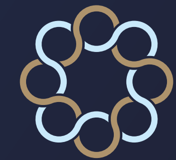

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POINTS OF VIEW

MONTHLY COMMENTARY FROM PARMENION INVESTMENT MANAGEMENT

August is the holiday month and with many key decision makers, in particular, the politicians, away from their desks, it's normal for things to be a little quieter. Theresa May, for example, took a three-week break for some walking in the Swiss Alps, presumably with the 'Sound of Music' on her iPod and 'Climb Every Mountain' on repeat. It would come as no surprise if we did not see a great deal happening in markets, but this August saw some pleasing gains.

Index	August Total Return (£ base)
FTSE Emerging Markets	5.36%
FTSE Europe ex UK	3.04%
FTSE USA	2.71%
FTSE World Index	2.66%
FTSE Japan	2.39%
FTSE All Share	1.39%
FTSE 100	0.93%

Source: FE, August 2017

Fixed interest

Short term interest rates remain subdued in the developed markets, although the expectation is that they will be moving up in the US. Inflation is not heading up above central bank targets but it is likely to edge higher, especially noting some of the short term factors we mention below. In fact, short dated US bonds contain a small negative term premium reflecting low expectations of inflation and continued demand for top quality, low-risk assets. Longer term, the outlook for bond returns is for a small premium above cash yields. Annual return estimates for UK Gilts, for example, over the next 10 years hover around 1%pa. Mark Carney may complete his second term at the Bank of England, without ever raising rates.

Jackson Hole

The annual meeting of global central banks took place in the mountains of Wyoming. Neither Fed Chair Yellen nor Mario Draghi, head of the European Central Bank, gave a great deal away. Yellen's contribution was essentially a piece of self-congratulation for the audience to enjoy for its regulatory response to the Credit Crunch, and perhaps a plea to the politicians not to have those changes reversed. Draghi praised the impact of multilateral policy organisations – hardly surprising if you see things from an EU perspective. He said nothing about the recent strength of the Euro, perhaps implying that he is happy to see the currency rise further.

The USA

Is it good luck or bad luck that comes in three's? Anyway, Donald Trump had to handle the triple threat in August of a deadly race riot, and the ensuing PR disaster, a significantly raised level of threat from North Korea and the chaos of a hurricane.

The upshot from events in Charlottesville was that Trump lost the spine from his caucus of senior business advisers, led out of the White House by the black CEO of Merck, Kenneth Frazier. Trump followed him out with a pointed tweet about his 'overpriced drugs' but the real damage was done to the President's standing.

The more we look at geopolitical events, like the North Korean standoff, the less we seem to worry. We were reminded by Deloitte that it took only a little over a month for the Dow Jones to recover its level after Pearl Harbour and similarly the market shrugged off the provocation of a missile over Japan as a side issue. The history of this situation is that the US has bought off North Korea in the past with cash and one assumes that it rather wants that arrangement to continue.

Storm Harvey, by contrast, looks like it has had an impact on the US mainland and economy that Kim Jung-un could only imagine. Estimates circulate of the damage costing between $30bn and $100bn (0.2%-0.5% of American GDP). This is smaller than some other natural disasters of recent years with Katrina costing $110bn (0.8% of GDP at that time), and the 2011 Japan earthquake $210bn (3.5%). As a clear national disaster, Congress will be less likely to prove awkward in increasing the federal debt ceiling in the Autumn and this will be a positive.

Where Harvey will have the greatest impact is in its disruption of gasoline supplies, and the hit to US refining capacity has seen petrol prices jump by up to 25% in the wholesale markets. Retail prices are still less than 50p a litre, in our terms, but the effect is estimated to be going to add as much as 0.3% to inflation once the downstream impact is felt at the pumps, in September. Unlike, George W. Bush, Donald Trump seems to have handled himself well in reaction to the disaster but his approval rating has hit a new low. Foreign adventure now seems to be tempting the 45th President, as much as it did the 43rd.

