ESTATE CAPITAL INVESTMENT PORTFOLIOS

OUTLOOK

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ESTATE CAPITAL

Earnings growth continues to provide support to global equity markets

Investors have experienced strong total returns in 2017 across a range of asset classes. The combination of good growth numbers, low inflation, low interest rates and reduced volatility has aided the economic conditions.

At the beginning of the year we were uncertain about the impact of Brexit, Donald Trump's presidency and a number of European elections. Throughout this year of change, market volatility has remained subdued as markets took these political risks in their stride.

There has been a noticeable pick up in global growth since the summer of 2016 which fortunately coincided with our Brexit Referendum. This economic pick up is still continuing at a rate of around 3.6% global GDP according to the International Monetary Fund (IMF). Developed economies are enjoying some of the strongest growth since the financial crisis resulting in greater employment across Europe and particularly in America and Britain where unemployment is at record low levels. Given this backdrop we now expect a burst of inflation. This has started to occur in the UK where inflation hit 3.1% in November mainly through the higher costs of imported food, goods and oil due to a devaluation of sterling. Inflation in the US is standing at 2.04% while in Japan it is 0.7%. Despite strong labour markets and loose monetary policy we are not seeing further rises in inflation in other developed economies. Governments have been able to allow their economies to grow at accelerated growth rates without creating a looming inflation problem which would require interest rate hikes to rein back. Due to the combined impact of globalisation, national and personal debt levels, the gig economy, disruptive technologies and developed world demographics the price power of labour is lower than would be expected and hence wage inflation is muted.

The global economy is undergoing its best ever growth phase with fewer countries currently in recession than ever. There is a general lack of signs suggesting a deceleration in global growth with the Purchase Manager Index (PMI), a key measure of market confidence, indicating positive across the globe.

Despite the high valuations placed upon developed world stock markets, high profits and expectations of earnings growth continue to provide support to

global equity markets. This however does not stop us being cautious about the future direction of markets.

With improvements in growth and unemployment the US Federal Reserve has progressively increased interest rates and in October also started a programme of unwinding its massive quantitative easing (QE) programme. The Feds balance sheet currently stands at US$4.5tn while pre crisis it was US$1tn. As bond assets come to maturity they will not be renewed therefore reducing the asset values held by the Fed by US$10bn per month. This amounts to switching from the largest money printing exercise in history to the largest money recovery exercise in history.

The Federal Reserve's tightening of money has been well signalled and markets have taken it in their stride seeing it as a sign of the strength of the economy. However, there are natural concerns as no one knows exactly how this monetary tightening will impact the economy. Printing money inflates asset prices and QE has produced big increases in stock, bond and property prices. However, the impact on wage rates, incomes, and goods and service's prices has been much slower.

Other central banks will want to follow the lead of the Fed in returning to normal economics. We have seen interest rate rises from the Bank of England (BoE) while the European Central Bank (ECB) has announced the tapering of its QE programme starting in 2018. The Bank of Japan (BoJ) however remains committed to zero interest rates and continuing its QE programme until inflation returns to the Japanese economy.

Another source of global growth is government spending. It would appear that globally the era of fiscal austerity has come to an end. According to the IMF, government spending will boost global GDP by 0.4% in 2017. During the period 2010 – 2015, government cut backs were a drag on growth.

As far as equities are concerned global markets have had a strong year and we remain positive about 2018. However, equities have reached historical highs in the US, UK, Europe and Japan and we have to be mindful of where value is to be found. With some markets at or close to fair value it is more difficult to grow returns. We need to be more selective and diversified. We see Europe, Japan and Asia as offering better value than the US due to lower valuations and ongoing recovery.

The US S&P 500 reached new highs in early December by hitting 2642 points up from 2250 at the start of January meaning the US leading index

grew by around 17.4% in 2017. Much of the growth comes from improved corporate earnings, particularly in the technology sector with companies like Facebook, Apple, Amazon and Microsoft doing very well. We do however see the US stock market as expensive but still profitable.

Market sentiment has not been dimmed by the ongoing failure of the Trump administration to realise many policy goals. The Senate Republicans did however pass the most radical overhaul of US taxes in 30 years on 2nd December, giving Donald Trump the chance of achieving his first legislative victory of his presidency. While there is expectation of personal and corporate tax reform in the USA, this may still stall in Congress due to the additional medium term cost to the national debt of some US$1.2tn. Asset managers believe there will be some tax reform but this will not have as much impact on asset prices as originally expected.

UK stock valuations are historically high having been encouraged by analysts revising their earnings expectations. However, without the tailwind that was the devaluation of sterling, we can expect a slowdown in the UK driven by weaker business investment and higher inflation reducing consumer spending. Although there has been some slowdown of investment and capital inflows, export orders have remained buoyant. The Bank of England's rise in interest rates from 0.25% to 0.5% was aimed at dampening inflationary pressure.

European companies are benefitting from improved global growth and loose monetary policy. Eurozone equities are relatively undervalued compared to the US and earnings are more likely to exceed expectations. European stocks have benefited from a catch up effect on earnings growth and valuations this year. The FTSE Euro First 300 index rose from 1445 in January to a high of 1560 in November, a rise of 7.9%. It stood at 1509 on 1st December.

