a couple of months ago it would have been hard to predict such an outbreak was imminent. Secondly, and tragically, it also reminds us of the ever-pressing need for healthcare and thirdly that healthcare has to continuously evolve to face new challenges.

Having acknowledged the futility of prognostication I will observe that sentiment and attention of markets and the media swing rapidly and sometimes unpredictability. Historically the fourth year of a US Presidential cycle has brought a lot of attention to bear on healthcare. However, in this cycle, 2019 (i.e. the third year of the cycle) seems to have generated focus on healthcare in the US. The results of these swings in attention is that valuations can move faster than the actual economic outlook of companies change. This can provide both opportunity and frustration.

We shall see if 2020 leads to even more discussion and debate on this topic or if the debate moves elsewhere.

Over the longer term however my view, and that of the company, remains unchanged - that healthcare demand will continue, and that innovation and disruption will create opportunities for investors.

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Paul Major and Brett Darke, managers of BB Healthcare:

At the time of writing, (late January, 2020), the trading environment for healthcare stocks has remained broadly positive as the early comments on Q4 trading have been in line and the "M4A" debate in the US continues to recede in the minds of investors as a credible threat to the status quo. US/china trade & wider macro. 2020 is a US Presidential election year and we are in no doubt that the macro-political noise level will remain high.

We classify healthcare investments into 16 different categories. Note: these are not the same as the GICS classification system used by MSCI and, sometimes, we re-classify stocks into different categories based on payor dynamics or similarity to peers. In order to provide Shareholders with some additional insights into our current thinking, we have summarised our high-level thoughts on the outlook by sub-sector in the following paragraphs:

- Biotechnology: having delivered stellar returns in 2017 and the first nine months of 2018, the US Biotech sector latterly struggled to deliver comparable returns to the rest of healthcare and has underperformed over the period since the inception of the company. As we have noted before, this feels rather against the run of success that the industry has demonstrated at a fundamental level; compelling innovations are far from scarce.

Concerns over drug pricing legislation and action to ease biosimilar entry seems to have been the main fear factors (arguably median pricing per treatment is significantly higher in this group) and this had receded somewhat. More importantly, M&A came back as a significant force at the end of 2019 and the pharma industry remains underweight new products to sustain growth.

One should never rely on extraneous factors like bid speculation to drive returns and it would not be unfair to suggest there may be some shorter-term sentiment setback if the M&A momentum is not sustained in the coming months. Coming back to fundamentals, there are many interesting trial read-outs, filing and approval decisions, we expect a more positive outlook in 2020 than 2019, but we also thought that last year and it proved misplaced.

- Conglomerates and pharmaceuticals: we have combined our comments on these two categories since investing in these sorts of companies is generally antithetical to our strategy. Nonetheless, they account for a material proportion of the MSCI Index and are thus very important for sentiment to wider healthcare. We see several overhangs to sentiment that might improve. For some companies such as Bayer and J&J, resolution of legal overhangs is probably the critical issue for improved sentiment.

  Thinking about large-cap pharmaceuticals more widely, the picture is more challenging. Firstly, let us lay out our long-term view: the split of therapeutics companies into pharma, biotech and specialty pharma feels rather arbitrary and backward looking. Generally speaking, most innovative drugs would classify as (and indeed originate from) biotechnology or specialty pharma, making pharma more of a legacy grouping of leviathans from another age, whose crapulous appetite for M&A and woeful R&D returns tell of a failed strategy kept alive by prodigious cashflows.

  The contrast in investor sentiment versus biotech over the past year is surely all the more notable in light of these contrasting fundamentals. Will the pendulum swing back, or will the safe haven of those well-defended cashflows remain alluring in an uncertain world? Generally we only like to invest in big pharma when valuation is very compelling and that still remains the case for Bristol-Myers (which, post completion of the Celgene deal is arguably more akin to a large-cap Biotech than a classical pharma stock in any event). A tough one to call, but we would think US pharma outpaces premium-valued European pharma over the year, especially as the ability of the current administration to pass legislation that has a material impact on the drug pricing environment is looking limited. This issue may well return to the fore after the election but the make up of Congress will be critical. Anything close to the status quo argues against legislation coming to fruition.

- Dental: everyone has teeth and they are invariably wonky. As such, orthodontics has very compelling long-term supply and demand characteristics. Within this, we continue to expect clear aligners to take market share from traditional wires and brackets and for Align Technology to remain at the forefront of this market evolution.

  Align experienced significant falls in Q4 2018 and Q3 2019. In both cases, the stock largely recovered within a few months. We saw both situations as more of a misunderstanding of the business than reflective of real issues (as the recovery attests) but we are chastened by the experience and more mindful of covering off event risk into reporting periods. That said, we see this investment as a core long-term opportunity.

- Diagnostics: this is one of our largest sub-sector exposures heading into 2020 and with good reason. The patient journey through the healthcare system begins with diagnosis and preventative health programs are predicated on screening. Better understanding of a problem is the first step to a solution and the tremendous improvements in diagnostic power (driven as much by computational factors as better chemistry and genetic knowledge) offer huge opportunities.

Our exposures cover a wide gamut from near patient testing to long-term monitoring and human genetics programmes. Despite the obvious growth potential, we also see significant value opportunities with some of our holdings, which are trading significantly below peer group averages. Our high weighting reflects our conviction and enthusiasm for this sector.

- Distributors: investment returns from this sub-sector probably depend more on the resolution of litigation and legislative overhangs around drug pricing and the US opioid crisis than it does on actual fundamental business performance. On the latter, the situation is probably looking better as generic drug pricing has stabilised versus recent years.

  Hopefully the market is now over its Amazon/Pill pack paranoia, allowing investors to ascribe a higher fundamental price/earnings; this low-margin, infrastructure-heavy industry will not be an easy marketplace to disrupt. However, since we cannot have any edge on the former points, we will continue to eschew this sub-sector.

