PROSPECT
WEALTH MANAGEMENT

INVESTMENT PROSPECTS

- **Global economic growth, apart from the UK, is approaching trend levels with a benign outlook.**
- **In the UK, inflation is undermining consumer spending and Brexit uncertainty is hitting investment.**
- **US and European central banks are likely to tighten monetary policy and UK bond yields may rise.**
- **The economic backdrop is favourable for equities, with the best prospects in Europe and Japan.**

REVIEW OF Q2 2017

Global economic growth continued to expand at close to trend rates in the second quarter with few surprises, though inflation generally accelerated modestly. The result was higher bond yields in the UK and Europe, producing small negative returns from government bonds, and small gains for equity markets. The pace of growth in the US slowed whilst interest rates were nudged up by the central bank as the labour market approached full employment. In the UK, there was a more noticeable slowdown in consumer demand as rising inflation squeezed personal incomes.

These trends of rising inflation and steady growth have produced market returns over the last 12 months much as we had expected, shown in the table opposite. Bond returns have been negative whilst equity returns have been strongly positive. Our portfolios have been positioned to take advantage of this, as can be seen in the results of our model portfolios overleaf. Most significantly our bond portfolio has produced a 14% return over the past year as UK corporate bond yields have fallen in response to a more benign economic environment than was expected in the immediate aftermath of the EU referendum.

The **Low Volatility Portfolio** also performed well for the quarter and was up 9% over the year, well in excess of the 3-5% target. The best returns over this period came from the medical property and renewable energy components, which more than offset weakness in the infrastructure fund, HICL.

Europe Turns the Corner

Europe has seen the biggest economic shift over the past quarter, with growth accelerating and the central bank beginning to prime markets for a gradual tightening in monetary policy. This had the effect of strengthening the currency, with the euro appreciating by 3% against sterling and by 7% against the US dollar. The stronger currency dampened expectations for corporate earnings growth, so equity moves in the quarter were small, despite the

Total Returns in Local Currency

Last Quarter and Last 12 Months

		Total Return for Market	
		3 months to 30 Jun %	12 months to 30 Jun %
Currencies v £	**Rate**		
US dollar	1.30	-3.7	2.2
Euro	1.14	3.3	5.1
Yen	146	-4.5	-6.1
Cash (3m)	**Yield %**		
UK	0.25	0.1	0.6
USA	1.27	0.3	0.8
Euro	-0.44	-0.1	-0.3
Japan	-0.17	-0.1	-0.5
Bonds (10yr)	**Yield %**		
UK	1.26	-0.8	-2.7
USA	2.30	1.4	-5.6
Germany	0.47	-1.3	-5.9
Japan	0.08	-0.1	-3.3
Equities	**Index**		
UK	Bats 100	1.0	16.9
USA	S&P Comp	3.2	18.0
Germany	DAX	0.8	30.6
France	CAC	0.8	25.0
Spain	SMSI	0.6	32.5
Italy	BCI Gen	1.3	31.4
Japan	Topix	7.1	31.7
Australia	All Ord	-1.0	14.6
China	Shanghai	-0.9	9.0
Alternatives	**Index**		
Property	IPD	1.4	3.9
Commodities	DJ UBS	-3.0	-6.5
Hedge Funds	HFR	-2.1	8.8

Source: Reuters

July 2017

election of business friendly Emmanuel Macron as French President. The news from Germany was also positive over the quarter, with an acceleration in domestic spending on construction in response to the migrant influx. During the quarter we added to our European exposure through the purchase of a fund investing in medium sized companies managed by Barings. Portfolios are now significantly overweight in the region, which has contributed to the strong outperformance of the international component of portfolios both over the last quarter and the last 12 months.

Other **International markets** performed well over the quarter with the US market hitting new highs as corporate earnings continued to expand. Japan produced the best return for the quarter in local currency terms, in response to the depreciation in the yen.

UK Equity Returns Mixed

The returns on the **UK equity** component of portfolios were disappointing over the quarter, though for the year the results have been close to those of the benchmark. The uncertainty over the course of Brexit did finally produce some long expected economic weakness, with slower consumer spending and company capital expenditure. The result was highly polarised returns, with some sectors, such as housebuilding, performing strongly whilst others, such as retailers, weakened. The general industrial companies tended to outperform on hopes of improving export orders, as a result of a weaker sterling against the euro, and rising demand from a resurgent European economy. Banks generally outperformed in response to the prospect of higher interest rates in due course. The effect was not uniform though, as smaller banks, such as Virgin Money, which are dependent on mortgage lending, suffered as a rise in interest rates leads to higher defaults and less property lending. The **UK equity funds portfolio** performed well over the quarter, with Scottish Value Managers producing the best performance.