We remain positive over Japanese equities as they are showing strong earnings growth and analysts have reviewed upwards their earnings forecasts. The Nikkei 225 Index gained 14.8% between January and November 2017. The market rise was led by oil, mining and car manufacturing. Economic data continues to improve with inflation now standing at 0.7%. Japanese companies are recruiting from a tight labour market thus pushing up wages. The BoJ has kept interest rate at 0% and the gradual but consistent improvements in the economy have been reflected in corporate results.

The developing Asian markets remain the most attractive region on a valuation basis particularly

Hong Kong, Taiwan, China, South Korea and Thailand. This region is the world's growth engine based upon export growth, increased domestic consumption and supportive monetary policy. Improvements in corporate governance and structural reforms have also been helpful. The consensus amongst economists is that Asia will enjoy a growth in GDP of 5% in 2017 and 5.1% in 2018. One of the major Asian stock market is the Hong Kong's Hang Seng Index. It increased in value from 22000 point in January to 29341 in November, a rise of 33%, but dropped back to 29074 by 1st December.

For investors with high risk tolerances, Brazil and Russia have improved growth prospects and look more attractive than in the recent past. Russian equities in particular have delivered strong performances. Russia's economy is largely based upon natural resources and energy therefore any increase in the oil price will add value to Russian stocks.

While most equity markets are trading at relatively high values there is always nervousness about a correction. We are not expecting this given the relative strengthening of the world economy and the potential for further growth. Investor sentiment should therefore remain intact. The risk to this centre around geopolitical risks in North Korea, Catalonia, anti-trade initiatives from the Trump administration, a decrease in credit confidence in China's regional banking sector or the Federal Reserve hiking interests rates too much and too soon. While these risks are material none of them seem at this stage to be a high risk to markets. This situation can of course change.

UK stock valuations are historically high having been encouraged by analysts revising their earnings expectations.

Is this an end to the raging bull?

The debate as to whether we are coming to an end of the long running bull market is raging. The US economic improvement has run for longer than the average post war upturn.

After 18 months of ever improving data from around the world, including the UK, many are forecasting it is inevitable that this continuous growth cannot continue, that growth will decline, and we will witness some form of asset value correction. The alternative to a correction is that we endure a period of sideways movement producing little growth.

The National Institute of Economic and Social Research (NIESR) have suggested that markets are vulnerable to a range of surprises from changes in sentiment to policy failure. One example would be the excessive rise in interest rates in the USA causing an economic slowdown. Other concerns were the overtightening of monetary policy by the ECB or a crunch in China's credit markets which could cause anxieties to spread and become a catalyst for a correction.

However, there are many reasons to expect the current positive trends to continue. Despite historically low unemployment, wage inflation has not yet risen to any meaningful levels. Economic outlook remains below its potential and is still rising. Often ahead of a recession, output is above its potential and falling.

The movement of bond yields is often a good indication of future prospects. The yield curve is a line tracing yields across differing maturities. If this line is falling away, it suggests poor growth. The yield curve has flattened recently as traders bought long-dated securities and sold short-dated securities on the belief that the Federal Reserve would raise rates more than investors expected. While the yield may have flattened recently, it still remains positive.

The prudent actions of central banks particularly the Federal Reserve is paramount. The pace of rate rise will be vital to future fortune as an over reactive Fed may damage the ongoing recovery. On current evidence however, the Feds heavily reported actions are measured, supportive and give good reason to expect continuity in economic conditions.

Positive company earnings reports and growth figures reinforce the picture of steady, ongoing global recovery. Although the withdrawal of monetary stimulus is likely to be significant and carefully executed it is another indication that the global economy is strong. Lingering wage weakness show there is still more growth capacity.

We are inevitably moving closer to the end of this current cycle and so are increasingly thinking of how to add protection to downside risk while still accessing growth opportunities. We have held an overweight cash positions but have introduced into all of our portfolios some Absolute Return Funds that invest in short and long equity positions that can provide growth and protection.

A €50bn divorce bill?

It is becoming clear that in order for the UK to secure a favourable trade deal the EU want the UK to pay out a €50bn divorce bill. The EU needs this money as the loss of Britain's contribution will hit EU budgets very hard. Plugging a hole of 16% of revenue in EU finances will provoke alarm particularly within the poorer countries and regions. A battle over the reduced budget looks inevitable.

The UK's desire to progress discussions on future trade relationships alongside discussions on the withdrawal arrangements was initially overruled by the EU. They have held firm on their position that the discussions should be consequential. Firstly, an agreement needs to be reached on the issue of EU citizens' rights, the divorce bill and the Northern Ireland border. Only when sufficient progress has been made on these points can discussions over future relations start. The first six rounds of Brexit negotiations have led to little real progress with the EU holding out for a bigger divorce bill.