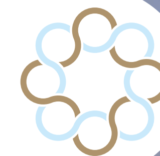
The UK

Over the summer break, it looks as if the Cabinet has been able to come to some kind of working arrangement between the Chancellor, Philip Hammond and David Davies, the chief Brexit negotiator. These two are philosophically on different sides of the argument around Brexit but look like they will collaborate on a softer, transitional approach to the disengagement. That would be a big positive if there was some hope things were moving a little faster in the direction of a successful outcome.

The return of MPs to Parliament will see if Theresa May's authority remains intact. A key indicator for politicians, the house price index softened in August, with the likely loss of dynamism in London pulling back expectations.

Europe

The upswing in sentiment towards Europe continues, and the Euro continues to strengthen. Politics is taking centre stage with Macron's attempts to reform the sclerotic French labour market and Angela Merkel looking for another term in the German elections on 24 September. After 12 years at the helm, she has huge international prestige and can point to a robust economy and full employment. The role of German Chancellor is taken by the leader with a majority of support in the Bundestag, so it is not a separate election of a single leader as in the US and France. Her performance in the weekend's election debate was a success.



MONTHLY COMMENTARY FROM PARMENION INVESTMENT MANAGEMENT

Asia, Pacific and Japan

The EU's trade deal with Japan stands as a symbol of what the UK Prime Minister would have liked to bring back from her visit, and she seems to have succeeded. The EU agreement, struck in July, envisages an end to tariffs on key manufactured goods, in particular, car parts, and closer alignment on pharmaceutical regulation, within commitments to more open trade in services. It comes into force in 2019, a key year for Brexit, and it looks as if Japan will allow a 'cut and paste' equivalent to the UK thereafter. But, there were words of caution too. Japanese business does not like worrying about the unexpected to disturb its planning, and the implication is they badly want transparency on what the outcome of our EU negotiations will be, as soon as possible.

Emerging Markets

China is hosting the 9th annual summit of BRICS nations in Xiamen this week, with a little harmony breaking out between the hosts and India, their immediate rival among the up and coming nations. The two sides have been in a stand off in the Himalayas, but have drawn back from anything appearing like confrontation.

China has sought to enlarge the membership of the BRICs group at the event by inviting five new delegations including representatives from Mexico and Thailand. The agenda will focus on the promotion of co-operation in trade and financial services, and China's communication and transport initiative, with its ambitious plan for heavy duty rail, road and shipping infrastructure binding China into the rest of the world. Their rail service from Yiwu in the east of the country 7,500 miles all the way to London began operation in January.

Chinese foreign exchange reserves

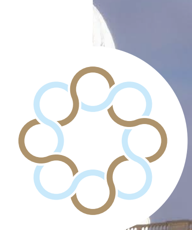
Source: tradingeconomics.com

On monetary matters, Chinese foreign exchange reserves rose by $24bn in August, making it six months of uninterrupted increase and bringing their total holdings of overseas currency back above $3trn. This is reassuring markets which were concerned capital might be leaving, potentially hitting global growth.

A sharp depreciation in the Chinese currency might be expected to cause a spike in deflationary pressure around the globe, as their goods would be suddenly so much cheaper. The signs are reassuring that the People's Bank of China has answered questions about its ability to maintain monetary stability at home.

* All performance data quoted in this article is derived from FE Analytics

First published on 7th September 2017 by Simon Brett of Parmenion Investment Management.



AS THE UK ECONOMY SLOWS, IS IT TIME TO FALL IN LOVE WITH THE FTSE 100 AGAIN?

Over the years, the FTSE 100 has become increasingly unloved. It's now rarely used as a benchmark for funds and, for the last two decades, has been largely outperformed by the FTSE 250. It's widely regarded as a stock market stalwart – experienced and a solid performer, but lacking in a little excitement.

