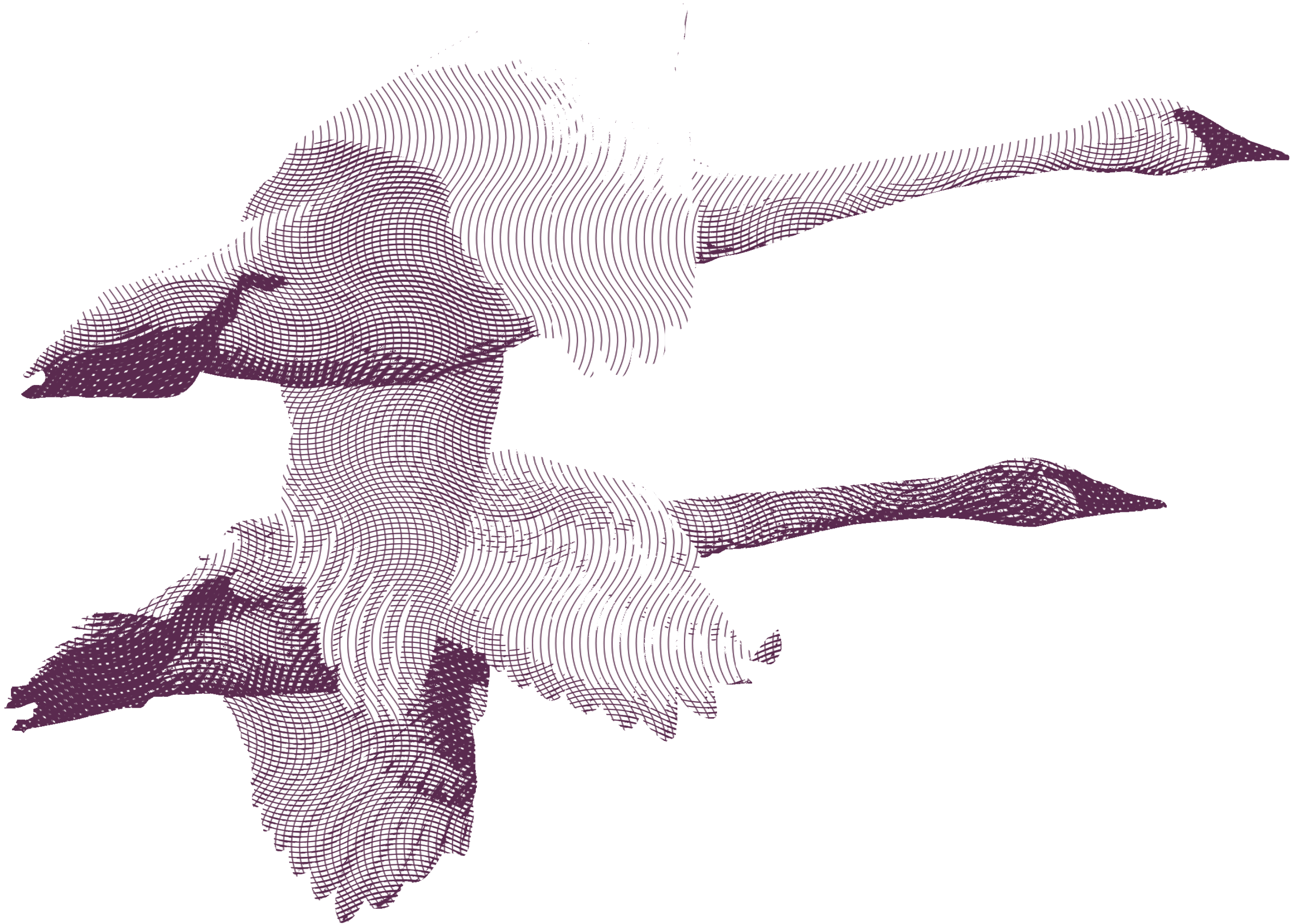
ESTATE CAPITAL INVESTMENT PORTFOLIOS
OUTLOOK

EDITION 26 Winter & Spring 2017



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ESTATE CAPITAL

The UK stock market has been on a short sugar rush

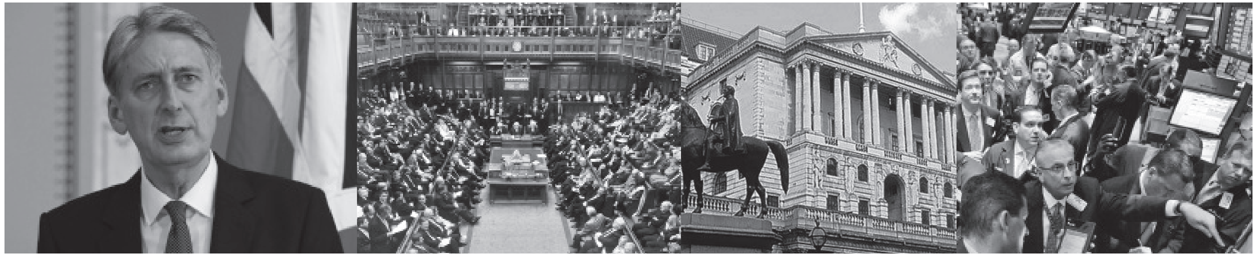
It would be reasonable to think that UK stock markets have been on a sugar rush from shortly after the Brexit Referendum in June until late October. Equity markets forged ahead as the pound devalued, taking the hit for the uncertainties of the leave result. Sterling stood at 1.48US$ prior to Brexit only to fall to 1.28US$ soon after.

British business has benefitted as its products and services cost less abroad due to the weaker pound. This has made British products more competitive and increased export sales. At the same time, the resulting repatriated profits are further boosted by currency exchange terms. This boost to business has been positive, but is not fundamental and will slow as sterling recovers ground and the impact of Brexit becomes clearer.

