Watson Moore's Monthly Investment Update

September 2018

Contents:

PERFORMANCE UPDATE

- **In a month in which the FTSE 100 fell 3.29%, we are very pleased that the majority of the portfolios grew in the range between 0.52% and 6.38%. The exception was the Income Generating portfolio which fell 0.26%.**

- The summer months typically are the weaker months for stock market returns, leading to the saying "sell in May and go away." However, the portfolios have shown gains ranging from 2.65% to 14.73% this summer. The FTSE 100 by comparison grew by just 0.54%.

- US stock markets continue to be the clear leaders with the S&P 500 growing by 4.21% in August and the technology-laden Nasdaq 100 by 6.25%. "Trumpenomics" appears to be working, with tax cuts and the rolling back of red tape the main catalysts.

- Whilst the US has been the leader, China and Europe have been lagging, mainly due to the "Trump Trade Wars".

- The volatility surrounding Brexit intensified with Sterling the most affected. It started the month against the US Dollar above 1.31, fell to below 1.27 but then recovered to just below 1.30. Normally the FTSE 100 responds positively when Sterling falls but this month it also fell. This could be a sign that a "no deal" is considerably more likely.

- The performance of the portfolios over the last month and year is shown below:

Portfolio	Performance % 1 month	Performance % 1 year
Foundation	**0.52**	**0.36**
Cautious	**0.69**	**-0.17**
Balanced	**1.28**	**2.20**
Adventurous	**2.41**	**6.11**
Dynamic Equity	**2.26**	**11.28**
Income Generating	**-0.26**	**1.90**
Third Industrial Revolution	**6.38**	**21.88**
Retirement Investment Solution 1	**1.20**	**1.08**
Retirement Investment Solution 2	**1.51**	**2.58**
Retirement Investment Solution 3	**1.80**	**4.00**

Please note that these figures do not include the Standard Life platform or Watson Moore's fees.

Trend Following Signals

The table below shows whether the asset class is either in a positive trend (✓) or a negative trend (✗). The portfolios will have more exposure to those asset classes in a positive trend and less (if any) to those in a negative trend. These are the main asset classes we monitor:

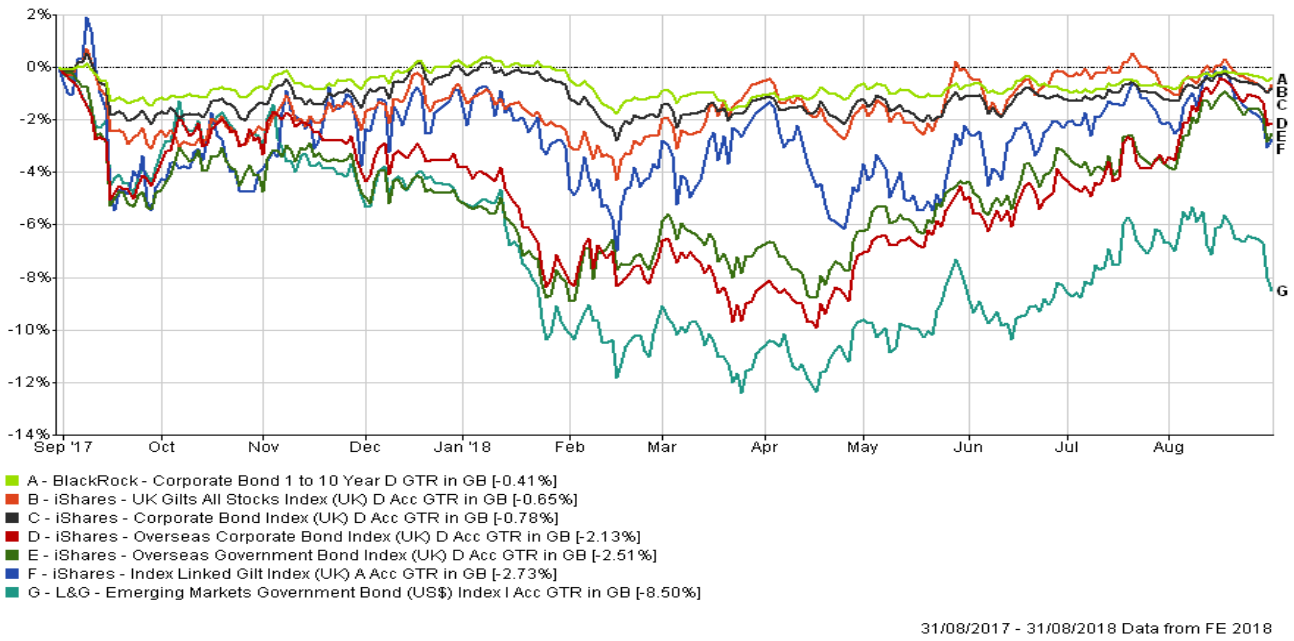
Asset Class	Trend Signal	Asset Class	Trend Signal
Global Equity	✓	Emerging Market Equity	✗
UK Equity	✗	Commodities	✗
Europe ex UK Equity	✓	UK Corporate Bonds	✓
US Equity	✓	UK Corporate Bonds (Short dated)	✓
Japan Equity	✓	UK Index Linked Bonds	✓
Pacific Equity	✓	Global Bonds	✗
Gold	✗	UK Gilts	✓
Global Property	✓	Emerging Market Bonds	✗
		Overseas Corporate Bonds	✓

