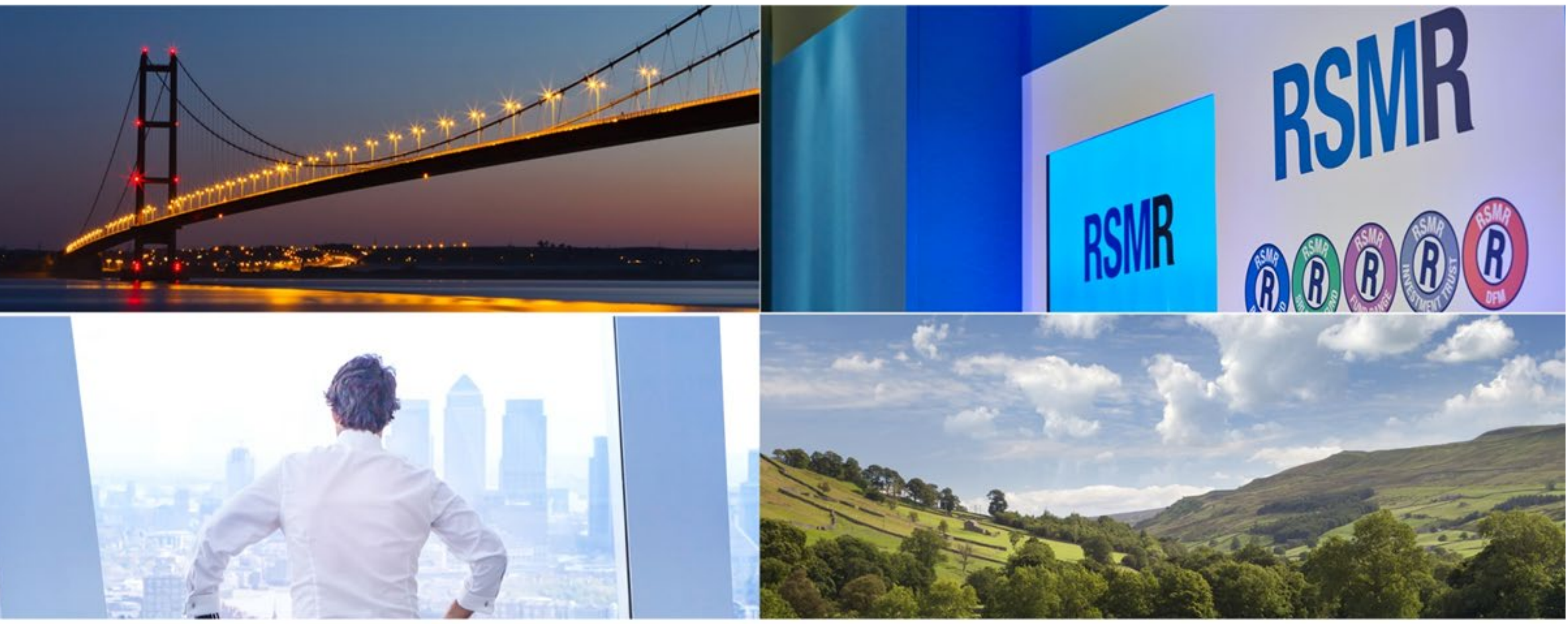

PRIVATE & CONFIDENTIAL

Grayside Quarterly Investment Bulletin

October 2018

General Economic Overview – Quarter 3 2018

The global economy presents an uncertain picture at the end of the third quarter. Whilst US growth continues to power ahead, the rest of the globe seems to be travelling at a different pace. The US has had an injection of adrenalin during 2018 with the corporate tax cuts allowing companies to build greater levels of profit and to repatriate foreign cash piles. This has in turn helped push the US stock market much further ahead than the rest of the world's markets, as higher earnings have started to reduce the very high PE ratios which caused concern in 2017 giving the market a less expensive look.

The US administration has continued to threaten global trade by imposing trade tariffs on countries outside its borders, in particular China and Europe. This has naturally caused retaliation with the end not yet in sight. The so called trade wars are one destabilising force in the global economy that has left us feeling that the level of uncertainty around global growth has increased this quarter. Sanctions have also been placed on Iran and Turkey alongside Russia making these economies weaker and creating further destabilisation. Trump's 'America First' policies have resulted in the S&P500 being 'first' this year amongst major markets, its relatively closed economy making it better placed to suffer less damage than many overseas markets. The US typically has defensive qualities in more difficult times, even when it is lacking valuation support.

Other factors adding to the uncertainty include Brexit in Europe and the rise of minor political parties such as the Five Star movement in Italy that have led to a populist movement gaining ground in elections across Europe. In Asia and emerging countries the threats over global trade and the strength of the US dollar have led to further uncertainty and this has been reflected in stock markets. Whilst these economies have much stronger fiscal positions they still react negatively to a strengthening US currency.

