TACIT

Investment Management

TACIT THINKING

JANUARY 2018

Independent thinking, global perspective

ECONOMIC REVIEW

"One of the great mistakes is to judge policies by their intentions rather than their results"

Milton Friedman

In their 1963 book, "A Monetary History of the United States," Milton Friedman and Anna Schwartz laid the blame for the recession of the late twenties turning into the depression of the early 1930's firmly at the door of the Federal Reserve. Specifically, they argued that aggressive monetary contraction by the Fed raised the expectation of deflation (a fall in the general level of prices) leading to a sharp rise in the "real" interest rates paid by consumers and businesses.

Many years later, Ben Bernanke, Chairman of the Federal Reserve throughout the financial crisis of our generation, gave a speech where he said that due to the work of Friedman and Schwartz, the Fed would never make the same mistake again.

In a paper written by Christina Romer in 2012 reviewing Friedman's work, she and her co-author noted that:

"When nominal interest rates are at the zero bound, expansionary monetary policy can increase output primarily by raising expectations of inflation and lowering real interest rates."

There in one sentence you have the rationale behind the monetary policy of just about every major Central Bank on the planet led, of course, by the Federal Reserve. In the absence of accommodative fiscal policy, quantitative easing has worked by "raising inflation expectations and lowering real interest rates."

Going into 2018, world growth is set to accelerate and average 3.7% per annum out to 2022 according to the recent World Economic Outlook published by the IMF.

There are therefore plenty of investment opportunities. However, the principal villain in this otherwise predominantly benign economic outlook is the United Kingdom.

Real growth in the UK economy has slowed noticeably post referendum from 0.5% per quarter in 2016 to 0.3% per quarter in 2017. This is a notable contrast to the other G8 economies where growth has been accelerating throughout 2017.

The sharp depreciation of the pound has raised inflation and lowered real incomes at a time when nominal wage growth is very hard to find. At the same time, UK productivity continues to lag very badly with the Office for Budgetary Responsibility noting that UK productivity will be 27% below the pre-crisis trend level by 2023. That translates into very weak wage growth, weak spending, higher borrowing and/or additional austerity.

Equally, the British consumer has not lost the taste for foreign goods; the UK deficit in traded good stands at 6% of GDP.

This combination of weaker growth, higher inflation and large current account deficit does not augur well for the pound. Ironically, from an equity perspective, the lower pound both raises export competitiveness and the value of British profits secured by firms with significant overseas investments. This type of company comprises much of the listed sector in the UK so weak economic news in the domestic economy can lead to rising profits and dividends in UK listed equity and does not necessarily lead to weak stock market performance.

Globally, we see a picture of convergence in many key economic variables. Low inflation rates in the Developed economies are, at last, gently rising and the high inflation rates associated with the Emerging space are gently declining. The global inflation rate is converging on 3% and is forecast to be stable around that figure for the foreseeable future.

Employment rates around the world are also rising. In some economies, notably the US,

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unemployment rates are already below the so-called NAIRU – the non-accelerating inflation rate of unemployment – which in earlier cycles would already have been a precursor to inflation sparked by higher wage demands.

So far, these demands are largely absent and the low wage growth coupled with weak productivity is probably the real key economic problem of our time.

Nonetheless, certainly in the US followed by the UK, we do expect to see wage growth coming through but not so fast as to threaten the inflation outlook or trajectory of interest rate rises. As far as interest rates are concerned we are almost certainly at the beginning of a tightening cycle but it is highly likely to be a much slower and lower cycle than we have seen in previous periods.

As the UK is the outlier in terms of growth; the outlier in terms of capacity is Europe. This is the major economic area where employment trends have not improved as much or as quickly as elsewhere in the global economy.

German unemployment at 4% is low but unemployment rates of 23%, 20%, 12% and 11% in Greece, Spain, Italy and Portugal point to pools of unused labour which will act to depress European wages until employment rates are significantly higher. Europe still has extensive spare capacity.

The other important area where we see global convergence is in trade. Trade flows measured by current a/c surpluses or deficits are reducing in size and trade is becoming much more balanced which is good news for sustainable trade growth.

China has adopted a trade policy which is much more open to foreign goods and China is as likely these days to be a net importer as a net exporter.

The key global imbalance lies closer to home. We have already mentioned the UK trade deficit but the counterpart to this is the German trade surplus which is some 8% of German GDP.