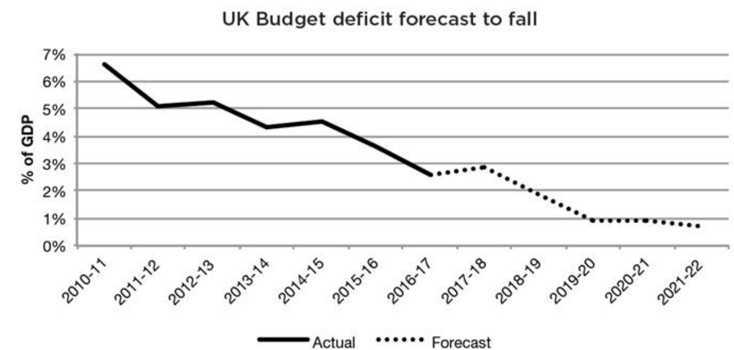
The UK has enjoyed over 20 years of strong economic growth, with smaller UK-centric firms performing well, and generally better than the mega-cap multinationals. Consequently it's not surprising that the FTSE 100 fell out of favour since it holds a high proportion of these global earners. Investors struggle to remember a time when large and established UK companies outperformed their smaller, faster-growing counterparts, hence the reason the FTSE 250 (a proxy for smaller, more domestically focussed businesses) became the UK index of choice. But could that be about to change?

Challenges facing the UK economy

It's clear that the UK economy is facing several challenges in the medium to long term, and typically the FTSE 100 comes into its own when the UK's economy is underperforming the rest of the world. Why? Because many of the companies within the index are global, and have operations in overseas markets. So what are the challenges facing the UK?

Government spending is unlikely to increase

July's report from The Office for National Statistics (ONS) saw the UK's first budget surplus since 2002, meaning the country spent less than it received for the first time in 15 years. And this trend looks set to continue. As the graph below shows, UK borrowing is at its lowest level since 2009, and is projected to decrease further over the next five years. Clearly, the Government is hoping that economic growth will come from elsewhere.



Source: Office for Budget Responsibility

"While UK economic growth looks set to hover between the 1% and 2% mark in the medium term, global economic growth continues to strengthen. In this environment, where optimism is the consensus view, it becomes even more important to remain disciplined with regards to the prices we pay for investments." - Philip Smeaton, Chief Investment Officer

Corporate spending has also decreased

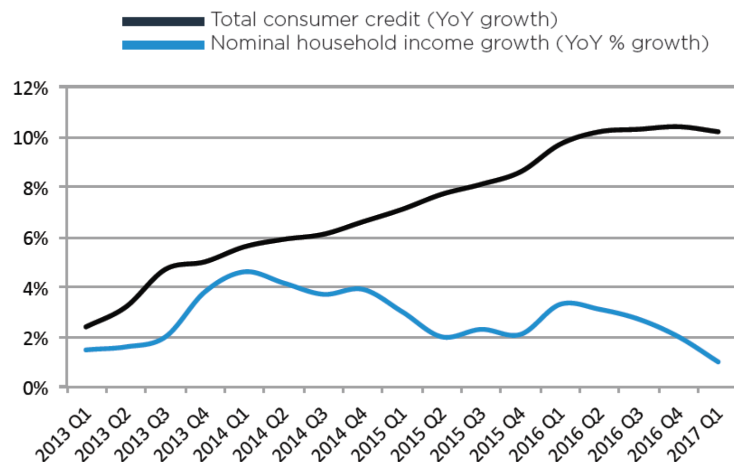
In addition to the Government tightening its belt, there are signs that private sector investment has also fallen. If this

pattern continues, we're unlikely to see any meaningful economic growth in the corporate sector – unless there's an influx of foreign investment, which is unlikely given that Brexit is casting a shadow of uncertainty over all but the most obvious investments.

Can the consumer save the day?

In many ways, the consumer has been something of a cushion for the UK since Brexit. They've continued spending and going on holiday... but for how long? With real wages falling, savings rates already at rock bottom levels and consumer credit growing year-on-year (see graph below), they are running out of tools to keep the economy buoyant.

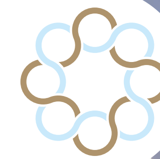
Consumer credit growth is now a real macroeconomic challenge
Annual growth rates of consumer credit and household income



Note: Net lending to UK individuals (excluding student loans), not seasonally adjusted.
Source: Office for Budget Responsibility

Unfortunately, the outlook for the UK economy remains subdued beyond the immediate future. We must be extremely selective of the kinds of UK businesses we own. If the rest of the world were to slow down (which is not something we expect), the chances of a recession here would be high.