- Facilities: we think hospital operators in developed markets are likely to continue to struggle at an operational level. The simple reality is that medical treatment is changing profoundly, and the infrastructure needed to deliver this care will change with it. As such, a typical operator is heavily exposed to debt and out-of-date infrastructure (think of a telephone exchange in late 1990s - for those under 40, Wikipedia can explain to you what a telephone exchange was). We have made an active decision to own the agents of change rather than the customers of that change.

  The notable exception is in developing countries rolling out national healthcare schemes (e.g. Asia and the MENA region). Here, the infrastructure is de-novo and the rising utilisation trend a clear positive. We are happy to own operators focused on these high growth markets.

- Generics: this has been a tricky sub-sector to navigate for a number of years and we do not see that changing in 2020. A confluence of factors (negative pricing, litigation, over-capacity, pro-domestic policy in China) weigh on the growth outlook. In the midst of all this, determining the right valuation becomes challenging and thus we are happy to remain on the sidelines.

- Healthcare IT: this is a sub-sector where we think the interesting stuff is outside the benchmark, which is dominated by Cerner and Veeva. We continue to see myriad opportunities in this area: healthcare is a veritable data treasure trove and, as much as we all like to think that we are special and unique, an actuarial analysis of your medical history and lifestyle can be highly predictive of potential future medical issues.

  These datasets will only become more powerful as the amount of familial genetic data available online increases. Preventative "population health" initiatives can be driven by these datasets, prompting early interventions in the highest risk member of society, thus lowering acute medical costs over the longer-term. Big Brother is watching, and he might just save your life.

- Healthcare Technology: if there was one segment of the market where we would like to have more exposure than we do, it is healthcare technology, which we describe as the application of continuous monitoring and algorithms to deliver improved care outcomes. Most of the opportunities are currently in the cardio-metabolic area.

  Sadly, the combination of limited listed options, tremendous potential and rapid visible growth has led to crowded longs and stretched valuations. It is hard to justify anything trading on double-digit revenue multiples. We will look to be more constructive in the event of a pull-back, but the momentum is definitely with this sector for those happy to ignore valuation.

- Managed Care: health insurers were in the eye of the storm in 2019 as the 'Medicare for All' debate took centre stage. Q4 2019 saw a significant recovery as the probability of the harshest iterations of this idea faded away. Nonetheless, investors are still nervous and valuations could rise further as the Primary campaigns progress (through a further row-back from Warren or more centrist candidates like Biden, Bloomberg or Buttigieg storming ahead). We have thus entered the year with considerable managed care overweight versus the benchmark, but this will likely decline if the sector continues its positive re-rating.
- Medical Technology: it is difficult to reduce such a broad swathe of companies to a few paragraphs of commentary. We are currently biased toward durable equipment vs. consumables, resonating with our views on the facilities sector described above (akin to re-tooling a factory for new production processes).

  Generally speaking, valuations are also less demanding at this end of continuum as well, especially versus the higher-technology end of consumer med-tech that better resonates with our wider investment approach than commoditised items such as large joint orthopaedics. We prefer more focused operators and generally see our exposure declining given overall valuation levels looking stretched, although we would likely be very active in the event of a market pullback.
- Animal Health/Other: we will not opine on this grouping as our investment mandate is around improving human health rather than animal health (eloquently described recently by someone as a "no pot, no pets" approach; there are now three Canadian-listed "medical marijuana" companies in the MSCI World Healthcare Index. We classify these into specialty pharma).
- Services: we expect to increase our exposure to the services space, around our wider theme of the 'democratisation of innovation'. If one accepts the previously posited paradigm that big pharma is woeful at R&D, the future belongs to smart PhD students who can turn their idea into a clinical stage programme (which pharma will then license or buy for a tidy sum).

  There is now an army of service providers to help with clinical trial design and management, animal disease models, contract manufacturing, sales and market support and so on. The volume growth opportunity for these service providers to the next wave of drug discovery innovators looks very positive, irrespective of the macro-political outlook.
- Speciality Pharma: this accounts for our largest exposure, alongside Diagnostics and is the reciprocal of the aforementioned bearishness on pharma. Therapeutics, in their various forms, account for roughly half the index's value in market capitalisation terms. With so much scientific innovation to come (the proportion of human diseases with known pathways but without drugs or with poorly effective treatments remains very high); the question is not 'should one invest in therapeutics' but rather 'how do I best invest in therapeutics'.

  For us, the approach is to concentrate on smaller, focused companies with clearly defined products or technologies that are not reliant upon presumed future R&D success beyond the visible late stage pipeline to justify valuation upside. Our increased weighting toward speciality pharma reflects the pivot away from Med-Tech as valuations have become more challenging and the corollary of opportunities thrown up by the previously discussed uncertainties overhanging biotech.

- Tools: this sub-sector covers laboratory equipment used in research and testing. We eschewed tools for most of the first three years of the company's life, feeling that longer-term growth expectations were on the high side. This was probably an overly cautious view, but our general sense is that the outlook is now more reasonable moving forward and we have made our first foray into this area. We may well increase our exposure further if we think valuation is supportive. However, as with the Healthcare Technology sub-sector, we are not willing to compromise on our longer-term return objectives or take on increased risk just to broaden our exposures.

Renewable energy infrastructure

(compare renewable energy infrastructure funds here)

John Rennocks, chairman of Bluefield Solar:

Power Prices

Whilst power prices reached six year highs of £67/MWh in September 2018, the period to December 2019 has seen prices fall close to 10 year lows, at £39/MWh. The driving force behind this reduction in day ahead power prices and short term forecasts is considered to be the oversupply of liquified natural gas, which in turn has led to falling gas prices.