The economic cycle is now very extended, making a recession of unknown magnitude a more likely scenario than the continuation of global growth. The current period is unusual in that it has drifted along at low levels of growth which in turn has kept inflation and wage growth more subdued than a typical economic cycle. It does not mean that a recession will definitely occur in the next twelve months but some signs of wage growth in the US and higher than expected inflation numbers in some countries may be the catalyst for change. The move to quantitative tightening is taking place across the globe with central banks withdrawing support in different ways, perhaps with the exception of Japan. The effect of this so far has not been significant but the global economy has been surviving on this injection of capital and we are moving into territory we have not seen for some time as this support weakens.

Equity Markets Overview

The interesting factor for most investors this quarter has been the almost binary reaction of stock markets to the economic and political uncertainty evident around the globe and to what is happening in the US. The main US markets have risen over ten percent this year with the Nasdaq up over twenty percent whilst the rest of the globe (excluding emerging markets) is more or less flat to slightly positive. This type of differential is unusual for its size and the length of time it seems to have been established for. The US economy is the strongest on current data but other economies are growing and have positive outlooks from their domestic companies, so why the difference? There is no single answer to this, US tax cuts, share buybacks and the focus of the markets on the technology sector in the US are some of the reasons but also the fear factors are stronger in Europe and Asia than in the US where the domestic economy is a much larger element of overall GDP. In the UK we can't avoid the effects of Brexit as markets rotate from positive to negative depending on what political statements are made about the state of the deal to leave Europe. Asian markets have also had a more difficult quarter as fears over a Chinese slowdown and the effect of tariffs on global trade in the region has caused concern, as well as a strengthening US dollar which always affects sentiment in the region.

UK

In August this year we saw the Bank of England raise interest rates for only the second time since the financial crisis. This was a unanimous decision and backed the need to put some levers in place for any forthcoming downturn. Inflation figures issued in September surprised many economists by coming in ahead of expectations, backing the decision to raise rates in August. The rate change was intended to be a careful balancing act by the Governor, as he went on to make comments about the continued threats from Brexit, whilst also aiming to keep control of inflation as wage demands creep up. Clearly much of the debate over the UK economy is focused on the potential outcomes of Brexit, the latest stage of which is the negotiation over the deal that takes the UK out of the European Union in March 2019.

The economy continues to grow at a modest but positive level and the main stock market has maintained a consistent level year to date although far behind the equivalent in the US. According to the latest Bank of America Merrill Lynch fund manager survey, global managers have been selling UK stocks at their fastest rate since 2016 – no doubt buying US tech stocks. Care is needed not to always follow the crowd however as many UK based companies have a global footprint and with the forward price earnings ratio for the UK at 13.5x there is some value returning to these markets. Despite all the current negativity there are managers who can make use of these opportunities picking stocks that can be and should be looked at for the longer term, not just the next six months. Undoubtedly, we have to be watchful over the UK economy and market given the ongoing uncertainty over Brexit but equally we should not ignore the opportunities that may arise.

US

The US stands out as the strongest economy in the West and is leading the continued positive movement in equity markets. The economy has been the beneficiary of recent corporate tax changes which has, for the time being, added to the heat in the US economy. The US economy seems to be moving further ahead of its global counterparts, evidenced most clearly in stock markets this year. This is not unusual but, driven on by the aforementioned fiscal stimulus, it does seem to be creating a worrying gap to the rest of the world. Slightly perplexing for many investors, this growth has not been reflected in higher inflation and wage demands given that unemployment levels are running at their lowest levels since before the global financial crisis. Recent data suggests this might be changing and if this is the case then we may see faster rate rises than currently predicted.

Trade wars and greater isolationism are easier for the US to justify given its large domestic economy but anything that affects overall global growth will eventually hit the US as well so a careful path needs to be trodden by the US administration, not currently known for its subtlety in negotiations! It is difficult to determine whether the US is in a late cycle growth phase but the likelihood is that record company profits are unlikely to be repeated into 2019 without further incentives or better than expected economic growth.

Europe

The pressure on markets outside of the US has also affected Europe and this can be seen in the confidence of investors in the stock markets around Europe. Political uncertainty is probably heightened in Europe because of the rise of the populist movement which has unnerved the traditional parties and structures. Add Brexit into the mix and the level of uncertainty is definitely elevated. That said, Eurozone growth is still expected to be over 2% this year and it can continue to benefit from the expanding US and Asian economies, specifically China, even if we see a slowdown from recent growth rates.

