gemini asset management

marketmatters

July 2018

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

After a tricky first quarter, most equity markets have had a better second quarter as you can see from the chart below. This has been helped by data confirming that the first-quarter weakness in US consumption was a temporary blip. US retail sales grew by over 6% year-on-year in May and unemployment fell to 3.8% – the lowest level since 1969.

A strong US economy gave the Federal Reserve (Fed) the confidence to raise interest rates again in June and signal two further increases to come this year, followed by three more next year. In contrast, after a string of disappointing data and still low core inflation, the European Central Bank (ECB) announced that interest rates will not be going up until at least the summer of next year, although they did confirm that eurozone quantitative easing (QE) would come to an end by the end of this year. At the end of last quarter, markets were convinced that the Bank of England would raise rates in May. However, May and then June came and went with no action. Nevertheless, a bounce back in UK retail sales, combined with the lowest unemployment since 1975 and surveys indicating firming wage pressure, suggest that rates will rise this year and next unless Brexit negotiations prove disruptive. Against this backdrop, the returns of government bonds of European countries have been broadly flat, other than in Italy.

World Stock Market Returns (local currency)

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	YTD	2Q 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 2.6%	UK FTSE 100 9.6%
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%	UK FTSE 100 1.7%	US S&P 500 3.4%
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 -0.5%	MSCI Europe ex UK 2.7%
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%	MSCI Asia ex Japan -2.6%	Japan TOPIX 1.1%
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 -2.7%	MSCI Asia ex Japan -3.1%
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%	Japan TOPIX -3.7%	MSCI EM -3.4%

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 June 2018.

Unfortunately, the recent weakness in the euro has not benefited European equities and has left Italian equities as a notable underperformer this quarter. On the plus side, contagion to other European bond markets has been minimal. The Eurobarometer survey for March showed that support for the euro in Italy has actually risen, with only 29% in favour of leaving the euro, 61% in favour of staying and the rest unsure.

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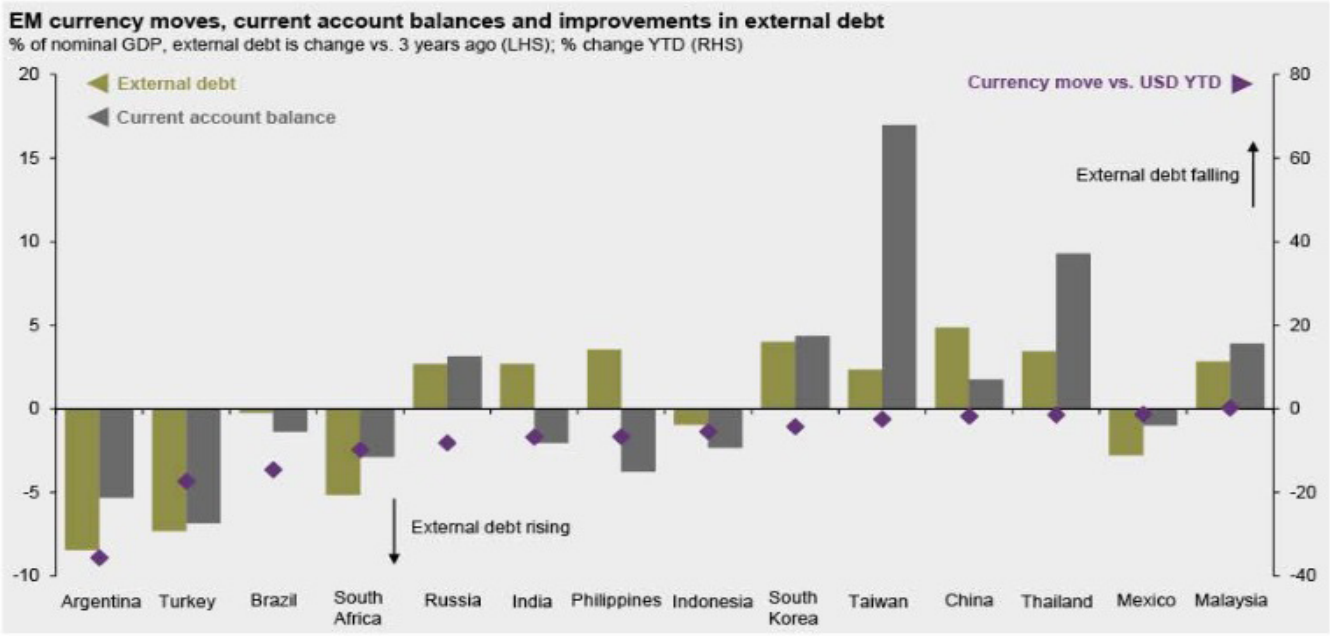
The dollar has not just rallied against the euro this quarter but against most currencies, and this has had important implications for equity markets. Sterling's weakness against the dollar has helped the FTSE 100 to deliver strong returns in local currency terms, as foreign revenues are repatriated, a theme we have seen since the EU referendum. In emerging markets, a stronger dollar has often proved a headwind to equity performance and that was certainly the case this quarter. The direction of the dollar is likely to remain important for relative equity performance going forward and unfortunately is currently particularly difficult to predict, with different factors pulling the dollar in different directions. In the short-term, the outperformance of US growth and interest rates may support the dollar, but at some point, ever-rising levels of government debt and a large current account deficit is likely to weigh on the currency.