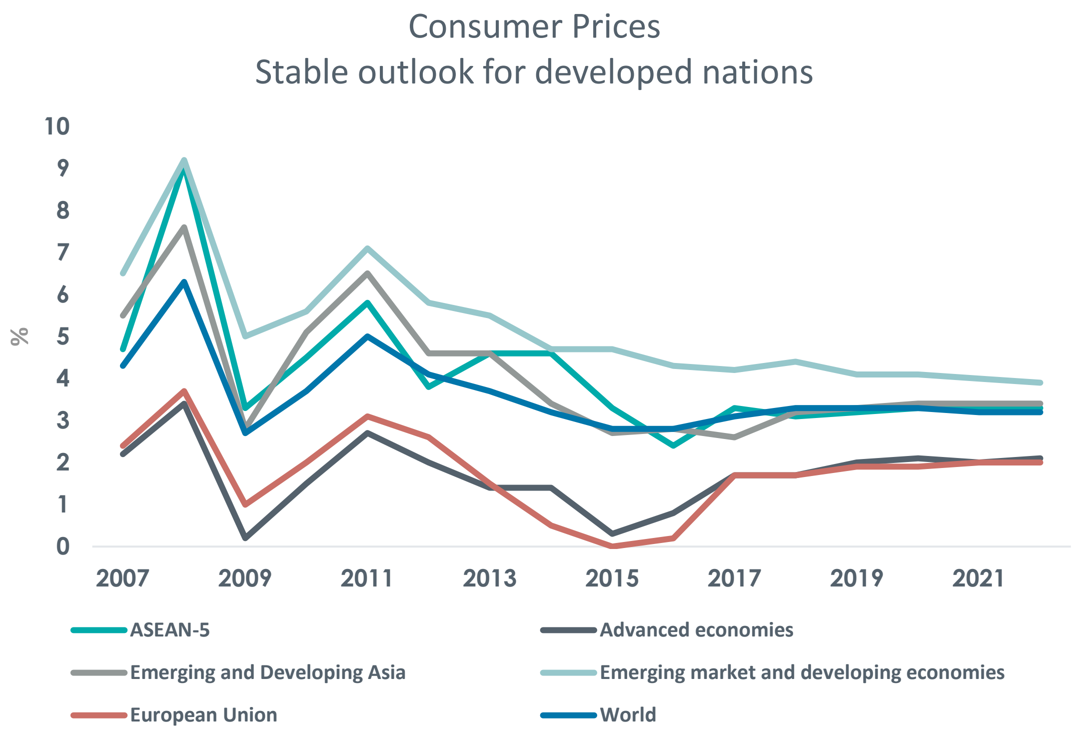
If there is one lesson from the financial crisis, it is surely that egregious financial imbalances are self-defeating. Nonetheless, Germany simply ploughs on sucking demand from countries within and without the Eurozone. More helpfully for Eurozone growth, this surplus should be recycled through German wages into higher domestic consumption expanding German demand. In aggregate, excess German saving is a tax on the rest of the world and like productivity is a key economic issue that should be tackled sooner not later.

In terms of markets, one of our key worries is that stronger growth and a bias to accepting somewhat higher inflation by Central Banks should lead to a “bear” market in bonds and fixed interest. This has been and remains the dog that didn’t bark. However, gilt yields and more importantly US Treasury yields are well off their lows trading at 1.24% and 2.47% respectively. Gilt yields traded below 1% in 2017 and Treasuries below 1.40% at the end of 2016.

We would see this gradual rise in yields as signalling a return to pre-crisis normality. Yields have been suppressed as noted above to secure economic recovery. Nevertheless, City traders have not seen a bear market in bonds since 1994. This is a real risk.

Nonetheless, while the outlook, short of return to recession, is fundamentally negative for bond markets, the growth outlook noted above suggests a fundamentally positive outlook for businesses and company shares. The key question for investors, wherever we think we are in the economic cycle, should always be what is in the valuation. Paying the wrong price in good times is not an effective strategy.

SYNCHRONISED GROWTH BUT HIGHER INTEREST RATES REMAIN ELUSIVE AS INFLATION IS SUBDUED GLOBALLY



Source: *Thomson Reuters, December 2017*

PERFORMANCE REVIEW

Last year was another good year for UK investors, with most growth assets rising in value. In this environment, we are pleased that all Tacit strategies provided positive absolute and 'real' returns in 2017 driven by our focus on long term valuations.

Returns were driven ultimately by an investor's allocation to equities as most equity markets rose by more than 10% as the economic environment improved and the global political environment stabilised after the events of 2016.