Teresa May sought to break through this impasse with her Florence speech. The UK sought a two year transition period during which we would continue to pay a total of €20bn into the EU budget meaning no state would be financially disadvantaged. The European Council President Donald Tusk suggested that trade talks could open in December if Prime Minister May improved her offer on what the UK pays to leave and a deadline was set to 8th December. There are strong voices in the EU who want negotiations for a trade deal to start soon and are fully aware that a bad deal for Britain is a bad deal for Europe. An improved financial offer has been made of around €50bn, far higher than the €20bn earlier offer and has opened the way for trade talks to begin.

If trade talks do start in late 2017 or early 2018 it will leave just over one year of the Article 50 timescale to negotiate the treaty and get it ratified through the many parliaments of Europe. Senior figures within the European parliament have made it clear that they would oppose any plan giving Britain the same benefits outside the EU as it has inside. As the MEP's have a veto on the final agreement this will be of concern to the final outcome.

This squeeze on time increases the importance of reaching an agreement over the transition period. We are now 9 months on from Article 50 being triggered and business and investors are no clearer on what the final relationship could be.

The UK stock market has benefitted from Brexit uncertainty. The devaluation of sterling has greatly boosted our manufacturing export profits. If Brexit remains uncertain, sterling will remain low and stock markets will remain buoyant. A good Brexit

deal should see sterling strengthen and stock values could reverse.

The Office of Budget Responsibility (OBR) has warned MP's that they should not fixate on the divorce bill but upon the growth prospects for the UK post Brexit and particularly the slowdown in UK productivity.

British businesses are calling for the transition period to continue current trading regulations as closely as possible so that businesses will only need to take into account one adjustment as a result of the UK withdrawal from the EU. The Confederation of British Industry (CBI) have reported that 60% of members are planning for a 'no deal' Brexit but would put these plans on hold if a transition deal was agreed by March 18. This is now looking more likely.

No one can predict the final outcome of Brexit from long queues of lorries trying to enter or exit ferry ports, a shortage of imported goods and higher inflation, to many countries seeking to sign new free trade agreements with an independent UK or all three. What is clear there will be people and businesses both adversely and positively affected. The sectors most impacted by a hard Brexit will be the financial services sector as well as the car industry, aerospace and aviation to name a few. Export difficulties will of course be sorted out but could be difficult in the short term.

There are also sectors that can benefit from a 'no deal' Brexit. The UK will be outside the EU customs union tariff agreement imposed on the rest of the world so, for example, food imports could be cheaper. Prices could fall even with a weakened pound.

Let us hope that the UK and EU secure an exit trade agreement that benefits cross channel commerce allowing both sides to advance.

No one can predict the final outcome of Brexit.

The possible impact of a No Deal

The Bank of England has recently stated that up to 75,000 high end jobs could be lost in the financial service sector following Britain's departure from the EU. This assumes that no special deal is made over EU passporting rights for UK financial services business. A survey conducted by Reuters of more than 100 major financial sector firms based in the UK suggested that the number of job lost would be more like 10,000 while Xavier Rolet the former CEO of the London Stock Exchange put the number at 250,000.

If the UK ends its Brexit negotiations without an agreement and trading with the EU under World Trade Organisation Rules it would mean banks based in the UK will lose their special passporting rights to operate within other EU countries. Under these conditions it would be expected that the EU impose a geographic restriction on where trading in Euro denominated financial insurance products would have to be based. That means trading jobs going to other EU countries. The European Banking Authority and The European Medicines Agency have announced that they will be leaving London to set up their offices in Paris and Amsterdam respectively.

Whatever the real number of job losses the fact remains that a 'no deal' Brexit could see a significant part of Britain's preeminent business sector move to the continent and with it the tax revenue.

London remains the largest financial centre in Europe with over 1 million people employed in financial services. Many believe that there will be a positive outcome to EU negotiations as the City of London supports so many EU businesses and governments in raising funds and concluding global deals. The corporations and governments of Europe will still want and need to access London's financial markets.

A recent report by Capital Economics concluded that the impact of a 'no deal' would be some economic dislocation and that growth would fall below 1%. The report expects that if faced with this scenario then the government would react with a combination of low interest rates, lower corporation tax, and increased investment subsidy to the sectors most adversely affected such as farming, car manufacturing and financial services.

The report suggests that the outlook of the UK economy is good and that 'no deal' is not as bleak as many predict. However, they expect some form of trade deal to be agreed ahead of the UK leaving the EU as it would be in all parties' interests. It also goes on to say that the City of London with its preeminent position as a global financial centre will endure outside the EU regulatory framework. In fact, the city could avoid the financial transaction tax helping London to lead the continent as a trading centre.

It does appear that the prospects of a softer Brexit have improved since the offer of a far greater divorce settlement. On the back of this situation investment bankers are predicting a pick-up in investment into the UK and an increase in consumption.

The UK economy is slowing but still doing well

While the UK economy is still doing well we have fallen down the G20 growth league as others have caught up. The UK is growing at a rate that could be reasonably expected. The National Institute of Economic and Social Research (NIESR) reported that the UK grew at 0.5% in the three months to the end of October meaning a 1.7% growth on a year on year basis. It may be true that without the Brexit uncertainty that these figures may be higher but exports have risen by 5.4% on the back of a devalued pound. The NIESR predicts that UK GDP will hit 1.6% by the end of 2017 and 1.7% for both 2018 and 2019. The 5 year prediction is 1.5% assuming a relatively smooth withdrawal from the EU which is their expectation.

