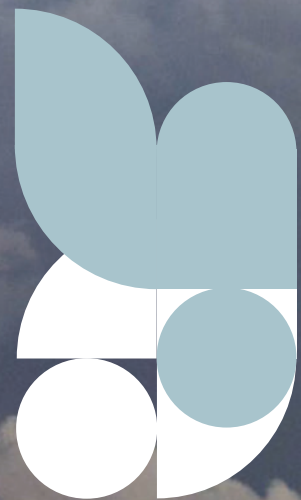


For professional
intermediaries only

Prepare for
turbulence



Rathbones
Look forward

What we
want to own

- equities, especially growth companies
- assets exposed to US consumers
- safe havens, including high-grade Swiss franc bonds, gold, cash and diversifiers
- commodities, both industrial and precious metals and energy.

...and what
we don't

- cyclical companies, particularly retailers and deep value
- government bonds, given low/negative real yields and unstable Western politics
- commercial property, especially retail space and offices
- sterling and the euro.

The value of investments and the income from them may go down as well as up and you may not get back your original investment.

Buckle up, it's going to get bumpy in 2018.

We believe changing monetary policy currents, combined with a more combative political mood, will cause more turbulence in asset markets. This call has been made – prematurely – many times over the past two years. By us and by many other investors. This was because the US didn't tighten nearly as fast as expected, while the central banks of Europe and Japan – and to a lesser extent the UK – continued to unleash considerable liquidity into the global economy.

This appears to be changing. GDP growth, employment, consumer confidence and inflation in the eurozone and Japan have all improved noticeably in 2017. The tremendous stimulus packages enacted by their central banks may start to unwind in the not too distant future. As for the US, it is barrelling ahead on an optimism about the future that is becoming self-fulfilling. If several large central banks begin tightening together, we think it could have a reasonable effect on global bond yields. That, in turn, would impact the discount rates used to value shares and property. And there we have the disruption.

Despite the greater turbulence, we are still optimistic about equities because we believe the chances of a recession in the US or China are remote (such a downturn would drag the rest of the globe into recession too). We are trying to avoid as much duration, or interest rate risk, as possible in all of our holdings, bonds and equities.

David Coombs

Head of Multi-Asset Investments

1. Drawn-out Brexit

This is the year. By the end of 2018, we should know the terms of Brexit and even whether the endeavour will actually go ahead.

Fluctuations in sterling – ‘the Brexit barometer’ – have had a huge effect on UK investors since June 2016. We think that will continue. Recently, sterling has become a much harder game to play. We think that, on a long-term view, sterling is significantly undervalued. But a lot can happen in the shorter term: unclear and shifting political stances are vying against changeable UK monetary policy; a strengthening Continental economy is clashing with continued political uncertainty in the EU; and unclear US fiscal spending is making it more difficult to determine the likely path of US interest rates.

In short, currency markets are more capricious than a cat with a vendetta. And that’s before you account for the – unlikely, but heightened – risk of a second referendum on Brexit, which would play havoc with sterling forecasts. Any bad Brexit news from here would likely mean further weakness in sterling. That would put the bellows to inflation, creating problems for income-producing assets. That’s not just bonds, but low-growth equities like utilities, infrastructure funds and commercial property, too. Conversely, any clarity on the future will likely push the pound higher, hurting FTSE 100 overseas earners and manufacturers.

As for the Government, the November Budget showed just how hamstrung it is. Chancellor Philip Hammond presided over an underwhelming affair where it appeared that money was too tight for any meaningful fiscal boost or spark of vision. The fragility of the Government means there is a threat that it could collapse, opening the way for Jeremy Corbyn’s Labour to take power in an early general election. The chances of this seem slim, but the potential effects are worrisome enough to keep this risk high up in investors’ minds. A failure over the Brexit negotiations seems the most likely spark for this tinderbox. If Mr Corbyn were to become Prime Minister, we believe gilt yields would rise and sterling would fall dramatically as foreign investors may abandon UK assets wholesale. Domestic equities would be hit hard, both by rising import costs and a fall in businesses’ appetite to invest (hitting economic growth). The ultimate result could be stagflation. If an election were called, we would avoid UK assets with extreme prejudice.