Europe has a robust domestic market with PMI data suggesting companies are still positive on growth. Overall valuations for European equities are on a forward PE of around 19x with an historic average of 14.3x according to J P Morgan research. These are higher valuations than investors would like but they are lower than in recent periods so some value has returned to markets. The threat of quantitative tightening also hangs over markets as the supportive monetary environment gradually fades. The ECB bond buying programme is set to finish in January 2019 and the environment in 2019 will need to be watched carefully as we head towards Brexit in March.

The one area that remains supportive is interest rates which are still low, (10 year German government bonds are 0.4%) which supports investment and means the dividend yield on European large cap equities still looks attractive. Europe, like the UK, needs careful monitoring as we move into quarter four and through into 2019 with the levels of uncertainty currently higher than normal.

Asia

It is difficult not to view Asian and emerging markets as very similar in terms of the main underlying economic influences and key countries – China for example is included in both areas when assessing the regional economic statistics as it has such an influence on the region that any issues it faces have a huge impact on sentiment and therefore investor confidence. The recent issues relating to trade wars between the US and China have affected views on the region with data suggesting the Chinese economy is slowing down as the leadership holds back from further fiscal stimulus. There are however positive tax cuts for companies in China as they look to support growth amid an escalating trade war with the US.

The rise of a globalised world economy has been a trend since the end of the Second World War so it should not be a surprise that at some point there will be road blocks to this continued expansion. The US administration is creating one such road block, as it serves their purpose at the moment and does not affect their domestic economy as much as those that are export led, such as Asian and emerging economies. A further, perhaps unintended, consequence of US monetary policy is the strength of the US dollar which has affected the Asian region given its higher proportion of dollar debt. Whilst this has fallen significantly since 2013 investors still react negatively to US rate hikes. The region does have strengths – India is a highlight with growth reaching 8% in June 2018.

Japan

Japan has seen improved growth over the summer realising 1.9% year-on-year as at the end of June. The quarterly corporate earnings season delivered solid results, suggesting that the positive momentum in corporate earnings remains on track. In terms of economic data, Japanese second quarter GDP growth was estimated to be 0.5% quarter-on-quarter, recovering from a decline of 0.2% in the first quarter of 2018. This improvement was underpinned by strong domestic demand, specifically consumption and investment. Lower than expected inflation led the Bank of Japan to make only small adjustments to its policy, and the bank confirmed that the current low interest rate policy would be maintained for 'an extended period of time'.

Much of the quarter was very quiet in terms of Japan related news, with investors focused instead on escalations in trade tensions between the US and China, and continuing strain within the European Union. The most important aspect for Japan has been the increased potential for the US to apply tariffs to auto imports. Although Japanese car makers already have moved some production facilities offshore, auto exports still represent a significant part of Japan's trade balance. Japan should not be disproportionately affected by the issues currently weighing on global equity markets, in fact, the different timing of policy cycles should actually work in Japan's favour as it continues to pursue an aggressively loose monetary policy while both the US and Europe look to tighten. Although there is now strong evidence that Japan is recovering from the soft patch seen in the domestic economy in early 2018, there is as yet no incentive for the Bank of Japan to signal any change in monetary policy.

Emerging Markets

These markets have been under stress so far this year as a combination of a slowing China with global trade wars, higher US interest rates and a stronger dollar have undermined the economic and financial progress made in many areas in the region. Added to this we have had the economic crises in Turkey and Argentina which, although small weightings in the MSCI EM Index, have added to the increasing investor concerns about the region. In 2016 and 2017 global recovery, low interest rates and rising commodity prices looked positive for stock markets, and they resulted in gains in the MSCI EM Index of 30% in 2016 and 25% in 2017. This was backed by the strength of emerging market currencies against the dollar. From January this year the tables have turned quite dramatically – rising US rates and a stronger dollar have finally bitten into the positive sentiment that had supported markets. Dollar strength led to currency rises in those countries with significant US debt such as Turkey and Argentina triggering a contagion that rippled through emerging currency and stock markets.

In 2018 to date the MSCI EM Index has lost just under 8% and volatility has spiked. In many ways the structural changes in many emerging market countries have insulated them from the rate hikes in 2017 but in 2018 the region has suffered across the board. Looking longer term, the current issues are not systemic as current account deficits have narrowed and currencies have been allowed to float more freely with only 10% of the region pegged to the dollar. Stronger balance of payments have improved reserves of foreign exchange within many economies, again improving fiscal strength. At this point emerging market stocks look better value than many other global stocks although this needs to be considered on a country by country basis. Argentina, Turkey and South Africa for example are enduring serious economic problems whilst India and Taiwan are engines of strong growth.

