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Investment Management

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A REVIEW OF ECONOMICS AND MARKETS AROUND THE GLOBE

APRIL 2018

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GLOBAL ECONOMIC OUTLOOK – H1 2018

ACCOMMODATING HIGHER BOND YIELDS

- Global growth remains robust
- Era of Quantitative Easing (QE) coming to an end
- Bond yields and breakevens beginning to climb
- Key Question for Equity Investors
  - Can real growth rates outpace real interest rates?
- Economic tailwinds tempered by political headwinds
  - Trade protectionism
  - Italian elections revive worst fears over European (dis)integration
- UK increasingly a "special case" as growth appears to be fading

OECD LEAD INDICATOR: SUMMARY

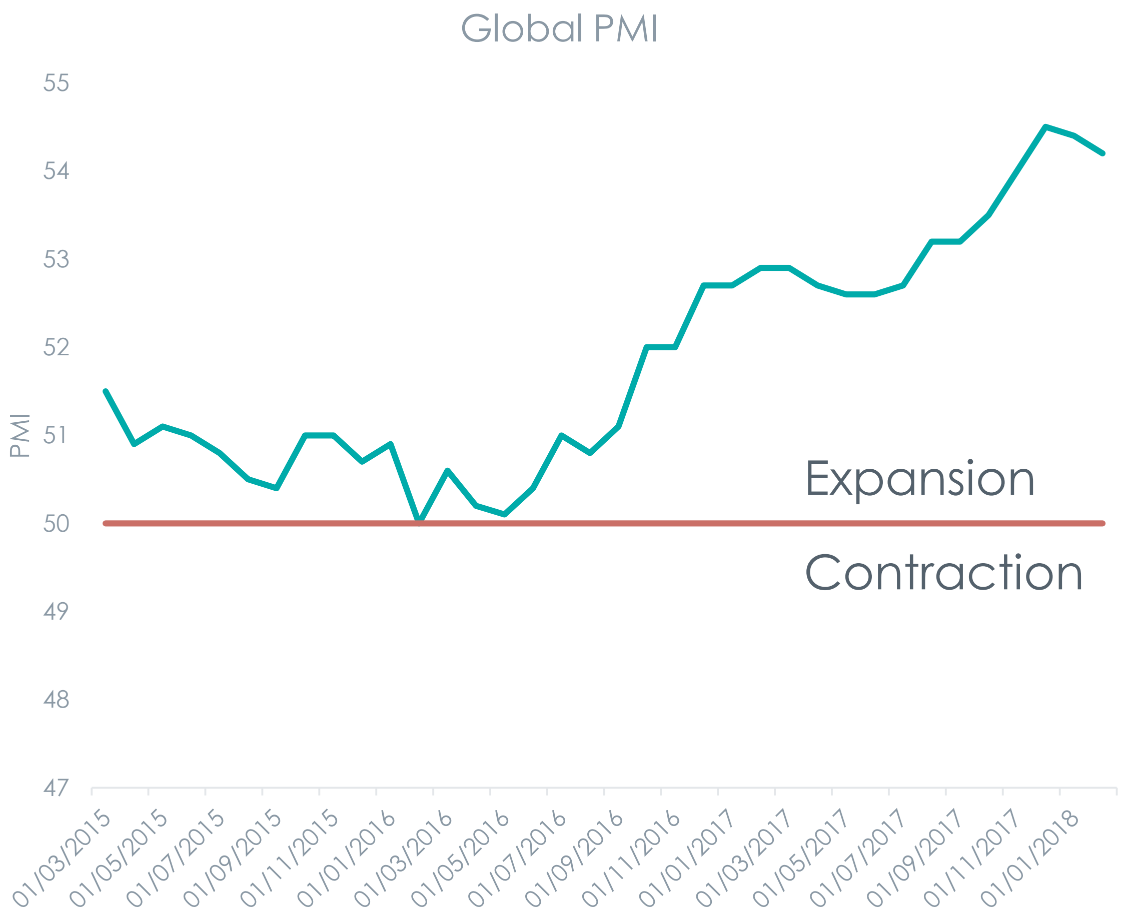
UK IS A SLOW OUTLIER, OECD GROWTH LOOKS ENTRENCHED & EMERGING MARKETS ARE GAINING STRENGTH

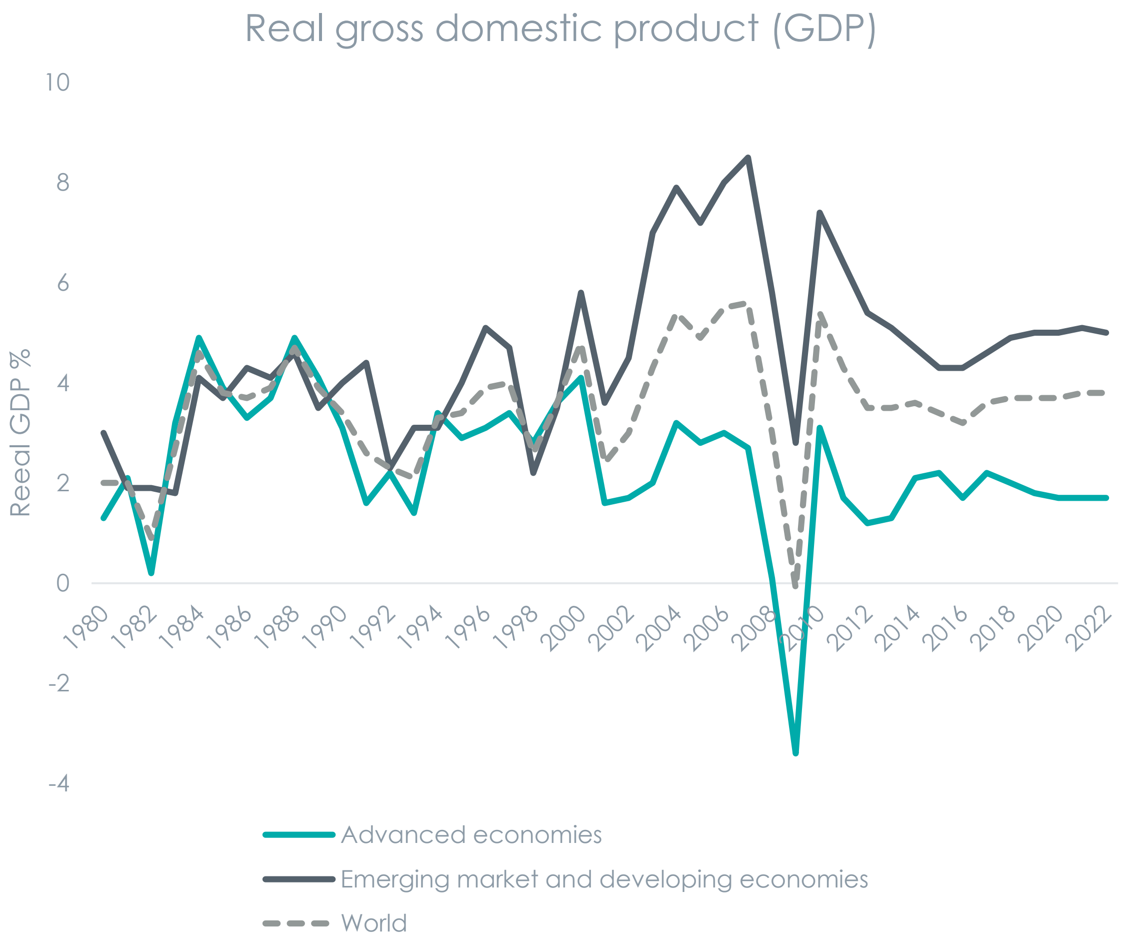
	Ratio to trend, amplitude adjusted (long term average =100)					Month on Month change (%)					Year on Year change (%)	Growth cycle outlook
	2017					2017					Latest month	
	Aug	Sep	Oct	Nov	Dec	Aug	Sep	Oct	Nov	Dec		
OECD Area	100.1	100.1	100.1	100.2	100.2	0.04	0.03	0.03	0.02	0.00	0.34	Stable growth momentum
Euro Area	100.5	100.5	100.6	100.6	100.6	0.06	0.05	0.04	0.02	0.01	0.63	Stable growth momentum
Major Five Asia**	99.7	99.7	99.7	99.7	99.7	0.01	-0.01	-0.01	0.01	0.02	0.11	Stable growth momentum
Major Seven	100.0	100.1	100.1	100.1	100.1	0.03	0.03	0.02	0.01	0.01	0.37	Stable growth momentum
Canada	100.2	100.3	100.4	100.4	100.6	0.03	0.05	0.07	0.09	0.11	0.59	Stable growth momentum
France	100.5	100.4	100.4	100.4	100.4	-0.02	-0.03	-0.03	-0.02	-0.01	0.26	Stable growth momentum
Japan	100.1	100.1	100.1	100.2	100.2	0.01	0.02	0.03	0.04	0.04	0.28	Stable growth momentum
Germany	100.8	100.9	101.0	101.0	101.0	0.11	0.09	0.07	0.03	0.00	1.25	Stable growth momentum
Italy	100.4	100.5	100.6	100.7	100.7	0.16	0.15	0.11	0.06	0.02	0.77	Stable growth momentum
United Kingdom	99.7	99.5	99.4	99.3	99.3	-0.09	-0.13	-0.14	-0.13	0.03	-0.65	Easing growth
United States	99.7	99.8	99.8	99.8	99.8	0.02	0.03	0.03	0.01	-0.01	0.30	Stable growth momentum
Brazil	102.4	102.8	103.2	103.5	103.8	0.41	0.42	0.38	0.32	0.30	3.69	Growth firming
China***	99.3	99.3	99.2	99.3	99.3	-0.01	-0.03	-0.01	0.02	0.05	-0.16	Stable growth momentum
India	99.8	99.9	100.0	100.1	100.3	0.11	0.12	0.12	0.12	0.12	0.85	Signs of growth gaining momentum
Russia	100.4	100.6	100.9	101.3	101.7	0.19	0.26	0.30	0.34	0.35	1.82	Growth firming

Source: OECD February 2018

GLOBAL GROWTH: SURVEYS POINT TO CONTINUED EXPANSION

Global Purchasing Managers Index (PMI): Off the top but still pointing to vigorous growth





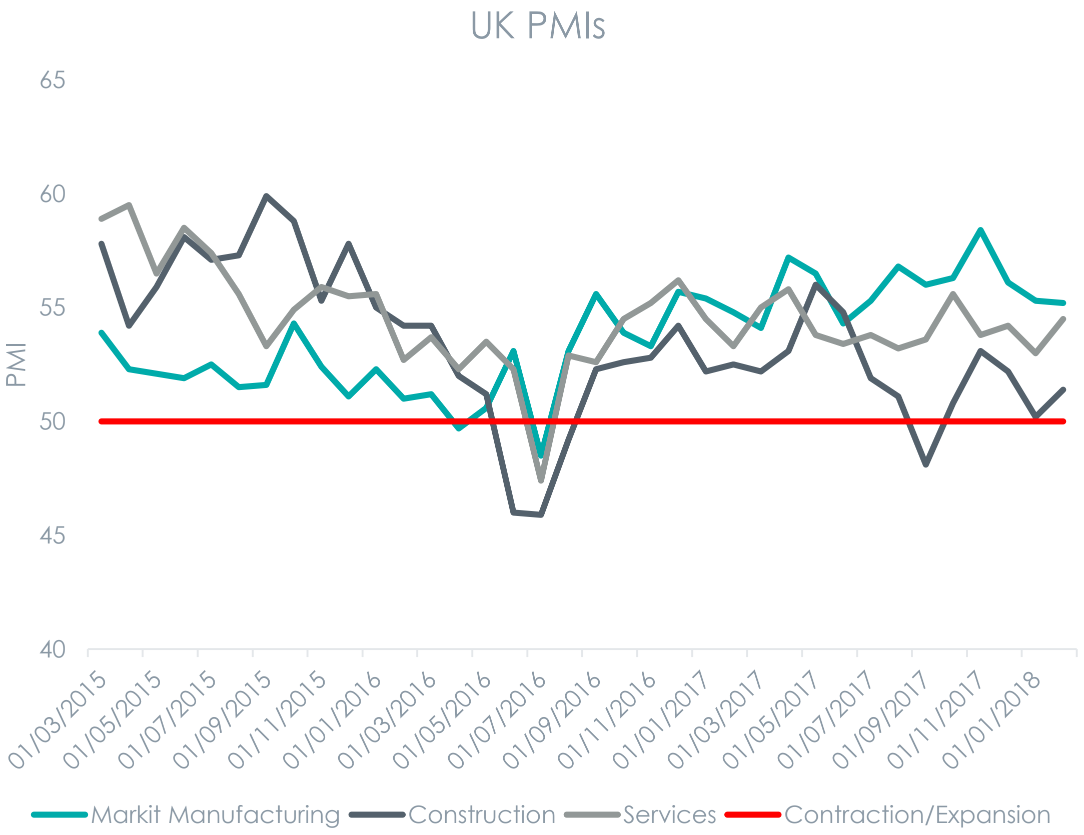
Source: Reuters, Tacit Investment Management

Source: IMF WEO Feb 2018, Tacit Investment Management

GLOBAL GROWTH: SURVEYS POINT TO CONTINUED EXPANSION

UK services rebound while Europe and US reflect change in real exchange rates

UK – PMI CONTINUES TO SURPRISE



PMIs ELSEWHERE IN EXPANSION TERRITORY

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Source: Reuters, Tacit Investment Management

Source: IMF WEO Feb 2018, Tacit Investment Management

GLOBAL GROWTH: SENDING DISCOUNT RATES HIGHER

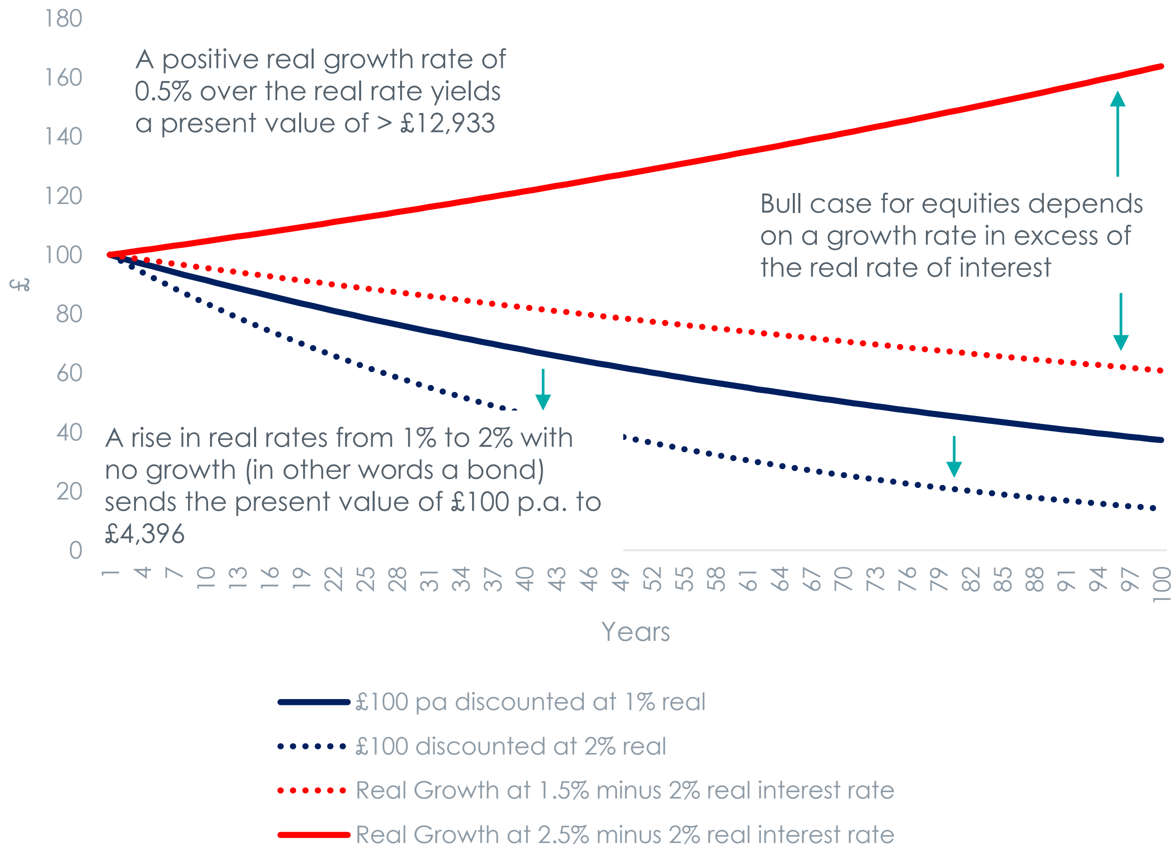
The real rate of interest, the key discount rate in assessing a future flow of income

WHAT IS £100 A YEAR WORTH?