Back in early June, two weeks prior to the UK referendum, we recommended a move from UK and European equity into the safety of cash. On the Monday after the poll, we recommended a return to these markets as values in the FTSE 100 index had fallen by 6%. Sterling then acted as the nation's shock absorber giving our exporters a massive price advantage. The FTSE swiftly grew from 5980 in late June to 7097 in early October, a gain of 18%. We have already seen most of that growth fall back with the FTSE 100 standing at 6752 on 1st December. There recent falls can be attributed to the High Court ruling over the government's right to avoid a parliamentary vote on the triggering of Article 50, the uncertainty over the US Presidential election and more recently concerns over the frailty of Italian banks. The election of Mr Trump did not bring the market falls many had suggested. In fact US markets have responded very positively to Trumps victory and have significantly rallied with both the S&P 500 and Dow Jones index hitting alltime highs in late November.

Theresa May has committed to a March 2017 start to the negotiations on Britain's exit from the EU. This act will formalise the uncertainty and early rounds of negotiations can be expected to be more about positioning than agreement particularly with elections due in Holland, France and Germany next year. It is therefore reasonable that sterling could maintain a relative lower value for some time while the uncertainty of Brexit remains.

Mark Carney, the Governor of the Bank of England (BoE), maintains that the drop in our currency value has been based upon a mistaken analysis of the state of the UK economy and its future prospects. He thinks markets have priced in a 'Hard Brexit' where



the UK reverts to a world trade agreement position leading to both import and export tariffs being charged. Mr Carney is hoping for more mutually beneficial outcomes from the ensuing divorce negotiations.

The latest GDP figures for the UK saw a 0.5% growth in Q3 matching the prediction made by the Office of Budget Responsibility (OBR) prior the referendum. Economists expect that any post Brexit slowdown will be much milder than forecasted. The expectation for 2016 annual growth is 2% with a reduction to 1.4% growth in 2017 as the full impact of Brexit becomes clearer. Similarly, the BoE also expects the UK economy to grow 1.4% next year with inflation set to rise to 2.7%. This is a threefold increase in current inflation rates. With a declining outlook for the UK economy, the BoE kept interest rates on hold at 0.25%.

The Office for National Statistics (ONS) confirmed that UK unemployment fell to 1.6 million in September, hitting an 11-year low. The jobless rate fell to 4.8% while the total number of people in work was at a record high of 31.8 million.

We feel that a UK rate rise will now not take place for up to three years over the Brexit negotiations period, leaving UK savers with little to look forward to. Inflation will be pushed up by a number of factors, including the impact of the falling pound causing an increase in the cost of imported goods, the rise of fuel costs and the start of wage inflation due to higher levels of employment. However, due to the expected fall in GDP growth and any recovery in the value of sterling could result in lower levels of inflation than are currently predicted. If however, the Brexit negotiations stall and sterling falls again inflation may rise above 3%.

Many economists believe that sterling has been over valued for some years and that our economy is overly reliant on the financial services sector. Several have argued that if a more balanced economy is desirable then sterling's fall is beneficial. It could bring about higher interest rates and consequently lower house prices, improved productivity and a manufacturing revival. The obvious downside for consumers is that imported goods will be more expensive and the cost of living will rise. We in the UK import 40% of our food and 90% of our clothes. There can be long term advantages, however the short term disadvantages will start to have an impact in the New Year.

It is not only the stock market that has enjoyed a post Brexit boost. The car industry and tourism have enjoyed strong growth. The Confederation of British Industry (CBI) revealed that its trend surveys showed manufacturing orders from foreign customers hit its highest level in Q3 for three years and that the outlook for Q4 was also very good.

We can expect Brexit related uncertainty to dampen some business investment irrespective of the recent Nissan and Google announcements. There is likely to be a deferment of investment and hiring plans as companies consider the real outcome of Brexit. Consumer spending is likely fall if the relative weakness in sterling continues and lifts import prices.

Phillip Hammond's autumn statement announced £3.7bn fiscal support to the economy through government spending on infrastructure such as road, rail, 5G broadband and housing projects in order to boost activity, but it was clear that his concerns over post Brexit growth restricted his ambition. This extra spending is aimed at combatting any slowing of activity over the Brexit period and improving the UK's poor productivity levels. The OBR has 'pessimistically' estimated that Brexit could cost the UK £58bn in lost economic growth. The Chancellor will need to borrow to cover this lost revenue so adding to the UK's already massive national debt which currently stands at £1.725tn and costs us £60bn pa in interest payments.

The jobless rate fell to 4.8% while the total number of people in work was at a record high of 31.8 million.

The City of London provides almost 10% of all UK GDP

The cross-channel trade in financial services, worth £30bn pa and employing over one million people, is underpinned by the EU passporting system which allows banks to operate freely across the continent. The City is the UK's single most significant sector providing almost 10% of all UK GDP and 11.5% of total tax revenue.

There is concern that if the free movement of services is lost, then UK and non EU banks will require new EU operations. This potential movement of financial services to Europe is a great concern to the City and also impacts commercial property demand. Disrupting London's free trade in financial services could see the loss of 35,000 jobs in financial, legal and accounting disciplines. Shares in banks have been affected with RBS falling 18.2% and Lloyds down 17.3% since the referendum.

Generally, it is felt that the City is too big and important to suffer significant transfers. Banks may set up EU operations so some jobs may be relocated but the bank headquarters will continue to reside in London. The City of London's counter claim to relocation is that it offers a fluid recruitment market of the best talent. London has a skilled workforce in every financial and legal sector. It offers the best possible environment in which to work with already established infrastructure and a stable political and legal system. Business is conducted in English, which is the international business world's common language. These considerations did not however prevent UBS from recently announcing that it was consolidating its European banking operations into Frankfurt.

EU national leaders would love a slice of the UK financial sector and therefore passporting rights will be a big issue in the negotiations over free movement of services and people.

Suspended property funds have now returned to active trading

In the days following the Referendum, the value of the pound fell sharply by 13.5% and stock markets became volatile. A loss of confidence in the UK led to a rush for redemptions from retail commercial property funds. This forced property investment funds to suspend trading in order to protect existing and remaining retail investors. The impact of moving to an exit price cost meant that portfolio valuations fell by 5% but once this exit penalty is removed the fund will regain that 5% value. It is for this reason we are holding our property positions as we expect the recovery of this 5% to happen soon.