Fixed Interest

This has been a perplexing area for investors for a number of years with the bond bubble failing to burst, as expected, in recent quarters. Interest rates have begun to rise across the globe with the US leading the way to normalisation but with a long way to go to get back to pre GFC rates. There is a good chance that the next phase of rate rises won't reach these levels before we roll into a more recessionary environment in which case the threat to bond holders' capital is much reduced compared to twelve months ago. The yield curve for government debt is very flat at the moment with little incentive to take on longer term issuance for retail investors. Spreads between government and investment grade debt are tight giving investors the conundrum as to whether they take more risk further down capital structure, or move into lower rated bonds. Even high yield debt has little more to offer in terms of spread at the moment. If spreads do widen then managers are likely to take advantage. Emerging market debt has been a source of good returns in 2017 but has illustrated its volatility characteristics in recent months with the threats to Asia from trade wars and a stronger dollar hitting valuations.

Some of the strongest performing managers at the moment have either taken more risk in lower grade bonds, moved into unrated assets or diversified more widely into asset backed securities including floating rate notes. One of the reasons for flat curves across different asset types is the demand for shorter duration assets to protect against higher interest rates. Shorter duration bonds have yet to prove themselves as yields have not moved up as quickly as investors expected. In credit, debt issuance is highest in investment grade companies who still believe rates are low enough for continued leverage. This leverage is now seen to be at a 25-year high which illustrates a further market risk with liquidity much lower than in previous pre-recessionary periods. With quantitative tightening in the background sentiment could turn quickly, in which case these risks may be greater than we currently have factored into our portfolios. The central case is more measured however, with few investors expecting sharp changes in data causing sentiment to turn unduly negative, but with little margin for making any gains at current rate and spread levels.

Property

The main source of returns from property is expected to be income and this has been evidenced in 2018 by the returns from various assets types within the sector. The return this year from commercial property has been around 5.3%, the majority of which has been income – in August income was 0.5% of the 0.6% total return. Analysis of the sectors suggests that the Retail sector was the worst performer to the end of August, with capital values falling by -0.4%, the fifth consecutive monthly fall. Rental values also fell, by -0.1%.

Two years on from the UK referendum on EU membership, commercial property has delivered attractive returns and, despite the negative sentiment following the vote, the decision to leave the EU hardly made a dent in the medium-term performance of commercial property. By the end of 2016, capital values had all but recovered their summer losses. The same property fundamentals that provided that resilience remain largely in place today. While the possibility of an acrimonious Brexit appears on the rise, transaction volumes – a gauge of investor appetite for risk – suggest a collectively more pragmatic outlook. Property remains a sensible asset for diversification as long as investors are prepared to retain assets for the longer term in the knowledge that liquidity in the sector is more limited than other assets.

Summary

The third quarter of the year has not produced any real changes in outlook. The prospects for global growth seem more muted as we move forward, with Asian markets reflecting concerns about a slowing

Chinese economy, as well as dollar strength, and the effect of higher tariffs on exports to the US. The US is probably the exception to this at the moment with expansion supported by tax incentives over 2018. This effect will start to fade into 2019 but it is possible that increasing inflation and wage demands will lead to higher US interest rates slowing down the current rate of growth. Other economies are expanding faster than the US (such as India), but at present they do not have the same global impact on GDP. At the same time we have monetary tightening from central banks, which is reducing central bank support to the debt markets as well as increasing the cost of money to institutions and retail investors. With high levels of borrowing in the consumer sector the threat to company profits is growing larger, and this will increase significantly if interest rates continue on an upward path. The corporate sector remains confident however with global PMIs generally holding above 50 which suggests continued expansion, but the days of uninterrupted economic globalisation do seem to be numbered as we observe more restrictive trade agreements being put in place. It is very difficult to pin-point where we are in the economic cycle and whether this latest improvement in US growth is a late cycle flurry or can be extended into 2019 and beyond.

Equity markets have been driven up by the technology sector in both the US and Asia with the headlines reflecting the continued growth of the large FAANG stocks in the US, but there is a broader technology stock premium across the globe. The technology sector has more substantial foundations than in the 1999 bubble, and it is not expected that we will get the same kind of fall-out if there were to be a recession of some kind – although they will not escape a downturn either. Most markets have been flat this year with the US being the exception from a positive perspective and emerging markets from a negative one. As we have noted above, rate rises in the US and consequent dollar strength has been a significant factor in this differential, but it has created pockets of value in emerging and Asian markets which longer term investors have looked to take advantage of. Fixed interest markets have had a more difficult year with pressure on yields and tight spreads making any gains very difficult other than in selective higher risk areas. The outlook for the rest of 2018 does not appear to be much different for retail investors with any real returns achieved from income rather than capital appreciation.

Overall economic growth is moving ahead at a steady if subdued pace with stock markets reacting very differently across the globe to current conditions. Managers that we speak to are more cautious in general with multi asset strategies holding more cash than in previous quarters, whilst being selectively underweight to certain sectors and regions but still favouring equities ahead of other assets.

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