The **AIM portfolio** had another good quarter with a 4.0% return beating the benchmark and contributing to a 24.1% return over the past 12 months. We have continued to increase the number of stocks in the portfolio, with two new healhcare names: Abcam plc is a Cambridge based biotech company that produces research grade antibodies and sells them via an online catalogue to research groups in universities, pharma and Biotech companies globally; Ergomed provides clinical trials for drug development by pharma companies. Partial profits were taken in Scapa Group and IQE after strong relative returns.

Alternatives Disappoint

Property continued to recover slowly from the sharp fall after the referendum vote, with the overall index up 1% over the quarter. Returns from property are highly mixed both geographically and by sector. Regional property is tending to outperform London, where there is uncertainty in particular over the office needs of the banking sector. Retail sites are suffering from the weak consumer demand, but growing online sales are producing higher valuations for warehouse space. In this precarious environment, sound property management is essential to creating value, so your M&G and Schroder funds will seek to optimise the rental income derived from their existing property holdings.

Commodities were down 3% over the quarter and 6% over the year. Oil prices fell 10% as US shale oil production recovered and more than offset the cuts made by the Middle East producers. Industrial metals weakened modestly as US growth was seen to be decelerating and gold was unchanged over the quarter.

Hedge Funds also produced a negative return for the quarter, with the lack of clear trends in any market providing little opportunity for significant gains. The multi-asset hedge funds in client portfolios produced small net gains for the quarter.

Prospect Wealth Management: Performance of Model Portfolios at 30 June 2017

Model Portfolio	Last 3 Months Prospect %	Last 3 Months Benchmark %	Last 12 Months Prospect %	Last 12 Months Benchmark %	Benchmark Name Total Returns
Low Volatility Portfolio	2.8	0.1	9.0	0.4	3 month LIBID
Bond	3.0	-0.2	14.3	2.6	Barclays / IBOXX
UK Equity	-1.7	1.0	16.5	16.9	MSCI 100
UK Equity Funds	1.9	1.0	16.4	16.9	MSCI 100
UK Alpha	0.7	1.0	23.6	16.9	MSCI 100
International Equity	4.7	0.3	30.1	23.4	MSCI World ex-UK
Equity Alternatives	-0.9	-0.3	2.8	2.3	Prospect Composite*

* IPD Property index, Bloomberg Commodity index, HFRX Directional index
* UK AIM portfolio inception Q1 2015

Source:Thomson Reuters

PROSPECT WEALTH MANAGEMENT

Economic Forecasts as at July 2017

	Real GDP growth		Unemployment rate		Inflation (CPI)		Budget % GDP	Central Bank rate		Current A/c % GDP
	2017	2018	Latest %	2017 %	Latest %	2017 %	2017 %	Nominal %	Real %	2017 %
US	2.2	2.3	4.4	4.4	1.6	2.1	-3.2	1.5	-0.6	-2.6
UK	1.6	1.3	4.5	4.7	2.6	2.7	-2.9	0.3	-2.4	-3.4
Eurozone	1.9	1.7	9.3	9.3	1.3	1.5	-1.4	0.0	-1.5	3.0
Japan	1.3	1.0	3.1	2.9	0.4	0.5	-4.5	-0.1	-0.6	3.8
China	6.7	6.3	4.0	4.0	1.5	2.0	-3.5	4.4	3.6	1.8

