MAZARS WEALTH MANAGEMENT INVESTMENT NEWSLETTER

Spring 2019

> "The market's change of mood was largely attributable to the US Federal Reserve's shift away from raising interest rates, and its indication that it would be "patient" in its approach to monetary policy."

Global stock markets regained their poise in the first three months of the year returning just under 10% in Sterling terms, and nearly recouping the losses from the final quarter of 2018. These gains were delivered despite continued concerns about economic growth which brought about a fall in sovereign bond yields and caused Gilts to rise by over 3% during the period. The market's change of mood was largely attributable to the US Federal Reserve's shift away from raising interest rates, and its indication that it would be "patient" in its approach to monetary policy. Thus it appears we are returning to a situation where interest rates may remain very low by historical standards for the foreseeable future, and with lots of money chasing few attractive investment opportunities (yields on safer assets remain very low) stock markets remain buoyant despite predictions of a forthcoming recession.

Leading indicators of economic growth continue to cast a gloomy shadow over the prospects for equities. Manufacturing Purchasing Managers Indices, which usually serve as a reliable indicator for future growth, fell significantly compared to the same measures from six months previous, and into contraction territory. We do however note that valuations on equity markets are no longer at the elevated levels seen over the last few years, and hence it may be argued that much of the bad news is already priced into markets.

At the time of writing (and most likely at the time of reading too!) the Brexit debacle trundles on towards no apparent resolution. Politics aside, markets do not seem to be in the mood to predict an outcome, with speculation on Sterling subdued, and foreign investors simply choosing to ignore the UK listed market until matters become clearer. The eventual outcome is highly significant in the short term for Sterling based investors, not least because the market is likely to deliver its verdict through its valuation of the Pound.

Our Investment Committee agreed to maintain our cautious stance reflected by our neutral position in equities and overweight position in gold. As Brexit and the value of Sterling continues to be a risk for UK investors, we implemented changes to protect our portfolios against a possible rise in the value of the Pound, and reinstated our exposure to domestically focused UK companies.

I hope you will find this newsletter interesting and relevant to you, and I would very much welcome any feedback you may have. Please do feel free to get in touch with your thoughts either by phone on 020 7063 4259, or by email on david.baker@mazars.co.uk.

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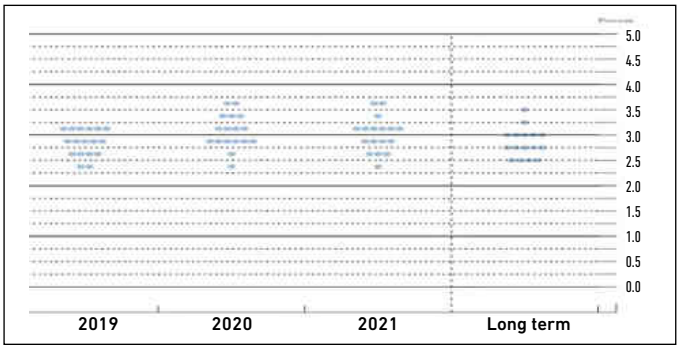
Economies and markets in brief

Fearful Fed

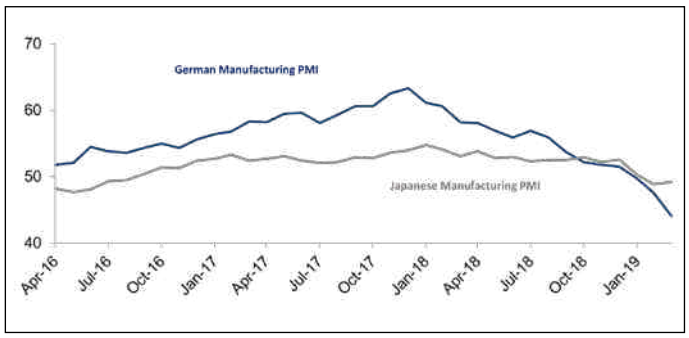
The Federal Reserve has signalled that it has become far more worried about economic growth and less worried about inflation. Last year they had been expecting three rate hikes in 2019 as the US economy continued to grow at a fast pace.