2. US-Europe conundrum (not for us though!)

For many years, we’ve preferred corporate America over its European cousin. For a decade, that’s been a pretty popular stance in investment circles.

In the 10 years since 30 November 2007, the S&P 500 has delivered a 79% return. The Euro Stoxx has fallen over that time – it’s still below where it was before the global financial crisis. However, lately European economic growth has started to turn around, leading many investment managers to change their historically dreary opinion on European shares. Not us though.

European inflation appears likely to remain muted. Growth has probably peaked – at 2.6%, relatively low for a region heavily tied to global commerce – and there are still plenty of unemployed in the bloc. For us to change our view on the Continent, we would need to see: a reacceleration in global growth; a sustained increase in bund yields; better prospects for the financial and consumer discretionary sectors; a global adjustment where value companies outperform growth.

We believe the great, fundamental shortcoming of Europe is the halfway house that is the EU. It needs true fiscal union for the project to work, to create significant blanket reform across the Continent (rather than patchwork, beggar-thy-neighbour political moves) and spur higher economic growth. There’s no appetite for such ever-greater union, which is why we continue to be dubious about the euro area. There are some great European companies, but economic constraints mean we cannot bring ourselves to invest a substantial portion of our funds more widely in the EU. In short, we don’t see 2018 being any different: US stocks will outperform European ones, in our opinion.

3. Out with the old

Computer games are big business. The next generation – both guys and girls – is more likely than any other to while away the hours with some electronic distraction. An explosion in the means of doing so has helped this. No longer do you have to be sitting at home in front of a PC or TV, hooked up to a console or own a Game Boy. Now nearly everyone has a gaming machine in their pocket: a mobile. And that hasn't slowed the growth in traditional video gaming either.

In September 2016 we bought a structured product that tracked a basket of eight gaming companies. Since then, it has appreciated by 80%. It's been an incredible investment so far, but we think there's more growth to come, particularly as virtual and augmented reality develops. Youngsters today are more likely to go to watch League of Legends at the O2 than go see Arsenal at the Emirates Stadium.

We're roughly 20 years into the digital world and the progress has been phenomenal. Everything is happening much more quickly today, and that goes for businesses and products as well. Risks are high at the bleeding edge of technology; the penalties for incumbent complacency can be fatal. And these risks are creeping into other industries too. The power and allure of the traditional brand is not as strong as it once was. Today, shoppers can use product reviews and the equalising power of internet searching to target the best deals. Big suppliers' command of prime supermarket shelves to squeeze out lower cost rivals is no defence online.

These days, the 'defensive moats' of incumbents are no longer as strong as they used to be. We are much more alert to the potential for traditional leaders to get dismantled by upstart rivals.