The Office of Budget Responsibility (OBR) said in its Economic and Fiscal Outlook report produced for the recent Budget that the impact of lower productivity means that real GDP growth will slow from 1.5% this year to 1.4% in 2018 and 1.3% in 2019 as public spending cuts intensify and Brexit-related uncertainty bears down on activity.

This more downbeat forecast for the UK's economic future is similar to the figures produced by the European Commission (EC). The EC forecast that the EU as a whole will enjoy 2.2% growth in 2017 and 2.1% in 2018, while the UK will slow to 1.5% this year and 1.3% in 2018. The EC view is substantially more downbeat than that of the Bank of England (BoE) who predicts growth of 1.7% this year and the next three years. The BoE predict that the UK jobless rate will fall to 4.2% and stay there for several years while the EU expect the unemployment rate to rise to 4.9% by the end of 2019.

UK company earnings forecasts have been upgraded with UK domestically orientated stock set to deliver earnings growth into double figures. The UK industrial and manufacturing output continues to grow but our trade deficit in goods and services widened in Q3 2017 due to increased imports of machinery. The very competitive value of sterling and healthy global demand is helping UK manufacturers compete in global markets. Foreign companies are switching their sources of supply to the UK due to the weakness in the GBP. Some economists argue that the devaluation in sterling was needed and is a good thing that should continue for the benefit of the country. The currency valuation benefit is boosting business but we do not know the future direction of sterling as the Brexit negotiations conclude.

We are still waiting for wages to rise

The number of people out of work fell to 1.4 million in Q3 leaving the jobless rate at 4.3%. UK unemployment is at a 42 year low and may fall further. There are 32.1 million people in work in the UK which is 279,000 more than in 2016. Job vacancies still remain significant with over 780,000 advertised vacancies suggesting that employers are still looking for staff and unemployment is unlikely to rise. Many parts of the UK are effectively fully employed so wages growth is likely to follow.

The Office of National Statistics (ONS) confirmed that inflation is currently running ahead of wage growth by 0.5% year on year. Inflation averaged 2.8% while wage increases have averaged 2.2% throughout 2017.

Wage inflation while employment is at a record high has not yet followed through mainly due to the gig economy, self-employment rates and falling productivity for every hour worked. Spending habits are linked to economic growth as household expenditure accounts for 60% of UK economic activity.

Inflation hit 3.1% in November which is a five year high and well above the BoE 2% target. One of the factors was the global demand for Brent Crude Oil taking prices to US$59pb up 20% on 2016. This rise in oil price will feed through to prices on food, transport and manufacturing. The NIESR have suggested a ‘no deal’ Brexit risks adding around 1% to the UK’s inflation if WTO tariffs are applied to imported goods.

For the first time in over 10 years, the BoE have raised interest rates from 0.25% to 0.5%. While the rise is modest and only reverses the cut made in August 2016 after the Brexit Referendum, it will still impact on variable interest rate mortgage holders but help savers. The Bank chose to raise interest rates as a result of rising inflation, stronger global growth and record low unemployment in the UK. While there is no strong expectation of another rise in the near future, markets are expecting another two more over the next 3 years.

The Governor of the Bank of England Mark Carney has said that Brexit related constraints on investment and workers coming to the UK are appearing to be holding back growth in the economy. The BoE also suggests that the weaker GB£ has driven up the cost of imported food, fuel and other goods but inflationary pressure is at its peak.

The interest rate increase was a boost of confidence in the economy. Ultra-low rates have benefited business borrowing and mortgage holders but have hurt savers and pension funds particularly those funds needing to match their assets to their long-term liabilities. Bond yields have, on the back of low interest rates and central government purchasing, become extraordinary low creating an asset price bubble in bond values. Raising interest rates gradually will ease this asset bubble rather than pop it.

The All Property Index yield remains at 5.1%

Despite Brexit uncertainty, the UK commercial real estate market has continued to behave in line with long term trends. Asian investors accounted for the majority of oversea investors but American and German investors were also active.

A weaker economic environment will almost certainly subdue investor demand but international buyers will still remain attracted to a weakened sterling denominated asset. Local buyers may postpone decision making until there is greater clarity over Brexit.

Forecasts for commercial real estate suggest strong returns for 2017 and beyond. The latest MSCI UK All Property Index takes a very positive view on capital growth at 8.2% in 2017. Such results are unexpected in light of the political and economic uncertainty. The five year forecast of 6.9% pa does however look a little optimistic.

The BoE has called valuations in the UK commercial property market "stretched and vulnerable to interest rate rises". Despite this warning, the All Property Index yield has remained at 5.1% since the summer of 2016. This stability reflects the strong demand for office space, particularly in London after the depreciation in sterling.

Yields in the retail sector have risen. These values are helped by low bond yields, gilt rates and less forced sellers in the market.