However, as the company was able to use its flexible PPA strategy to take advantage of strong power prices in September 2018, striking fixes for over two years on the majority of its portfolio, the average price achieved per MWh for the period to 31 December 2019, at £56/MWh, was considerably higher than both the average day ahead base load price of £41/MWh and the average price for the period to December 2018 (being £46/MWh).

Longer term forecasts have once again been lowered; the last increase in medium term forecast prices was in the curves released in December 2016, reflecting prices which are now more than 30% below expectations at the company's 2013 IPO, as falling gas prices in the near term have combined with expectations of increased renewable generation post-2030.

As the depth of available forecast data deepens and the assumptions around renewable penetration increase, the company took the decision in H1 2019 to subscribe, on a 12 month trial basis, to a third power price forecaster. Over this period the company has been impressed with the quality of information received and so intends to blend this third power price curve into future Directors' Valuation alongside, or perhaps as a replacement of, one of its existing forecasters.

Non-Subsidised Opportunities

The last six months has seen the emergence of a number of unsubsidised solar farms being constructed. Whilst the total capacity of these sites is small, it is likely that 2020 will see solar deployment gathering momentum.

Tim Ingram, chairman of Greencoat UK Wind:

In 2013, when the company first listed, 7 per cent of the UK's electricity demand was supplied by wind energy. By 2019, this figure has increased to 20 per cent. Wind continues to be the most mature and widely deployed renewable energy technology in the UK. In June 2019, the UK parliament adopted a net zero emissions target for 2050, going further than previous legislation, which mandated 80 per cent emission reductions by 2050. Decarbonisation of the electricity sector, primarily through renewable generation, will be critical to achieving this.

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Manager's report for Greencoat UK Wind:

There are currently 23GW of operating UK wind farms (14GW onshore plus 9GW offshore). In monetary terms, the secondary market for operating UK wind farms is approximately £60bn. The Group currently has a market share of approximately 4 per cent. As at 31 December 2019, the average age of the portfolio was 5.3 years (versus 4.9 years at listing in March 2013).

In June 2019, the UK parliament adopted a net zero emissions target for 2050, going further than previous legislation, which mandated 80 per cent emission reductions by 2050. Decarbonisation of the electricity sector, primarily through renewable generation, will be critical to achieving this. The target is for 30GW of offshore wind capacity by 2030, supported by the CFD regime. We are also now seeing the development and construction of onshore wind farms on a subsidy free basis. We do not expect any material change to the company's business as a result of the UK exiting the European Union.

The key value driver affecting operating UK wind farms is the wholesale power price. In general, independent forecasters expect the UK wholesale power price to rise in real terms, driven by higher gas and carbon prices.

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Manager's report for Renewables Infrastructure Group:

Emissions Reduction Targets and Climate Change

Action on climate change is becoming increasingly embedded within the political agenda. Europe has essentially achieved its 20% greenhouse emissions reduction target for 2020 but, notwithstanding the increasing volumes of renewable energy being deployed (renewables now accounts for almost a third of all electricity generated in the EU), significant additional policy initiatives across the entire energy sector will be needed if it is to meet its current binding 2030 targets of a 40% cut in greenhouse gas emissions and 32% share of renewables of total energy consumption (i.e. all sectors, not just power) and 80% by 2050.

Under the comprehensive proposed European Green Deal announced in December 2019, the European Commission plans to increase these 2030 targets, with the greenhouse gas emissions reduction target for 2030 increasing from 40% to a proposed level of 50-55% and a new law enshrining a commitment to net zero carbon emissions for 2050.

The UK government has already set in law a target to reach net zero emissions by 2050, a bigger cut in emissions than the 80% target legislated in the Climate Change Act of 2008, although not the route to achieving this. Were this even more stringent target to be achieved globally, the UK government's advisory Committee on Climate Change estimates that there would then be a 50-50 chance of staying below the recommended 1.5°C temperature rise by 2100.

Power Prices and the Impact of Renewables

Given the critical importance of reducing emissions, estimates for additional renewables capacity across Europe have consistently increased over the past few years. Renewables has minimal marginal cost, impacting the base load price if more expensive marginal generation is not required in any period. There have been instances of negative power prices for short periods in some European power markets where the mismatch between generation and demand has been most significant. The increases in expected renewables deployment has had a dampening effect on power price forecasts, as renewables are expected to set the power price more than previously expected over the long term.

These increased expectations may also have an impact on the specific achieved power prices for renewable energy assets, to the extent that favourable weather conditions result in excess power production compared to power demand - a "cannibalisation" effect - notwithstanding the introduction of increasingly smart ways of using, storing and transporting power to better match with generation, which is expected to mitigate this effect.

Allowances are made in the power price forecasts used by TRIG for reductions in the base load prices where renewables set the marginal price more often and for the cannibalisation effect, reducing the captured prices beneath that which would be expected for a base load (i.e. "24/7") generator. Such allowances increase over time in keeping with power price forecasters' assumptions for renewables deployment. Investors should note that these factors do increase the complexity associated with power price forecasting (alongside other assumptions such as gas and carbon pricing and electricity demand) and that significantly accelerated or deeper renewables build-out scenarios may represent downside risks on power prices.

Solutions for Integrating Renewables

As renewables penetration increases, solving the problem of integrating large proportions of intermittent renewable energy into the grid is likely to be achieved via a variety of ways. Energy storage is set to play a key role, and as costs continue to decline, revenues from "load shifting", frequency response services and capacity markets is strengthening the economic case for battery storage provision. Part of the solution will also come from power users who will be incentivised to use power when it is available through more favourable pricing. Such intelligent use of energy, known as Demand Side Response, or "DSR", can help soften peak demand and fill-in troughs to respond to when power is most abundant, affordable and clean. This enables the grid to better integrate high levels of renewable output by making the demand on the grid more flexible. In the UK, currently the amount of dedicated DSR capacity the National Grid can call on is approximately 3GW, compared to a UK peak demand of c.60GW. Growth in DSR and the scale adoption of electric vehicles can significantly aid the transition to a lower carbon future by mitigating the intermittency of the renewables generation.