4. The death of Fairy Liquid?

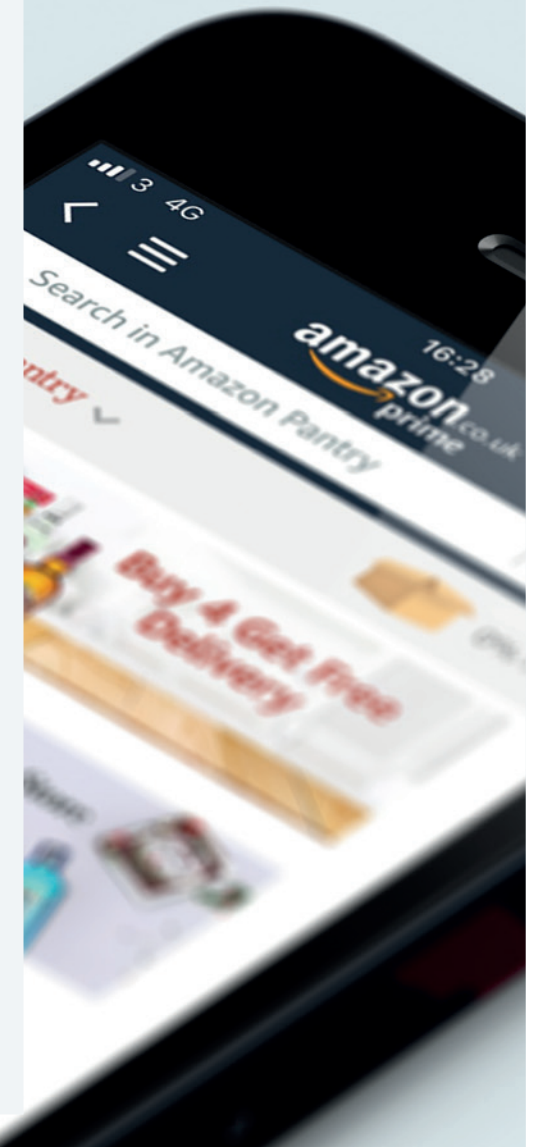
There is a new factor risk in equity markets: the Amazon Effect. Share prices get beaten up simply on a rumour that Amazon may enter a company's market. Even decades of unrivalled dominance is no defence – investors seem to feel Amazon is unstoppable.

We can't remember the last time we met a company or fund manager for an update and Amazon wasn't mentioned. Even Ferguson, one of the largest US plumbing suppliers, had a strategy for ensuring its online sales platform was buttressed against an offensive by Amazon.

Jeff Bezos's e-commerce monster hasn't just been ripping into retailers – it's been hurting suppliers and manufacturers too, by offering cheaper alternatives to branded goods. You can buy Fairy Liquid for £1, but the Morrisons store brand is right next to it for 60p (Amazon has a partnership deal with Morrisons supermarkets in the UK). And Fairy Liquid isn't the only branded good getting squeezed in this online war. It's batteries and nappies and a thousand other everyday products. It's pharmaceuticals and gig tickets and television networks.

Amazon's algorithms know more about what customers want than they do. Its business model is less selling stuff online than it is creating low-cost, high-value services by fine-tuning processes to be as lean as possible. That is a tremendously transferable business skill.

The bottom line is that owning Amazon is now kind of a hedge against this Amazon Effect factor risk – along with being a fantastic investment in its own right. Like gold, another popular hedge, Amazon is difficult to value. How much potential earnings are on offer from a company that is building such formidable defensive moats around itself? With both gold and Amazon, you can make arguments that it looks expensive or that it's too cheap almost simultaneously. And like gold, you are arguably buying Amazon with faith – that Jeff Bezos will deliver.



5. Misplaced China-phobia

Here's a stat: 30% of the world's GDP growth since 2010 was China. That's phenomenal. Now that can't continue forever, and the law of large numbers is working against the Chinese growth rate. As the country's economy gets bigger, it simply cannot sustain 6.5-7% growth.

But it's important to remember that the absolute amount of economic activity is far larger than when the rate was much lower (obvious, but sometimes overlooked). Also, the quality of this growth should increase as the nation's leadership tries to reduce reliance on debt-fuelled expansion of heavy industry and encourage technology and services businesses. We call these areas the 'New China', and they are where our focus is. There are great companies benefiting from the rapidly increasing number of Chinese air travellers; others are dominating the internet and video games in the world's most populous market; while many more are making the most of the nation's burgeoning middle class.

We've always been more optimistic about China's prospects than the market, and we continue to be so. Yes, it has problems: debt and disintegrating productivity growth are two of the largest. But it's one of the major drivers of the global economy in the 21st century. Its government has an iron control on all parts of the economy giving it many more levers to pull and twist to deal with challenges. It's going to be an exciting journey over the next decade or more. This will benefit China's neighbours and greater Asia as well – including Japan, whose corporations are having a fantastic run of earnings. We think Asia is one of the most promising areas in the world for growth right now.