European growth exceeds the UK

The Eurozone grew by 0.6% in Q3 of 2017 which was above analysts' expectations.

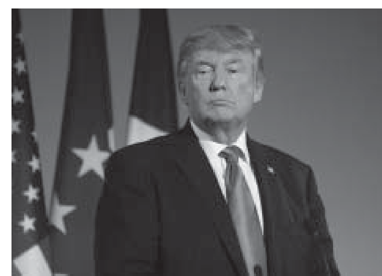
The annual growth rate has been 2.5% while European unemployment stands at 8.9% which is the lowest for nine years. European inflation however fell to 1.4% in October well below the 2% target set by the ECB. These figures are encouraging and show that the continents economy is growing and more people have work. The ECB will continue with ultra-low interest rates and their QE programme in order to get inflation rising again.

While there is degree of catching up in Europe's GDP growth, the Eurozone economy once again grew faster than the UK showing a continuing period of growth divergence. The Eurozone growth was 0.7% in Q2 followed by 0.6% in Q3 while the UK achieved 0.4% and 0.3% in the same periods. When looked at on an annual basis this is a difference of 2.5% compared to 1.7% which in monetary terms is significant. As the UK is further down the recovery path, our inflation at 3.1% is ahead of Europe's 1.45% prompting the BoE to raise interest rates by 0.25% in November.

The ECB intends to start to cut back on the level of bond purchasing that it conducts each month from January 2018. The current level of €60bn purchases will be reduced to €30bn. This policy, aimed at boosting inflation and employment, could come to an end by Q4 2018 as the need for such high bond purchases will have been reduced now that Europe is in a growth cycle.

Within Europe, there have been some growth successes such as the Greek economy returning to growth this year. Spain is also enjoying improving economic fortunes in both GDP and employment growth. The volatile condition of Catalonian politics could impact on this if Spanish bond yields spiked on a constitutional crisis and the country suffered higher borrowing costs.

Trump wants a less regulated and less taxed America



It has been nearly a year since Donald Trump was installed as US President. During that time we have seen the stock markets rise but little in the way of actual policy success from the new administration. Mr Trump has as yet not changed any economic policy but there is a feeling amongst business leaders that growth prospects have improved particularly over regulation. Clearly Trump wants a less regulated and less taxed America and business approves.

The US markets have done well in recent months, pushed up by higher earnings growth from the technology giants like Microsoft and Amazon. These gains moved US stock markets to new highs with the S&P 500 hitting 2692 on 1st December, up 17.4% this year.

The rise in technology stocks was aided by the announcement from the Trump administration of proposed cuts in corporation taxes. This additional incentive drove markets higher at a time when no such incentive was needed in America. US markets were already in good shape due to global demand and growth. The rise in oil prices bolstered the large US energy sector.

Around 50% of all earnings made by S&P 500 companies are from outside the US giving evidence that the world economy is strong. The relatively weak US$ has made US exports a little cheaper in foreign markets which has resulted in earnings growth. Over the last two quarters, US GDP has increased by an annual rate of 3% while US consumption increased by 2.4% and business investment grew 8.6% year on year.

The Trump administrations new tax reform proposals include reducing the existing seven tax bands to three 12%, 25% and 35% and reducing corporation tax from 35% to 20%. The corporation tax cut would be a major boost to company retained profits. Some analysts think that Wall St is over optimistic about stock prices based upon the proposed tax cuts given the impact any reduction will have on the US national debt and the array of political interests that need to be convinced the country can afford the risk of raising the Federal budget deficit to fund it. Mr Trump's first policy success could be his tax reforms that have now passed through both the House of Representatives and the Senate.

While the growth numbers for the US were very encouraging in Q3 some analysts were expecting a downturn in growth due to the devastation caused in the southern states by Hurricanes Harvey and Irma. In fact, the hurricanes did effect job growth with only 18,000 new jobs created in September reflecting the job losses in Florida and Texas. In October, US employers added a further 261,000 new jobs which is the biggest month for jobs since July 2016.

US wage growth has been slower than would be expected for an unemployment rate of 4.1%, the lowest since 2000. This may be a signal that unemployment can fall further before the labour market is tight enough to cause wage inflation.

The optimistic outlook for US growth and consumption strengthens the case for the Federal Reserve rising interest rates gradually. Fed Chair Janet Yellen feels the US is ready for less monetary stimulus as the economy has performed well and there is confidence in the outlook. In October, the Fed started to unwind its portfolio of bond assets at a rate of US$ 10bn per month. One impact of reversing quantitative easing is that long- term borrowing costs will rise.

Asian stock market growth has impressed

Asian stock markets have had a good year supported by renewed activity from China. Stock markets in Japan, South Korea, Hong Kong, India, Taiwan and Indonesia have through strong corporate profits, increased economic stimulus, growth in demand and consumption hit new highs.

Since the financial crisis, global markets have been moving steadily upwards as massive liquidity and ultra-low interest rates have created a growth environment for stock values. Asia has certainly benefited from the US demand and the gains made in US markets. It would seem that as long as the US continues to spend, there will be good times for Asian stocks.

