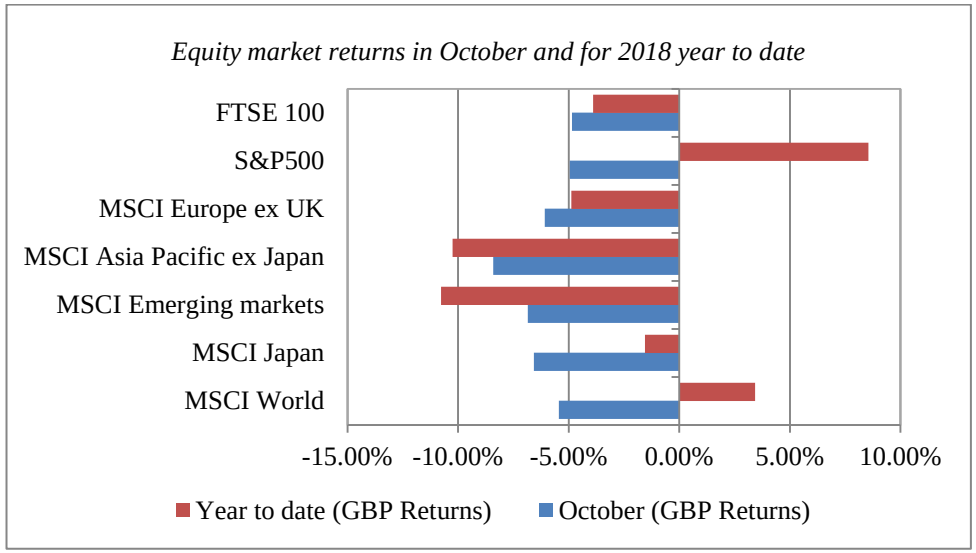
TOREVELL & PARTNERS

Economic Background – October 2018

Stock market volatility

October saw sharp falls in global equity markets with the MSCI World index down by around 5.4% over the month in Sterling terms. The FTSE 100 index fell below 7,000 during the month before recovering slightly to finish October at 7,128. The S&P 500 index fell by 6.9% in US Dollar terms whilst the MSCI Asia-Pacific ex Japan and Japanese indices fell by more than 9% in local currencies.

The continuing weakness of Sterling reduced these losses slightly for UK investors. All major global equity indices are down in value over the last 3 months, and with the exception of the S&P 500 index, are down since the start of the year. Foreign exchange movements have helped convert a modest 2.5% gain in Dollar terms to a gain of 8.6% in Sterling. In contrast Asia-Pacific ex Japan and emerging market indices are down by more than 10% since the start of the year.



A number of factors are likely to have contributed to the falls. The IMF downgraded its global growth forecasts for 2018 and 2019 (from 3.9% to 3.7%), citing the introduction of import tariffs between America and China, weaker growth in Europe, Japan and the UK, and the impact of rising interest rates on some emerging markets.

Strong economic growth in America may also have played a part and the decision of the US Federal reserve to increase interest rates had an impact on currency markets and has increased the borrowing costs of many emerging economies.

Global debt markets

Global debt levels and prices remain a major risk to financial markets. The benchmark ten-year US Treasury yield rose to 3.2% and whilst other global bond yields rose initially, they fell back as investors sought out the perceived safety of bonds as equity markets fell back. Japanese and Swiss 10 year government debt continues to offer a zero or negative yield. Italian bond yields have risen as its credit rating has fallen to one level above junk status but German 10 year bond yields remain low at around 0.4%. UK 10 year yields are around 1.5%. We continue to regard these yields as unattractive and unsustainable in the medium term. If (or when) yields start to rise towards their historical averages investors will suffer significant capital losses.

Demand for corporate debt remains extremely high but we are starting to see some troubling parallels between current debt markets and those that preceded the global financial crisis. Moody's, one of the major global credit agencies, have raised concerns about the deteriorating quality of guarantees and covenants given to investors and their European covenant quality indicator fell to its lowest ever level in the 3rd quarter of 2018. At the same time investors appear keen to take up recent debt offerings with many issues being oversubscribed. This include companies well outside the investment mainstream such as Tilray, a Canadian based producer of marijuana products which saw its $450 million convertible Bond offering oversubscribed, even though the costs of interest payments on this debt exceed the total revenues generated by the company last year.

Any exit from corporate bonds is likely to be complicated by uncertain levels of liquidity for these investments.

