gemini asset management

marketmatters

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Market Review - Review of markets over the third quarter of 2018

A booming US economy has driven US stocks higher this quarter, leaving US equities some way ahead of the pack over the year as a whole. In September, US consumer confidence hit its highest level since 2000, while the monthly average of initial jobless claims fell to the lowest level since 1969. Wage growth rose to the highest level since 2009, supporting retail sales growth of over 7% year on year. Also, the National Federation of Independent Business's survey showed that small businesses were the most optimistic they've been since the survey began in 1974. Against this remarkably strong growth backdrop it's not surprising that US equities have delivered attractive returns.

At the start of the year the market thought there was only a 20% probability that, by now, the Federal Reserve (Fed) would have already raised rates three times this year. Even at the start of July, markets thought there was a 40% chance that the Fed wouldn't increase rates again in the third quarter. However, by the time the Fed raised rates for the third time last week, bond markets had already fully priced in the increase, with US Treasury yields drifting higher over the quarter.

Emerging market (EM) equities have been weighed down by a slowdown in the pace of Chinese credit growth, fears over the vulnerability of some economies to tighter US monetary policy and concerns about the potential impact of global trade tensions. China has successfully slowed the pace of non-bank credit growth but, faced with the external headwind of US tariffs, the authorities are now easing policy to support domestic growth, while maintaining regulatory pressure on shadow lending. This should provide some support for those EM countries that depend on Chinese demand.

Source: Thomson Reuters Datastream, Schroders Economics Group, G0032, September 24, 2018.

On the other hand, the EM economies that are most reliant on external funding are finding the tightening in US monetary policy challenging. As the Fed continues to raise rates, EM countries with large dollar-denominated debts may continue to struggle. Should growth in the US slow then whilst this does not bode well for risk assets, slower growth in the US is likely to be accompanied by a weakening in the US dollar (USD). This would provide some relief to the emerging markets whose relative performance is closely tied to the USD as can be seen by the chart shown left

Higher oil prices are not helpful in this context for those EM economies that are large oil importers, particularly those whose currencies have fallen sharply, further increasing the cost of imports in local currency terms.

UK equities have been weighed down by fears of a no-deal Brexit. Interestingly, the inverse correlation between the pound and UK equities has broken down recently. Perhaps, as the deadline for a deal edges closer, investors are becoming less willing to view the possibility of a no-deal Brexit as a positive for the stock market, even with the Sterling weakness that would accompany such an outcome.

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It is possible that investors view deadlock within the Conservative Party as increasing the risk of a Labour government with a populist agenda. This concern complicates the outlook for UK investors, who had become used to a weak pound helping UK stocks. This makes the outlook for UK equities particularly hard to predict.

World Stock Market Returns (local currency)

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	YTD	3Q 2018
MSCI Asia ex Japan 38.0%	UK FTSE 100 -28.3%	MSCI Asia ex Japan 67.2%	MSCI Asia ex Japan 15.6%	US S&P 500 2.1%	Japan TOPIX 20.9%	Japan TOPIX 54.4%	US S&P 500 13.7%	Japan TOPIX 12.1%	UK FTSE 100 19.1%	MSCI Asia ex Japan 35.9%	US S&P 500 10.6%	US S&P 500 7.7%
MSCI EM 33.6%	US S&P 500 -37.0%	MSCI EM 62.8%	US S&P 500 15.1%	UK FTSE 100 -2.2%	MSCI Europe ex UK 20.0%	US S&P 500 32.4%	Japan TOPIX 10.3%	MSCI Europe ex UK 9.1%	US S&P 500 12.0%	MSCI EM 31.0%	Japan TOPIX 2.0%	Japan TOPIX 5.9%
UK FTSE 100 7.4%	Japan TOPIX -40.6%	MSCI Europe ex UK 29.0%	MSCI EM 14.4%	MSCI Europe ex UK -12.1%	MSCI Asia ex Japan 19.7%	MSCI Europe ex UK 24.2%	MSCI Asia ex Japan 7.7%	US S&P 500 1.4%	MSCI EM 10.1%	Japan TOPIX 22.2%	MSCI Europe ex UK 1.4%	MSCI Europe ex UK 1.9%
MSCI Europe ex UK 6.6%	MSCI Europe ex UK -42.7%	UK FTSE 100 27.3%	UK FTSE 100 12.6%	MSCI EM -12.5%	MSCI EM 17.4%	UK FTSE 100 18.7%	MSCI Europe ex UK 7.4%	UK FTSE 100 -1.3%	MSCI Asia ex Japan 6.4%	US S&P 500 21.8%	UK FTSE 100 1.0%	MSCI EM 0.1%
US S&P 500 5.5%	MSCI EM -45.7%	US S&P 500 26.5%	MSCI Europe ex UK 5.1%	MSCI Asia ex Japan -14.6%	US S&P 500 16.0%	MSCI Asia ex Japan 6.2%	MSCI EM 5.6%	MSCI Asia ex Japan -5.3%	MSCI Europe ex UK 3.2%	MSCI Europe ex UK 14.5%	MSCI EM -2.6%	UK FTSE 100 -0.7%
Japan TOPIX -11.1%	MSCI Asia ex Japan -47.7%	Japan TOPIX 7.6%	Japan TOPIX 1.0%	Japan TOPIX -17.0%	UK FTSE 100 10.0%	MSCI EM 3.8%	UK FTSE 100 0.7%	MSCI EM -5.4%	Japan TOPIX 0.3%	UK FTSE 100 11.9%	MSCI Asia ex Japan -3.5%	MSCI Asia ex Japan -0.9%

Source: FactSet, FTSE, MSCI, Standard & Poor's, TOPIX, J.P. Morgan Asset Management. All indices are total return in local currency. Data as of 30 September 2018.