At the same time, the growth in China this year has supported other economies in the region with its demand for imported goods and materials. The improvement in Chinese growth this year has pushed up the whole of Asia.

It is thought that the Japanese stock market has scope for further growth. With US$18tn of cash held in low yielding Japanese government bonds, there is massive domestic capital that could see Japanese stocks as a more attractive investment. Japanese equities are relatively cheap and have been publishing improving results.

South Korea’s outlook is particularly good with a 50% increase expected in corporate earnings mainly due to the high price of memory chips. The export of semiconductors, smart phones and cars has given the economy a big boost resulting in rising consumer confidence and spending. The South Korean stock market has some of the world’s most undervalued stock mainly due to poor corporate governance. This is changing to a UK style corporate code which is encouraging to investors.

Interestingly investors seem largely unconcerned about the threats and missile testing by North Korea. Analysts generally consider these threats as posturing and overblown but that view could change if threats turn to actions.

Another threat to the region is US interest rate rises which could affect investment and debt repayment costs, China’s regional banking debt levels and the increased concern about a correction in high market values.

Will China succeed in restricting credit and pollution?

Chinese share values have performed very well. The Shanghai Composite Index grew by 11% while Hong Kong's Hang Seng Index grew by 37% in the year to November.

Just as in the USA, Chinese technology stocks such as Alibaba and Tencent have risen sharply. However, China's heavy indebtedness continues to concern investors. Chinese borrowing stands at US$28tn which is 250% national GDP.

The IMF increased its forecast for Chinese expansion in 2017 from 6.2% to 6.7%. It stressed that this was the result of Beijing putting a higher priority on hitting its growth target than on the quality of the economic output. The Chinese government pledged to double the size of the economy between 2010 and 2020 and is prepared to see non-financial sector debt rise rapidly in order to achieve its aim. If this occurs, the IMF believes that debt as a proportion of GDP would rise to almost 300% by 2022 The IMF's experience suggests that China's credit growth is already on a dangerous trajectory with increasing risks of a disruptive adjustment or a marked growth slowdown.

The IMF have expressed concern at the methods used to keep the Chinese economy expanding though a combination of government spending on infrastructure projects and a willingness to allow state-controlled banks to lend more for speculative property development. It said the buildup of public and private debt would limit the ability of the Chinese authorities to act in the event of a financial crisis. While the IMF has warned about these dangerous debt levels, other analysts consider these fears overplayed as the Chinese government owns the country's banks and will stands behind them and their borrowing.

The 19th Chinese Communist Party Congress was held in October and established President Xi Jinping as China's most powerful leader. With a strengthening of his authority his anti-corruption campaign will continue but there is unlikely to be any shift to greater political freedoms. We are also unlikely to see widespread privatisation of state owned assets. However some economic reforms are expected such as opening the financial system to foreign investment.

The new Chinese government wants to deal with the risks in the Chinese financial system by bringing credit growth under control, cooling the property market and improving China's appalling pollution problem through emission limits. If the government does restrict credit and pollution, we are likely to see future growth slow to a sub 5% level but this growth will be more sustainable.

Japan

The Nikkei 225 hits new highs

Japan's stock market hit its highest value since 1996 after the re-election of Prime Minister Shinzo Abe. The ruling Liberal Democratic Party lead coalition retained its two thirds parliamentary majority thus encouraging markets that Mr Abe's economic reforms would continue. The Nikkei 225 rose to 22819 by 1st December helped by the depreciation in ¥ and so boosting Japanese export activity. Global growth and rising wages within Japan have increased domestic spending.

Another term for Prime Minister Abe means that the Japanese government stimulus programme of structural reforms, QE and fiscal stimulus will continue. Abenomics, named after Mr Abe, started in 2012 and is now starting to show signs of success. Japanese GDP expanded by 0.3% in Q3 and 0.6% in Q2 which on an annualised basis is 2.6 %. Japan has enjoyed six consecutive quarters of growth. Japanese unemployment is at 2.8% the lowest in 20 years.

While the US Federal Reserve and the European Central Bank are gradually tightening monetary policy, the Bank of Japan will maintain a loose monetary position with zero interest rates and heavy bond asset purchases. These policies are aimed at weakening the ¥ to boost profits of exporting companies, while also making savings less attractive and equity investment more attractive.

Japanese companies have improved corporate governance, payed out higher dividends to investors and bought back shares in order to boosting stock values. These values remain reasonable and the outlook is good.

Oil

Oil prices rise on global demand

Last year, oil prices averaged US$45 per barrel but Brent Crude oil is now edging US$60pb.This is over double the price it was in spring 2016. The price is based upon global growth strengthening and an agreement between Russia and the OPEC oil producing nations to reduce production. This agreement, aimed at reducing oil over supply and ending the glut in oil, is now to be extended beyond March 2018. Although it has been successful in boosting the oil price, non OPEC counties outside the agreement could start increasing production encouraged by high prices.

One such country is the US. Its flourishing shale gas and oil facilities now account for 14% of the world's production. Shale gas has been an agent for change in keeping production high and prices low. Shale production allows Texas to challenge Saudi Arabia as an oil producer and with this influence shale could keep the oil price within a range of US$40 –US$60pb.