"We recently took the decision to tilt our UK exposure towards firms that have a focus in foreign markets, and away from businesses that are purely UK-based. This naturally draws us to FTSE 100 companies, as they better represent what we're trying to achieve." - Matthew Brittain, Investment Analyst

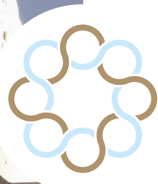


The global view

Global growth appears broad-based, and set to remain strong in the third quarter of this year. We're still concerned about the fact that asset prices are being driven even higher. This is increasing the level of risk for investors, as a negative economic surprise would lead to a larger fall in asset prices.

The markets have generally lost interest in President Donald Trump and have returned their attention to central bank policy. We expect the US Federal Reserve to begin letting its balance sheet unwind in the background while it continues to raise interest rates in a steady and predictable fashion.

The European Central Bank is moving towards a less accommodative monetary stance, and we expect it to taper its quantitative easing when the current programme ends,



eventually moving interest rates higher in about 12 months' time.

Global headline inflation rates are likely to remain stable around the 2% mark, as oil prices have traded in a fairly narrow range over the last 12 months.

First published on 6th September by Sanlam UK.

THE ESCALATING COST OF FURTHER EDUCATION

Last month saw many students celebrating (and commiserating) the arrival of their A-Level results. Assuming they got the grades they were looking for, many will now be considering their options for further education.

Few of us would argue against the value of higher education, but with the cost of tuition fees soaring (the maximums were trebled back in 2012), parents and students are being forced to think twice before assuming university is the next best step.

Unless you're Scottish, and planning to study in Scotland, the annual cost of tuition fees is more than £9,000 a year[1], meaning students will have to find nearly £30,000 to see them through the average three-year course. And that doesn't include residential fees, the cost of learning materials, and other university expenses. In fact, according to the Institute of Fiscal Studies, self-funding students in England are likely to graduate with average debts of a staggering £50,8002.

Thinking ahead and saving for the cost of further education could arguably be the best start you could give your child in adulthood – especially if that cost proves to be £50,000 per student. Here are some ideas on how you can go about it:

Junior ISA

You can currently save up to £4,128 a year into a Junior ISA, which your child can then access when they are 18 years old. At the moment, the best interest rate on the market is 3.25%3. Assuming you save for 10 years, achieving that rate of interest, you will have saved £49,427 - enough to cover the fees, and more at today's rates. The obvious benefit of an ISA over any other form of savings, is that it's tax free. You can also invest within stocks and shares within a Junior ISA to potential achieve longer term returns given University may be several years in the future.

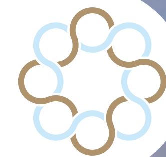
Gifting from grandparents

There are different ways that grandparents can help towards university fees. They are entitled to gift up to £3,000 each year, inheritance tax (IHT) free, which could then be placed into a savings account or investment (including a Junior ISA). They could also make a larger lump sum contribution, but if they die within seven years of making the gift, it may be liable for IHT.

Grandparents can also use a trust to gift money, which gives them the control over how the money is spent, and can also potentially lessen their IHT liability. This is a complex solution though, and professional advice is essential.

Plan to use your pension tax-free lump sum

It makes a great deal of sense to maximise your pension savings now, with the view to potentially using some of it to fund tuition fees in the future. Not only is it a tax-efficient way to save, you currently have the freedom to access those savings when you turn 55 years old, and you're entitled to take the first 25% of those savings tax free. You would need a pension pot of at least £200,000 to give you a tax-free lump



sum of £50,000, although that doesn't account for how much you will need to live on in retirement, and you should seek advice to ensure you don't run out of money.

Investing for growth

There are many ways to invest for growth, such as a stocks and shares ISA, or a bespoke investment portfolio. You could even invest in property. While such investments can produce better longer term returns than a savings account, it is always best to approach them with a medium to longer term view, such as a five to ten year investment.

[1] Source: www.ucas.com/ucas/undergraduate/finance-and-support/undergraduate-tuition-fees-and-student-loans
[2] Source: www.ifs.org.uk/publications/9334
[3] Source: www.moneysavingexpert.com/savings/junior-isa#bestbuy, as at 10th July 2017

First published on 18th August 2017 by Colin Haywood, Wealth Planning Director at Sanlam UK.