UK

Attention continues to be focused on the ongoing Brexit negotiations. Whilst some progress has been made the draft agreement appears to be equally unpopular with those who support a hard exit, and those that argue that we should never have voted to leave in the first place. The proposed Brexit deal looks likely to struggle to be approved by Parliament and the risks of a chaotic No Deal Brexit have increased. We continue to

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believe that well managed companies remain better placed to deal with the outcome of Brexit than individuals or the wider country, and many multinational companies are already very experienced in dealing with different tax and regulatory regimes.

Perhaps understandably, UK stocks have become less popular with global investors since the result of the referendum, with a recent analysis by Invesco suggesting that the PE ratio of UK sourced revenues has fallen from around 20 ahead of the referendum to around 11. In contrast the PE ratio of US sourced revenues has stayed relatively constant at 22.

Whilst there is no doubt that the uncertainty resulting from Brexit has made the UK less attractive to outside investors, the extent of the falls in the UK stock markets does raise a question as to whether share prices have fallen too far. By some measures UK share prices are now pricing in a recession equivalent to around 4%-5% of GDP. This would represent a major shock to the UK economy and, with a more optimistic view point, suggests that there is scope for share prices to recover even if Brexit is bad, but just not quite as bad as investors have feared.

October also saw the UK.'s first budget on a Monday. Better tax receipts than expected enabled Philip Hammond to announce major increases in spending, whilst bringing forward certain tax allowances. Overall the budget appears to have been relatively well received and we were encouraged to notice that there were no significant changes to the taxation of pensions, ISAs or other investment wrappers. At the same time, the Chancellor was keen to stress that a failure to agree a Brexit deal would require a further budget.

US technology companies

US technology companies have been a major driver of US stock market returns over the last couple of years. Whilst September saw Apple and Amazon both valued in excess of $1 trillion, October saw their share prices fall sharply, with Amazon losing $120 billion in market capitalisation by the end of October. A number of high profile companies posted lower than expected results. Netflix was an exception, reporting better than expected subscriber numbers. At current market levels the Netflix is valued at around $130 billion, well down from its peak but still remarkable for a company that had a negative cash flow of nearly $700 million in the last quarter. The company is heavily dependent on debt financing and recently announced a further $2 billion bond offering that will take its debt above $10 billion.

China

Chinese stock markets have fallen sharply since the beginning of the year with the Shanghai stock market composite index down by 25 percent since early January.

Chinese technology companies have also struggled with the BATs (Baidu, Alibaba and Tencent down in value since the start of the year (Tencent holdings is down by more than a third for the year to date).

We remain concerned that Chinese stock markets are heavily dependent on speculation. Our September, commentary included a number of examples where company valuations had collapsed by 75% or more. October has brought further examples of problems in Chinese property markets which have been an important contributor to Chinese growth figures over the last few years. Investors in China's four large real estate companies saw their share prices fall by 10%-25% in the space of a few weeks. Recent reports suggest property vacancy rates in Chinese cities are above 20% (which is well above levels elsewhere) and protests by Chinese homeowners, protesting at falling prices.

In light of these risks, and our continuing doubts over the accuracy of Chinese figures and fundamental property rights, we continue to limit our direct investment in China

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Outlook

Stock market volatility is an uncomfortable but inevitable consequence of investing into equities. Despite this volatility we continue to believe that well managed equity funds offer the greatest potential to generate real capital growth and income over time.

One of the challenges of current investment markets is that asset classes that have traditionally been regarded as safe havens are already at prices well above their normal levels. As noted above we are unwilling to invest in government bonds that provide little if any yield and which will lose money if held to maturity, nor are we convinced that the marginally higher yields on offer from corporate bonds are sufficient to compensate for the additional credit and liquidity risks these involve.

The gold price has remained relatively stable. In Dollar terms the price is around 10% lower now than it was 5 years ago. Commercial and residential property markets also appear to be softening.

After recent falls some equity markets are substantially less expensive than they were a few months ago, and in the case of UK equities, appear attractively priced when compared with their historical averages. Our in-house analysis of stock market returns (from 1990 to 2016) suggested that investing after a stock market fall of 10% can have a meaningful impact on future returns, and significantly reduced the likelihood of losing money through holding shares over a 5 year period. Past performance is no guarantee of future returns and, in this case, the uncertainty of Brexit and Sino-American trade relations is likely to generate additional volatility over the coming months.

In current market conditions we believe that cash reserves can play an important role in portfolios. As interest rates begin to rise cash balances can provide some income but with no capital. Perhaps more importantly cash can provide a source of liquidity if markets fall further, which can help to avoid having to sell investments when they are down in value, or to add to long term holdings if opportunities arise.