December's Federal reserve "Dot Plot" where members express where they expect US interest rates to finish for the year:



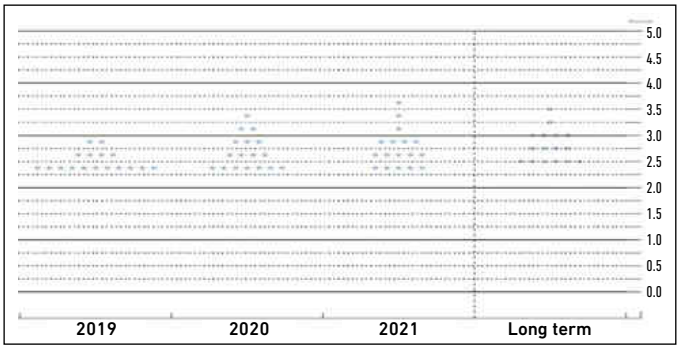
Now Jay Powell predicts no rises in 2019, with only one further rate hike planned in 2020. What is more they plan to halt the reduction of their balance sheet, known as Quantitative Tightening, in September.

Worrying data for exporters



Economic data from countries dependent on exports is starting to look worrying. Rising protectionism, especially in the US, has been blamed, although it is more likely that a general slowdown in the Chinese economy is the main factor. Both Germany and Japan had worrying Manufacturing PMI figures in February which are a sign that the sectors may be contracting. Flash manufacturing PMIs for Japan in March were unchanged, but show output falling at the fastest pace in almost three years due to sluggish demand. February's export numbers were also weak in Japan, down -1.2%, although Germany's were up +1.8%. Countries such as China and the US, which have huge internal markets, are less affected by fluctuations in global trade, however we are wary about the growth prospects in exporting nations such as Japan, Germany and South Korea.

Federal Reserve "Dot Plot" now:



There are questions as to whether the Federal Reserve has acquiesced to pressure from Donald Trump to halt the speed of rate hikes, which he views as detrimental to his 'jobs first' agenda. However with global economic data trending down the change in tone isn't too much of a surprise.

TWEET IN 280 CHARACTERS (OR SO!)

The US yield curve has inverted – run for the hills, a recession is about to hit!!!!!... Or is it? An inverted yield curve has been a good predictor of recessions in the past, but with central banks now manipulating both long and short yields, this may not be the indicator it once was.

JARGON BUSTER

MODERN MONETARY THEORY (MMT)

With global policymakers struggling to restore sustained economic growth, this fringe economic theory is growing in followers. At its core are three ideas:

1) Governments with their own currency and central bank, a floating exchange rate, and no significant foreign currency debt face no purely financial budget constraints.

2) All economies, and all governments, face real and ecological limits relating to what can be produced and consumed.

3) The government's financial deficit is everybody else's financial surplus.

According to this theory balanced government budgets are unnecessary, instead balancing the economy is more important through government programmes, which is why it is a theory popular among more economically left leaning politicians, but is unlikely to find support in conservative circles.

Ethical/Sustainable/SRI Funds

What is 'ethical' investing?

These funds allow investors to invest in companies that benefit society, or at least do less harm to society. This empowers investors and investment management companies to engage in the market according to their values and have more influence over individual companies and their social and environmental practices.

Types of funds

We can understand the different types of funds by considering their investment processes.

- The traditional approach is an 'Ethical' fund, which employs negative screens in their investment process to eliminate businesses that make profits from 'unethical' business practices. For example, companies involved in industries such as firearms, tobacco, alcohol or fossil fuels are generally excluded.
- Conversely, managers may use positive screens and invest in companies that make a conscious effort to benefit society and the planet, such as companies that develop alternative energy. These tend to be described as 'Sustainable' funds.
- ESG investing, which stands for environmental, social, and governance, is a more recent trend. Companies are scored on environmental practices, how they treat workers and whether they have good corporate practices.