Where carbon intensive sources, such as natural gas, continue to be used as is likely for flexible generation and for heating and industrial processes, including the use of hydrogen that is produced through a process requiring natural gas, emissions will need to be mitigated through carbon capture and storage. Grid upgrades and in particular the build out of interconnectors joining markets (e.g. GB to Norway and GB to France) will also increase the respective grids ability to provide more consistent levels of power from intermittent resources by reducing dependency on localised weather conditions.

Increased Electrification

Due to the relative ease of decarbonising electricity compared to fossil fuels, used for example in heating and transportation, the electrification of energy usage will have a central role in delivering a decarbonised future.

Electricity is expected to be increasingly used to power vehicles. For example, in the UK, the National Grid Future Energy Scenarios, which forecasts the long-term energy demand in the UK, suggests that around 35m pure electric vehicles could be on the road by 2050, with a rapid acceleration in deployment between 2030 and 2040 as the ban approaches and electric vehicle costs drop. Since this forecast was prepared, the government has brought forward its target of ending the sales of new petrol, diesel and hybrid cars to 2035 (previously 2040).

Electrifying vehicles has potential benefits for the renewables sector, increasing electricity demand but also smoothing electricity usage through the hours of the day and providing a source of electricity storage. Smart charging and vehicle-to-grid technologies are expected to be able to store electricity during peak renewables production times and feed power back to the grid during peak hours. This has the potential to help balance electricity demand and stabilise prices

A further source of increased electricity demand is expected to arise from space heating. Currently much of Europe uses natural gas for space heating, which leads to carbon emissions. One solution to reduce the carbon footprint of heating is to use clean hydrogen that can then either be blended with natural gas to heat spaces or be burned alone as a clean fuel. The cleanest way to produce this hydrogen would be to use the electrolysis (utilising electricity from renewable sources), which would then be used for heating. Furthermore, forecasters expect increased use of electric heat pumps (already used in Germany, France, Italy and Spain) across Europe.

The extent to which electrification is increased beyond current expectations, through demand from new sectors such as space heating and transport, may provide support to long-term power prices.

United Kingdom & Ireland

There have been significant developments relevant to the renewable sector in the UK in 2019. Under the prior Conservative government, the UK became the first country in the world to set a net-zero emissions target for 2050. This target was then confirmed in the Conservative party manifesto prior to the election victory for Prime Minister Boris Johnson. The new UK government's policies include a commitment to 40GWs of installed offshore wind capacity by 2030, continued support for new nuclear and a ban on new internal combustion engine vehicles by 2030.

The year also saw over 5GW of offshore wind capacity procured through the contract-for-difference auction mechanism at lower than expected clearing prices of £39-£42/MWh in 2012 terms (equivalent to around the £46-£50/MWh today), although it should be noted that these are still to be financed and built. There was no appreciable onshore wind or solar deployment. In Ireland, the government approved the first auction under its Renewable Energy Support Scheme (RESS) with the longer-term goal of reaching 70% renewable electricity by 2030.

With a relatively stable political outlook, notwithstanding Brexit, renewables policy looks set to continue to be favourable. Key questions remain around future UK carbon pricing policy and membership of the EU's internal energy market, as well as any future referendum on Scottish independence and any impact this could have on local energy policy and liability for existing subsidies.

France

Offshore wind progressed significantly in France in 2019, though still a nascent market compared to the UK and Germany, with supportive subsidy policies for onshore wind and solar remaining largely unchanged. In October 2019, a law was passed by the French parliament requiring an increase in the capacity of offshore wind tenders to an average of 1GW a year to 2024.

With significant low carbon generation, through hydro power and nuclear generation, France's renewables agenda (113GW by 2028 from c.50GW today) will largely be driven by the plan to close four to six nuclear reactors by 2028 and a further 14 reactors by 2035 (as confirmed during 2019). With regular auctions confirmed under the 10-year energy strategy plan, subsidised wind and solar remain central pillars to France's renewables agenda.

Germany

The deployment of renewables continues under the implementation of the long-term 'Energiewende' transition to a low carbon energy sector, with a target 80-95% reduction in carbon emissions. Offshore wind represents a crucial aspect of Germany's transition and in October 2019 the government increased the offshore wind capacity target to 20GW. However, 2019 saw very little onshore wind deployment with resulting stresses being put on the sector's supply chain and notably Senvion, a turbine manufacturing company, going into administration before the Operations and Maintenance part of the business was acquired by Siemens Gamesa.

Low gas prices and high renewable energy output also helped reduce coal, including lignite, generation, and it was announced that Germany's coal capacity will reduce from over 40GW in 2017 to 17GW by 2030, and be completely phased out by 2038, confirming long-awaited proposals. Long term political support for renewables deployment remains.

Sweden

A continuing favourable political background combined with the land available for large-scale installations and strong wind resource makes Sweden a European leader for unsubsidised (or near-unsubsidised) onshore wind development. Integration of high levels of renewable generation into the Swedish grid is aided by a significant hydro resource, helping to balance the system by storing energy (rather than generating) when renewable resource is high.

Spain

Spain is seeing the deployment of subsidy free solar PV. Due to a combination of declining capital costs, favourable land conditions enabling large scale installations and strong solar irradiation, solar projects in Spain are now viable without recourse to any state subsidy. This has resulted in over 3GW being installed in 2019, and with a further 12GW in various stages of development, Spain is currently the leading European market for solar deployment.

Spain has ambitious decarbonisation targets (74% renewable electricity consumption by 2030), supported by the governing coalition parties, and benefits from a significantly improved financial outlook following the strong performance of its economy over the past five years. With projects now no longer reliant on government subsidies, and viable purely based upon market fundamentals, the risk of regulatory change is significantly mitigated.