- What would you accept today as a lump sum in return for a stream of payments in the future?
- The answer depends on the present value of the stream of income discounted at an appropriate rate minus the market value of a comparable cashflow.
- As a bond is no more than the discounted present value of a stream of future payments the discount rate matters and arguably the “real” rate of interest matters more.
- The present value of a bond offering a fixed coupon of £100 per annum in perpetuity falls from **£6,365 to £4,396 (a fall of 31%)** if real rates rise from **1% to 2%.**
- By contrast the same income stream assuming it grows in perpetuity at **0.5% over the real rate has a present value of £12,933**.

- (As for most DCF analyses I have stopped the calculation at 100 years. Discount rates have always been higher in the past making the long distant payments a tiny percentage of the present value. This doesn’t quite hold at ultra low discount rates but the difference is not material)

The Present Value of £100 pa Discounted at Different Real Interest Rates



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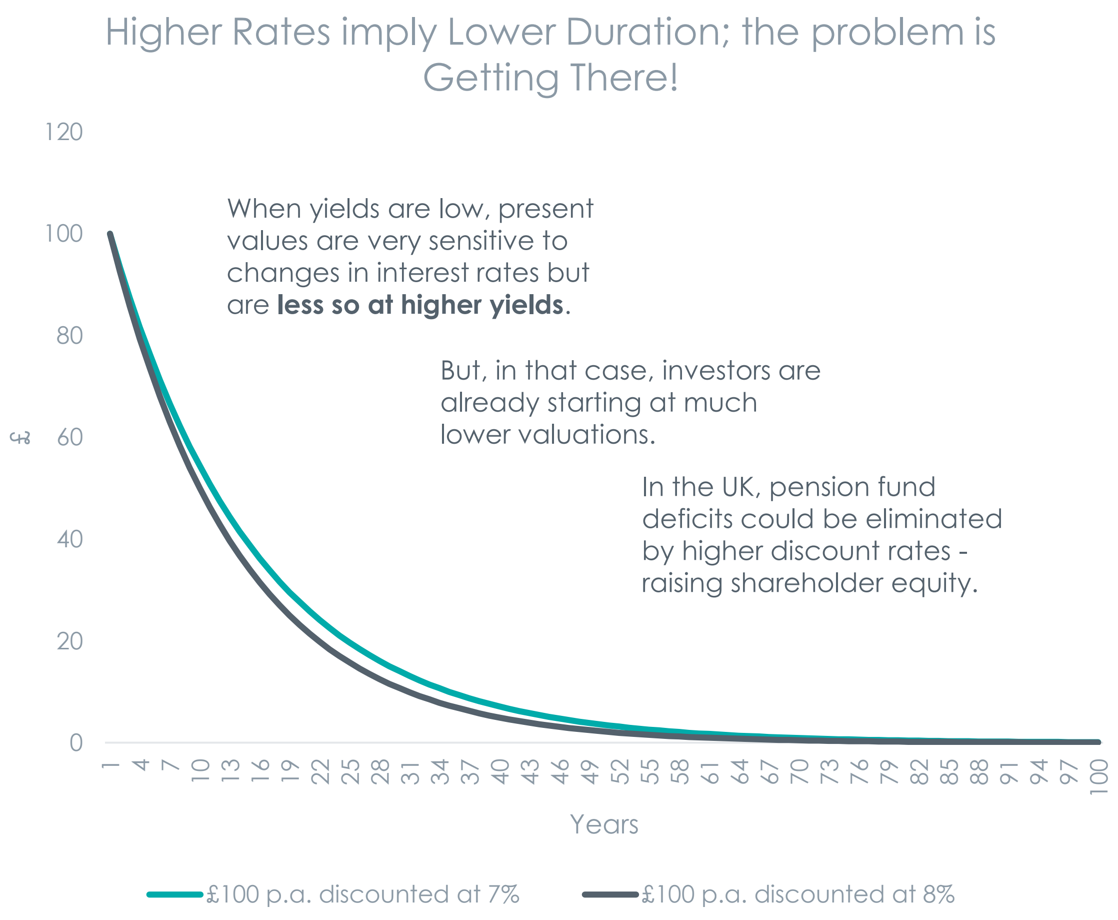
Source: Tacit Investment Management

GLOBAL GROWTH: SENDING DISCOUNT RATES HIGHER

The legacy of the global financial crisis and QE is a massive duration problem

WHAT IS £100 A YEAR WORTH?

- Financial suppression in order to maintain low real rates – the object of QE at the zero bound – has successfully avoided a depression but at the cost of a significant duration risk as interest rates normalise from their historic lows.
- When interest rates were at 7%, a 1% move upwards to 8% would send the present value of our **£100 income stream to £1,349 from £1,526 a drop of just -11.6%.**
- This simple model highlights a number issues:
  - All asset prices have been supported by low real rates and concomitantly low discount rates
  - The cost of normalisation as a function of the very high duration of financial assets due to exceptionally low interest rates will be large
  - There is no case for long duration "fixed" coupon investment in the current environment of rising bond yields and perhaps, higher real yields
  - **The case for equity is more nuanced. If you believe that the function of QE was to maintain low real yields long enough to kickstart a sustained recovery and you believe that policymakers will maintain "real" interest rates below "real" growth rates then the case for equity is very much intact.**



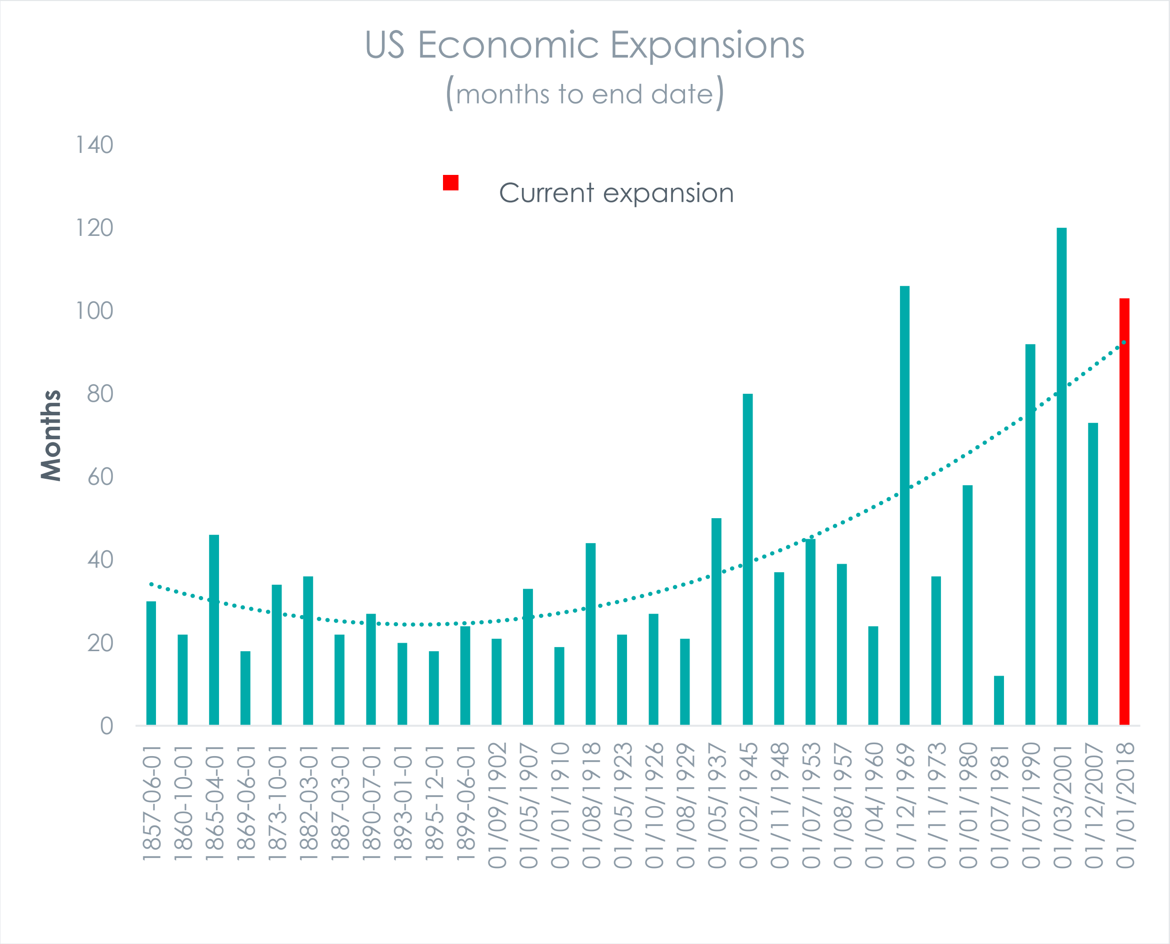
Source: Tacit Investment Management

IS THE CURRENT US EXPANSION TOO OLD?

Growth is clearly key but this expansion is already the third oldest on record

IS A RECESSION OVERDUE?

- In the US records go back to 1854. In all there are 1,958 observations.
- In this period the US has suffered from recession in 577 months i.e. 29% of the time
- The US economy has experienced periods of expansion for 1,381 months i.e some 71% of the time.
- Over time expansions have tended to last longer with less output volatility than in previous periods.
- Most commentators see this a function of better data, stronger oversight and better management by the Federal Reserve.
- The most recent data release has US GDP accelerating toward 2.5% real.