Trade concerns have weighed on equities, with markets outside the US most affected. This has dragged on Chinese and emerging market equities. Further interest rate rises in the US which could in turn create dollar strength could put additional pressure on the most vulnerable emerging market economies. The market has shown some ability to distinguish between the weak and the strong, with Indian equities up over the quarter. European equities have also been affected, with auto companies suffering on fears that US tariffs could be applied to car imports. The conclusion of this scuffle is extremely hard to predict, but the longer this goes on for the greater the risk that it starts to impact sentiment more broadly.

The big emerging markets "crises" of the past usually had one thing in common – they were all preceded by a sharp rise in US interest rates. The problem is linked to how governments and corporations often finance themselves. Due to the lack of market depth and liquidity in many local markets, governments and corporations often issue debt in dollars. Rising US interest rates therefore increase the cost of US dollar debt financing, while any rise in the value of the US dollar will swell the size of dollar denominated debts relative to the domestic economy of the issuing government or company.

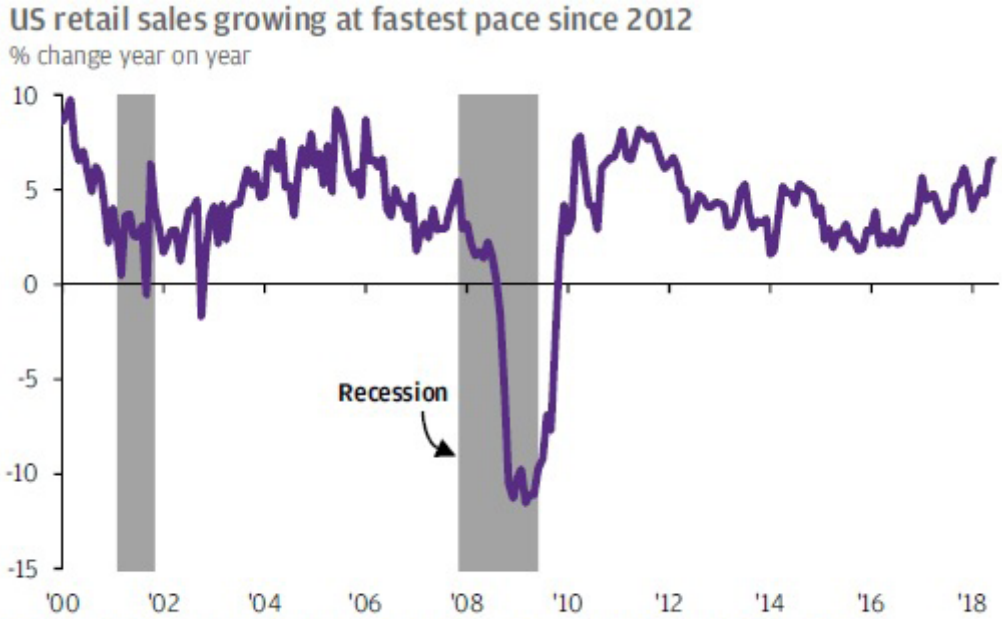
In recent years there has been a trend towards issuing debt in local currency which has reduced the direct dependency on US interest rates, however, the total amount of US dollar denominated debt has increased substantially in the last 10 years with governments and corporations taking advantage of historically low US interest rates. It would be unfair to assume that this risk is evenly distributed across all emerging market economies.