Source: Thomson Reuters

MARKET OUTLOOK

Interest Rates and Currencies

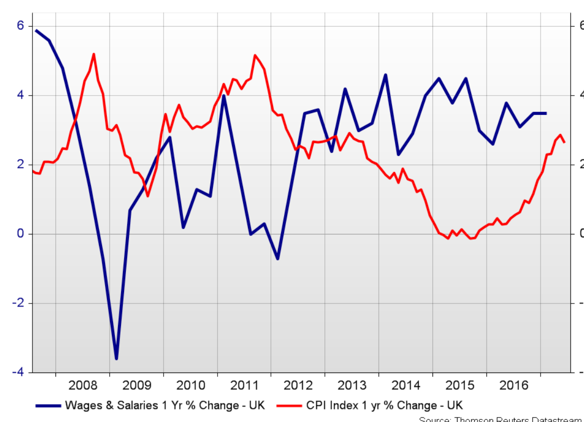
The overall outlook in the developed economies is for interest rates to remain close to current levels for the rest of this year, despite an improving economic outlook in the US and Europe. In the US, growth is expected to remain around 2.2%, close to the long term trend, for this year and next. There are signs though, that after 8 years of growth the US cycle is starting to slow, with the pace of employment growth lower and car sales faltering. The result is that the rate of inflation has slowed from 2.9% to 1.6% currently and that appears to be holding back wage inflation, despite unemployment being at a cyclical low. At the same time, it looks as though productivity is at last starting to improve as the sustained economic upturn provides the confidence for businesses to invest. In this virtuous circle of low inflation, low wage growth and improving productivity, we expect the US central bank to only raise interest rates by 0.25% by year end, thereby prolonging the growth cycle. With the US running a current account deficit, the dollar is likely to depreciate modestly without the support of materially higher interest rates.

In the UK, Brexit is creating considerable uncertainty over the path of the economy over the next 18 months. Growth has been downgraded to 1.6% for this year and 1.3% for next as higher inflation, currently 2.6%, eats into consumer purchasing power and capital expenditure weakens on Brexit fears. However, the environment remains supportive for the UK economy - low interest rates, an undervalued currency, low unemployment and accelerating growth in Europe. It is for these reasons that three out of nine members of the Bank of England monetary policy committee recently voted to raise interest rates. We think an increase is unlikely ahead of 2018 given the economic uncertainties and as a result sterling is likely to remain undervalued against the dollar and should depreciate against the euro, where valuation is close to parity.

UK Bond Market

Real UK government bond yields (i.e. after inflation) have remained negative thanks to the glut of global savings and as central banks have bought up bonds to keep yields low to keep financing costs low. This environment is slowly changing with the US central bank raising interest rates and shortly due to start selling off the bonds it purchased. The European central bank has indicated recently it will start to tighten policy, probably starting in September. The effect of this announcement was to push UK bond yields up by some 0.3% last quarter, even though the Bank of England ("BoE")is unlikely to follow suit.

UK Consumer Prices and Wages are Rising



BoE policy is largely determined by the expected path of inflation, but in the wake of Brexit that is highly unpredictable. Will the higher inflation rate caused by the currency depreciation provoke a wage-price spiral or will it lead to weaker economic growth and lower inflation in 6 months time?

In this unpredictable environment we will maintain our focus on investment grade corporate bonds with short duration that provide protection against a rise in bond yields in the event that inflation does rise and the BoE tightens policy in line with the US and European central banks.

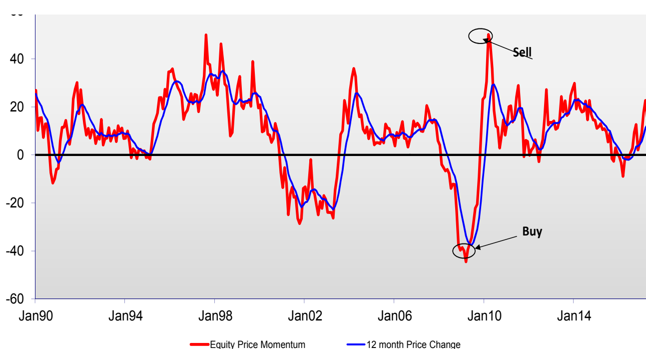
Equity Markets

The US, European and Japanese economies appear to be in a benign phase of trend levels of growth, rising employment and low inflation. With surprisingly little sign of wage inflation in any economy, central banks can keep interest rates low in the hope of sustaining the cycle. The hope is that this favourable environment promotes confidence in consumers and business and encourages investment. There are the early signs that this is happening in the US, though we have yet to see improvements elsewhere. This is a favourable background for equity markets, which are supported by corporate earnings in each of the major markets hitting new highs. This in turn explains why stock markets too are at all time highs. The manufacturing surveys in the graph opposite show that the US and Europe are at peak levels for this cycle, whilst the UK is trending down as worries over Brexit damage business confidence.