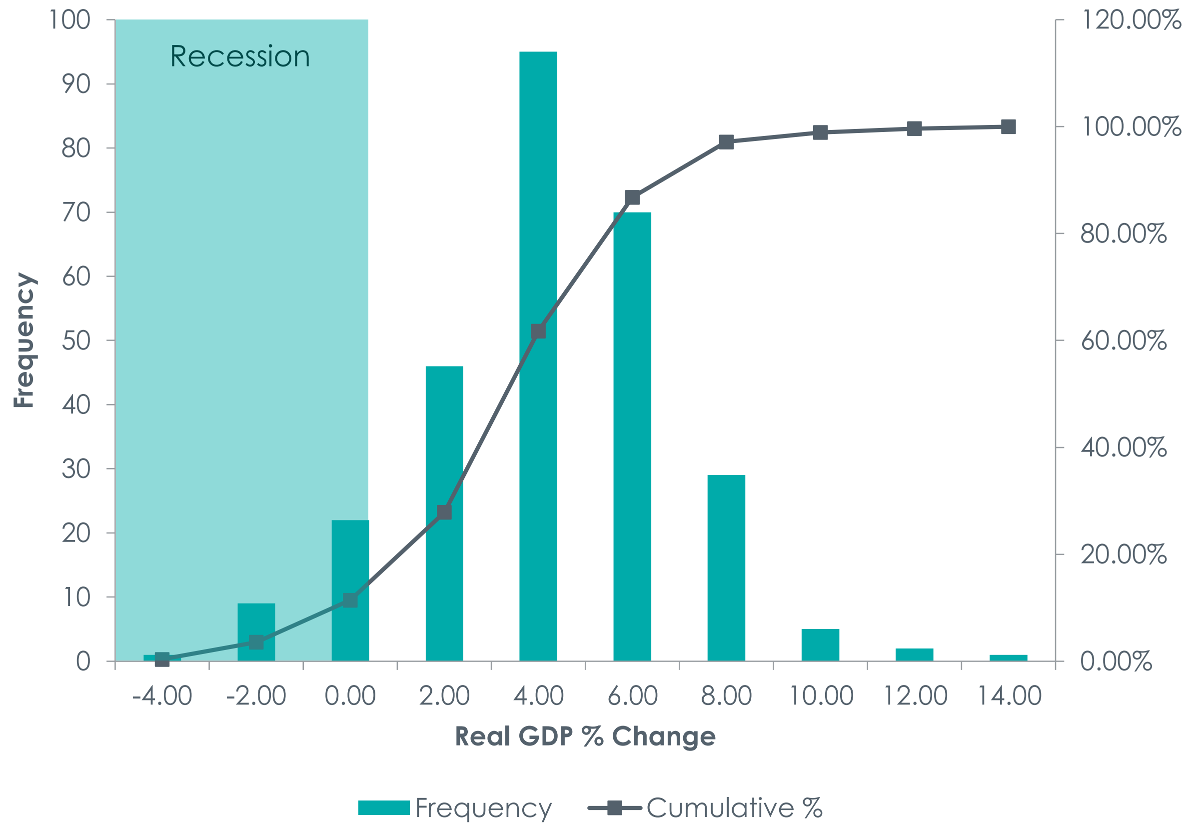


Source: St. Louis Fed, Tacit Investment Management

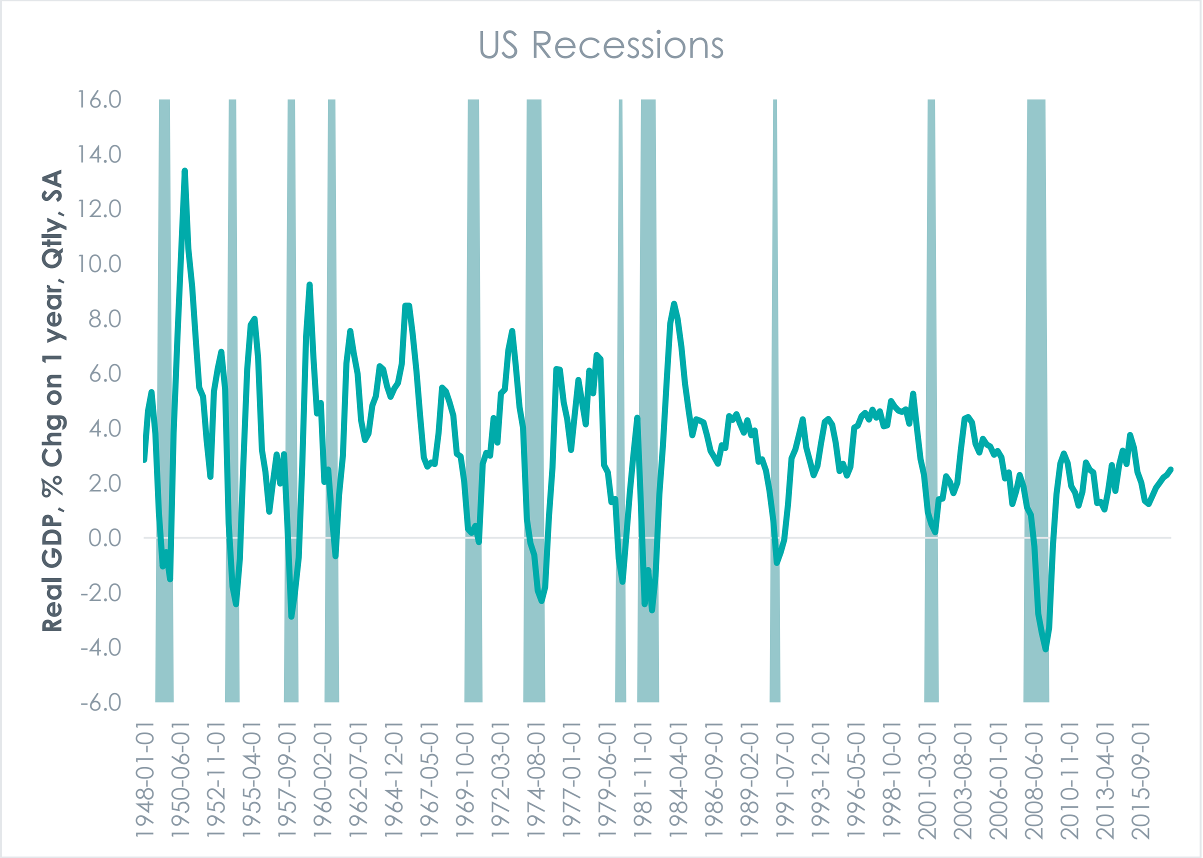
THE CURRENT RECOVERY IS FROM THE WORST POST WAR RECESSION

Postwar: output volatility has declined (1948 – present day)

US REAL GDP – between 2 & 6% real 58% of the time



PERIODICITY OF US RECESSION HAS LENGTHENED



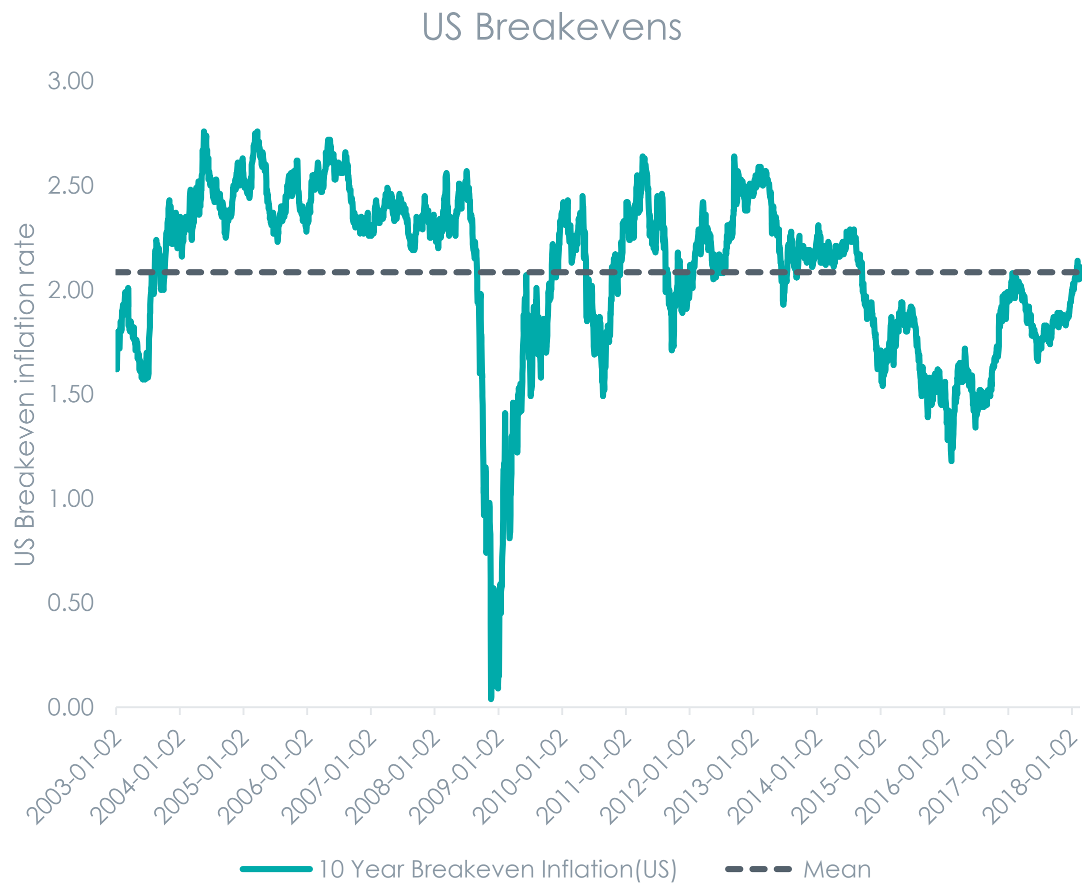
Source: St. Louis Federal Reserve, Tacit Investment Management

US BREAKEVENS – HEADED HIGHER

Bond yields point to a "normalising" economy

US REAL COST OF CAPITAL INCREASING FROM HERE

- Higher interest rates run the risk of raising "real" interest rates dampening investment
- If real rates increase then both conventional and index linkers will come under pressure but a higher inflation component will temper the duration of linkers relative to conventionals
- A rapid change in the term structure of interest rates will be very destabilising
- In 1994, Fed tightening caused a 12% sell off in bonds that impacted equity prices
- In 1979, the Fed raised interest rates sharply to engineer a recession to end the inflation of the 1970s
- There are few parallels this time around except that the Trump tax cut could lead to a rapid acceleration of activity at a time when the economy is already expanding forcing the Federal Reserve to tighten earlier and faster
- This fear is likely to be the cause of recent volatility in markets



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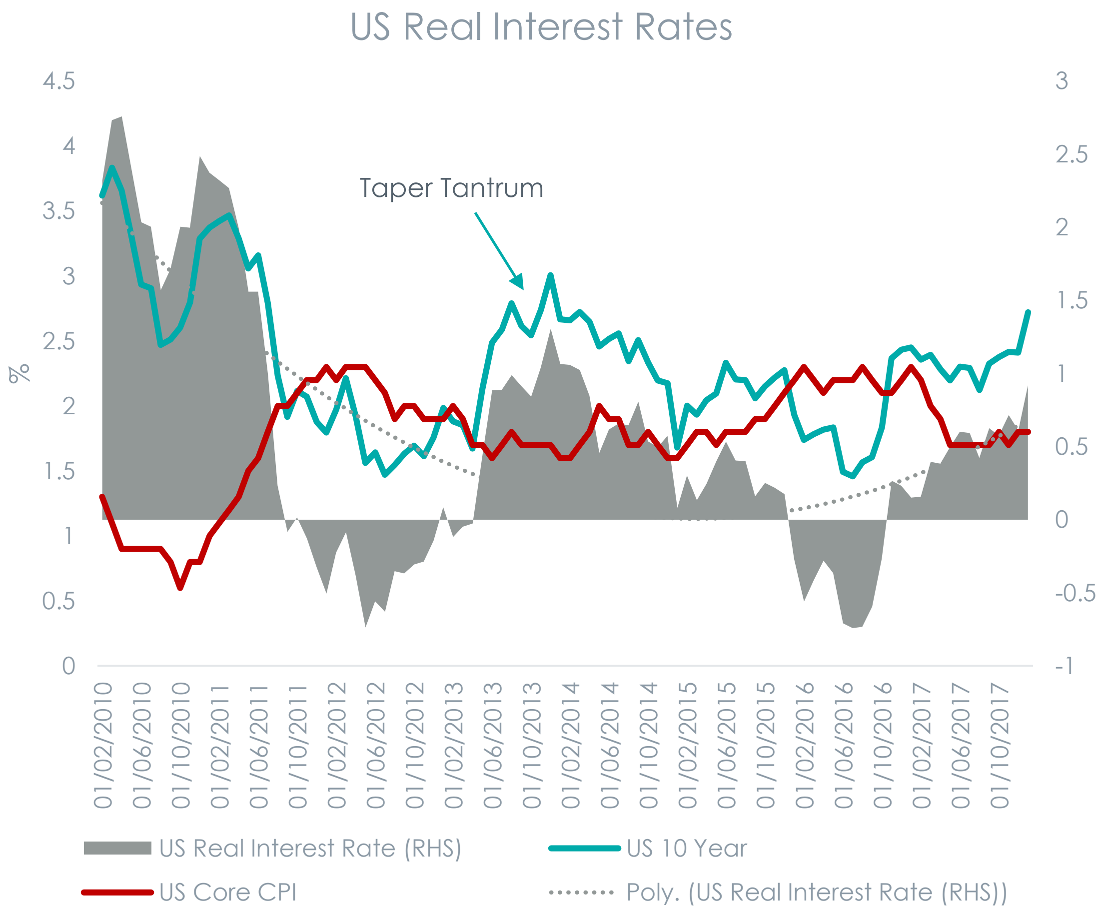
Source: US Federal Reserve, Tacit Investment Management

US BREAKEVENS – HEADED HIGHER

The beginning of the end of the QE era

MUTED REPEAT OF THE "TAPER TANTRUM"

- It is clear that Quantitative Easing was hugely successful in driving down real interest rates to less than zero
- Ben Bernanke did not make the mistake of his predecessors in the thirties of:
  - Allowing credit lines to seize up
  - Allowing disorderly liquidation of financial institutions
- As the 10 year yield climbs toward 3%, the zero bound will be left behind and the case for monetary support will cease
- There are two quite separate risks:
  - The Trump Tax Cuts force the Fed to raise rates into an overheating economy or
  - Core CPI fails to raise and "real" rates tighten policy before the Federal Reserve, meaning further "planned" rate rises would tighten policy still further possible stifling the present expansion prematurely
- As the chart indicates, Core CPI is still below target and recent bond weakness has led to an increase in "real" interest rates



Source: Tacit Investment Management

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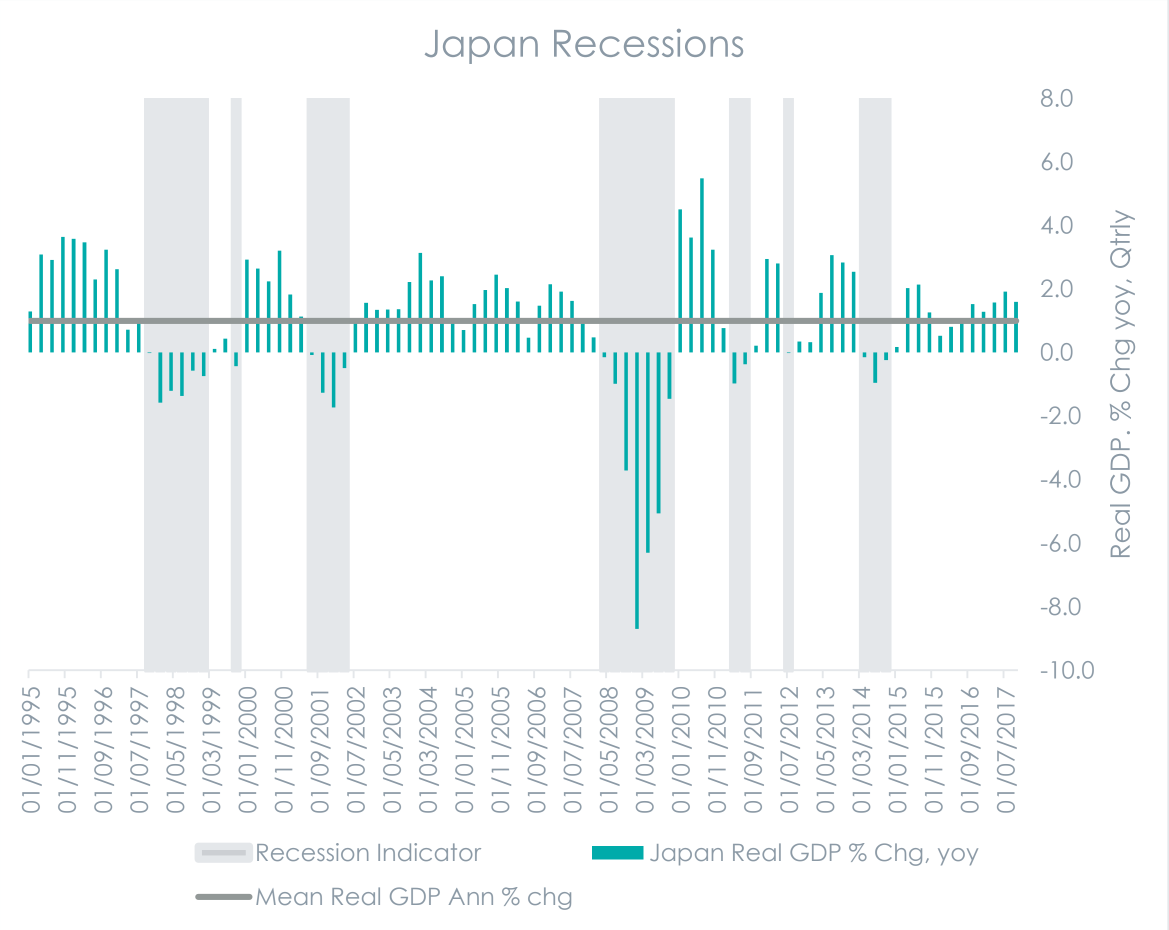
Japan

ENJOYING THE LONGEST UPSWING SINCE 2002- 8

CHRONICALLY LOW GROWTH

- Since the end of the great Japanese boom in 1989, Japanese GDP growth has averaged 1% per annum real
- At the same time, the economy has slipped in and out shallow recessions/deflations seemingly unable to attain self-sustaining domestic lift-off
- The experience of a Japan during the global financial crisis was more severe than the US but the economy has been supported by unprecedented monetary easing
- Yet, Japan has not implemented the corporate or tax and wage reforms that would release cash trapped on company balance sheets
- The counterpart to Govt deficits are the large corporate surpluses that lie unspent and uninvested lowering ROEs and hampering productivity