INFLATION: WHY WE EXPECT LITTLE CHANGE IN THE MEDIUM TERM.

UK inflation may persist above 2.5% for the rest of the year, but we expect it to fall back towards the Bank of England's target of 2% throughout 2018. This should keep interest rates on hold for the foreseeable future.

When thinking about the inflation picture and how it translates to interest rates, it is important to consider the domestic drivers of inflation which the Bank of England can influence, and the external drivers over which it has little control.

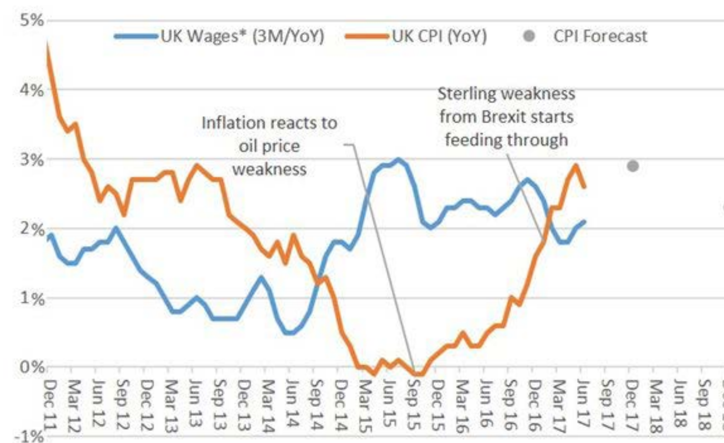
The most recent inflation numbers surprised on the downside. The consumer price index increased by 2.5% over the year, compared to a 2.6% expectation. This was driven by slightly cheaper prices at the pump for motorists. Unfortunately for those of us that take the train to work, retail price index increased by a little bit more than expected at 3.6% versus one year ago, and this will translate into rail fares rising by the same amount.

When you step back from the month on month changes in inflation though, the UK inflation picture has been driven by large external forces over which the Bank of England has little control, but ensures inflation remains fairly predictable.

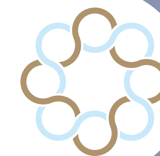
In very general terms, the 2015 inflation story was driven by oil prices falling drastically. Inflation was 0.2% that year, although excluding food and fuel it was 1.4%. The Bank of England wasn't overly concerned with these low numbers, as they viewed this as a transitory external impact that wouldn't (and didn't) impact the longer-term inflation picture.

In 2016 inflation was heading back to target as the impact from oil price declines was fading. The UK's vote in the EU referendum then sent Sterling sharply down versus our major trading partners. UK producer prices – the cost of production for UK companies – went sharply higher very quickly, and much of 2016 and 2017 has been about producers passing those higher costs through to consumers, leading to inflation rising from almost zero in 2015 to almost 3% in 2017.

Negative real wages still weighing on inflation



Source: ONS
*Average Weekly Earnings Excluding Bonuses 3M/Year on Year

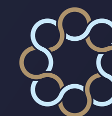


2018 will (barring a Brexit referendum, Trump election, commodity price crash or similar event) be about the subsiding effect from weaker Sterling on inflation and then the numbers will represent the underlying drivers of inflation in the domestic economy.

These underlying drivers paint a picture of the UK economy which will, over the medium term, run near or slightly below the Bank of England's inflation target. Wage growth has been weak, and even following a recent pickup to 2.1% will not be a driver for significantly higher inflation. Consumers and the market still believe the Bank of England's inflation target has credibility, and so expectations are fairly well anchored. Fierce online competition and technological change are likely to keep prices in stores under control. Technological development makes current electronics prices cheaper. Commodities seem to be in ample supply given recent investment to supply Chinese demand – which is waning slightly. Combined these factors make for a very benign inflation picture in the UK and globally.

Finally, beyond 2018, the exact nature of the agreement the UK reaches with the EU will be a big driver of inflation. We expect Brexit to be a small medium term negative for the UK economy and so might weigh on inflation.

First published on 21st August 2017 by Francois Kotze, Assistant Fund Manager at Sanlam UK.



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