Despite this generally favourable situation, some markets are more attractive than others based on their market valuation and price momentum. The **US stock market** remains very expensive but has been sustained by corporate earnings growth and the hope that the Trump administration will enact sweeping cuts to corporate taxes. However, as the chart below shows, momentum is beginning to fall, reflecting a slowdown in the pace of earnings growth and the rise in interest rates. Whilst the fundamentals of the US economy remain positive, this points to the stock market needing to pause in it's upward trend for the growth in the economy to catch up. It is for this reason that we are underweight in the US stock market.

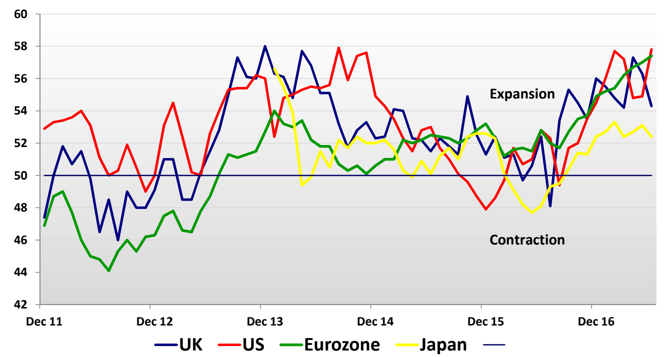
In the **UK,** price momentum is similarly falling and pointing to the stock market being vulnerable to disappointments over the pace of economic growth in the event that consumer demand weakens faster than expected or corporate capital expenditure declines in the face of uncertanty over Brexit. The Conservative Party conference takes place on 1-4 October and that could be a catalyst for a leadership challenge and a further period of unsettling

US Equity Price Momentum is Starting to Fall



Source: Valu-Trac

Manufacturing Surveys Trending Up, Except UK



Source: Thomson Reuters

political upheaval. We are already underweight UK equities and look to further reduce our exposure imminently in favour of Japan. Within the UK portfolio, we are reducing our exposure to the consumer sector, even though it has a low valuation, as the consumer savings ratio is at a record low and real wages are falling thanks to the rise in inflation since Brexit. Instead we are looking for companies with solid growth prospects with substantial overseas earnings. As a result we have recently added two investments in the pharmaceutical sector, BTG and Indivior, which offer attractive growth on reasonable valuations.

European stock markets have paused for breath in the last quarter but economic growth is accelerating and equity price momentum remains positive. Northern Europe is now seeing rapid economic expansion as domestic demand growth outpaces exports due to the huge influx of immigrants. This is creating a positive spiral of government investment, corporate capital investment and consumer spending. Even Greece is now able to refinance its debt in the public markets, which is a measure of the degree to which confidence in the Eurozone has recovered. We are overweight in European equities and are looking to add some property exposure in Germany to take advantage of the expansion there.

In **Japan**, the favourable conditions we reported previously have continued, supported by continued quantitative easing by the central bank. The result has been a weaker yen, which has supported export earnings at a time when demand from the US and China have been strong. Chinese consumer spending, for example, was growing at an annualised 11% rate in the second quarter and we expect this robust demand to continue. Japanese corporations are now raising investment and we are hopeful this will lead to higher economic growth in 2018. As a result we plan to add 2% to Japanese holdings through the purchase of another fund, where we expect to see attractive gains as investors anticipte accelerating earnings growth.

Commercial Property

The UK property market has continued its recovery over the past year in the aftermath of the referendum result, although the returns are polarised between sectors and regions. The retail sector posted the weakest returns, whilst the standout performer was the industrial sector. This also reflects changes in consumer behaviour with increasing retail sales volumes generated from online transactions rather than from traditional high street shops. Within the offices sector, there was significant regional difference with central London values and rents falling, whilst markets outside of the capital were fairly buoyant.

The two funds that comprise your property exposure both achieved postive returns for the quarter, with total returns from M&G and the Schroder Real Estate Investment Trust of 1.6% & 4.7% respectively Both funds continue to work on initiatives to enhance rental income streams and improve valuations from lease renewals and property refurbishments.

We have been patiently monitoring our exposure to the property sector. As the post-Brexit recovery has continued, sentiment has improved and overseas buyers have been attracted to the market to take advantage of the attractive sterling exchange rate. In February 2017, we reduced our exposure, selling one of our funds in favour of an increased weighting to European equities. Our two remaining funds have had little exposure to central London offices considered vulnerable to banking relocations to the Eurozone, or the beleagured retail sector under strain from consumers tightening up on their credit fuelled spending. Whilst the UK outlook is underpinned by low interest rates and modest economic growth, we are now taking steps to replace some of our UK property exposure with an investment in continental European real estate.