Summary of Portfolios

This summer has been rewarding for our portfolios and they have now recovered from the losses experienced in February and March this year. We do appear to have clear leaders and losers in equity markets, with the US being the leader and China being the loser. The portfolios continue to be overweight US equities as our investment philosophy attempts to invest more in those markets that are high up on the momentum scale i.e. the ones that have performed the best over the last year.

However, the stock markets of Europe and Emerging Countries have been struggling and have certainly been affected by Donald Trump and his trade wars. The portfolios have less money invested in these areas, although European smaller companies have been outperforming so we have a reasonable amount of exposure to them.

All of the main Bond asset classes have fallen over the last year (see chart below) as the prospect of higher interest rates is proving to be a headwind. The Trend Following philosophy has kept our exposure to Bonds lower than normal.



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Cautious, Balanced and Adventurous portfolios

The portfolios reduced their exposure to UK Equities as the FTSE 100 was one of the main asset classes to fall over the month. In Bonds we are seeing much more volatility. This month Emerging Market Bonds fell back below trend and therefore exposure was decreased. Short dated Corporate Bonds moved above trend, so exposure was added in the Cautions portfolio. On the momentum side Corporate Inflation Linked Bonds replaced UK Government Inflation Linked Bonds. The main changes to the three portfolios were:

Fund	Cautious	Balanced	Adventurous
L&G Emerging Markets Bond	-2.5%		
Fidelity Index UK	-2.0%	-2.0%	
iShares Corporate Bonds 1-10 Years	+2.5%		
M&G UK Corporate Inflation Linked Bonds	+2.5%	+5.0%	+2.5%
iShares Index Linked Government Bonds		-5.0%	-2.5%

Dynamic Equity portfolio

The momentum philosophy that forms the core of this portfolio attempts to invest more money in those markets that are experiencing the strongest growth. No changes were again made this month. The portfolio is overweight US Equities as they continue to be ranked high on the momentum scale.

Foundation portfolio

The Foundation portfolio decreased its exposure to UK Equities, Commodities and Emerging Market Bonds as they broke below trend. Exposure was increased to short dated Corporate Bonds and the market neutral funds.

Income Generating portfolio

A fund switch was implemented towards the end of August in order to diversify the portfolio. The holding in the Invesco Perpetual High Income fund was reduced from 10% to 5%, with the proceeds reinvested into the Schroder Income fund. The Schroder Income fund has a slightly different investment style to the Invesco Perpetual fund in that it likes to invest into companies that have experienced a fall in their share price. They classify these companies as being “value” and hope to identify companies in which the reasons behind the share price fall are only temporary and hence a recovery can take place. Historically the different investment style has ensured that the Schroder Income fund has outperformed when equity markets have rallied with the Invesco Perpetual fund outperforming during the more difficult times. We believe that diversifying the investment styles within the portfolio will hopefully lead to a smoother performance overall. In addition, both funds pay their income on different dates, so this will lead to a smoother monthly income for our clients whom are receiving an income from the portfolio.

Third Industrial Revolution portfolio

It was another great month with the portfolio returning 6.38%. The one-year return is now over 21%. All of the six funds that we invest in produced strong positive returns over the month, with the Cyber Security fund the best performing one, with a rise of 11% in August.

Retirement Investment Solution portfolios

The trend following part of these portfolios decreased its exposure to UK Equities, Commodities and Emerging Market Bonds as they broke below trend. Exposure was increased to short dated Corporate Bonds as well as cash. The Retirement Investment Solution portfolios are invested in not only a trend following portfolio, but the Foundation and Dynamic Equity portfolios as well.