Gold

Investors see better value in equity over gold

Gold demand has fallen this year by 9% in Q3 as the market was hit by slowing demand and a new sales tax in India. Inflows into gold bullion exchange traded funds which track the price of gold were also down. Investors are seeing better value in currencies and equity over gold. The rise in bond yields has also had an influence on the attractiveness of gold.

Fixed Interest Securities

Government bonds are unattractive at current prices

The global upswing continued with strong economic. This expansion combined with only modest inflation has allowing the Federal Reserve Federal Open Markets Committee (FOMC) to withdraw monetary stimulus. The FOMC started to withdraw assets at a rate of US$10bn per month in October. The ECB has also indicated that it is preparing to taper its QE programme.

With the FOMC and potentially the ECB not renewing their bond purchases and without a central banker to pick up this supply, it is likely that there will be a significant increase in bonds on the market. Bond yields will have to rise to attract buyers and bond prices will fall to accommodate the yield rise.

The UK economy is showing signs of slowing from its growth in 2016 while inflation has picked up to 3.1% in November. The Bank of England increased interest rates by 0.25% in November against a backdrop of above target inflation and low unemployment. This rate rise lead to an increase in UK government bond yields and a strengthening of sterling.

The Feds balance sheet reductions plus the ECB's reduction of its QE programme throughout 2018 should keep some upward pressure on bond yields. However, at current price levels, the near zero yields on government bonds are unattractive.

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

1st December 2017

PORTFOLIO SELECTIONS

There seem few signs of a slowdown as growth is evident in the USA, Europe, Japan and the emerging economies. Despite the high valuations placed upon the developed world's stock markets, the high profits in the US and recovery elsewhere continues to provide support for global equity markets. The major central banks of Europe, Britain and Japan continue to support low interest rates and liquidity.

US equity valuations are high relative to the other major stock markets and historical averages. US corporate borrowings are back to high levels and exposes the US markets to some vulnerability. The improved earnings growth and momentum in the economy prevents us from underweighting US stock. The European economy continues to improve and equities are underperforming relative to the pick-up in economic growth and therefore offer further growth opportunities. We have taken a slight overweight position in European stock. We will maintain our positions in Asia, Japan and emerging markets where companies are trading on less demanding valuations and continue to deliver earnings growth.

We are taking an underweight position on the UK mainly due to the downgrade in growth forecasts. The FTSE 100 multinational companies have done well due to sterling devaluation. Ultimately however, the currency will find a new post Brexit level that we cannot predict.

We are decreasing our holdings in fixed interest securities, particularly government bonds. We will remove conventional gilts from our direct holding but retain index- linked gilts due to the pick up in inflation. The projected returns from government bonds are modest at best in all major currencies. Corporate credit is better placed, particularly high-yield and long-dated investment grade bonds. Emerging market credit offer attractive alternatives. Our bond focus will remain in strategic bonds and high yield bonds. We are sensitive to the possibility of a bond market correction because of the ending of QE from the Fed and then the ECB.

We expect returns across all major asset classes to remain subdued as central banks raise interest rates and unwind QE programmes over the next 12 months or more. There is something of an upside to equities on the basis that few alternatives are available for growth and yield. Real Estate also look quite resilient as the attractiveness of property compared to other long duration assets has improved.

High stock markets are vulnerable to shocks or spooks and sources of risk to markets remain in the form of North Korea, a Catalonian stand-off, a heavy slowdown in China or Donald Trump failing to deliver tax reforms.

Bonds, stock and property assets continue to benefit from subdued inflation with little sign that this likely to change other than in the UK. However an increase in inflation could undermine asset values, but this seems unlikely in the near future.

We are inevitably moving closer to the end of this current cycle and so we are increasingly thinking of how to add protection to downside risk while still accessing growth opportunities. We have held our

overweight cash positions and have introduced into all of our portfolios some Absolute Return Funds that invest in short and long equity positions that can provide both growth and protection.

We have retained our portfolio diversification into differing asset classes in the form of UK brick and mortar property funds, global property securities, global infrastructure funds, insurance market funds, target return funds and cash.

As of 1st December 2017, our best performing funds held within our portfolios over the last 12 months have been;

Henderson China Opportunities Fund	40.24%
Old Mutual UK Smaller Companies Fund	40.10%
Veritas Asian Fund	36.93%
Blackrock European Dynamic Fund	35.73%
Lindsell Train Japanese Equity Fund	33.55%
Legg Mason Japanese Equity Fund	32.78%
Fidelity Emerging Asia Fund	30.78%

The main reasons behind these returns are the growth in Asian, Japanese and European markets. Stock markets in these regions are at all time high valuations. The performance of the Old Mutual UK Smaller Companies fund was due to the stock selection and encouraging environment for UK small cap stock.

As on 1st December our poorest performing funds held within our portfolios over the past 12 months have been.