Source: St. Louis Fed, Tacit Investment Management

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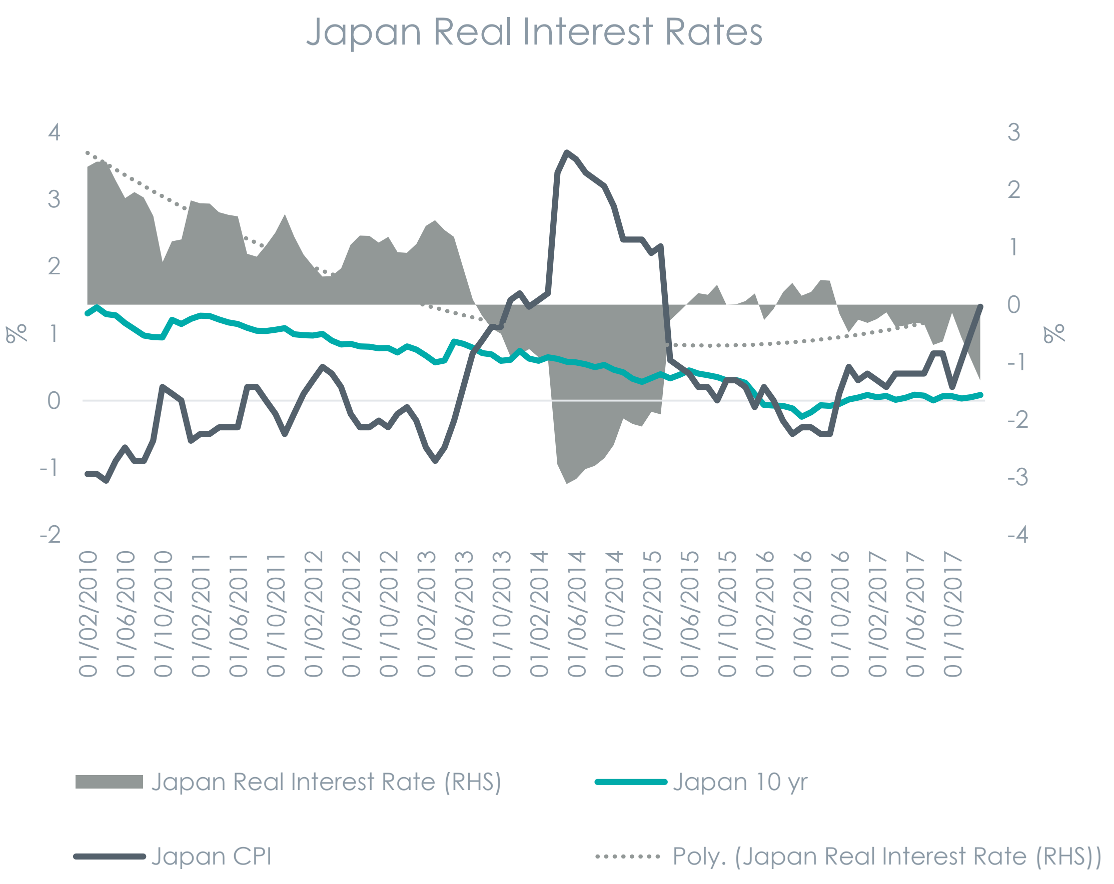
Japan

ENJOYING THE LONGEST UPSWING SINCE 2002/8

KURODA SPEAKS OF ENDING QE

- Until recently, the policy of the Bank of Japan has been to embark on unlimited QE with the express intention of capping long term bond yields below 0%
- This policy has been successful at the expense of the BOJ balance sheet which sits at over 100% of Japanese GDP
- As the chart indicates, Japanese CPI is creeping up – to around 1.5% and whilst QE caps long-term rates, real interest rates have been drifting lower supporting risk assets
- However, Hanika Kuroda, the re-elected governor of the BoJ has recently mooted bringing the QE programme to a conclusion
- Given the very low level of Japanese yields and the scale of the QE policy, this could be very destabilising for the Yen and other risk assets

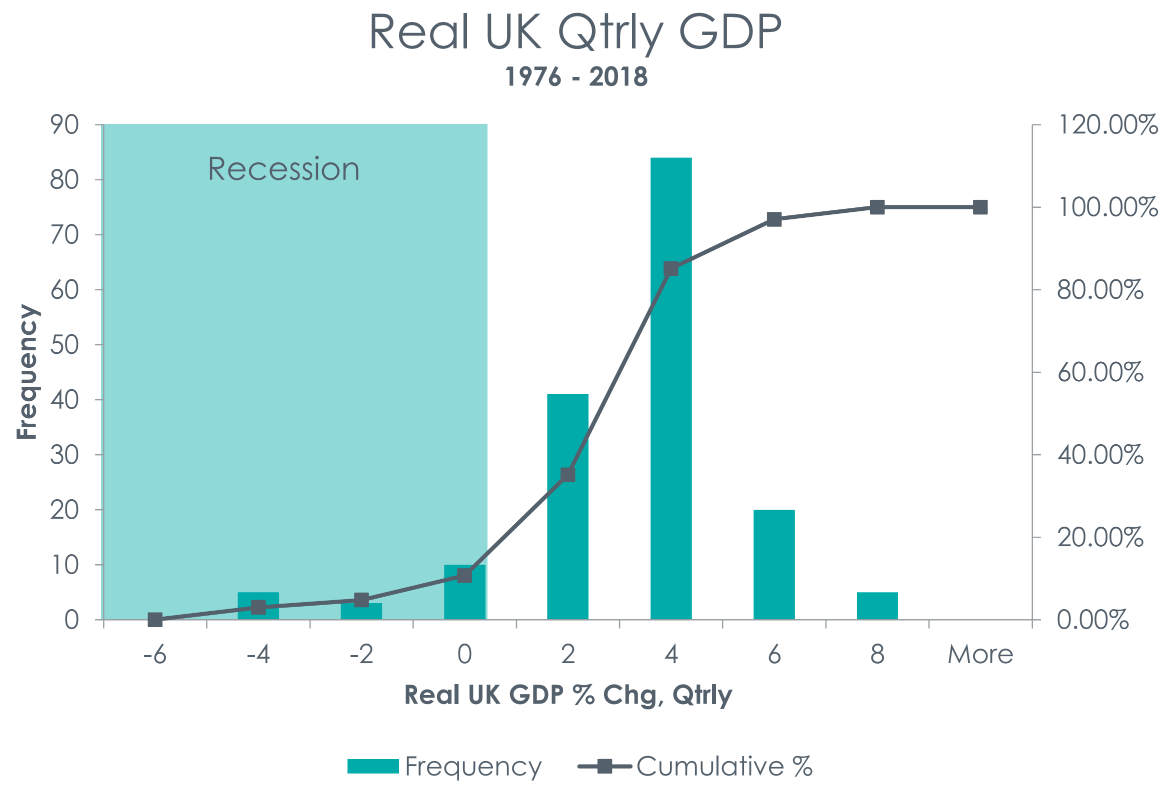


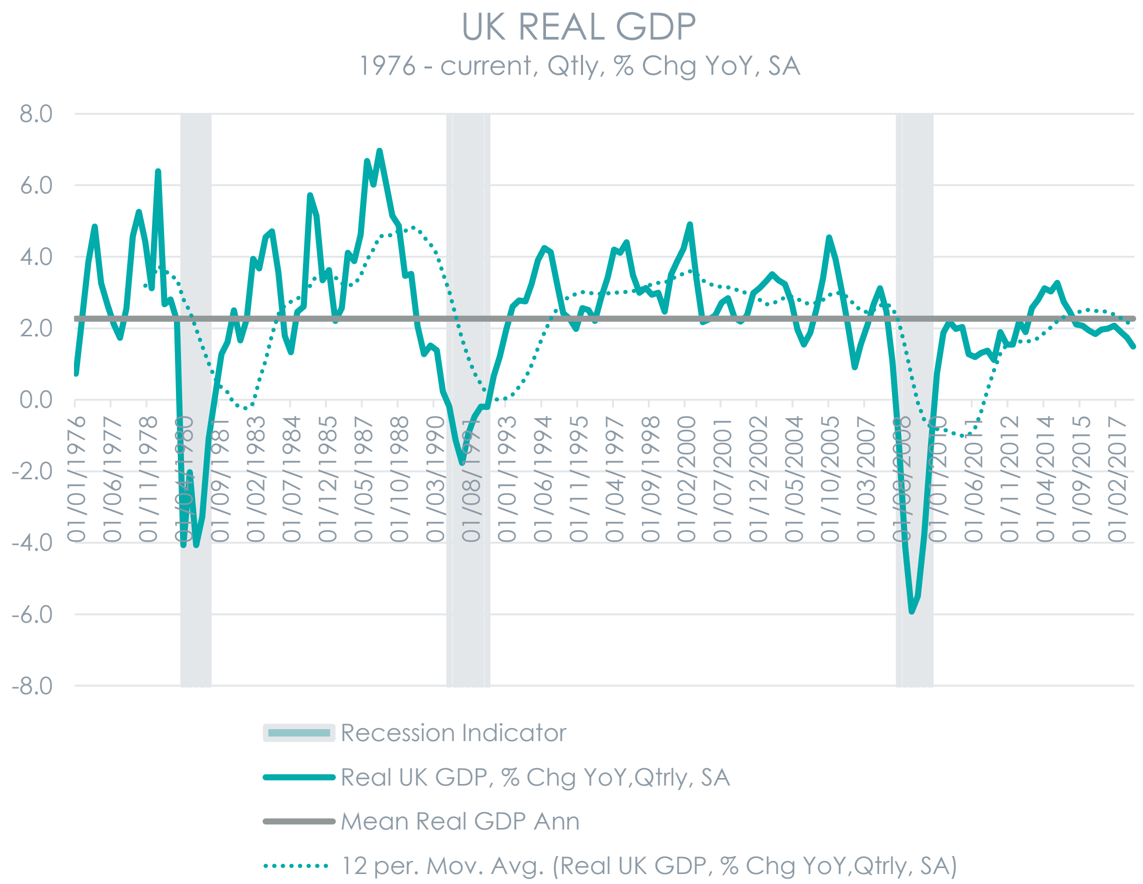
Source: St. Louis Fed, Tacit Investment Management

United Kingdom

UK "real" GDP beginning to show the anticipated impact of Brexit

IS A RECESSION OVERDUE?





Source: St. Louis Fed, BOE, Tacit Investment Management

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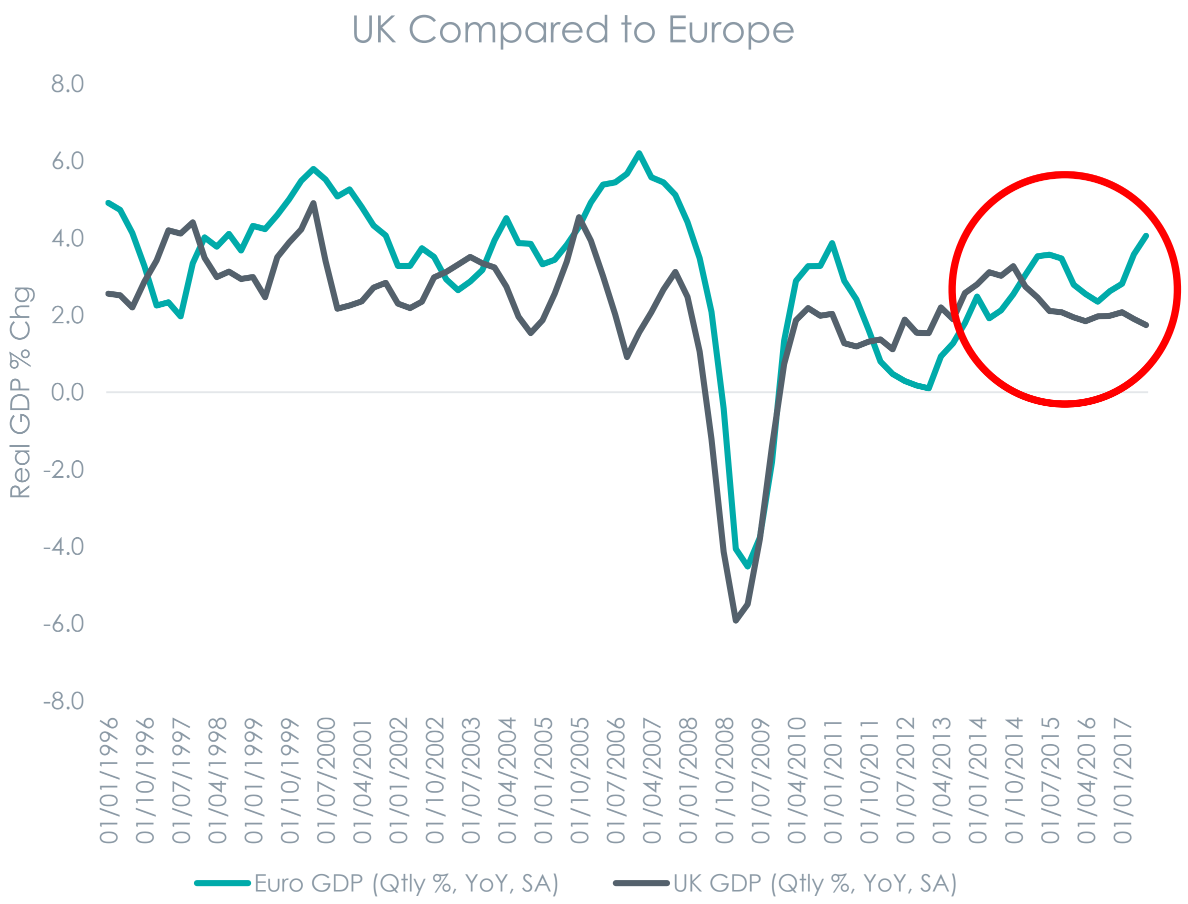
United Kingdom

THE BRITISH ECONOMY IS STARTING TO LAG EUROPE BY SOME MARGIN

STALLING SPEED?