The reduction in value of central London office space is one of the most marked impacts of the Brexit vote. However, while Brexit's eventual impact on UK commercial property demand remains unknown the appeal of commercial property income as compared to cash or gilts is still strong.

The property market has since settled and suspended funds have now returned to active trading with values starting to recover. The fall in the pound has also magnified the attractiveness of central London property to overseas investors.

Our general view is that commercial property will not suffer a lack of demand as the movement out of London of banks and/or bankers will be less than feared.

Is free trade under threat?

This year international trade agreements seem to have come under growing political and populist attack across the developed world. It has taken seven years for Canada and the EU to negotiate the Comprehensive Economic and Trade Agreement (CETA) only to be threatened by the Wallonia region of Belgium. The Walloon Parliament almost derailed the entire agreement when it was due to be ratified.

The CETA required approval from 38 EU national and regional parliaments and was seen as a litmus test as to whether the EU was capable of reaching complex trade agreements. The success of CETA is of particular interest to the UK as we consider our own trade negotiations.

CETA was not the only trade deal facing protectionist backlash. The Transatlantic Trade and Investment Partnership (TTIP) and the Trans Pacific Partnership (TPP) are languishing without the political will to see them concluded. The TTIP between the USA and the EU would account for 50% of global GDP but is now unravelling while the TPP between 12 Pacific Rim countries that collectively account for 40% of world GDP has stalled in the US Congress. President elect Donald Trump has promised to withdraw American support for the agreement on his first day in office.

Following the drawn out nature of the CETA negotiations, it is clear that a free trade deal with the EU would be better negotiated within the two year time frame of Article 50, while we are still members of the EU and therefore can negotiate with the EU Commission. Beyond the two years, any agreement would face the possibility of being vetoed by the member states or regions similar to the fate of the CETA deal.

The future agreement between the UK and the EU will be complex and extensive. The deterioration of recent trade deals will concern markets over Britain's ability to establish these agreements swiftly and easily. Prime Minister Theresa May is determined to see Brexit concluded and the path to success will depend upon her and Chancellor Angela Merkel reaching a mutually beneficial agreement. Both women will have compatible objectives as both countries are faced with similar challenges. There are several elections due to be held in the Eurozone in 2017 not least in France where incumbent president Francois Holland has decided not to seek re-election and is expected to be replaced either by Republican Francoise Fillon or National Front leader Marine Le Pen.

Future trade deals are the key to Britain's future prospects. While the media coverage will inevitably be focussed upon our relations with the 27 remaining EU member states, there are another 165 non-EU states to trade with. These countries account for the vast majority of the world's growth. The potential outcome of Brexit is that Britain could be bold and seek free trade agreements across the world. We could be the first large economy to commit to trade in the same way that Singapore has so successfully done.

In a world were free trade agreements seem to be stalling, Britain could take a lead. It is becoming clear that free trade and the EU are not as compatible as one might think. Britain could therefore get ahead of the EU on agreements with countries such as India, China, the USA and Australia. We would have some advantages as Britain does not have vested interests and heavily state subsidised industries to protect.
We have much to gain from unrestricted commerce. Britain as a free trading economy with low corporation tax would be an attractive home for any EU focussed business.

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US Markets rally to Trumps low tax and high investment agenda

Donald Trump vowed to 'rebuild America from the ground up'. With Republicans now in control of both Chambers of Congress, he has the mandate to push ahead with few obstacles in his way. This will avert the past paralysis and obstruction that limited President Obama and would have also awaited a President Clinton.

There may be friction between the central personalities who failed to support Donald Trump but House Republicans will hardly resist his plans to cut corporation tax from 35% to as low as 15%. He is likely to gain support for his plans to replace the current seven tier income tax system with a three tier system and in doing so cut income tax from 39% to 33% for the rich, to 25% for middle earners, but increase tax rates from 10% to 12% for the less well paid. Republican are not likely to block his calls for a spending spree on bridges, tunnels, telecommunications, cyber security, water systems, pipelines and the electricity grid. Infrastructure built by American workers using American materials.

Donald Trump looks to have taken a leaf out of Ronald Reagan's philosophy of getting government out of the way of business and cutting regulation and taxes. Trump is also adding stimulus in the form of significant infrastructure investment to improve productivity. Financial markets are becoming encouraged by Trump's proposed infrastructure spending. Stocks and bond yields have risen and when adding this to tax cuts, we can expect economic expansion.

America's infrastructure is in a poor state after many decades of relative neglect. A large taxpayer funded or private sector funded road and bridge building programme would be a boost for jobs. For a country with high employment, the unemployment rate is currently 4.9%; the outcome is likely to be growth and inflation.

Trump understands that a 35% rate of corporation tax is very high by international standards. The equivalent UK rate is currently 20% while in Ireland it is 12.5%. This is why so many US companies are now based in Ireland to the annoyance of US politicians. American growth has been affected by their high tax rates and a cut to 15% would be a major boost to investment and production.

The Tax Foundation has suggested that the combined effect of the potential changes in corporation tax, the new incentive for US business to repatriate capital and a simplified income tax system could boost US GDP growth by 6.8% over 10 years with wages rising 5.5% and stock values 21% over the same time scale. The last time the US unleashed a fiscal stimulus when the economy was not in recession was in the early 80's this pushed up the value of the US$ and forced the Federal Reserve to raise interest rates to control inflation.

Tax reform seems to have been one issue that has eluded the US for some time. The greatest tax cut killer is uncontrolled public spending and heavy deficits. For Trump to deliver on his tax reforms, he will need to control public spending. The most costly of which is welfare and pensions at 33.6% and health care at 26.6% of Federal spending.

A major concern to environmentalists is Mr Trumps view on global warming. He has stated that global warming is an ‘expensive hoax’. His ‘America first energy plan’ seeks to access further untapped shale, oil and natural gas reserves as well as reduce energy regulation and lift the moratorium on energy production on federal land.