Old Mutual Gold and Silver Fund	-5.53%
iShares Overseas Corporate Bond Fund	0.90%
CF Woodford Equity Income Fund	1.07%

The reasons behind these returns is that gold funds generally fell back as bond yields improved and equities continued to rally. Overseas corporate bonds where influenced by price falls as yields increased as well as sterling devaluation impacting oversea income. Neil Woodford has had a poor period of performance due to some stock picking errors. None of these funds will be retained in the 28th Edition of our portfolios.

As far as the 28th Edition of our portfolios is concerned, eight of the funds from the 27th Edition have been substituted while nine new funds are added. Our asset allocation remains broadly in line with that of Edition 27. We are holding high levels of cash and have reduced our fixed interest, US and UK exposure across the portfolios to help dampen volatility. We have also introduced into all of our portfolios some Absolute Return Funds that invest in short and long equity positions that can provide both growth and protection. Our general strategy is to remain very 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 4th December 2017, as measured against the associated national Investment Association (IA)

benchmark, has been very 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 39 out of 45 occasions (87% competency).

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 39 out of 45 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 Willis 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 4th December 2017

Below are the past five year's gross investment returns for each of our portfolios from 4th December 2017

Portfolio	*6 months*	*1 year*	*2 years*	*3 years*	*4 years*	*5 years*
Defensive	1.43%	7.70%	10.00%	12.53%	20.20%	23.46%
Conservative	2.14%	9.98%	16.23%	20.77%	31.13%	39.22%
Balanced Income	0.35%	9.63%	14.62%	18.34%	27.36%	40.91%
Balanced Beta	2.16%	12.87%	24.13%	25.47%	38.55%	50.18%
Balanced Higher Income	0.03%	11.12%	17.43%	-	-	-
Balanced Alpha	3.44%	15.76%	29.01%	34.41%	47.35%	60.15%
Speculative Beta	2.15%	13.85%	30.12%	30.62%	44.67%	63.91%
Speculative Alpha	3.95%	18.15%	33.22%	38.38%	54.57%	87.13%

Discrete Portfolio Performance from 4th December 2017

Below are the gross investment returns for each of our portfolios for each 12 month period over the last five years from 4th December 2017

Portfolio	*2017*	*2016*	*2015*	*2014*	*2013*
Defensive	6.77%	2.64%	2.49%	6.52%	3.00%
Conservative	8.78%	6.35%	4.21%	8.07%	6.62%
Balanced Income	8.81%	4.91%	3.84%	7.06%	11.30%
Balanced Beta	11.62%	10.75%	1.38%	9.54%	9.13%
Balanced Higher Income	9.89%	6.40%	-	-	-
Balanced Alpha	13.78%	12.52%	4.81%	8.76%	9.41%
Speculative Beta	12.30%	15.31%	0.75%	9.53%	14.45%
Speculative Alpha	15.63%	14.09%	4.80%	10.28%	22.53%

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 5th December 2012 to 4th December 2017 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 Willis 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 2018 - Edition 28

Portfolio	Risk	Money Markets	Fixed Interest	Property	UK Equity	US Equity	Europe Equity	Asian Equity	Japan Equity	Global Equity	Other Assets
Defensive	2	44%	16%	10%	5%	8%	5%	5%	0%	0%	7%
Conservative	3	41%	16%	10%	6%	8%	5%	6%	2%	0%	6%
Balanced Income	4	25%	17%	10%	21%	6%	5%	10%	0%	1%	5%
Balanced Beta	5	25%	16%	8%	7%	11%	8%	14%	3%	1%	7%
Balanced Higher Income	6	23%	16%	8%	26%	5%	6%	10%	0%	1%	5%
Balanced Alpha	6	22%	12%	7%	8%	15%	9%	15%	4%	0%	8%
Speculative Beta	7	19%	12%	6%	9%	16%	9%	17%	4%	1%	7%
Speculative Alpha	8	17%	9%	6%	11%	18%	9%	17%	5%	1%	7%

Perspective Range of Return & Volatility

Portfolio	Risk	Return	High	Low
Defensive	2	3.01%	11.53%	-5.51%
Conservative	3	3.90%	17.90%	-10.10%
Balanced Income	4	4.51%	21.87%	-12.85%
Balanced Beta	5	5.09%	25.81%	-15.63%
Balanced Higher Income	5	5.09%	25.81%	-15.63%
Balanced Alpha	6	5.67%	29.75%	-18.41%
Speculative Beta	7	6.19%	33.63%	-21.25%
Speculative Alpha	8	6.77%	37.57%	-24.03%

Investment Ratios

Portfolio	Risk	Beta	Alpha	Sharpe Ratio	Info Ratio
Defensive	2	0.65%	1.26%	0.16%	0.08%
Conservative	3	0.94%	2.50%	0.72%	1.48%
Balanced Income	4	0.85%	0.98%	0.51%	0.10%
Balanced Beta	5	1.10%	1.51%	0.71%	0.93%
Balanced Higher Income	6	1.18%	0.09%	1.55%	1.18%
Balanced Alpha	6	0.92%	2.89%	1.04%	1.06%
Speculative Beta	7	1.08%	0.79%	0.75%	0.48%
Speculative Alpha	8	1.16%	2.15%	0.96%	1.09%

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

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