Summary

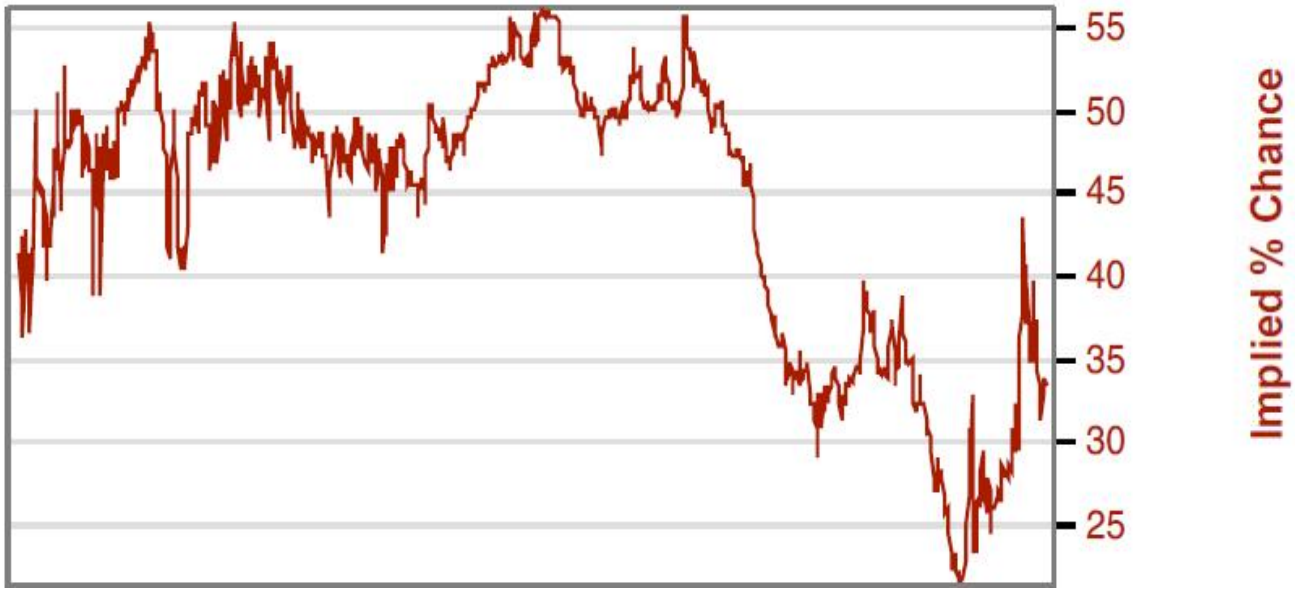
Most developed stock markets are above trend, with the exception being the FTSE 100 which is lagging and fell significantly last month. Bonds are displaying more volatility than normal due to how quickly investors believe interest rates will rise. They are therefore breaking above and below trend more regularly. We are pleased with the performance of the portfolios, albeit the higher risk ones are performing significantly better than the lower risk ones.

ASSET CLASS REVIEW

This section will give you an insight into our current thinking, as we have attached some charts that look interesting. This month we focus on the Trump effect as we have seen some stock markets surge higher since he was elected President, but others not go up so much.

Percentage chance of Trump not lasting his full term has increased

Without repeating the news stories, August was not a great month for Trump and the chance of his not lasting the full term has increased from a low of 20% to nearly 35%. However, the chart below (courtesy of the Betfair Exchange) shows that it was as high as 55% early on in his Presidency:



US stock markets have rallied

Since Trump became President on 8th November 2016, US stock markets, such as the Dow Jones below, have rallied:

Trump has publicly declared that if he is thrown out of office then the stock market would crash. We can see that the above market has increased this summer which shows that the increased chance of his not surviving has not affected markets. One of the main reasons for the rally has been the tax cuts he introduced in 2017 and it is unlikely that these will be reversed even if he left office. Therefore, Trump being removed may not reverse the gains made in US stock markets since November 2016. Apart from a brief period early in February, US stock markets have remained above trend during his time in power and have been one of the best performing markets in the world.

China has been affected by Trump's trade war

China initially surged similarly to the US stock markets but then when the threat of a trade war began to materialise, Chinese stock markets gave back most of their gains. A trade war remains a big threat to Chinese stock markets and the trend is clearly down.