What ramifications this policy may have on the global price of oil is unclear but with general demand falling as technology improves oil is unlikely to see significant growth from the US$54pb mark that it is currently trading around after the recent OPEC production level agreement. The challenge for oil producing countries and oil companies alike is there is an expectation that most cars will be electric within 15 years. Currently 70% of oil production goes towards transportation.

With the dust settling over the election of Donald Trump as US President, Wall Street has responded positively with significant gains in industries and sectors that could benefit from the proposed fiscal stimulus. By 1st December both the S&P 500 and the Dow Jones indexes rose to a twelve month high of 2199 and 19191 respectively. Generally, there has been renewed optimism with sectors such as construction, healthcare, banking and defence doing well.

The value of the dollar strengthened as markets digested how Mr Trump’s policies could impact growth. The pound also gained and recovered lost value against both the US$ and the €. The fall in the € has much to do with the impact that Brexit and Trump has on the Italian Referendum on 4th December, the Netherlands General Election on the 15th of March and the French Presidential Election on the 23rd of April.

Trumps potential policy changes of cutting individual and corporation tax, spending US$550bn on infrastructure and boosting American military capacity are likely to give rise to inflation. This revival in inflation expectations has seen the US 10 year Treasury bond yields rise to 2.3% from 1.8% pre-election. Yields on US 10 year Treasuries are the benchmark price for global money. Any rise will have an impact of forcing up yields in both sovereign and corporate debt in the rest of the world. When yields are raised to counter inflation invariably bond prices will fall to compensate. The resulting price fall saw US$1tn being wiped off global bond prices as yields around the world

followed suite.

The American economy added 176,000, 191,000, 161,000 and 178,000 new jobs in August, September, October and November with average wage growth rising too. This is helping to pick up household spending but US inflation remains steady at below the Fed's 2% target even if other measures of inflation are rising. This allows the Fed to be patient and if need be hold back on any further interest rate rises.

However, most economists expect Janet Yellen to announce a rise in Federal interest rates. A rate rise is as much about dampening inflationary pressure due to the steadily improving job numbers as it is about the Fed's credibility to act. Donald Trump has heavily criticised the Federal Reserve for keeping interest rates low and creating a "false economy". This may also put pressure on the Federal Open Markets Committee (FOMC) to act on December the 14th.

The Fed does want to get ahead of the inflationary pressure curve and return America to normalised economics. If rates do rise, then there will be an impact on businesses around the world leading to a recalibration of borrowing costs and rising bond yields. Rising US$ values and higher interest rates will hurt emerging market economies. The MSCI Emerging Markets Index fell 7% in the week after the 8th of November US election.

Higher interest rates around the world will lead to higher borrowing costs. With national, corporate and household debt at near record levels, the outcome may have some unintended consequences.

The outlook for the US economy looks attractive and therefore even at its current high value the US stock market is worth supporting along with specialist infrastructure funds. However, we are concerned about the trade protectionist stance taken by Trump. If Trump were to launch a trade war against China and Mexico with a tit-for-tat tariffs imposed on imported goods, then the fall out for the global economy would be devastating. The world cannot deal with an all-out trade war as this would result in mutually assured destruction and therefore is highly unlikely.

'Generally, there has been renewed optimism with sectors such as construction, healthcare, banking and defence doing well'

We may be nearing the top of China's latest growth cycle

The level of currency outflows from China has again become a significant issue. In September, net outflows reached US$55bn while this does not match the outflows we witnessed in January 2016 when the mismanaged shift in exchange rate policy saw US$70bn a month leave China, it is still a concern.

The recent credit driven expansion has peaked with Beijing seeking once more to control property speculation. The belief that the strong recovery in China will start to run out of stream has prompted this recent capital flight. The levels of money now leaving China gives an indication that capital investors are concerned.

The People Bank of China (PBoC) spent US$27bn defending the renminbi in September but it did not stop a currency exchange slide to 6.91 Yuan per US$, an eight year low.

Deutsche Bank has stated that they anticipate that the renminbi could fall further in value by up to 20% against the US$. A Chinese devaluation of this scale would have a massive impact on the world economy through the export of even cheaper manufactured goods into Europe and the US, creating deflation rather than inflation. While this remains a possibility, the greater likelihood, due to China's massive foreign currency reserves, is the continuation of a gradual and managed depreciation of the renminbi.

Beijing has burnt through US$800bn of its foreign reserves since 2014 in an attempt to hold up the renminbi. The central authorities are trying to curb excess production across many sectors including steel, ship building, chemicals and solar panels. Concerns still exist that regional communist party bosses with local vested interests are only paying lip service to these cut backs.

Fixed capital investment in China is running at US$5tr a year, as much as in both Europe and North America combined. The recent stimulus from Beijing has seen the economy firing on all cylinders but the world cannot absorb such overproduction without implications elsewhere - such as the dumping of cheap steel on world markets. While Chinese authorities again announced that the economy hit its 6.7% annual targeted growth rate, the more respected proxy growth gauge for China is reading 5.6% pa this year, up from last year's 4.4%. This growth has not been focused on private companies, but on state owned industries and further property speculation.

Residential mortgages made up 71% of all loans in Q3, an increase of 26% on the previous year while land prices have risen 140% in the major cities. In the past year, house prices in Beijing have risen 28%, they have risen 33% in Shanghai, 37% in Xiamen and 47% in Hefei. China's real estate market is again heading for a bubble of the state's making. As they move from boom to probable bust developers could be left with a US$ 1.1tn debt. This is similar in value to the 2007 US subprime market.

The International Monetary Fund (IMF) global stability report has warned that China has a 22% credit excess of GDP and that the number of banks that are exposed to junk credit jumped by 50% in the past twelve months to US$6tn. The wholesale funding market has risen by 30% most of which is overnight lending. This means borrowers have to roll over their lending every day leaving them exposed to a sudden increase in interest payments or a lack of liquidity just as we saw in 2008.

There is a concern that China has over lent to its own state-owned regional banks or state-owned companies and may have to write these debts off. While central authorities easily have the cash to do so, it is not welcome. China is flexible enough to choose when and if to write off debt as it is lent only between state-owned institutions. The PBoC can always create new money to keep the affected banks liquid during what would likely be a prolonged process.