- Most European indicators point to a strong upturn on the continental mainland
- The recent Italian election results will have been particularly unwelcome in Brussels
- The UK, despite the message from the PMIs, appears to experiencing a sharp moderation from the pace of growth to the end of 2014
- At the same time, UK core inflation has moved up toward 3% putting the Bank of England in a dilemma of whether to raise rates pre-emptively or to allow the cost increases caused by the devaluation post Brexit vote, to pass through
- The UK is now the slowest growing major European economy

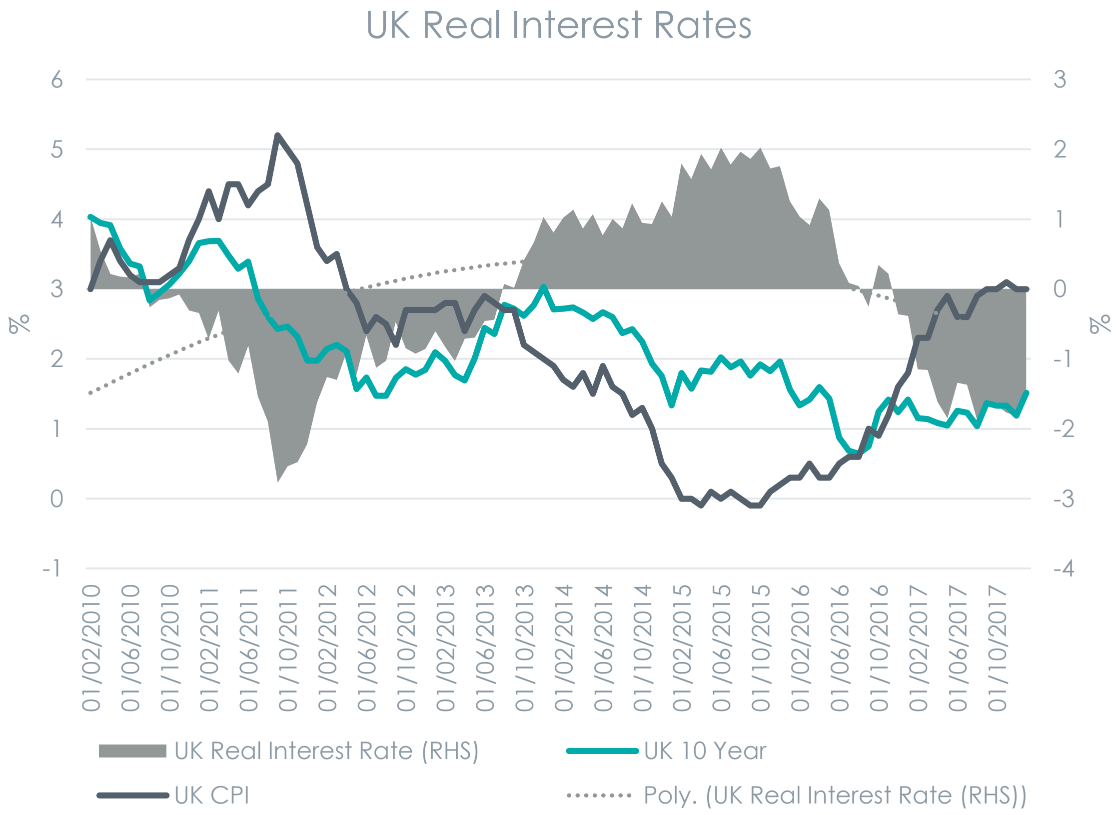


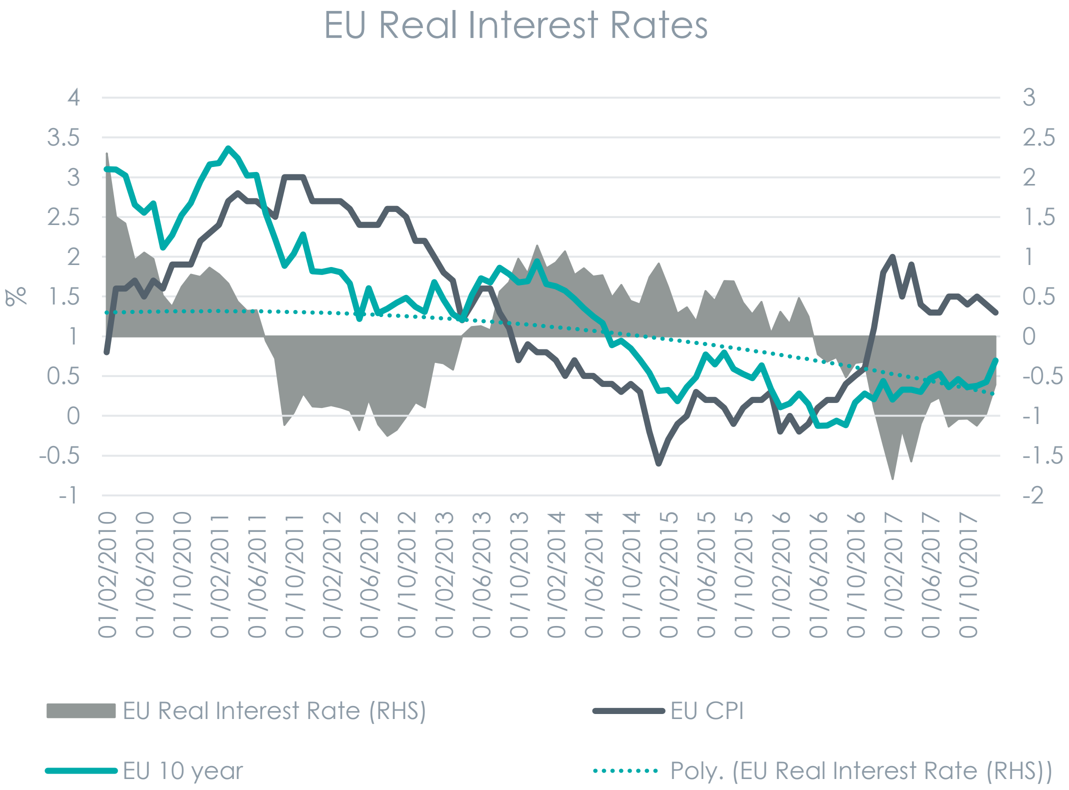
Source: OECD.stat, Tacit Investment Management

United Kingdom/Europe/Brexit

QE succeeded magnificently in bringing "real rates" down

IS A RECESSION OVERDUE?





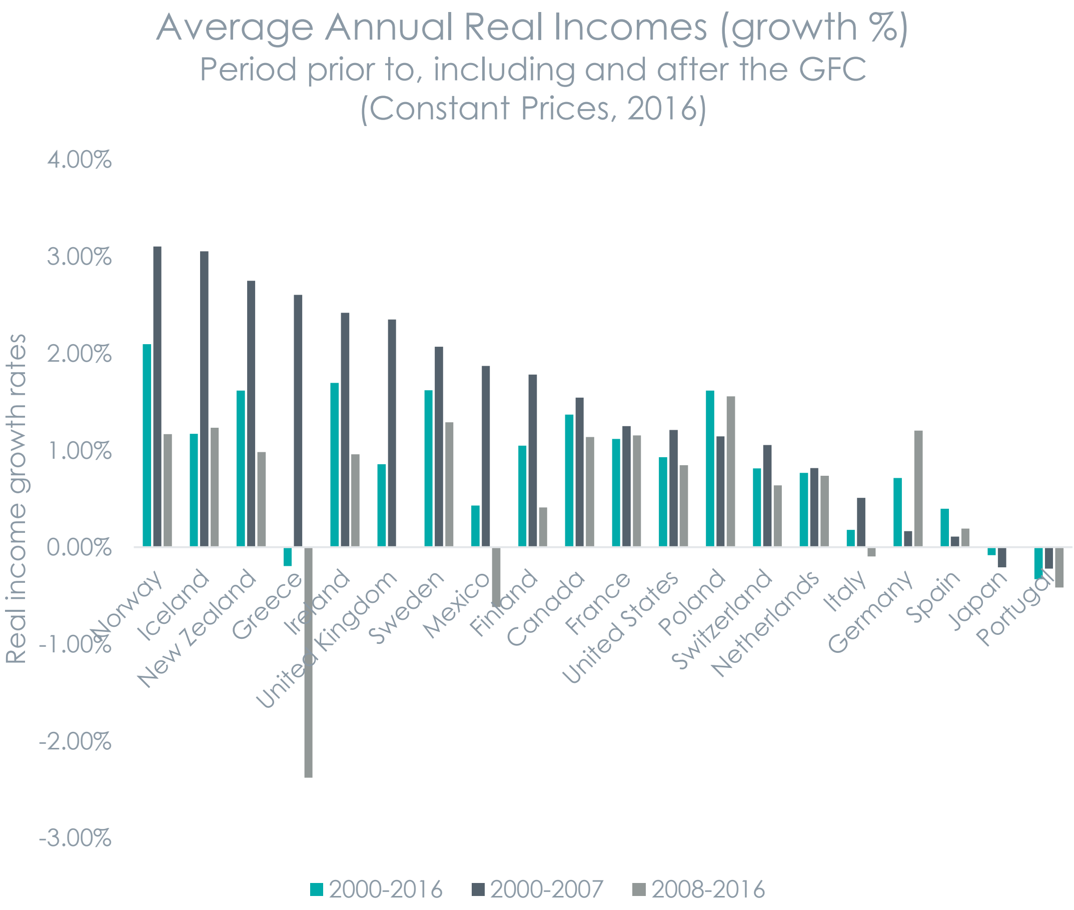
Source: Thomson Reuters, Tacit Investment Management

GLOBAL DIVERGENCES POLITICS

RISING ECONOMIC GROWTH RATES RAISE DISTRIBUTION QUESTIONS

REAL INCOMES HAVE NOT RECOVERED

- Incomes generally accelerated and peaked up to 2008
- Average real income growth since 2000 has less than 1% per annum with Japan and Portugal experiencing negative average real income growth
- Post crisis, income growth remains lower than the period 2000-7 with the exception of Germany where real income growth is accelerating
- There is some evidence that wage growth more generally is beginning to accelerate and high employment rates should cement some wage inflation: supporting debt servicing and consumption
- The pre-crisis neo-liberal settlement is clearly under pressure and political change in response is likely to be redistributive in character



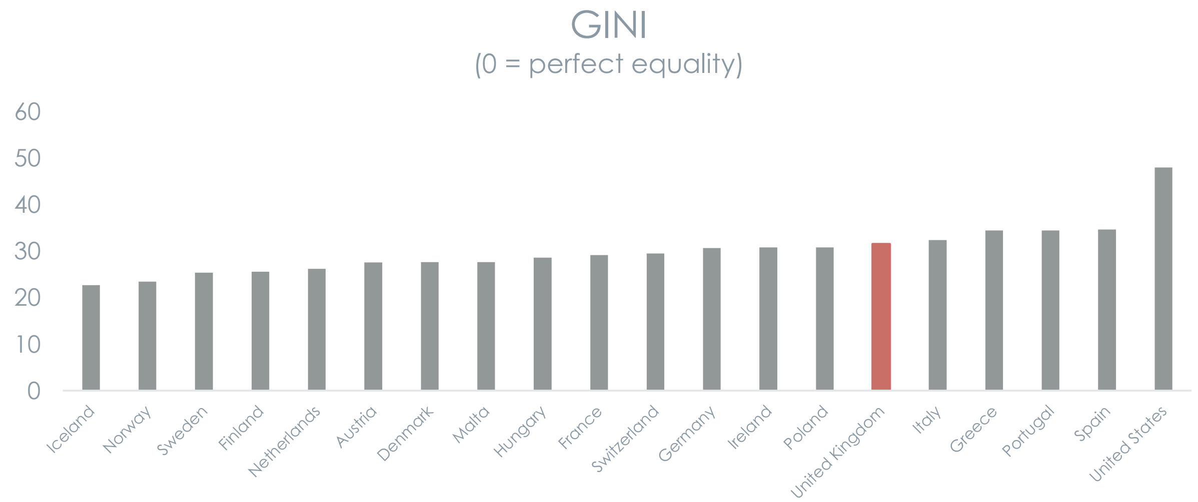
Source: OECD, Tacit Investment Management

GLOBAL DIVERGENCES – INCOME INEQUALITY

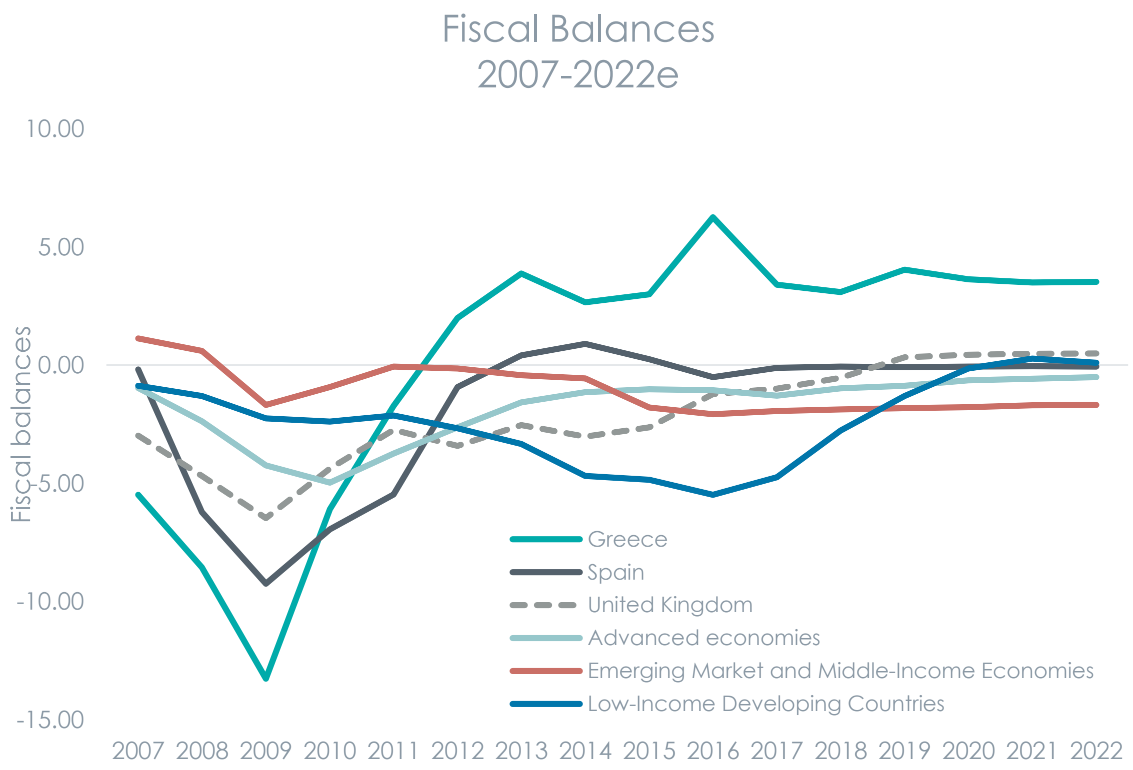
WAGES AND LIVING STANDARDS HAVE BEEN SQUEEZED

PUBLIC FINANCES ARE BACK IN BALANCE

- In the US populism has found expression in tax cuts despite such policy favouring the already wealthy
- In Europe and the UK, populism is likely to give rise to higher public borrowing and higher public spending
- The net economic impact is similar but years of austerity have provided headroom for additional spending in Europe