Europe - after the initial rally now trending sideways

Whilst not to the same level, Trump has also introduced tariffs on European goods. This has coincided with European stock markets moving sideways but displaying a series of lower highs since October 2017. This is negative, and we now view Europe as being very correlated to the Trump effect:

In Summary

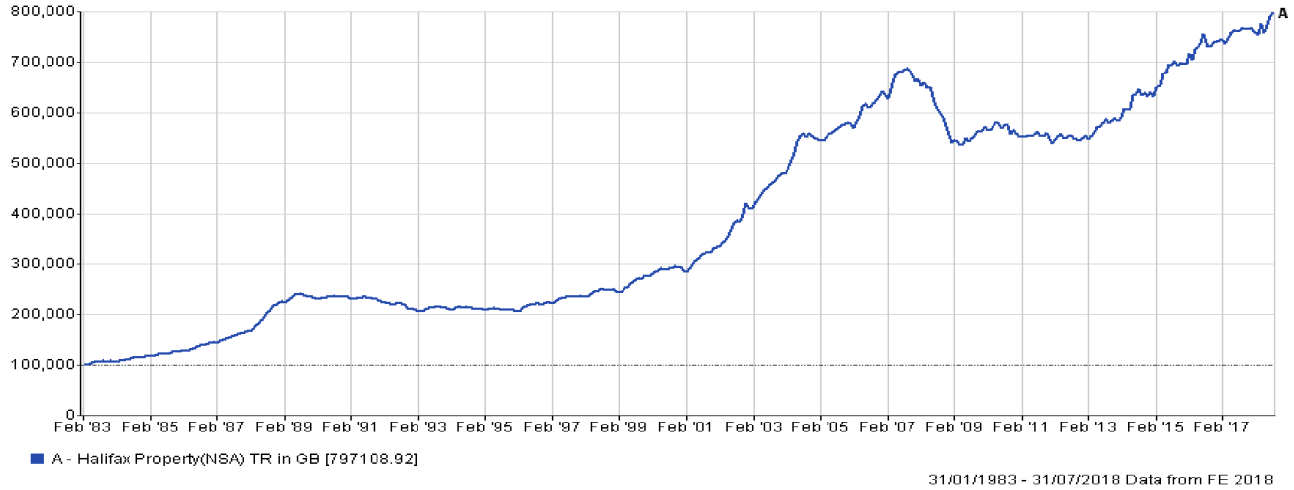
Since Trump came to power we have experienced an increase in our wealth. However, after the initial bounce in most global markets, there has been a huge divergence in performance. US stock markets have been the best performers whereas big exporting regions such as China and Europe have declined due to the imposition of tariffs. Whilst the chance of Trump not lasting the full term has increased, US stock markets have continued to go up. Perhaps if Trump did leave office then this could have a positive effect on other stock markets and we could see a reversal of their recent declines. Currently US markets remain above trend, Europe has been above and below trend over the last few months (currently above), but China is below.

HOUSE PRICES AND INTEREST RATES

The housing market appears to have slowed a little over the last quarter. This could be a combination of interest rates starting to go up, fear of Brexit, changes in the taxation on Buy-to-Let landlords or even the World Cup. We decided to dig a little bit deeper to see what was going on, as a housing market slowdown in the UK could be the trigger for a recession here and a potential fall in equity markets.