Market and Policy Outlook

Across TRIG's core markets, civil activism has brought climate change to the forefront of public attention this year keeping climate change firmly on the political agenda. A thriving renewables industry looks to be essential in order for the UK and Europe to achieve its climate related targets, with energy supply (power, heat and transport) currently still representing over c.30% of greenhouse gas emissions in Europe.

Decarbonisation makes it difficult to predict what power markets may look like over the longer term. However, because of the significant investment needed to increase new sources of renewable generation and then to replace renewables generation that have reached the end of their lives ("repowering"), there is a favourable context for continuing political and regulatory support for renewables.

Commodities and natural resources

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

Olivia Markham and Tom Holl, managers of Blackrock Energy And Resources Income:

Market review

This has been another year where markets have been buffeted by trade wars, changes in direction from various central banks around the world and, of course, tweets from the US President. Despite a very volatile start to the company's financial year 2019 as markets sold off sharply in December 2018, the rapid pivot by the Federal Reserve (the Fed) from tightening to loosening of monetary policy provided the supportive backdrop for many equity indices to make new highs through 2019. Lack of inflation meant that there was little general investor interest in the commodities themselves, which are seen by many as a hedge in a portfolio against rising inflation. In the short to medium term we expect many of the deflationary pressures, such as the impact of technology and ageing populations in the western world to persist so commodities are more likely to be driven by specific supply and demand characteristics as opposed to any uplift from inflation-driven financial inflows.

Whilst the mining sector just failed to keep pace with broader markets, energy companies again underperformed and delivered a negative return for the year. This was a result of Exploration & Production (E&P) companies underperforming again as investors fled riskier oil companies and sought their exposure via the Integrated Oil Majors, which actually fell less than the price of oil over the twelve months. The investment portfolio continues to focus the majority of its energy holdings in the Integrated Oil Companies (IOC) because many of these offer attractive yields and evolving business models, and because we cannot see a clear catalyst for E&P companies to deliver a sufficiently large inflection in returns to compensate for their higher risk business models.

Energy

Following a strong first half of 2019 for oil markets, the second half of the year lacked a clear trend for oil prices as weaker economic data and geopolitical events pressured oil markets down and up respectively. The headline event for the oil sector was the attack on the Saudi Arabian oil facilities in September when the world's largest oil processing facility, Abqaiq, was hit by drone strikes, which affected an apparent 5.4m barrels per day of productive capacity (around 6% of the world's oil supply). This caused the oil price to jump to over $70 per barrel but these gains were quickly given back as the faster than expected operational recovery by the operator, Saudi Aramco, was compounded by worse than expected economic data towards the end of September.

The Organisation of Petroleum Exporting Countries (OPEC) meeting in July offered little excitement compared to the December 2018 meeting where the production cuts were announced that sparked the oil price rally in the first part of 2019. The July meeting saw the existing production cuts rolled for a further 9 months as the members looked to support the oil market and resulted in little drama in the oil markets. As we moved into the final part of 2019, attention turned to the early December OPEC meeting, which was assigned greater importance given the poor economic backdrop experienced in the autumn. OPEC and Russia agreed to further cuts of 500,000 barrels per day (roughly half a percent of global supply). The oil price reacted positively but in a very modest way, ending the day of the announcement up only 1%.

No discussion on the oil market is complete without an analysis of the US shale industry. 2019 has been a pivotal year for US shale – prior to this year, there was a consensus in the market that shale oil production would continue to grow in the medium term (the next 3-5 years) driven by technology enabled productivity gains and plentiful capital to fund drilling. Both of these assumptions have been challenged this year. Whilst technology does continue to improve recoveries and lower some costs, the pace of improvement appears to have slowed and some companies are having to move from the best (cheapest) geology to more challenging (expensive) rocks. On the funding side, many of the shale operators have been pressured by investors to pivot away from volume growth and towards free cash flow generation. This reduces the outlook for future supply growth. Also, investors are becoming more cautious on the longer-term business model for shale companies, especially those that are smaller in scale – this can be seen in the higher cost of debt faced by shale companies, in general, now relative to the start of the year.

As we look to 2020, oil markets look balanced to modestly over supplied without further OPEC production cuts, at least for the first half of the year. We would therefore expect oil to trade closer to the bottom end of its recent price range. However, as we look towards the end of 2020 and beyond, the combined impact of US shale production growth slowing significantly and non-OPEC, non-US production starting to suffer from the lower investment levels seen in the last few years, is supportive of a stronger oil price.

A table showing the declining capital expenditure by oil companies, which supports our view of lower supply growth in the medium term, is shown on page 13 of the company's Annual Report for the year ended 30 November 2019.

A table showing the median Decline Rates (fall in supply each year from existing producing assets) by major basin is set out on page 13 of the company's Annual Report for the year ended 30 November 2019.

Mining

In our interim report, we discussed the characteristics of a strong first half of 2019 for the mining sector, which was driven by better than expected iron ore prices. The second half of the year started well with iron ore continuing to move higher due to the continued supply disruption from Brazil. However, towards the end of the summer, not even commodities supported by supply disruption could overcome the downturn in global economic activity. This downturn was seen in purchasing managers index readings across many of the main economies going below 50 – indicating contraction in the manufacturing side. This synchronous slowdown in global demand caused many of the mined commodities to trade at or around twelve-month lows at the start of September.

However, sentiment began to turn in the last two months of the year and economic data began to improve, albeit from a low base. This was particularly notable in China where towards the end of the period steel margins increased significantly and property data showed some positive signals too. Given the uncertainty for manufacturers and other businesses caused by the Trade War, there had been de-stocking across the industrial supply chain in China. For example, steel, iron ore and copper inventories were lower than historical averages. In our view, this means that any pickup in economic activity as we go through the first half of 2020 is likely to be positive for such commodities.