AUSTERITY IS COMING TO AN END

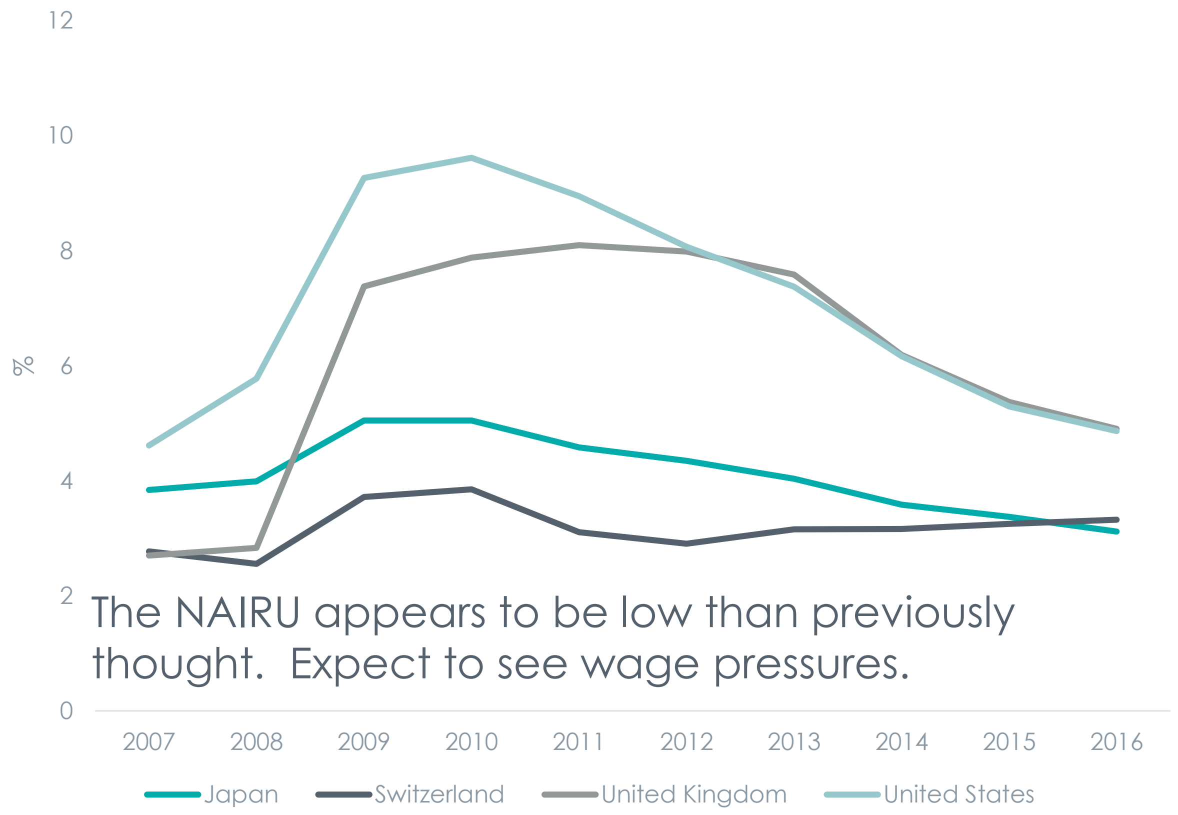


Source: UN WIID, Tacit Investment Management   IMF, Tacit Investment Management

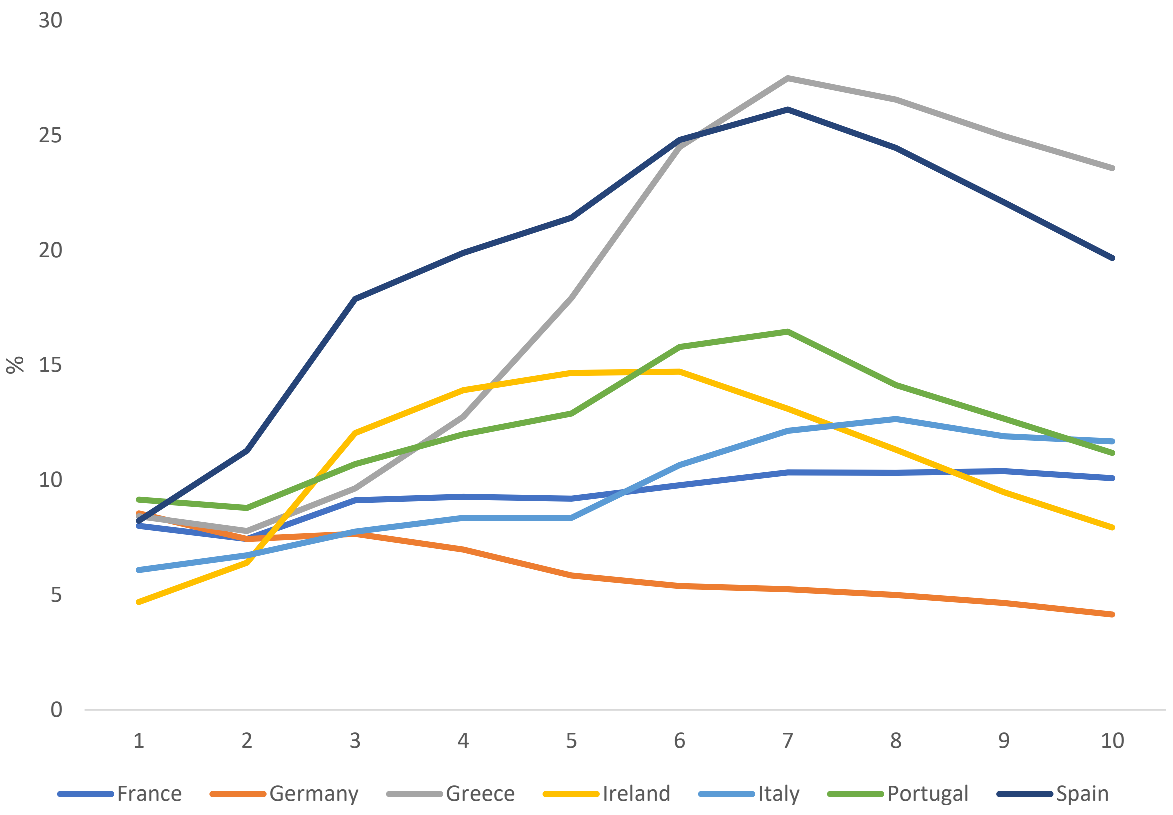
GLOBAL DIVERGENCES - UNEMPLOYMENT

GLOBAL **EMPLOYMENT** RATES ARE HIGH EXCEPT IN EUROPE

UNEMPLOYMENT – BELOW NAIRU



ABUNDANT LABOUR IN EUROPE



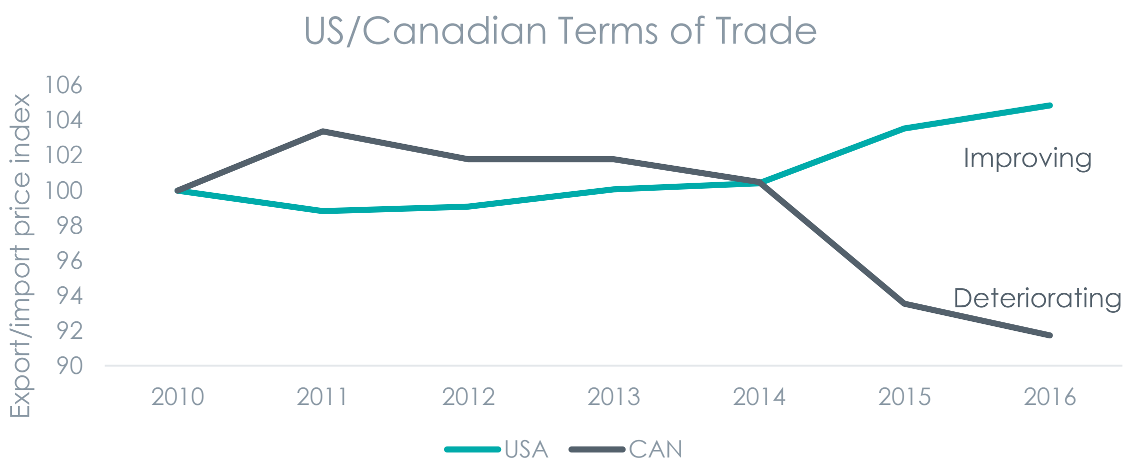
Source: IMF WEO Nov 2017, Tacit Investment Management

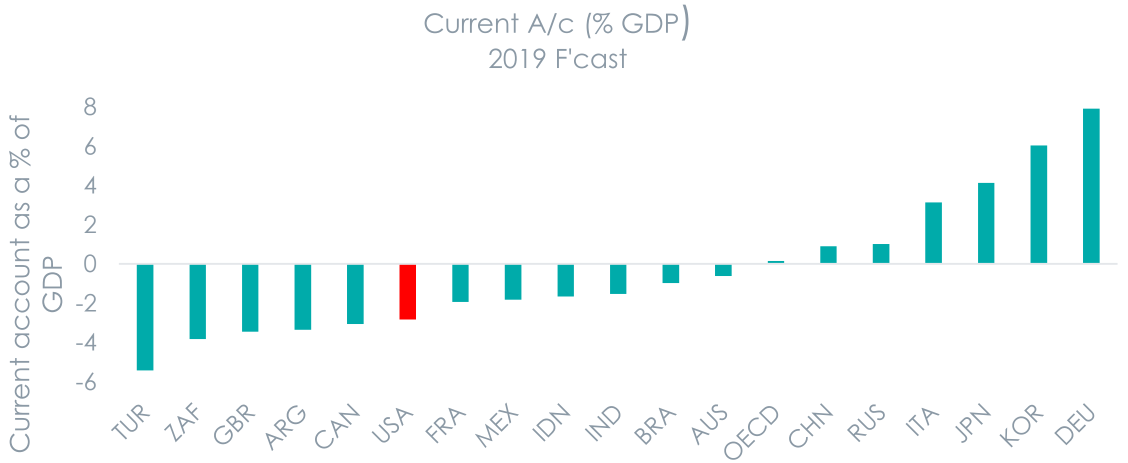
GLOBAL DIVERGENCES TRADE

RISK OF A TRADE WAR – MEMORIES OF SMOOT-HAWLEY

UNCLEAR WHY TRUMP WANTS A TRADE WAR

- The US is running a current a/c deficit of under 3% of GDP
- This compares to Germany which runs a current a/c surplus of 8% of GDP and which should be real focus of trade negotiation
- Canada is the principal source of Aluminium exports and relative to the US, Canada has already experienced a significant terms of trade shock
- China, a previous object of Trumpian opprobrium, is running a balanced trade policy
- The history of the Smoot-Hawley tariff of 1930 is widely interpreted as a damaging piece of legislation that tipped a recession into a depression
- The impact of tariffs on metals will be small, Canada being the chief victim but it opens up the risk of greater protectionism, higher prices and thus higher interest rates





Source: OECD, Tacit Investment Management

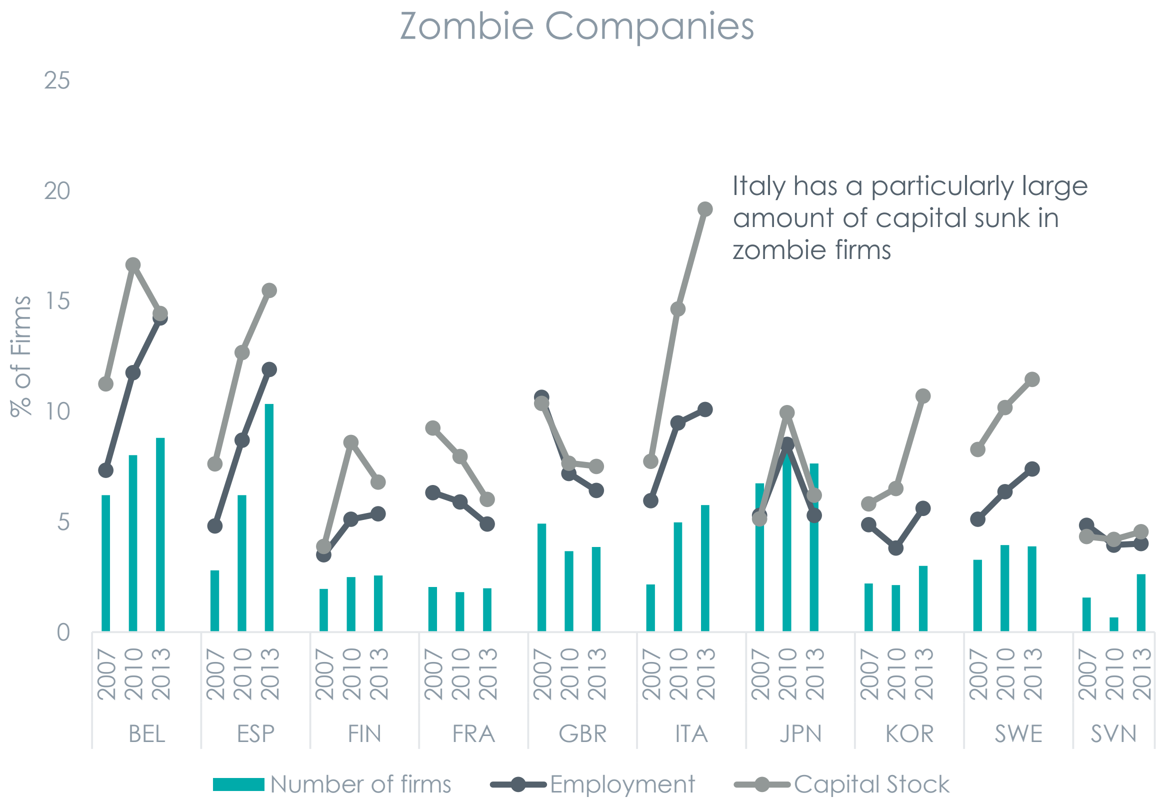
GLOBAL DIVERGENCES – PRODUCTIVITY

QE HAS HELPED UNCOMPETITIVE FIRMS SURVIVE

CREATIVE DESTRUCTION

- Low productivity growth has been a feature of the recovery from the GFC
- Recent failures in the UK: Maplins, Toys R Us, … suggest that this process of "creative" destruction is accelerating and is likely to accelerate further as the rate cycle intensifies
- Research by the OECD suggests that there are three inter-related sources of Labour productivity weakness:
  - Survival of "zombies" – firms that would not normally survive a competitive market
  - Capital misallocation – i.e. capital sunk in zombies that unavailable to be deployed elsewhere
  - Stalling technological diffusion i.e weak capex as a function of insufficient returns on capital
- As the economy moves away from the QE era, it is likely that productivity will improve as zombies are liquidated and capital including human capital is deployed elsewhere

COMPANIES AGED >10 yrs with <1x Interest Cover



Source: **OECD Policy Paper "Confronting the Zombies Dec 2017, Tacit Investment Management**