6. Parched cycle

Economic growth is slower now than during past booms, but that hasn't necessarily been bad for share markets.

Around the world but especially in Western markets, equities have boomed over the past several years. Those companies that have benefited most are the ones that are growing steadily, regardless of the muted wider expansion in the economy. While we think the considerable gains notched up in 2017 are unlikely to continue next year, we still expect modest gains, albeit with higher levels of volatility.

One thing that should continue, however, is the outperformance of growth stocks compared with value stocks. When growth is scarce, investors tend to pay up for companies that offer it – and the higher quality the earnings, the more they are willing to pay.

Many of these companies are riding the growth of new industries and technologies. That could be the rising tide of electronic and contactless transactions, the computerisation and automation of vehicles or the wave of e-commerce. It's not just the sexy technology companies that fall in this camp either. Some others are winning market share in sectors as old as industrialisation because of prudent investment, courageous leadership and good old-fashioned cash flow management.

There are great companies all over the world, in an all manner of industries. You just have to take the time to find them, understand them and let them grow.



7. For the few not the many

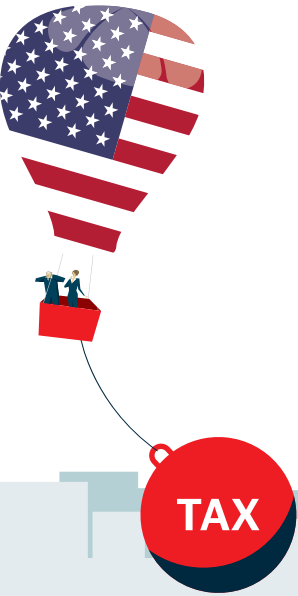
We believe American tax-cuts – when they arrive – will undershoot expectations. They’ve been built up too much in investors’ minds for them to give anyone a happy surprise now. Also, congressional Republicans are too divided to deliver something truly revolutionary.

The latest tax plans tabled in the Senate and the House of Representatives offer modest cuts to personal income taxes for the middle class. In fact, for many poorer Americans, they will be worse off in several years’ time. This tax plan is shaping up to be one for corporations, those earning more than £100,000 and the self-employed and small businesses that can better structure their affairs. The cut to corporation taxes will not have a huge impact beyond simplification, because most listed US corporations pay an effective rate way below the statutory rate. But it would have some effect, particularly on banks. And the ability to repatriate foreign earnings should also add some wind to American corporate sales. More money in the pockets of the self-employed and small businesses would also help buoy business and consumer confidence, both of which are relatively high already. US wage growth – which has started sneaking upward in 2017 – should also help in that regard.

Still, we have a nagging feeling that this may not come to fruition at all. Or if it is passed, it could be dismantled somehow. If the tax plan does go through without a hitch, it seems more likely that the US Federal Reserve could make all three interest rate rises it has forecast for next year. That would send the dollar back on an upward trend after a lacklustre 2017.

However, new Fed Chair, Jerome Powell, is an unknown. He is widely seen as another Janet Yellen, but this is not guaranteed; he could well end up more dovish – or hawkish. It’s important to remember that the Fed has consistently under-delivered on rate increases, so the market has little faith. Fed Funds futures put the probability of three 0.25% interest rate hikes in 2018 at 19%.

We will be watching Mr Powell closely, along with the several more Fed members that are to be appointed in 2018. Any change to the mood of the FOMC will have significant effects on interest rate expectations and therefore on the values investors put on future cash flows. Because of this environment, we have been adding to assets that should do well from rising interest rates, such as banks and insurance companies. Where we own consumer product and service companies, we are being careful to avoid those areas where squeezed punters will stop spending first. That means we are generally avoiding US hotels, restaurant chains and retailers. Instead, we are holding strong brands that are able to streamline costs and use their business clout to pass on any inflation to retailers.



Get in touch

For more information, contact our intermediaries team on **020 7399 0000** or visit **rathbones.com**

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