One area of material weakness in the mining sector during 2019 was thermal coal (which is used in coal-fired power stations). During the year there was an increase in supply of coal within China as a number of new mines continued to ramp up and transport bottlenecks eased with some new and expanded rail infrastructure brought online. Whilst thermal coal will be a significant part of the energy mix (especially in Asia) over the next couple of decades, it faces multiple headwinds. Regulation is of course becoming increasingly anti-coal, the alternatives continue to become more cost competitive and consumers of power (both industrial and retail) are increasingly demanding lower carbon energy from power generators. The speed of change in the investment community's attitude towards coal has seen a step-change this year and the cost of capital faced by coal companies has risen – reflected in coal companies trading at substantial discounts to other mining and energy companies. We are not convinced that these valuations are sufficiently attractive given the risks the companies face and did not hold any pure thermal coal companies in the portfolio at the end of the year.

Outlook

Mining and energy are both classic cyclical sectors, highly exposed to global trade and overall levels of economic activity so we expect the on-going trade tussles between the US and other countries, notably China, to have a significant short-term influence on the direction of these markets. Stepping away from this unpredictable (but important) factor, we remain positive on the medium-term outlook for the energy sector as the investment boom in shale matures and the contraction in conventional oil capital are both set to tighten the supply of oil in the early part of the decade. However, as noted in the energy section of this report, we are cautious on the shorter-term outlook so have positioned the portfolio to reflect this, with a view to increase exposure on any meaningful share price falls.

The shorter-term outlook for mining is slightly more positive and we have substantial holdings in the major diversified mining companies such as BHP as well as a number of copper companies. Given the strong free cash flow generation of the largest companies in the mining sector and their bias to return cash to shareholders, we do not see many small or mid cap opportunities that are attractive relative to their larger peers.

Evy Hambro and Olivia Markham, managers of Blackrock World Mining:

Mining sector review

After the declines in the last few months of 2018, the year started from a low point on valuations. Investor sentiment for miners remained weak due to fears on global growth and the seemingly perpetual debate on a global recession. This was part of the two-speed economic system where services, which make up the majority of the developed markets economies, were held up on the back of modest global growth and technology names moved from strength to strength. Blame for the manufacturing recession has fallen at the feet of the 'trade war'; Donald Trump's broad campaign is to level the playing field with China and reduce the US/China trade deficit, as well as to protect American Intellectual Property and restrict Chinese players in critical industries like defence and 5G. This created uncertainty in China and delayed investment decisions and spending, slowing growth. The manufacturing industry globally was also negatively impacted by tightening credit conditions, caused by the Federal Reserve raising interest rates in the fourth quarter of 2018. This all contributed to the economic slowdown, which in turn was negative for mined metals as they are used in physical manufacturing, as well as construction. However, as the year unfolded, governments around the world took action with many cutting rates, injecting liquidity back into the economy and stimulating growth through fiscal spending. This sudden shift from quantitative tightening (QT) back to QE took investors by surprise and perpetuated the strong returns to growth away from value.

Given the above, expectations for commodity prices at the start of the year were low, especially for iron ore, and consensus positioning was for prices to fade as the year progressed. Soon into the year, the tragic collapse of the Brumadinho tailings facility in Brazil happened and, with it, huge amounts of iron ore supply were removed from the seaborne market. This disruption caused a rally in price but also the closing of the price differential between low and high grade ore. This led to a rally in the valuations of iron ore producers, especially those with balance sheet leverage, and not owning the likes of Fortescue Mining resulted in significant lost relative return.

The base metals suite suffered during the year with average prices for 2019 lower than those of the prior year. Nickel was the only exception to this as prices were supported by the Indonesian government ban on exports of nickel ore. As a result, base metal equities were generally laggards compared to the diversified names as the latter's exposure to iron ore meant cash generation significantly exceeded expectations.

The precious metal suite was a standout performer within the whole commodity space. Prices of gold, platinum and especially palladium soared on the back of the move to more accommodative and stimulative government policies. Gold had its best year in the last decade with prices rising 18.7% over the year, as demand from investors increased significantly on the back of the move back to QE. In addition, Central Banks were also large buyers of gold in 2019. Purchases were up 2.5% over the prior year and this now marks the eleventh year in a row of buying by Central Banks after over 30 years of selling prior to this. The move in gold was substantial but this was pedestrian compared with the 52.0% rise in the price of palladium. Shortages of supply and continued growth in demand meant prices moved to reflect the tightness in the market and platinum group metal equities soared higher.

In the interim report we emphasised the underlying themes that the company invests in, with portfolio returns largely driven by those themes as opposed to just commodity beta. These themes evolve as the fundamentals of the companies and markets change. For example, from 2016 to 2018 the company had significant exposure to deleveraging. This theme has largely played out and the companies have moved from deleveraging to rewarding shareholders. Resource replenishment, capital discipline, asset quality and growth remain key drivers of portfolio selection and we expect these to continue to support positive performance of the portfolio over the longer term. The reform agenda in China continues to play a key role in commodity markets especially with the increased global focus on the environment. A new area for the company has been to review opportunities in recycling and reuse of materials. We expect this area to be a core part of global materials' production in years to come but at present the opportunity to invest in this area remains challenging due to a lack of choice.

Sustainable materials

The rise of the electrified vehicle (EV) has continued this year, led by growth in sales of EVs in China which grew 1.3% year-on-year (Source: Autocar, January 2020). Sales have been incentivised by significant subsidies in China. However, the subsidies were so successful they are now no longer required to meet government targets. As such these subsidies were halved in July 2019 and will likely be reduced again in 2020. This was a headwind to EV sales in China in the second half of the year. Nevertheless, despite the recent hit to sentiment, China again committed to EVs and increased targets. In December, China released the latest draft of its New Energy Vehicle 2035 plan and increased the 2025 target from 20% of automotive sales to 25%. China appears to be driven to lead in the auto industry, reduce pollution and secure energy independence.