Sirius is a German property development company which owns 500 buildings for light industrial use on 47 business parks. Sirius targets an annual 15% total shareholder return and has recorded an annual capital growth of 10% in the last 3 years.

Commodities

The favourable growth outlook for the global economy and a lack of upward pressure on the US dollar should be positive for commodities. However, the oil price appears to be capped at around $50 / barrel by rise in US shale oil production and the inability of OPEC to reduce output significantly and place upward pressure on prices. Energy prices seem likely to move within a narrow range in the near term.

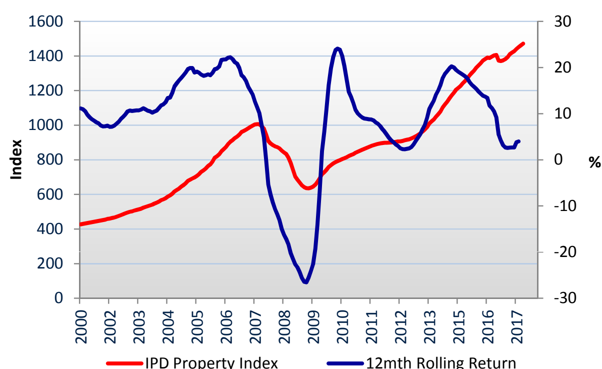
There seem to be few catalysts for a significant move in precious metals in the coming months though a weaker dollar would be positive for gold. Industrial metals have been helped by the strength of the Chinese economy and we expect that to maintain its positive momentum over the next three months, which should support these commodities. Finally, agricultural prices have been rising as a result of hot and dry conditions in the US and Canada, with wheat yields reduced in Europe and Ukraine as well. As the chart below shows though, commodities are at the low end of their price cycle and at this level should be maintained in the portfolio as a useful diversifier.

Hedge Funds

To the extent that we see some positive trends in equity markets over the coming months we may expect to see better returns from hedge funds. The multi-asset funds we hold use a wide variety of both long and short strategies, but if, as we expect, equities trend upwards, then we would expect the funds to pick up on these trends and exploit them with the benefit of the leverage that is inherent in hedge funds. Like commodities, these strategies do provide a useful diversification for portfolios and the ability to take advantage of areas of markets that are not accessible to traditional investors.

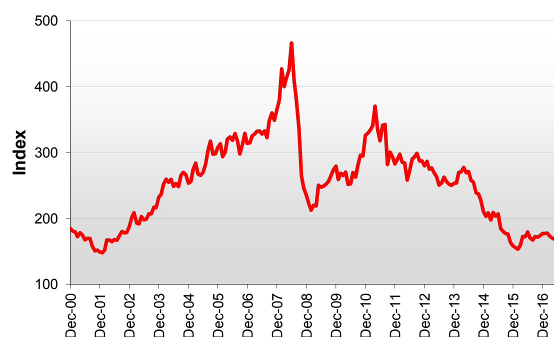
Matthew Hunt

UK Commercial Property - Price Upturn Continues



Source: DataStream

Commodity Price Index - Stable Environment



Source: Bloomberg

Asset Allocation For July 2017*

50% Bond / 43% Equity / 7% Alternative Model

		Strategic Benchmark			Q3 2017 Tactical weights	Weighting vs Strategic Benchmark
		Min %	Benchmark %	Max %	%	%
Cash:		0	0	10	1	+1
Bonds:	UK Government	0	25	60	0	-25
	UK Corporate	0	25	60	40	+15
	Total Bonds	40	50	60	40	-10
Equities:	UK	20	30	40	29	-1
	US	0	7	17	3	-4
	Europe (ex UK)	0	2	13	8	+6
	Japan	0	2	12	1	-1
	Asia / Emerging	0	2	12	4	+2
	Total Equities	33	43	53	45	+2
Alternatives:	Property	0	3	13	6	+3
	Commodities	0	2	12	4	+2
	Hedge funds	0	2	12	4	+2
	Total Alternatives	0	7	17	14	+7
Total			**100**		**100**	**0**

Source: Prospect Wealth Management

* This table shows the asset allocation agreed to be applied to all portfolios for the current quarter, using a 50/50 benchmark as an example.

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