In Japan, there are now more jobs available per applicant than at any point since 1974. Banks also continue to expand credit, in stark contrast to the deflationary period in the early 2000s. The rally in the dollar against the yen, helped by rising interest rate differentials, has been supportive of Japanese equities over the quarter.

Since the beginning of the year, there has been a material weakening in the eurozone manufacturing new export orders survey. Much of the weakness appears to have come from a sharp slowdown in exports to China. As the Chinese ease policy to support domestic demand this pressure could ease but a potential further deterioration in the external environment continues to pose a risk to eurozone growth. The main risk is that weaker exports combined with higher oil prices feed into weaker domestic consumption, which has so far held up pretty well, supported by falling unemployment. Consumer confidence has fallen steadily since the start of the year, with a particularly sharp decline in France. Italian political developments and the pending approval of the new budget could also prove a source of volatility over the coming quarter, although Italian government bond yields have already risen materially since April.

The most obvious near-term risk to the global economy is the potential for a further escalation in trade tariffs emanating from the US, and the subsequent retaliation. So far, the US is imposing tariffs on about $250 billion of imports from China, and China has retaliated with tariffs on about $110 billion of US exports to China. This covers nearly 90% of all China's imports from the US. The tariff rate is scheduled to increase in January if a deal cannot be reached and an escalation to imposing tariffs on all of China's exports to the US has been threatened. Any subsequent weakening in trade growth will have a greater impact on China than the US. The $250 billion equates to around 11% of China's exports or 2% of GDP. Should the US impose a third round this would hit 3.5% of China's GDP. The equivalent calculation for the US suggests that only 1% of GDP would be affected if China put tariffs on all its imports from the US. Markets have done the same calculation, judging from the significant outperformance of the S&P500 against the China A-share index. As Donald Trump said: 'trade wars are good and easy to win' and the markets appear to be backing him.

However, China has options beyond tariffs. For example, many US companies have chosen to trade with China through their locally based subsidiaries. Companies such as GM sell more cars in China than in the US while Apple sells twice as many iPhones, for example. The authorities can make life very difficult through zealous enforcement of regulations should they fall foul of the government. More generally, US companies may find they are at a disadvantage when bidding for contracts.

Fixed income returns have been pretty uninspiring, with high yield credit outperforming government bonds. Against a backdrop of very strong growth, rising inflation and rising interest rates in the US, it is notable that, while unexciting, fixed income returns haven't been as bad as some might have predicted. The returns on government bonds can be seen on the chart overleaf.

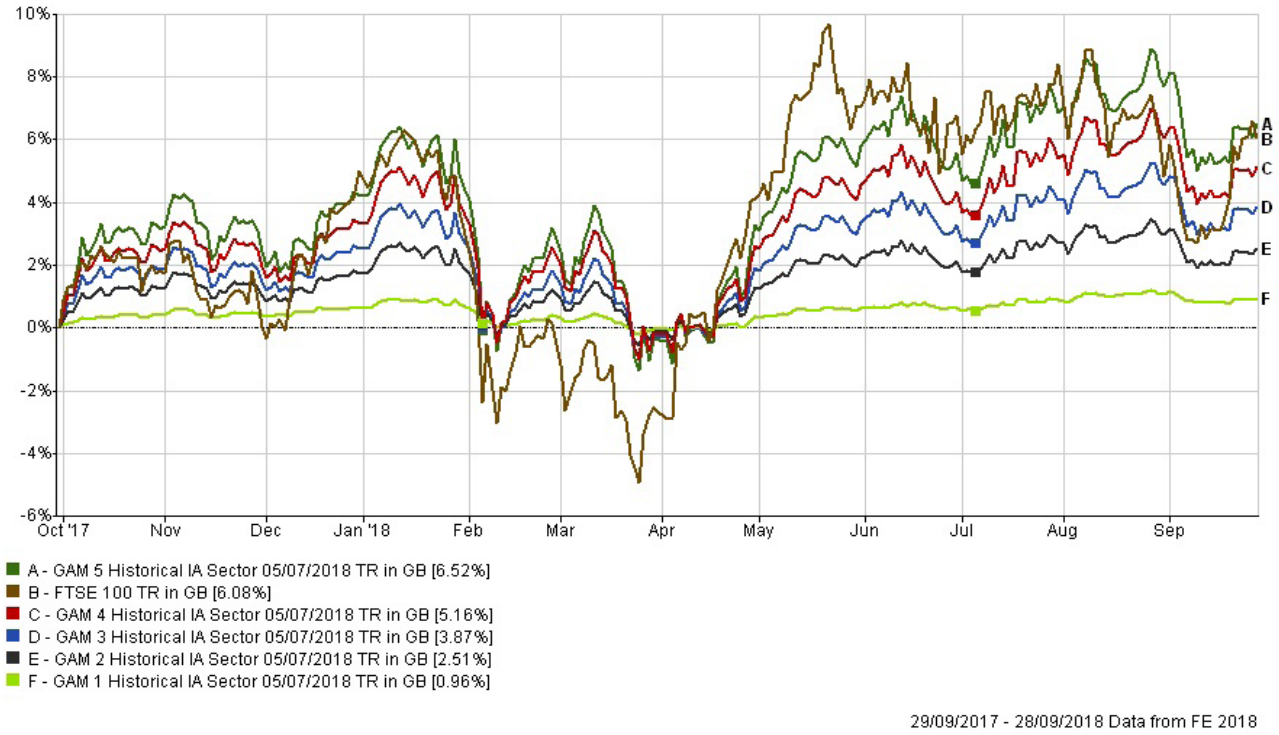
Overall, global growth remains positive but less synchronised than last year. For now, the US stands out as the clear leader in terms of growth. In the near term, the main risk appears to be that the trade conflict will escalate and weigh on businesses and consumers alike. Whilst there have been signs of this happening outside the US, the US itself has remained resilient.