The Pound settled in 2017 following significant falls following the Brexit referendum. Against the US$ it rose by over 10% whilst against the Euro, a currency that rose markedly against all global peers, it only fell marginally. Increased volatility was and will likely remain a key feature in the area as investors quantify the impact of rising interest rates and the pulling back of quantitative easing programs around the world.

Our strategies were and are positioned on a cautious footing as equity valuations remain above long-term averages in most areas. This stance is driven by a combination of our understanding of economic cycles, the structural deflationary forces at play in the global economy, our analysis of individual market sectors and stocks at present. This positioning has meant that portfolios have not participated as strongly in the recent leg of the equity market rally. Our experience however tells us that equity market returns are not linear and that the valuation of the asset you own is important over the medium term.

This is by no means an excuse: if we were better at timing markets, the results would have been different over the period. However, history would suggest that perfectly and consistently timing markets is impossible.

Having said this, there was a clutch of holdings in our strategies that provided around 20% returns during the year: namely Finsbury Growth & Income, JO Hambro UK Equity Income, Loomis Sayles US Equity Leaders and Jupiter Financial Opportunities.

Our focus on valuations has led to our strategies being constructed with an index agnostic approach and it is pleasing to see that performance was driven by very different exposures. Our exposure to financial stocks for example provided strong returns as investors have begun to forget about the issues from a decade ago whilst this exposure also helped mitigate volatility as banking stocks actually become more profitable in an environment where interest rates rise.

In the UK, a market that has been shunned by global investors, our exposure actually delivered better returns than would have been obtained by tracking the S&P 500 index in the US,

The Stabiliser component of portfolios delivered a flat return over the year, however, and most importantly, it reduced the overall volatility of each of our strategies (its primary purpose) during periods of larger equity markets falls such as in late November.

Investors' appetite for technology stocks showed no let-up in 2017 and valuations within this area of the market are among the highest when compared to the global market. We are long term believers in the economic benefits of this technology cycle, however, this is an area of the market that will become more volatile as the very nature of this sector's attraction, innovation, means that there are very long lead times between new technologies being delivered and the monetisation of these technologies into cashflows that ultimately drive company returns.

Technology exposure is therefore not held within all of our strategies due to its current valuation and potentially more volatile behaviour from this juncture.

STRATEGY OVERVIEW

"The policy of being too cautious is the greatest risk of all."

Jawaharlal Nehru

At Tacit, we do not construct our strategies using annual forecasts as many of our peers do. In fact, our gut was for a more muted return in 2017 as interest rates finally began to rise in the US and investors readjusted from more expensive areas of the markets to cheaper sectors.

Instead, we have focussed on the objective for each of our strategies and adjusted our positioning to increase the probability of our clients achieving their objectives. For some of our strategies this lead to double digit returns, but for others returns were more muted. It is important to remember muted does not mean low: achieving a 'real' return is not guaranteed. In fact, achieving a 'real' return whilst interest rates remain near zero and inflation averaged 4% (UK RPI) would be deemed a solid result.

Not being forced into predetermined asset allocation benchmarks and positions relative to this has been key to delivering for our clients over the past seven years. As we have said many a time before, Investment Committees at most houses spend much of their time comparing relative valuations. Very few professional investors focus on absolute valuations: does this investment look attractive in its own right in the current environment and, most importantly, will it still look attractive if the environment changes?

As always, looking ahead, we must focus on the risks taken to generate returns and not get complacent after years of rising markets. We believe that generating positive 'real' returns will be significantly more difficult this year than in any of the past seven years. It is our belief that 2018 will be a materially more difficult period for investors, our approach included. We say this because the assets have become more expensive as they have risen in value and investors put little or no value on liquidity. These two factors when combined are historically signals of a late investment cycle rather than early.

We cannot guarantee returns over any particular period, but we deem it our duty to manage risks when valuations become elevated in the investments we like (favour). Tacit strategies are positioned to reflect this environment to help give our clients the best possible chance of maintaining the 'real' value of their portfolios whilst inflation remains elevated in the UK and interest rates remain near zero.

As always, real risks will only become apparent after the event.

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JANUARY 2018

IMPORTANT LEGAL INFORMATION

Opinions constitute our judgment as of this date and are subject to change without warning. The value of investments, and the income from them, can go down as well as up, and you may not recover the amount of your original investment. Past performance is not a reliable indicator of future results and forecasts are not a reliable indicator of future performance. Where an investment involves exposure to a foreign currency, changes in rates of exchange may cause the value of the investment, and the income from it, to go up or down. The information in this document is not intended as an offer or solicitation to buy or sell securities or any other investment or banking product, nor does it constitute a personal recommendation.

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