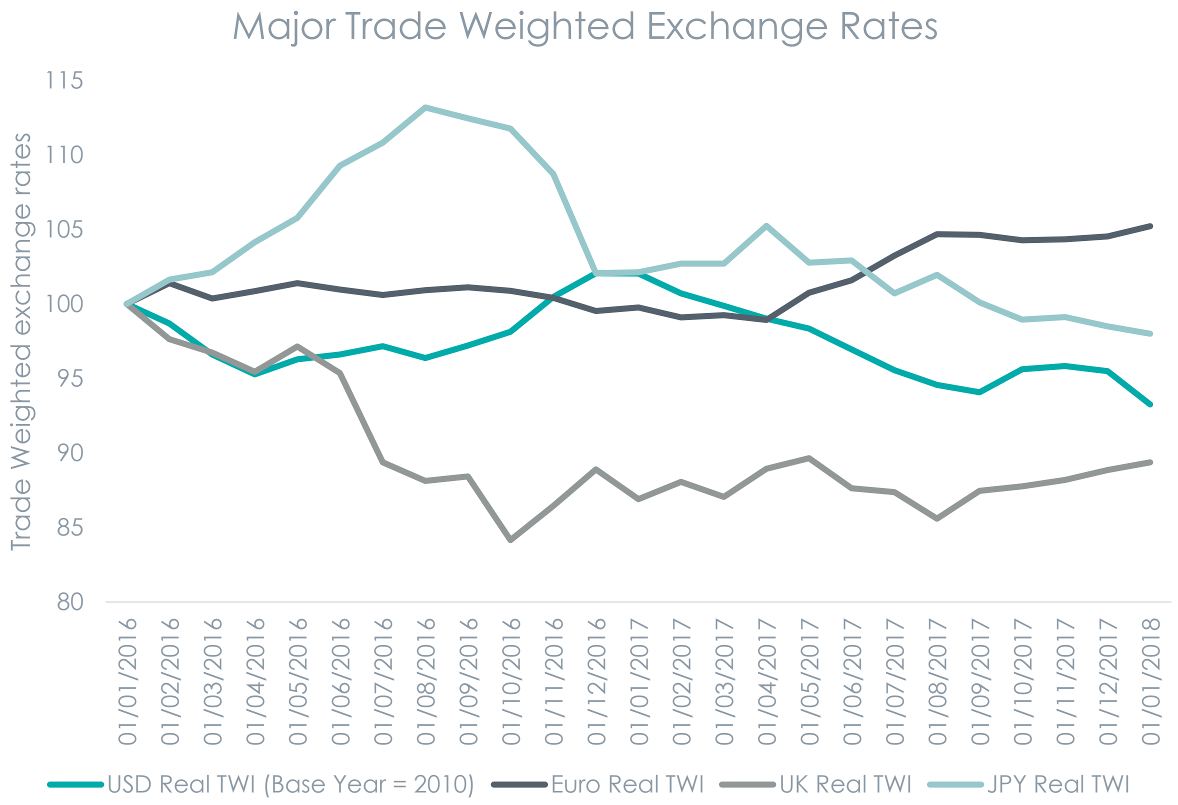
TRADE WEIGHTED EXCHANGE RATES

Real exchange rates should bring trade flows into balance

FLOATING EXCHANGE RATES

- The recovery in the Eurozone is reflected in the rise in the real exchange rate. Europe (Germany) has benefited for some time from an undervalued exchange rate. This is should be the real focus of Trump's trade war but his recent announcements affect Canada and Mexico.
- The Brexit induced devaluation of Sterling seems to have run its course and Sterling appreciation has been a recent headwind for UK listed equity.
- The US Dollar presents a conundrum where higher interest rates and higher bond yields should be driving the dollar higher. There is some confusion about the administration's attitude to the "strong dollar" policy that has dominated in the past.
- Japanese exporters will continue to benefit from Yen devaluation to the extent that trade frictions with the US can be avoided.

RISE IN EURO TWI SHOULD BE FOCUS OF TRADE



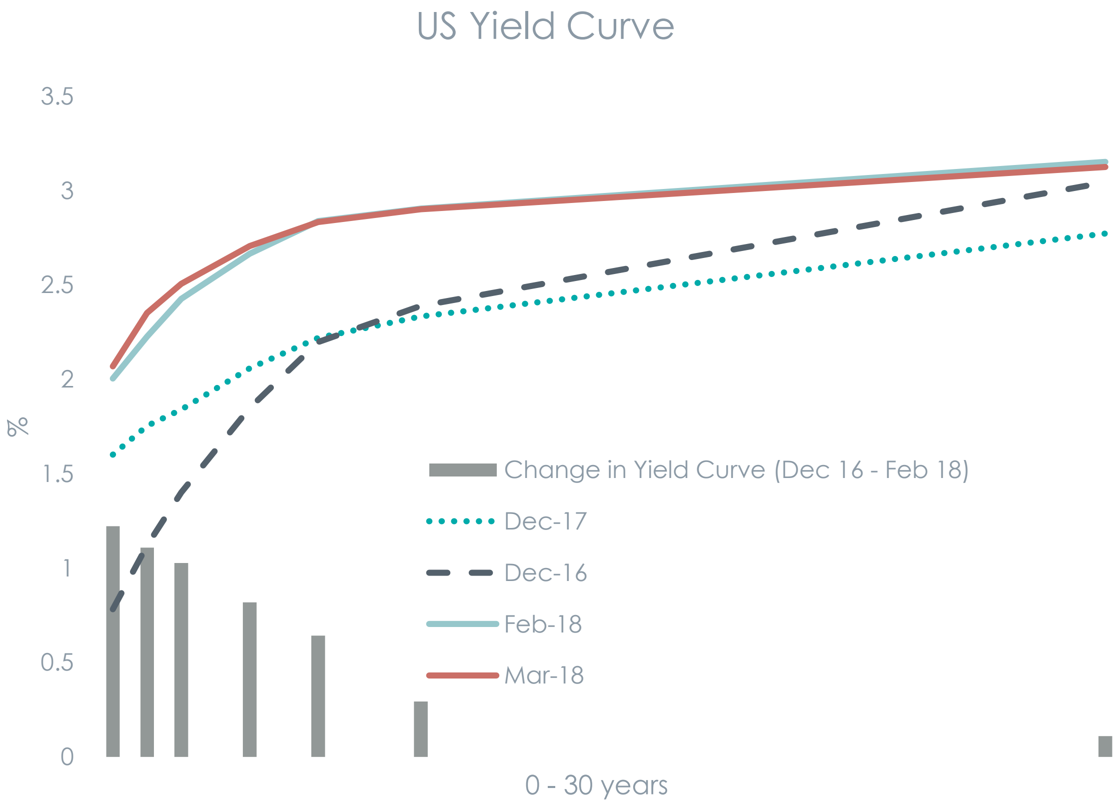
TRUMP'S AMERICA – DISCOUNTING STRONGER GROWTH?

TEN YEAR APPROACHES 3% BUT RATES ARE LIKELY TO REMAIN LOW REL TO EARLIER PERIODS

EXPANSION LOOKS TO CONTINUE & EVEN OVERHEAT

- US markets have tightened policy markedly since our last conference. Equity markets have responded by falling to incorporate a higher cost of capital.
- Previously it looked like Fed policy had tightened too early forcing bond markets to price-in lower long-term growth prospects. The Trump tax cut has reversed this completely and the yield curve has shifted up by roughly 1% point at the short end and ½ point at the long (Feb 18/Dec 17)
- Despite equity market volatility, the new curve is consistent with stronger growth and modestly higher inflation but there are two risks:
    - Higher inflation as a function of the Trump stimulus may force the Fed's hand to tighten earlier than currently expected. We don't know whether Jay Powell represents a departure from or continuity with the Yellen/Bernanke regime.
    - Or a rise in "real" interest rates; in principle negative for bonds and equities *but* equity earnings momentum may well offset a rise in discount rates particularly if high labour participation reignites US productivity.

US BENCHMARK



Source: Thomson Reuters, Tacit Investment Management

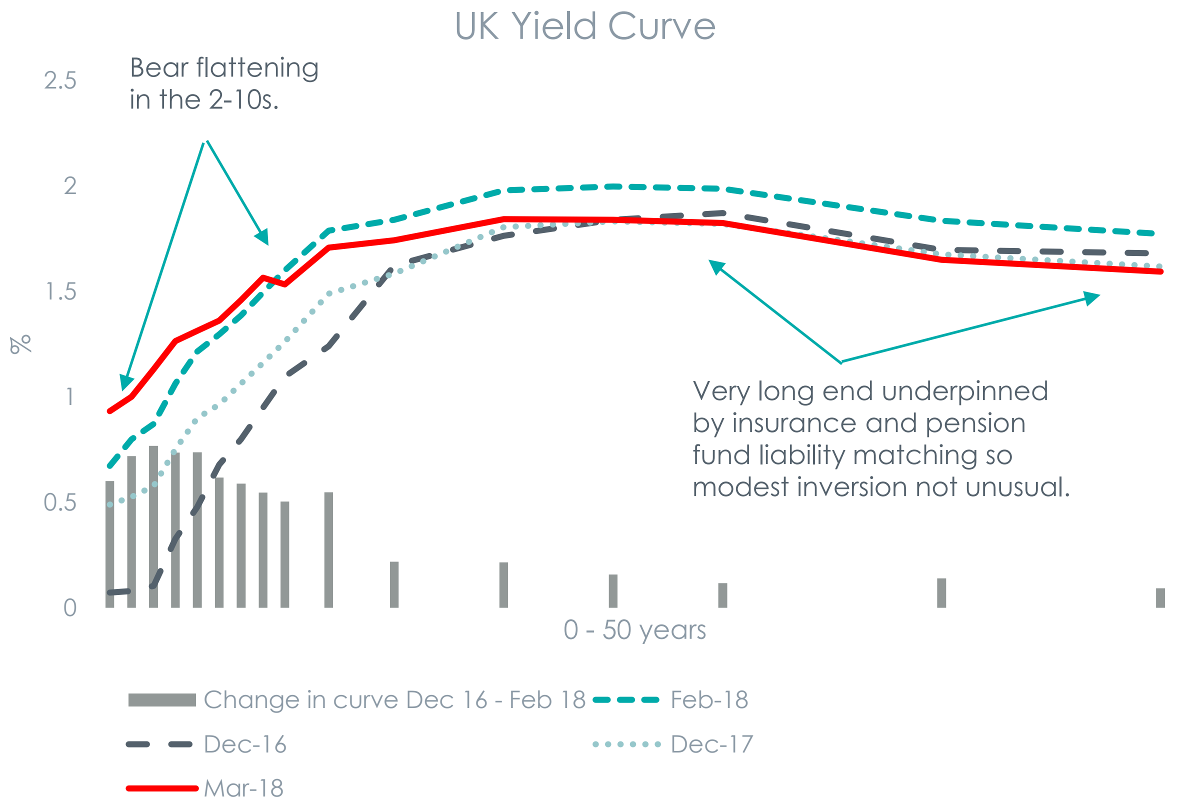
BRITAIN – CLOUDED BY EU NEGOTIATIONS

CURVE FLATTENING ACCELERATING SINCE FEBRUARY (AT BOTH ENDS)

POINTING TO NORMALISATION

- As in the US, the yield curve has seen an almost parallel shift upwards since our last conference. The bear-flattening of Dec 17/Dec 16 seems to have ended.
- The shape of the curve is consistent with strengthening growth with the market demonstrating little concern surrounding fears of higher inflation.
- As in the US, the BOE will be content to see modestly higher inflation to maintain low "real" rates but given that the UK is a mere 12 months from exiting the EU with no sign of a credible plan it is possible that the UK could see a toxic combination of:
    - Lower investment, as firms defer, cancel or relocate investment away from the UK and/or
    - An inflation shock via tariffs, trade friction and a sterling depreciation forcing the BOE to raise rates more aggressively than previously expected
- Interestingly, the UK government still has access to long term funding below 2% so still has some **fiscal room** for manoeuvre to mitigate an economic shock.

UK BENCHMARK



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Source: Thomson Reuters, Tacit Investment Management

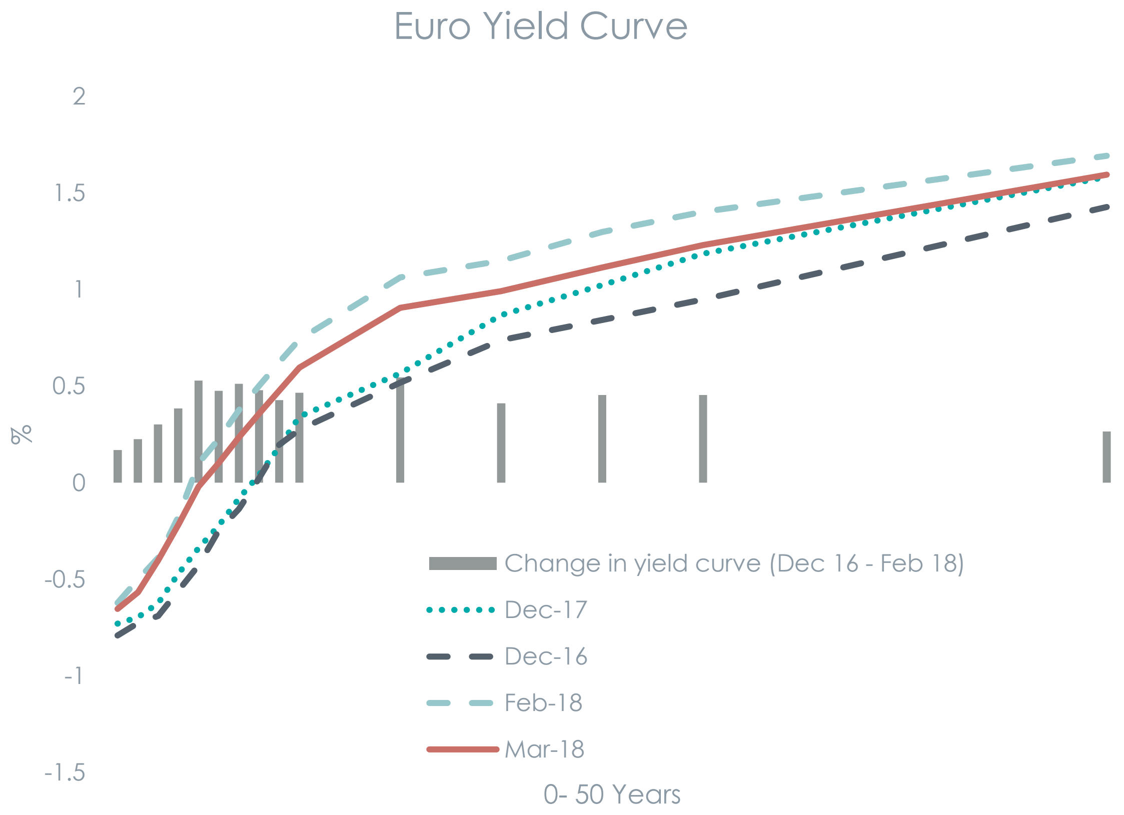
EUROPE – CONSISTENT AND ENTRENCHED BEAR STEEPENING

STEEP BUT LONG YIELDS HAVE DROPPED SHARPLY IN ONE MONTH

CRISIS OVER?

- Data coming out of the European economy suggests that the recovery from the crisis period is broadening out across Europe with much of the internal rebalancing via wage deflation complete.
- German wage growth is rising faster than the Euro average whilst peripheral wages have been suppressed by very high unemployment levels.
- The EURO benchmark yield curve is anchored at the short-end by continuing QE whilst the steepening of the curve is consistent with broad based economic growth.
- Although the curve has steepened markedly, by half a point at the 10 -15 year part of the curve, funding rates are still very low offering little impediment to a recovery in investment, wages and consumption.