The main raw materials that go into batteries, cobalt and lithium, were hit by the tempering of expectations after strong price increases in 2017 and 2018. However, it is important to note that the absolute tonnage demand continues to grow strongly. For cobalt prices it was a year of two halves, with prices down in the first half before Glencore acted to balance the cobalt market in August with a decision to suspend the Mutanda project in the DRC for two years, impacting 20% of global supply. A key driver here has been production from the DRC where both Chinese and artisanal producers responded with surprising speed to the very high cobalt price in the first half of 2018. We also saw ESG concerns come to the fore in 2019 with Apple, Alphabet, Microsoft, Dell and Tesla facing a lawsuit by a human rights group over alleged child-labour abuses in the supply chain for cobalt used in their products. Both higher prices and supply chain concerns have resulted in increased thrifting of cobalt enabled by technological advances.

Prices for lithium moved lower throughout the year and ended down by 31.5%. As well as the tempered growth outlook, prices have been hit by bottlenecks in the battery supply chain with some Australian miners being unable to sell their lithium spodumene concentrate due to processing capacity projects being delayed. The holding in Albemarle was hit by negative sentiment around lithium prices and fell 5.2% during the year. Albemarle's key advantage, a portfolio of long-term contracts which secure pricing in exchange for quality supply, enabled Albemarle to mitigate losses in such weak markets. Currently we see signs of stabilisation in the price decline going into 2020. Prices are now sufficiently low in lithium for supply to be exiting the market, particularly at the junior end where we saw two bankruptcies of lithium project developers, Nemaska Lithium and Alita Resources. Albemarle also remains well placed to benefit from volume growth, with a number of key expansion projects such as Atacama and Greenbushes. Albemarle further added to its project pipeline by acquiring 50% of the Wodgina deposit from Mineral Resources. Immediately after acquiring the stake, Albemarle paused operations in an effort to deliver more value in the long term and we expect it to remain disciplined in their supply of material into the market.

Another major battery metal is nickel, where demand is likely to stand to benefit from the increased penetration of EVs and thus demand for lithium batteries which contain nickel in the cathode of the battery. However, today the number one use of nickel driving near-term demand is stainless steel production. Not all nickel production is created equal when it comes to suitability for different end-uses and for battery cathodes the most efficient raw nickel units are nickel sulphide tonnes, whilst for stainless steel ferronickel is very cost effective.

Base metals

Base metals were the weakest part of the commodity mix during the year with nickel being the only base metal to record a high average price year-on-year. A combination of generally weak industrial activity and resulting low demand growth left the complex under pressure from financial investors who chose to use the forward markets to express a negative view on the global economy. Large short positions in copper were a feature of the year and it was only towards the year end that these started to close. On the supply side, 2019 was a year of low growth and disruptions but the scale was not enough to move prices higher. With the general macro risk for the global economy now improving it is hoped that base metal demand should recover during 2020 and, with limited supply growth, prices should put in a better performance over the near term.

Within the copper space the company has a large exposure to more growth orientated producers and it is hoped that when the metal price starts to improve these names should deliver strong performance due to a mix of balance sheet leverage, production growth and exploration potential. Key holdings are Freeport-McMoRan Copper & Gold, First Quantum Minerals, Ero Copper, OZ Minerals, Lundin Mining and Ivanhoe Mines. The company also has holdings in debt securities issued by copper producers and these should also perform well with better metal prices.

During the year, the price of nickel went through a major cycle as depressed demand left the price languishing at the start of the year after a rapid sell-off in the second half of 2018. No sooner had the year begun prices started to rally and early price hikes were compounded by the announcement of export bans from Indonesia. The price soared and touched an intra year high of almost US$8.50/lb before giving up some of the gains during the final quarter of the year. The company has two main exposures to nickel via a holding in Norilsk Nickel, which is a diversified base metal and Platinum Group Metals

(PGM) producer in Russia, and Nickel Mines. The latter is a high growth company with exposure to domestic production of nickel in Indonesia which is integrated directly into a stainless-steel production facility. During the year the shares were up 137% despite having issued new equity to fund the ongoing production growth. The miner is now very well positioned to harvest returns from its existing assets, whilst also having further growth options it could develop.

The rest of the base metals complex was very weak, especially by comparison to precious metals and iron ore. The company had minimal exposure to this area but, given the price falls to levels below long-term averages and improving macro outlook, it is an area we plan to monitor closely during the coming year as commodity prices have a long record of mean reversion.

Bulk commodities

The iron ore price was up 28.1% in 2019 with the market significantly impacted by the tragic Brumadinho tailings dam incident which occurred at the beginning of the year. The tailings dam at the Feijão iron ore mine which is owned by Vale suffered a catastrophic failure collapsing and killing 272 people. The Feijão tailings dam was constructed using the 'Upstream' method, which meant that the dam's stability relied on the tailings material and this is seen as a key weakness of the Upstream construction method. Following the disaster, Vale announced that it would decommission nine Upstream iron ore dams in Brazil and suspended around 60mt of production. This, in addition to the direct production impact, resulted in Vale's iron ore production falling by around 80mt in 2019 compared with 2018, equivalent to 6% of global seaborne demand. Vale has guided for the 60mt of production to recommence once the dams are de-characterised over 2020 and 2021 (*Source: Vale Quarterly results*).