The PBoC is keen to maintain a stable liquidity and credit policy. As long as global financial conditions remain accommodating, any slowdown is likely to avoid a major policy intervention. However, the levels of mortgage and housing market excess will become a problem if not fixed.

We may be nearing the top of China's latest mini cycle as the majority of the 2016 stimulus is now behind us. We do however expect the authorities to continue with its support for infrastructure investment. China's growth will probably remain throughout 2017 despite the financial threats.

One great challenge facing China is the lack of a social welfare system. This is exacerbated by wage and urbanisation increases and an aging population due to their one child policy. Due to the vast population, it is estimated that to build a welfare state for the Chinese people would cost and require a 5% GDP growth each year for the next twenty years.

Japan is relying heavily upon export activity

Japan's economy expanded at a faster than expected rate in Q3 due to higher exports resulting in Japan's GDP growth rising to an annualised rate of 2.2%. This was the third consecutive quarter of expansion.

There are concerns that a Trump presidency will hurt Japan if anti-trade rhetoric becomes a reality. Since the election, the ¥ has been falling against the US$ making Japanese goods cheaper abroad. For Japan and its big export reliance, this is good news.

There are concerns however that domestic demand is weak and Japan is relying heavily upon export activity. In order to counter this weak consumption, the Japanese cabinet has attempted to boost growth through spending with another economic stimulus package worth more than US$275bn.

At October's meeting of the Bank of Japan (BoJ), the timeline for hitting its 2% inflation target was pushed back again. This is the fifth push back since QE programmes were started in 2013. This has again raised questions about the country's economic recovery.

The four fastest growing economies in the world are all in developing Asia

The four fastest growing economies in the world are all in developing Asia. Each is pro-business and should see accelerated growth over the next two years. This growth will be achieved without fiscal stimulus and with relatively normal interest rates.

If taken as a four, Indonesia, Vietnam, India and the Philippines will comprise the world's 4th largest economy and are set to become the third ahead of Japan. These countries' stock markets have done well. Indonesia is up 14.6% year-to-date to the end of Q3, Vietnam up 14%, India is up 9.3% and the Philippines is up 8.6%. The currencies of all four have been stable against a strong US$ so returns have been impressive. Equally, their bond markets have been active with strong inflows into emerging market local currency debt funds all year.

Generally speaking, emerging markets are more volatile than developed markets but if a country can provide the main drivers of growth such as low wages, pro-business culture, control over corruption, a solvent banking sector and good infrastructure then they can become a great medium term investment story.

When India's Prime Minister Narendra Modi took office in May 2014, the main challenges facing him was to improve the Indian government's finances and the solvency of Indian banks in order to push through a boom in infrastructure development. The reform of the banking system has been difficult as corruption and cronyism has shaped state bank lending policies for decades. Every effort has been made to delay or dilute the needed reforms to the point that this year the much respected Governor of the Reserve Bank of India, Raghuram Rajan stood down. His replacement was his deputy Urjit Patel who has maintained the reform agenda.

Even with these infrastructure lending delays, India is growing at 7% pa. A solid infrastructure investment policy could push this to 10% pa for several years. Recent growth has been consumer driven through credit as private banks increase their market share over less efficient state banks.

The growing middle class is an investment theme in most emerging market economies but is particularly strong in India.

Of the four economies, Indonesia is the least exciting. The country has a massive population of 257 million and wage growth is fuelling a consumer

boom. The government needs to start significant infrastructure improvement or wage growth will stall and the consumer driven growth will decline.

In the Philippines, wages are lower and labour is cheaper than in China. Its large English speaking workforce is growing by two percent per year. Again, just like other emerging economies, greater infrastructure spending will be needed to continue their development.

Despite its large well educated workforce wages in Vietnam are a quarter of the cost of wages in the east coast of China. The country is still communist so it follows a command style economic model. Foreign investment, particularly in electronics and electrical manufacturing has been significant. Vietnam has a global market share of 3% which is the next largest after China who's market share is 5.5%. Vietnam is one of the few countries that can combine very low wages and a pro-business government.

'The growing middle class is an investment theme in most emerging market economies but is particularly strong in India'

The economies of Latin America are finally turning a corner

The economies of Latin America are finally turning a corner. After a few painful years of recession the region should return to growth in 2017. This turnaround is due to shifts in policy in Brazil and Argentina. Both countries have worked on controlling debt. Business and consumer surveys are showing a pickup in confidence.

Brazil was the strongest performing equity market drawing support from higher commodity prices. The Mexican economy is also in good shape underpinned by a strong labour market and low interest rates. Mexican equities will however be affected by the policies of newly elected President Donald Trump.

Bond investors are betting on a rate rise

The fall in the value of sterling post-Brexit, the likely rise in the cost of imported goods to the UK and the stimulus policies of newly elected US President Trump has created the expectation of rising inflation. The BoE is predicting UK inflation to hit 2.7% in 2017.

This revival in inflation expectations has seen US 10 year Treasury bond yields rise to 2.34% from 1.8% on Donald Trump's election. This rise is down to inflation expectations and the likely rise in US interest rates.

Yields on US 10 year Treasuries are the benchmark price for global money. Any rise will have the impact of forcing up yields in both sovereign and corporate debt in the rest of the world. Bond yields have risen in the Eurozone's economically stressed countries. Italian 10 year debt exceeded 2%, while Portugal's hit 3.5%. Even ultra-safe German 10 year Bunds saw yields rise to 0.32% having recently been in negative yield territory.

When yields are increased to counter inflation invariably bond prices will fall to compensate. In the second week of November the resulting price fall saw a massive US$1tn being wiped off global bond prices as yields around the world followed suite.

We are facing a world economy where QE is having less impact and governments are now seeking to use fiscal stimulus rather than monetary levers. We can see a general move to tax cuts, infrastructure spending and house building that is putting people and materials to work. The policy shift can create growth but also inflation. It is the inflation threat in the US that is spooking the bond markets as inflation in other developed economies is not so apparent.