2011	2012	2013	2014	2015	2016	2017	YTD	3Q 2018
UK 16.8%	Italy 21.3%	Spain 11.3%	Spain 17.0%	Italy 4.9%	UK 10.7%	US 2.5%	Spain 1.9%	Spain -0.5%
US 9.9%	Spain 6.0%	Italy 7.4%	Italy 15.7%	Spain 1.7%	Spain 4.2%	UK 1.9%	Germany 0.7%	US -0.7%
Germany 9.8%	Germany 4.5%	Japan 2.2%	UK 14.1%	Global 1.3%	Germany 4.1%	Global 1.3%	Japan -0.5%	Germany -0.8%
Spain 6.6%	Global 4.1%	Global -0.4%	Germany 10.5%	Japan 1.3%	Japan 3.6%	Spain 1.1%	Global -1.1%	Global -1.0%
Global 6.3%	UK 2.6%	Germany -2.3%	Global 8.5%	UK 1.2%	Global 2.9%	Italy 0.8%	UK -1.5%	Japan -1.2%
Japan 2.3%	US 2.2%	US -3.4%	US 6.1%	US 0.9%	US 1.1%	Japan 0.2%	US -1.8%	UK -1.9%
Italy -5.9%	Japan 1.8%	UK -4.2%	Japan 4.8%	Germany 0.4%	Italy 0.8%	Germany -1.4%	Italy -4.6%	Italy -1.9%

Source: FactSet, J.P. Morgan Economic Research, J.P. Morgan Asset Management. All indices are J.P. Morgan GBIs (Government Bond Indices). All indices are total return in local currency. Data as of 30 September 2018.

Portfolio Performance

The charts below show performance of our discretionary risk rated portfolios over the course of the last 1 and 5 years. The charts are based upon our existing discretionary models looking back and so only take into account the asset allocation and fund changes made since March 2017 i.e. since the models were created. The data beyond this therefore presumes investment in the same funds and asset allocations as of March 2017. The charts compare performance against the FTSE 100 in order to demonstrate the importance of spreading risk through diversification. Whilst a direct comparison of our portfolios with an equity index such as the FTSE 100 is not like for like it does give an indication of volatility and performance differences on a risk-adjusted basis.



Source: Financial Express Analytics data 29/09/2017 to 28/09/2018. Past performance is not a reliable indicator of future results. All figures given do not include any initial, on-going or product provider fees.

Source: Financial Express Analytics data 01/10/2013 to 28/09/2018. Past performance is not a reliable indicator of future results. All figures given do not include any initial, on-going or product provider fees

Asset Allocation and Fund Review

The investment committee reviewed various asset allocation models alongside in-house research. As a result of this there were **no changes** to the asset allocation models in your plans during quarter 3, 2018.

We were forced into one fund change however having been informed that the Baillie Gifford cash fund was closing. We subsequently switched out of this fund in favour of the L&G Cash Trust fund.

We are constantly monitoring asset allocation and fund selection and it is likely there will be some changes implemented in quarter 4

Secure Client Login

Our Secure Client login portal allows the investment team to act swiftly with regard the reporting and fund switching process. An increasing number of clients are signing up for this service.

If you have not already registered and would like to do so, please do not hesitate to email us at **investment.team@gemini-wm.com** and we will set you up for this facility.

We continue to welcome client feedback of this service. You can use one of the two email addresses on the Client Login portal to contact us, alternatively please contact Gemini's Investment Analyst, Curtis Yardley, on 0121 354 2700