This was a significant shock to the market and resulted in sharply higher prices versus expectations. Although these high prices have incentivised an increase in supply at smaller mines, it has not been enough to stop global seaborne supply shrinking year-on-year. Notably the other big three suppliers outside Vale - Rio Tinto, BHP and Fortescue Metals - have not increased production. Supply in iron ore remains highly concentrated with the 'Big 4' supplying over 60% of the seaborne iron ore market. These major producers have evidenced they are pursuing a value over volume strategy limiting growth to maintain price and preserve margins. It is likely that the iron ore price will need to continue to incentivise new production, as well as draw down on inventory to balance the market in 2020. The ongoing resumption of suspended Vale production in 2021, as well as the ramp-up of Vale's Northern System production which was unaffected by the disaster, should balance the market in 2021.

Against this supply backdrop we have seen global demand growth this year, despite higher prices. This demand growth could only be met with a drawdown in global inventories. Iron ore is mainly used in steel production and Chinese steel production grew by 8.3% in 2019 as steel mill profitability remained strong, particularly for construction materials. As the Chinese economy has matured and generated more scrap steel, the mix of steel raw material has moved towards scrap steel, away from iron ore, and we saw this continue in 2019 with scrap accounting for 18% of Fe units from 17% in 2018 (Source: Citi).

The company has benefited from the high iron ore prices through positions in Rio Tinto and BHP which returned 36% and 20% respectively. The company's position in Vale has hurt performance with a sterling total return of -1% (Source: Bloomberg).

Coking coal is another key steel raw material, but unlike iron ore the price was down 37.6% in 2019. China introduced a quota system for coal imports in 2019 with the aim to prevent imports rising on 2018 levels and protect domestic thermal coal producers. As part of this, coking coal imports were also blocked. In addition, European coking coal demand was weak, partly due to falling demand for auto steel. Indian demand has increased, mitigating some of the impact of the Chinese quota, with India now the biggest seaborne coking coal market. The thermal coal price fell 36.0% through the year; as well as the Chinese import restriction, low Asian LNG prices and coal-gas switching in Europe, has weighed on demand.

The company's coking coal holdings include Teck Resources and Coronado Global Resources which have both negatively impacted the company's performance in 2019. However, both companies remain on attractive valuations and Coronado in particular has a track record of returning excess capital to shareholders, having returned 50% of its year end share price in dividends during 2019. Likewise, Teck Resources has paid special dividends during the last two years and is now regularly buying back its shares.

Precious metals

2019 was a stellar year for precious metals as a group. Gold and silver prices were up by 18.7% and 15.5% respectively and this is the first year in nine that we have seen such significant moves. Key within this move for the companies is that the price increase has come about when the companies were already generating decent returns and, as such, this extra margin should flow through to the bottom line given the absence of growth in capex and debt to repay. It will still take some time for shareholders to receive the full benefit given that the price increase was mostly second half weighted, but it is very encouraging to see the first signs of this coming through. During 2019 several gold miners raised dividends; for example, Agnico Eagle Mines raised its dividend by 40%, Barrick Gold by 66% and Alamos Gold by 100%, but the most impressive has been Newmont Mining. Following the purchase of Goldcorp in the early part of the year, Newmont paid out a special dividend which is reflected in the income of the company this year. In addition, in December Newmont announced a US$1bn share buyback, the first for a gold producer for many years. Then, in January 2020, Newmont announced a 79% increase in its annual dividend and that they had already completed half of the buyback. Newmont has raised the bar for shareholder returns in the gold sector and we look forward to other companies following suit.

The last two years have been a busy period for M&A teams in the gold sector. The end of 2018 saw the merger of Barrick Gold and Randgold Resources, followed quickly by the takeover of Goldcorp by Newmont. This was then followed by the merger of Barrick and Newmont's Nevada gold assets to create a massive market-leading US gold business with huge synergies to come. Others have also been busy as the big players divested non-core assets. The famous Australian Super Pit was sold by Newmont and Barrick to Northern Star and Saracen Mineral. In Africa, Barrick sold the Massawa project to Teranga Gold and completed the buyout of the minorities in Acacia Mining, whilst in Canada Newmont sold Red Lake to Evolution Mining. We expect this period of gold company consolidation to continue as the mid cap producers look to gain relevance in global financial markets by increasing the size of their businesses. The company has been very active during the year by helping to finance some of these deals and harvesting returns in the process.

The PGMs were the leaders within the precious metals area. The long bull run in these metal prices, especially palladium, continued in 2019 and with it the turnaround in the profitability of the producers. The company bought a position in Impala Platinum during the third quarter of 2018 and it has been one of the best performers within the company. The shares were up 312% in sterling terms during 2019 and the company has used the improving margins to strengthen the balance sheet and diversify its production away from South Africa into Canada. The other holding in the company is Northam Platinum which, like Impala, saw a huge 207% increase in share price during the year. Outside of these producers the company has exposure to PGMs via a holding in Norilsk Nickel and through Anglo American. Profit margins and free cash flow are expected to remain elevated for the near term and, should South African producers start to pay decent dividends, then this could turn into a driver of income for the company as a whole.

Outlook

After the strong returns generated during the year it might seem foolish to expect another year of competitive total returns for the mining sector in 2020 but, with macro risks seemingly on the turn for the better, the outlook is relatively favourable. The US and China have recently agreed a 'Phase One' deal on new trade terms and this might mark a reversal in trade fears that have been a burden on commodities demand ever since the last US Presidential election. In addition, the return to accommodative monetary policies in 2019 has left the global economy poised for an increased level of economic activity especially in China and the US. During the last few months of 2019 data was very supportive of this view, with strong US labour markets and a recovery in the Chinese Manufacturing Purchasing Managers' Index to a 7-month high supported by rallying retail and industrial sales in China.

In Europe, the data is less supportive but still not negative and with increased clarity on Brexit following the UK election this risk should start to fade. Offsetting the positives is the ongoing threat to growth from the recent virus outbreak. This looks potentially set to cause downgrades to economic growth given the likely disruption to trade via travel restrictions and consumer confidence. At the time of writing concerns are rising and we will watch out for signs of it being under control before deploying additional risk in the portfolio.

QuotedData

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