Recently UK 10 year gilt rates jumped to 1.1% following news that the consumer price index (CPI) had reached 1%. The UK is expected to see CPI rise to 2.7% in 2017. Bond yields are particularly vulnerable to inflation. This is not just a UK story as yields all around the world are up.

Overall, short duration bonds offer some protection from jumps in US interest rates. US investment grade bonds look relatively attractive as does UK and European investment grade credit due to the BoE and ECB corporate bond buying programmes.

There has been a particular upside in local currency emerging market debt due to currency stability and improving economic fundamentals such as current account balances. Local currency bonds generally have lower duration than hard currency EM debt which should make them more resilient to a spike in global long term bond yields.

It is against this background we have set out our portfolio recommendations.

7th December 2016

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PORTFOLIO SELECTIONS

Portfolio Selections - January 2017

The global recovery is generally on track with the support of low interest rates, accommodating monetary policy, improving employment rates and growing consumption. The risks remain the potential for US protectionist trade policies, the pace of China's growth, the growing issue of political uncertainty in Europe, the rate at which US interest rates may rise and the implications this has upon commodity prices and emerging market debt repayments.

The US Federal Reserve is expected to deliver another hike in interest rates on the 14th of December. This comes at a time when the appetite for further additional stimulus from the BoJ, BoE and ECB is reducing. Therefore, global financial conditions may become less accommodating over the months ahead.

The effectiveness of quantitative easing (QE) to boost demand is losing its impact and so governments need to step in where previously central banks took the lead. The increase in government spending in such projects as Hinckley Point, HS2 and Heathrow's third runway are good examples of the new focus on infrastructure expansion likely to be seen in 2017 and onwards.

We expect the concerns over China to resurface in 2017. A hard fall in growth is not expected but China is now likely to be past the peak of the mini growth cycle that was a result of last year's stimulus. We are now seeing steps being taken to rein in property speculation through tighter mortgage restrictions. China's stimulus withdrawal and the resulting gradual slowdown plus the pressure on the renminbi pose a risk to growth in both China and emerging Asian economies. We are cautious of falling Chinese growth but recognise that emerging Asia have the best long-term prospects for growth for any region in the world. We will therefore reduce our direct Chinese holdings but increase our Emerging Asia holdings.

American GDP growth is expected to finish the year at 1.5% as it picked up pace in the second half of the year. Throughout 2017 we should see continued growth in the labour market and an associated rise in wages. A strong US$ will have an impact upon export trade but the American domestic market should be robust particularly if Trumps infrastructure and tax reducing plans are fulfilled. With job numbers and wage growth improving, a December rate rise is likely and further moderate rate rises in 2017 look reasonable. We are positive about the prospects of the US$ and the relative strength of the US economy. We are happy to extend our positions in US equity with an emphasis upon private listed infrastructure and mid cap and small cap corporations who will principally benefit from Republican policies.

The steep fall in sterling following the Brexit referendum has supported UK equities given their high dependency on foreign earnings. However, the stabilisation of commodity prices also supports UK equities given the FTSE 100's heavy exposure to the natural resources sector. While we enjoyed a quarter long boost to UK equity values, the relative strengthening of the pound and weakening of the

euro has lessened this recent advantage. UK economic growth is likely to weaken over the medium term amid uncertainty over the Brexit settlement. UK consumer confidence has been strong since the summer but while the post Brexit economic data is holding up well, lower business investment, slower job growth and weaker consumption are likely to become a drag as Brexit related uncertainty starts to materialise.

The impact of currency depreciation is now noticeable with cost increases in imported goods. Post- Christmas inflation is expected as the higher cost of imports will boost inflation by 1-2%, peaking in 2018. With real income growth running at 2%, it will not be long before spending power is affected. Fiscal stimulus in the form of infrastructure investment, measures to boost consumer spending and business investment, including corporation tax cuts, will go a long way towards limiting Brexit fall out. We will ease down our positions in the UK but expect sterling to still hold a competitive valuation throughout the coming months.

The UK Brexit raises concerns over European growth prospects. Slower UK growth will have an impact on Europe. Europe is particularly vulnerable to stagnant global trade growth and its inability to formalise trade agreements easily does not help. Political uncertainty lies ahead in the form of the Italian referendum on constitutional change and then general or presidential elections in Holland, France and Germany in 2017.

Despite these uncertainties, European equities are very well priced and prone to upward movement given the region is at an earlier stage in the recovery cycle. The monetary backdrop is supportive as the ECB QE programme is in place until March. European growth has increased through wage growth and consumption. This may result in rising inflation. Any improvement in inflation will allow the ECB to start to taper or even withdraw its €80bn per month stimulus package later in 2017. Eurozone negative interest rates may also move back to zero. While growth in Europe is improving we are concerned about the outcome of the various European elections creating uncertainty and so will pare down our European exposure until later in 2017.

Earnings momentum has slowed in Japan despite the introduction of negative interest rates by the BoJ in January 2016. The ¥ actually strengthened which was a setback for export sensitive Japanese stock. However, for the greater part of 2016 the ¥ has fallen against the strengthening US$. The BoJ is likely to become a major shareholder in the Japanese stock market and maintain its extremely loose monetary policy. This framework allows for further negative interest rate cuts to further reduce the value of the ¥ and increasing the value of its overseas earnings. Stock values are attractive and Japanese corporations with large cash reserves have plenty of scope to boost dividends or make stock repurchases. The Abe government policies should support growth prospects. Growing US consumption will boost import sales from which Japan can benefit. While our Japanese holdings are relatively modest we will retain our exposure.

It is expected that emerging market growth will pick

up this year with stable commodity prices and an increase in developed world consumption. However, as the major influences upon growth – Chinese stability, commodity demand and the fact that loose monetary policy from the major developed world central banks is now progressively coming to an end, emerging markets can be vulnerable to change. South Africa and Turkey with current account deficits of over 5% of their GDP are a concern. India and Brazil have both made significant progress in closing their deficits and can cope with a strengthening US$ while Korea, Taiwan and Thailand have near record surpluses.