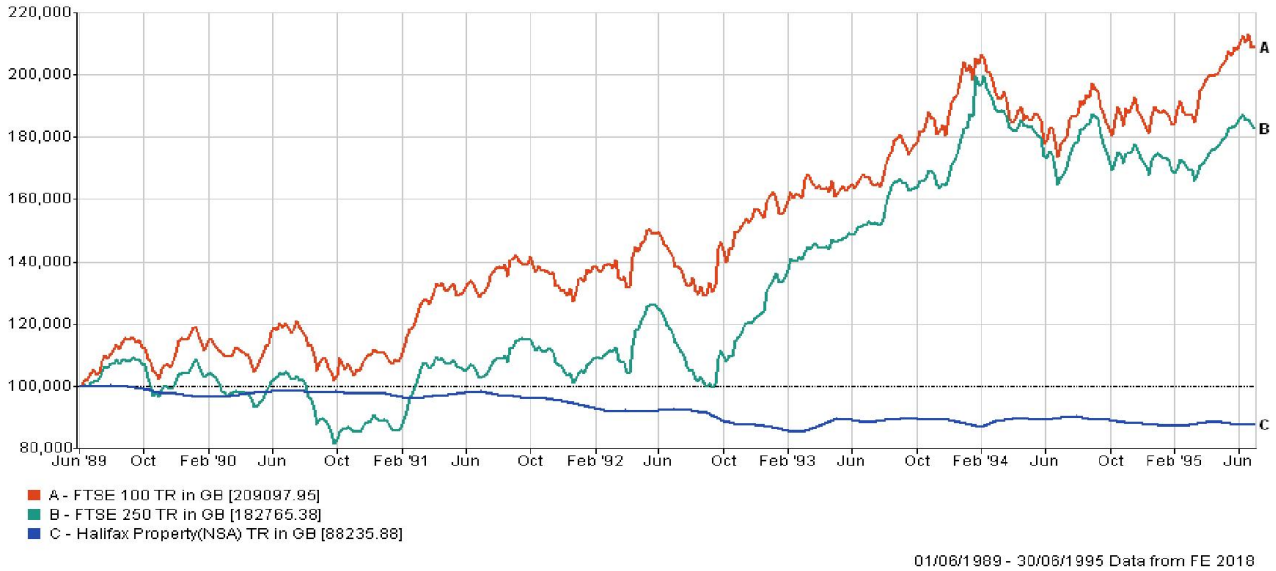
House price inflation

The latest information from the land registry office shows that the average property rose in value by 0.3% in June, taking the average annual price rise to 2.7%. However, London saw a fall of 0.6% in May and the North East was worst hit with a fall of 1.9%. Flats also fell by 0.4% which may be due to the impact of tax changes on Buy-to-Let landlords. The average asking price on Rightmove dropped by 2.3% over the last month, showing that we may be on the verge of a housing market slowdown. This is reinforced by the number of completed house sales falling 19.3% in April 2018 when compared to April 2017. On the positive side, the chart below shows how house prices have risen over the last 35 years and how a house worth £100,000 in 1983 is now worth £797,108:



Falling House Prices and the impact on stock markets

The global stock market crash in 2008 also coincided with the UK housing market falling. However, the last major down period in the late 80's and early 90's initially caused UK stock markets (FTSE100 and 250) to move sideways but over the period both indices rose significantly:



Therefore, a house price slump does not necessarily mean a stock market slump. The house price slump above was blamed on the change in MIRAS which meant that you could no longer receive tax relief on your mortgage interest. The equivalent today is the removal of being able to offset mortgage interest against rental income for Buy-to-Let investors. This could therefore trigger the next house price (or flat price) falls similar to 1989, but this does not necessarily mean stock markets falling as well.

Interest Rates

Finally, people are concerned that rising interest rates will cause a property market slump. The chart below (apologies for the lack of clarity but Bloomberg are not that user friendly!) shows the Bank of England Interest Rate going back to 1911. Interest rates have averaged 5.321% over this period with the peak being in the early 80's.

Clearly if the Bank of England increased interest rates back up to their long-term average overnight, then we would have problems in the UK economy and house prices would fall. However, the indication is that we should only get two more hikes before the end of 2019. In fact, we still appear to be in the perfect economic situation in which we have low interest rates, low unemployment, low/moderate inflation and a growing economy. This is very conducive for house prices inflation.

Summary

House prices have certainly shown signs of a short-term peak. This is possibly due to changes in taxation as we have seen the price of flats (which has a higher Buy-to-Let ownership than houses) fall. Brexit may be causing some confidence issues which has led to sellers reducing their asking prices in the hope that they can sell before a possible no deal outcome, but the economic situation should provide some support.

Our view is that the change in taxation could be the catalyst for falling prices, but this may be contained to typical rental properties such as flats.

FINAL COMMENT

Trump, Brexit and the possible increase in global interest rates are the factors driving investment markets currently. Trump's policies are benefitting US stock markets, but recently Chinese and European stock markets have fallen due to his actions. Brexit is causing Sterling to be more volatile than normal and with talk of a "no deal" increasing, we saw Sterling fall last month. This usually leads to the FTSE 100 increasing in value due to the fact that overseas profits when converted back into Sterling are higher, but last month we saw the FTSE 100 fall quite significantly when compared to other major markets.

We have also seen Bond markets fall over the last year due to interest rates rising or the expectation that they will rise over the next few years. Finally, there are signs that the housing market in the UK has slowed down, which could be as a result of Brexit and the effect of a change in taxation policy.

We can therefore see many potential catalysts which could cause higher than normal volatility in global markets. Our trend-following investment strategy will hopefully protect us from those markets that could suffer and help increase exposure to those markets that perform the best.

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