The chart below focuses on a couple of metrics to show countries that could be most vulnerable although it does not mean a crisis is inevitable as other factors such as corporate earnings and the growth outlook for the economy will play a part. If the green and/or the grey bar is below the zero line the country's amount of debt written in a foreign currency has increased over the past 3 years (green) and also has a current account deficit meaning the country has more money leaving the country than coming in (grey) and vice versa. The purple dots show the country's currency performance vs the dollar. If the currency performs negatively against the dollar this increases the cost of the external debt.



Source: Bloomberg, Oxford Economics, Thomson Reuters Datastream, J.P. Morgan Asset Management. Current account balance and external balance are as of end of 2017. Past performance is not a reliable indicator of current and future results. *Guide to the Markets - UK*. Data as of 30 June 2018.

As widely documented the US economy is currently booming. As mentioned in previous publications, consumption accounts for around 70% of GDP in the US and data released in the second quarter showed that US Retail sales in June grew by the strongest rate of growth since 2012, a combination of the strong labour market and lower taxes are clearly giving consumers the confidence to spend.

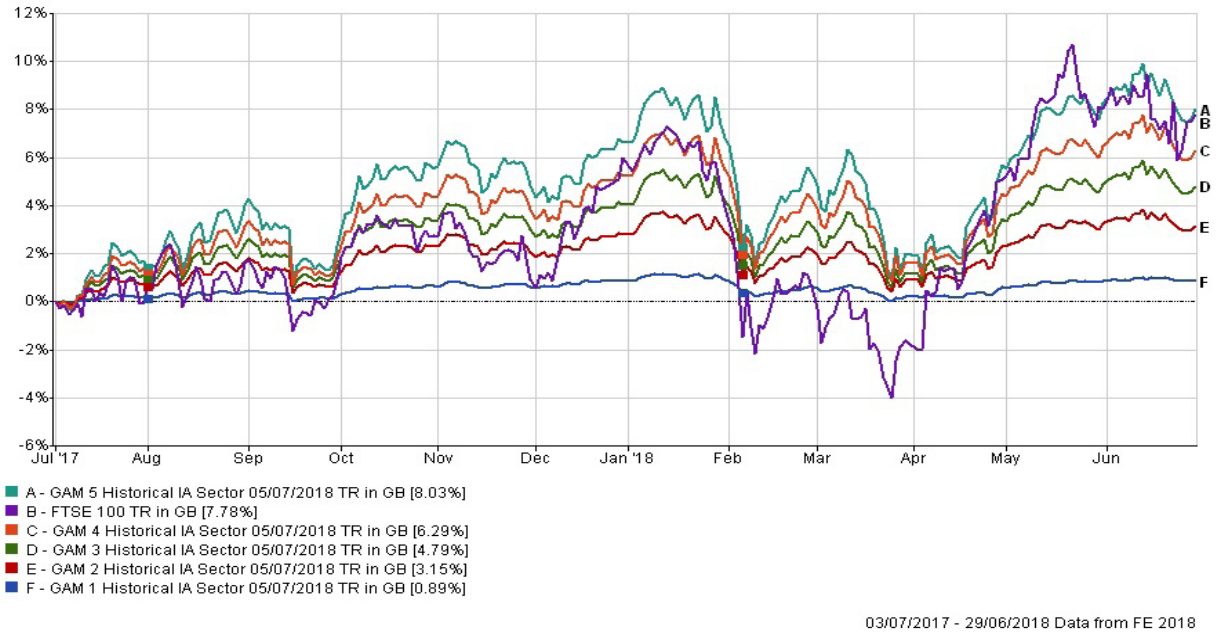


Source: NBER, Thomson Reuters Datastream, US Census Bureau, J.P. Morgan Asset Management. Grey bars indicate recessions as determined by NBER. Data as of 20 July 2018.

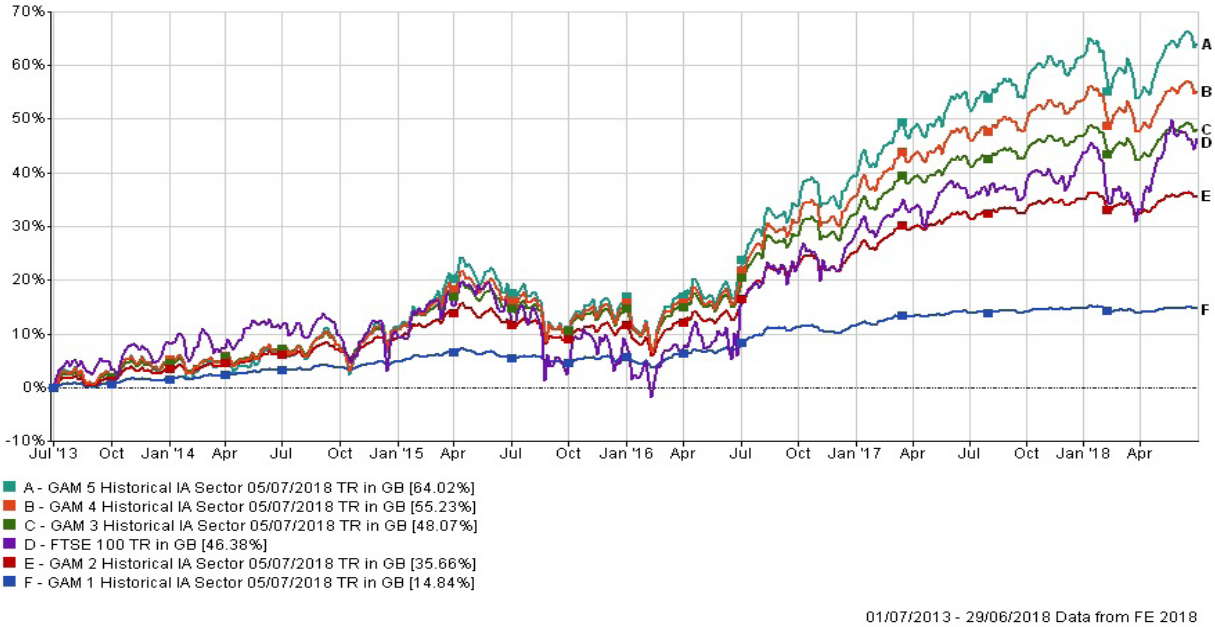
Overall, growth still looks healthy and corporate earnings are growing strongly. It is clear though that there are a number of potential political risks to markets over the second half of the year, highlighted recently with events in the UK. The strength of the US economy is also causing the Fed to gradually remove the punch bowl from the party i.e. QE. The US tax cuts should keep growth going strong into 2019, but once this wears off combined with tighter monetary policy things may start to bite and the economy could be left nursing a hangover heading into 2020.

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 31/03/2017 to 29/03/2018. 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 01/07/2013 to 29/06/2018. 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 fund choice or the asset allocation models in quarter 2 2018.

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