Emerging markets are attractive given the expected direction of long term currency appreciation. It is important to be selective with Asia as the preferred region because their predictive returns look higher. The combination of strong cash flow growth and robust balance sheets to support stable dividend payments help maintain stock valuations in Asia. The main concerns will be the impact of future Fed rate rises, the possible start of protectionist trade agreement renegotiations, the rate of growth in China and the path of commodity prices. We do not think that Fed rate hiking will be overly aggressive so we are happy to maintain our relatively modest position in emerging markets but extend our exposure to South East Asian economies.

UK monetary policy is likely to stay highly accommodative for a longer period due to the negotiations over Brexit. The BoE has relaunched a QE programme and reduced interest rates from 0.5% to 0.25%. This places the BoE more in line with the ECB rather than being closer to the Fed's position as was the case consistently pre-Brexit.

The returns on UK gilts are very low although yields have been driven up due to the threat of inflation. Similarly, the case is the same on the continent with overvalued bonds being hit by US Treasury yield rises and the risk that the ECB will taper or even end its QE programme. Therefore European yields can be expected to raise meaning bond prices will fall. With yields across the developed world very low and likely to remain relatively low, there has been a movement to emerging markets local currency debt. Corporate balance sheets remain in good shape and default rates are low.

With the expectation of both rate rises and inflation in 2017, we have reduced our exposure to fixed interest securities. Those we do hold will mainly be strategic bonds and investment grade corporate bonds. We will avoid government gilts and inflation-linked gilts. While there is an expectation of inflation in the UK in 2017 this may not be as high as some predict as sterling has regained some of its falls and GDP growth next year looks likely to be less than 2016.

We are very aware of the implications of the exit penalties that still apply to both the Henderson and Threadneedle Property funds that we hold. When these penalties were applied to discourage out flows in mid-June it stopped us from de-risking this asset from the portfolios ahead of Brexit. The result was a 5% fall in portfolio values. We expect this penalty to be lifted very soon and as a result the 5% reduction will be recovered meaning our portfolios will see an immediate uplift in value. As we have

been overweight in property this 5% charge has held our portfolios back against national benchmarks. It is for this reason we are maintaining our property holding to the same percentage as held in the 24th Edition.

We expect further US$ appreciation which has a negative influence on gold prices. Throughout 2016 with a background of uncertainty gold priced mainly increase reaching US$1370po in July. Gold has since fallen back to US$1168po particularly with the prospect of the US$ rising in value further on the back of interest rate rises. It is for these reasons we have avoided holding gold.

We are however mindful that with a world of uncertainty facing us as well as the likely rise in inflation, gold is a useful counter balance. We may therefore consider adding a small gold position within the Defensive portfolio to reflect not only geopolitical policy risk, but the higher debt and potential inflation risk In other portfolios gold is represented in a broader natural resources fund.

As of 1st December 2016, our best performing funds held within our portfolios over the last 12 months have been;

Schroder US Mid Cap	34.35%
Schroder US Smaller Companies	33.79%
Blackrock Pacific ex Japan Tracker	30.76%
Old Mutual North America	30.74%
Fidelity China Focus	29.66%
First State Global Listed Infrastructure	29.11%
Henderson China Opportunities	28.28%
Man GLG Japan Core Alpha	27.43%
HSBC American Index	28.34%

The reason behind these positive returns has been the significant growth in the USA economy resulting in the US stock markets reaching all-time highs. The growth in China is due to the recent government stimulus which we expect to start falling away, while growth in Japan is a result of government policy to devalue the ¥.

While our poorest performing funds were;

Axa Framlington Biotech	-5.27%
Threadneedle Property	-4.65%
Invesco Perpetual Strategic Income	-4.20%
Henderson Property Fund	-4.01%

The Biotech fund has been carrying losses over the past twelve months but recent performance has been much improved. Both of our property holding are suffering a 5% reduction as they and are priced at the exit price. We are expecting this charge to be lifted shortly adding the 5% value back to the fund.

As far as the 26th Edition of our portfolios is concerned, eight of the funds from the 25th Edition have been substituted while four new funds are added. Our asset allocation remains broadly in line with that of Edition 24 in order to retain the property allocation and the overall portfolios risk profile. However, they have been tilted towards sectors which we feel offer better security and growth prospects going forward. We continue to hold meaningful levels of cash and property across the portfolios to help dampen volatility but we have reduced our fixed interest exposure. Our general strategy is to remain well diversified across all portfolios.

We are pleased to report that the gross performance of our portfolios in each of our eight portfolios up until 1st December 2016, as measured against the associated national benchmark, has been quite satisfying. The relative performance is measured over six time periods from 6 months, 1 year, 2 years, 3 years, 4 years and 5 years. Five of our portfolios showed up very well producing some significant gains ahead of benchmarks over all time periods. Collectively the eight portfolios outperformed their respective benchmarks on 33 out of 44 occasions (75% competency). However, I am disappointed to report that this success factor is our lowest outperformances in the thirteen years we have been running them. Our Defensive portfolio has fallen short of its benchmark but in some respect that is expected due to its high cash and low equity content. It did however achieve its objective of comfortably beating cash returns. Our Balanced Income and Balanced High Income have recently fallen below their respective benchmarks due to our overweight position in property and the recent falls in bond prices. We will retain our overweight position in property funds awaiting the removal of the 5% reduction in exit price.

Our performance is reported on the next page of this Outlook Report as well as on our website **www.estatecapital.co.uk**

Collectively our eight portfolios outperformed their respective national benchmarks on 33 out of 44 occasions.

PORTFOLIO PERFORMANCE

The Estate Capital Investment Portfolios

'The global balance of investments across differing asset classes is the primary driver of portfolio returns'

The Estate Capital Investment Portfolios now offer eight risk related investment strategies designed for medium to long-term investors seeking capital growth and income from a portfolio of leading investment funds. The individual funds that make up our diversified portfolios are selected on the quality of the fund manager and both the quality and consistency of past performance.

There is a wide range of asset classes across global markets available to investors. Our portfolios bring together a diversity of global equities, fixed interest securities, cash deposits, commodities, precious metals, infrastructure and property. The global balance of investments across differing asset classes is the primary driver of portfolio returns.