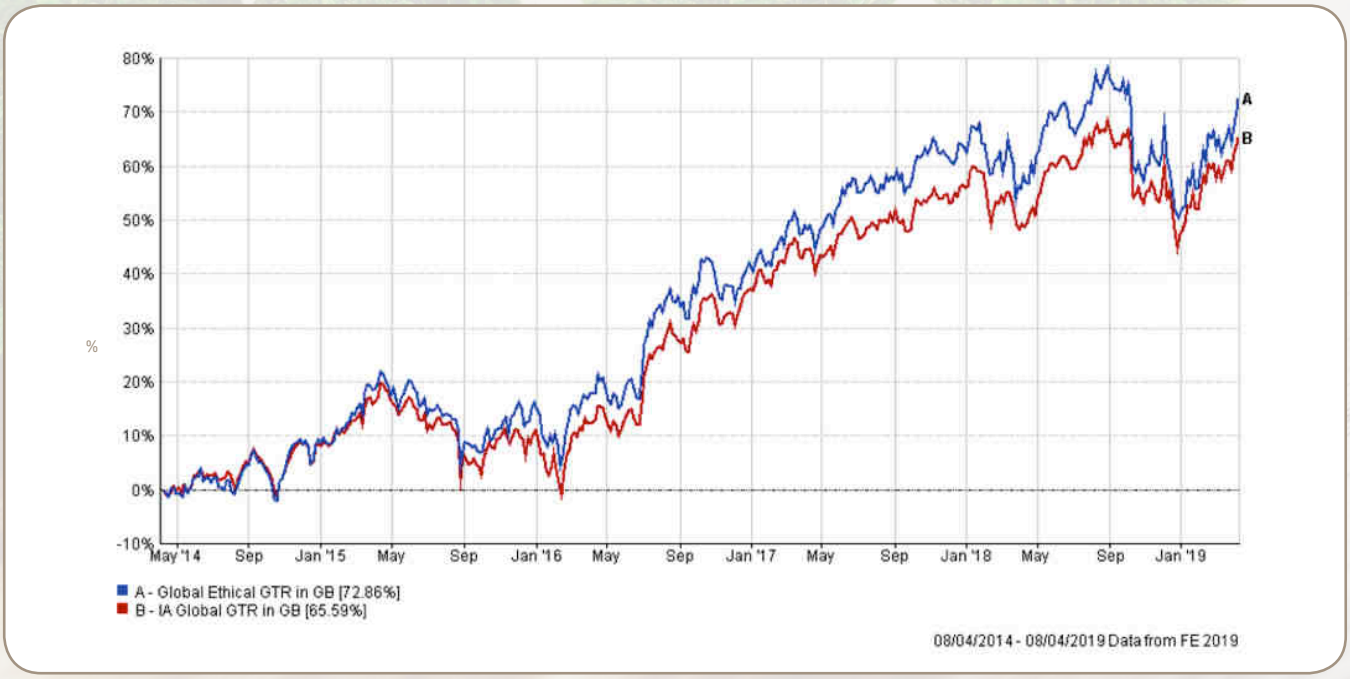
In reality many funds in the sector apply a mix of all three of these techniques. Increasingly, even funds which have no formal mandate to invest ethically are employing these techniques, as companies that are eligible under these criteria may be considered less risky as they are less likely to fall foul of legislation or poor PR.

Characteristics

Ethical funds tend to have a bias towards investing in companies that have high growth potential in areas which are exciting from an ethical and sustainability point of view, such as green energy. As a result, these stocks tend to have higher valuations. There is often a slight tendency towards cyclical businesses, since defensive companies such as tobacco and energy providers often don't meet investment criteria, so performance tends to more closely mirror the health of the economy. Ethical funds also tend to invest more in small and medium-sized businesses because many large-cap businesses fail to pass screens.

Performance

The past year has been good for ethical funds as growth stocks have performed better than value stocks, although the funds in our ethical portfolios have had mixed performance due to the sell-off in late 2018. Over the long run funds which employ ethical and sustainable selection criteria have generally done as well if not better than peers. However they have come to prominence in a period where growth has significantly outperformed value, so a reversal of this trend could see underperformance. Below is a chart of an equally weighted portfolio of our global ethical equity funds versus the IA Global sector:



UK Small and Mid-Cap Funds - In Focus

What are UK small and mid-cap funds?

UK small and mid-cap funds give exposure to small to medium size public businesses listed in the UK. These funds typically invest in companies in the FTSE UK Small Cap index and the FTSE 250 index, but can go even smaller in market capitalisation and hold positions in the less regulated and more volatile AIM index.

Why do we use them?

UK small and mid-caps have over the long term offered a return above large-caps, as smaller companies tend to have much greater scope to grow their earnings. However the uncertainty of future earnings do make smaller companies a more risky investment. They are generally viewed as under-researched, enabling greater outperformance for good stock selectors. Small to mid-caps typically have less of their earnings coming from overseas compared to large-cap heavyweights, which increases correlation to Sterling compared to companies like Shell or Rio Tinto. Small-to-mid, or SMID cap funds as they are sometimes called, are more tied to the local economy which can be a blessing or a curse depending on the economic growth of that particular country.

Our approach

We have been running an underweight position to UK risk assets amid Brexit fears, weaker economic growth projections and lower productivity growth, however we have moved back to neutral this quarter due to the receding risk of a "No Deal" Brexit. Small-cap exposure is provided through Marlborough Special Situations who run a diversified portfolio of UK small caps, using a process based around quality-growth metrics with over 40% of the fund in AIM shares. Our UK mid-cap exposure is through Franklin UK Mid Cap, who run a more concentrated portfolio, in part due to the smaller universe, with a value based strategy focused on downside protection of capital.

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