Our asset allocation is built using a fully modelled asset allocation tool. This system is powered by research from actuaries Towers Watson and investment data from Financial Express.

This modelling system offers us great accuracy to build and test the most efficient blend of assets for our eight model portfolios. Each new edition of our portfolios is published on our website with fact sheets, performance figures, risk ratings and range of returns.

We benchmark and publish our portfolio performance against the most relevant national averages and are happy to say that our selections have enjoyed an enviable track record.

Cumulative Portfolio Performance from 7th December 2016

Below are the past five year's gross investment returns for each of our portfolios from 7th December 2016

Portfolio	*6 months*	*1 year*	*2 years*	*3 years*	*4 years*	*5 years*
Defensive	1.61%	2.27%	4.47%	11.75%	14.84%	24.38%
Conservative	4.12%	5.85%	9.95%	19.45%	26.75%	40.31%
Balanced Income	4.79%	4.76%	8.07%	16.47%	28.76%	44.37%
Balanced Beta	8.04%	10.43%	11.65%	23.33%	33.09%	49.56%
Balanced Higher Income	6.03%	5.91%	-	-	-	-
Balanced Alpha	8.33%	11.66%	16.29%	27.61%	38.19%	52.13%
Speculative Beta	12.18%	14.63%	14.99%	27.49%	43.69%	61.39%
Speculative Alpha	10.15%	12.95%	17.35%	31.18%	57.73%	81.85%

Discrete Portfolio Performance from 7th December 2016

Below are the gross investment returns for each of our portfolios for each 12 month period over the last five years from 7th December 2016

Portfolio	*2016*	*2015*	*2014*	*2013*	*2012*
Defensive	2.64%	2.49%	6.50%	3.00%	9.32%
Conservative	6.35%	4.20%	8.05%	6.62%	12.86%
Balanced Income	4.91%	3.84%	7.07%	11.31%	14.26%
Balanced Beta	10.75%	1.38%	9.52%	9.13%	13.85%
Balanced Higher Income	6.40%	-	-	-	-
Balanced Alpha	12.52%	4.81%	8.75%	9.42%	11.23%
Speculative Beta	15.31%	0.75%	9.53%	14.45%	15.08%
Speculative Alpha	14.09%	4.80%	10.28%	22.53%	18.42%

The value of investments can fall as well as rise. Past performance is not a guide to future performance. Investors may not get back the money invested. Cumulative and discrete performance charts show % growth from 7th December 2011 to 7th December 2016 calculated using bid prices with income re-invested into the fund net of tax.

PORTFOLIO PERFORMANCE

Asset Allocation

It is commonly acknowledged that 90% of long term total return comes from having the correct and most efficient blend of asset classes for any given risk level. Our asset allocation is built using a fully modelled asset allocation tool provided by Old Mutual Wealth. This system is powered by research from actuaries Towers Watson and investment data from Financial Express. This modelling system offers us great accuracy to build and test the most efficient blend of assets for our eight model portfolios. Each new addition is published on our website along with fact sheets, performance reports, risk ratings and range of returns.

Here are the asset allocations for our eight portfolios.

Rates of Risk Related Returns

We have also published both the historic and anticipated future gross returns for each portfolio. These predictions are achieved through statistical modelling and provide a realistic range of expected returns going forward. Here are the prospective returns for each portfolio. These returns are not guaranteed and are only an illustration of potential gains or losses.

We have also published the investment ratios for the portfolios giving investors a risk related performance measure of each portfolio against the risk free return, the market return and the benchmark return.

Asset Allocation January 2017 - Edition 26

Portfolio	*Risk*	*Money Markets*	*Fixed Interest*	*Property*	*UK Equity*	*US Equity*	*Europe Equity*	*Asian Equity*	*Japan Equity*	*Global Equity*	*Other Assets*
Defensive	2	49%	11%	18%	7%	9%	1%	2%	0%	3%	0%
Conservative	3	33%	21%	15%	9%	11%	3%	6%	2%	0%	0%
Balanced Income	4	16%	22%	20%	22%	9%	5%	6%	0%	0%	0%
Balanced Beta	5	10%	22%	16%	15%	15%	6%	12%	3%	1%	0%
Balanced Higher Income	6	9%	19%	15%	31%	10%	6%	10%	0%	0%	0%
Balanced Alpha	6	9%	19%	13%	13%	22%	5%	14%	3%	2%	0%
Speculative Beta	7	2%	19%	16%	16%	19%	6%	18%	3%	1%	0%
Speculative Alpha	8	3%	6%	16%	14%	33%	7%	14%	4%	3%	0%

Perspective Range of Return & Volatility

Portfolio	*Risk*	*Return*	*High*	*Low*
Defensive	2	2.55%	11.06%	-5.96%
Conservative	3	3.45%	17.45%	-10.55%
Balanced Income	4	4.09%	21.45%	-13.27%
Balanced Beta	5	4.57%	25.30%	-16.16%
Balanced Higher Income	6	5.27%	29.36%	-18.82%
Balanced Alpha	6	5.27%	29.36%	-18.82%
Speculative Beta	7	5.78%	33.23%	-21.68%
Speculative Alpha	8	6.36%	37.17%	-24.46%

Investment Ratios

Portfolio	*Risk*	*Beta*	*Alpha*	*Sharpe Ratio*	*Info Ratio*
Defensive	2	0.62%	1.37%	0.14%	-0.05%
Conservative	3	0.95%	2.35%	0.68%	1.59%
Balanced Income	4	0.84%	1.16%	0.38%	0.24%
Balanced Beta	5	1.08%	1.85%	0.60%	0.94%
Balanced Higher Income	6	0.80%	-1.51%	0.47%	-1.73%
Balanced Alpha	6	0.90%	3.07%	0.80%	1.12%
Speculative Beta	7	1.09%	1.74%	0.61%	0.68%
Speculative Alpha	8	1.18%	2.45%	0.72%	0.99%

Maximise your returns with a level of risk you're entirely comfortable with

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