EURO BENCHMARK



Source: Thomson Reuters, Tacit Investment Management

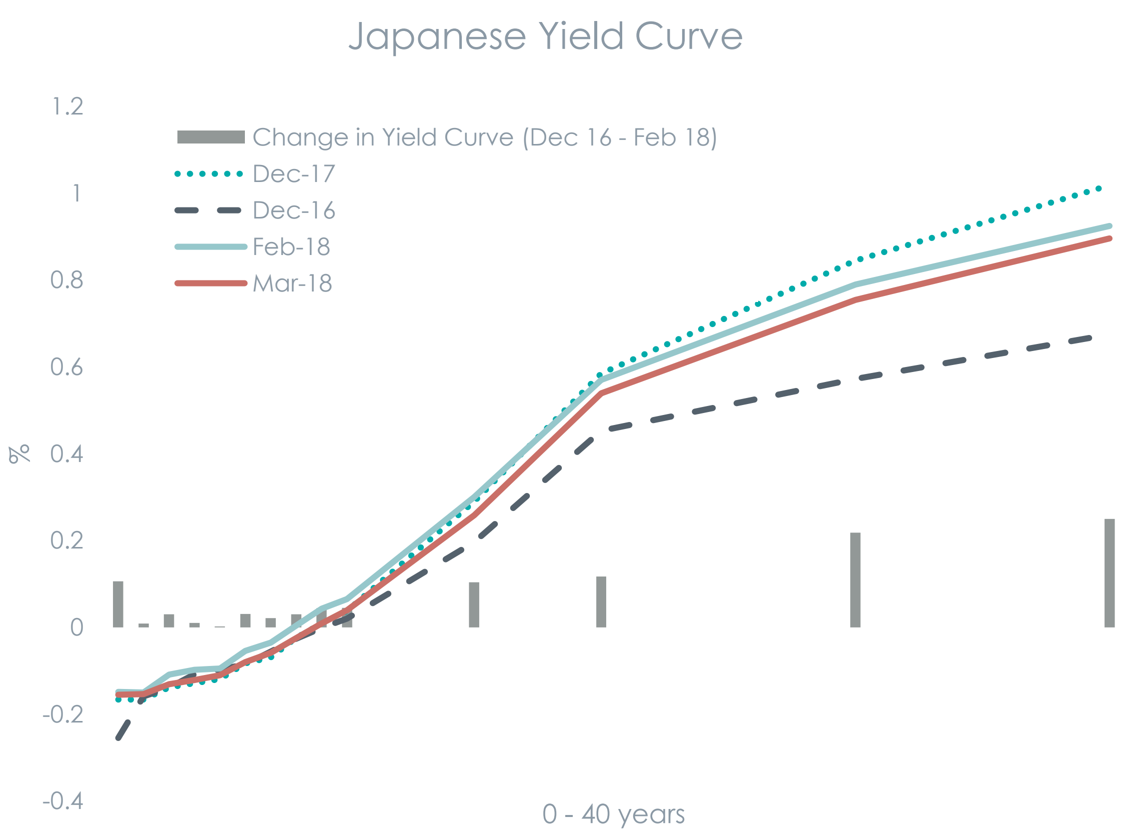
JAPAN – HARUHIKO KURODA RULES

BUT MASSIVE MONETARY STIMULUS VIA QE IS UNEXPECTEDLY UNDER REVIEW

THE BOJ OWNS THE BOND MARKET

- The only major bond market which has seen long bond yields fall since our last ISG is Japan. The reappointment of the architect of Japan's monetary policy strongly suggests more of the same.
- The BOJ now owns some 40% of outstanding bonds yet inflation is staling and government expenditure is still ballooning. Japanese short-term rates remain negative whilst the long end is capped by the BOJ at 1%.
- The expansion of the National Debt is associated with some macro-economic improvement: low unemployment (2.8%) and a near doubling of the Nikkei index but it is unclear how this experiment in debt monetisation will end.
- For the moment official intervention will support the economy and related markets but one would expect the massive supply of Yen to undermine the currency at some point perhaps leading to a Minsky moment if and when Japan leaves the zero bound.

JAPAN BENCHMARK



Source: Thomson Reuters, Tacit Investment Management

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WORLD FIXED INCOME MARKETS

YIELD CURVES ARE FORECAST TO REMAIN POSITIVELY SLOPED

	Key short- rates				10Y Bond Yield		
	Mar	Dec	Direction		Mar	Dec	Yield Curve 1 year ahead
G5	2018	2018			2018	2018	
Euro area	0	0.00	**No Change**		0.55	0.85	**Positive Slope**
US	1.625	2.13	**Bias to Tighten**		2.55	2.70	**Positive Slope**
China	2.5	2.20	**Bias to Loosen**		3.95	3.80	**Positive Slope**
Japan	-0.1	-0.10	**No Change**		0.00	0.10	**Positive Slope**
UK	0.5	0.50	**No Change**		1.40	1.50	**Positive Slope**
Other advanced							
Switzerland	-0.75	-0.50	**Bias to Tighten**		-0.05	0.25	**Positive Slope**
Australia	1.5	2.00	**Bias to Tighten**		2.70	3.25	**Positive Slope**
South Korea	1.75	1.75	**No Change**		2.70	2.60	**Positive Slope**
Taiwan	1.375	1.38	**No Change**		1.05	1.00	**Inverting**
Emerging economies							
Brazil	7	7.25	**Bias to Tighten**		11.00	12.00	**Positive Slope**
Russia	7.75	7.00	**Bias to Loosen**		7.35	6.90	**Inverting**
Poland	1.5	2.00	**Bias to Tighten**		3.55	3.75	**Positive Slope**
Mexico	7.25	7.00	**Bias to Loosen**		7.50	7.55	**Positive Slope**
Chile	2.5	3.25	**Bias to Tighten**		4.50	4.60	**Positive Slope**

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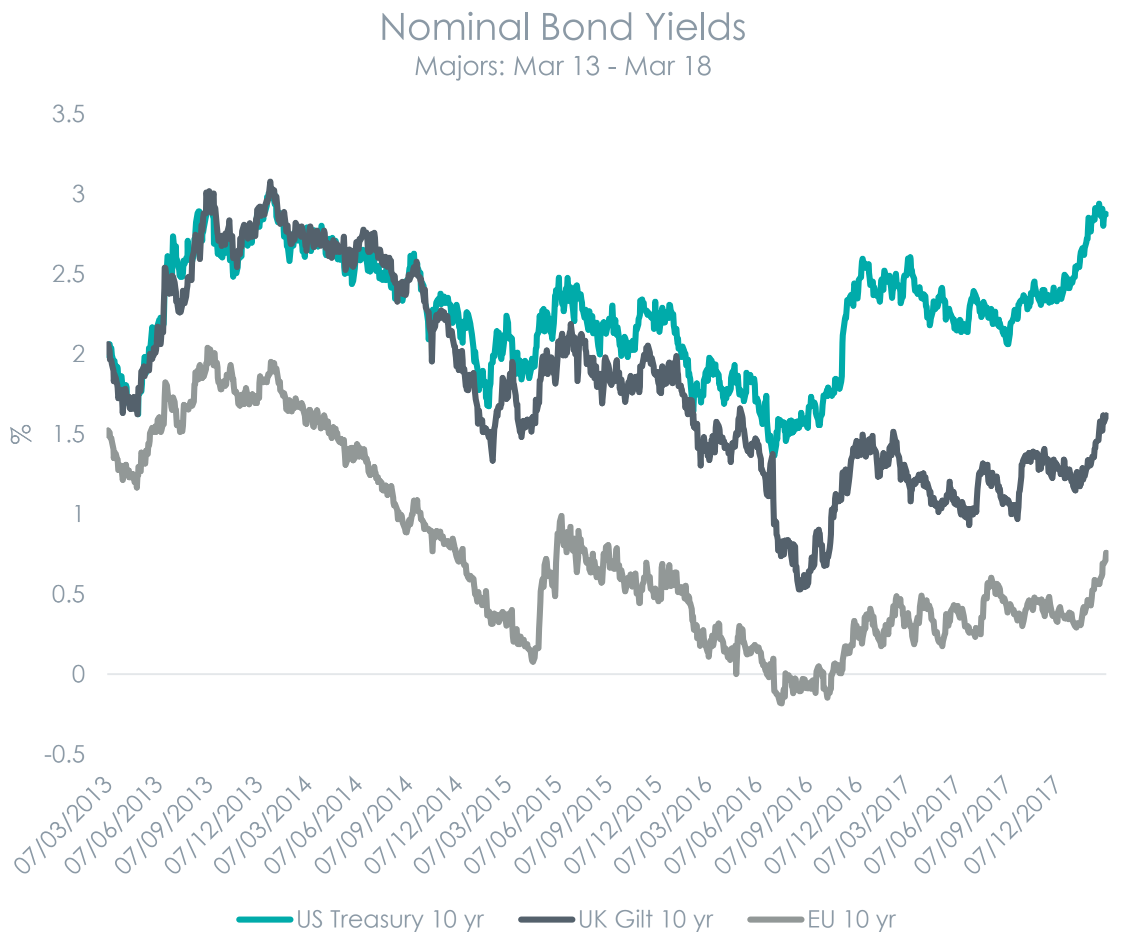
Source: Thomson Reuters Datastream, SG, Tacit Investment Management

KEY BOND MARKETS

ANTICIPATING STRONGER GROWTH

BACK TO NORMAL

- The US is close to full employment.
- The Trump tax cuts are likely to raise spending (even if the multiplier is less than 1 as the wealthy have a low propensity to consume)
- Wage pressures are quiescent but beginning to rise
- US bonds have moved to discount a stronger outlook
- Bond markets in the UK (possibly prematurely) and Europe are also discounting stronger growth and/or tighter policy
- As long as this return to normality does bring with it stronger economic growth them equities should not be derailed
- But, for the first time in a long-time "overheating" is word that is being used to describe the US economy

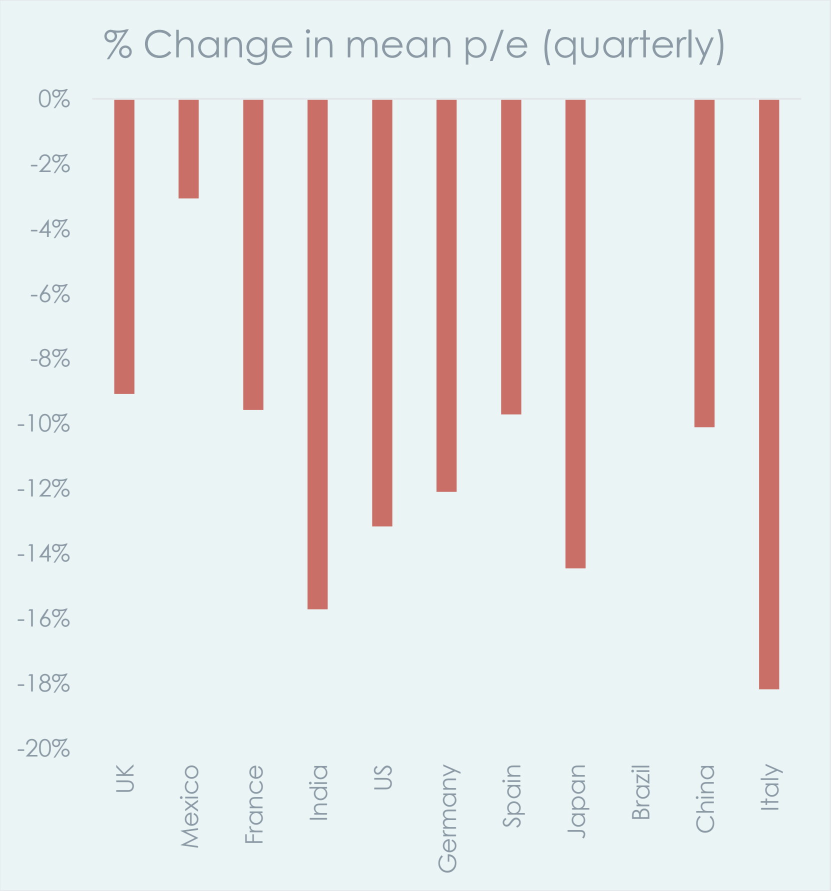


Source: St. Louis Fed, Tacit Investment Management

VALUE – ALPHA

MARKETS HAVE CHEAPENED LED BY ITALY, JAPAN AND INDIA

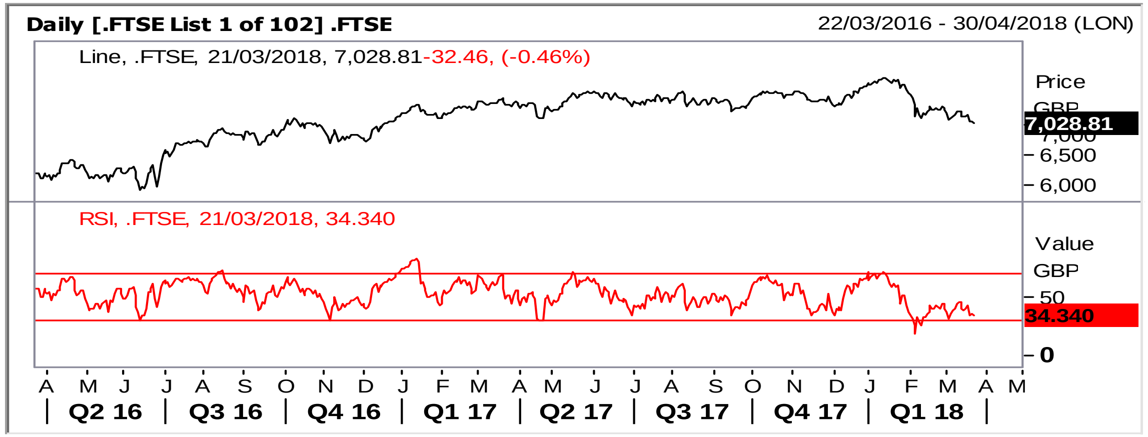
Country PE ratio	PE Ratio 2017		PE Ratio 2018e		PE Ratio 2019e	
Americas	Mean	Median	Mean	Median	Mean	Median
US	21.3	20.8	17.8	17.8	16.1	16.1
Canada	16.5	16.6	15.2	16.3	13.7	14.6
Mexico	18.1	17.2	15.8	13.6	14.2	12.5
Brazil	17.3	18.3	14.3	15	12.4	13.7
Europe						
France	16.5	17.9	15.1	16.3	13.8	15.1
Germany	14.5	18.7	13.8	17.1	12.6	15.8
Italy	14.8	17.7	12.6	14.8	11.2	13.1
Spain	14.4	16.6	13	15.5	11.7	13.7
UK	15.1	15.5	14	14.4	13.1	13.3
Asia						
China	8.9	11.5	8	9.6	7.2	8.4
India	23.3	27.6	19.3	22.9	16.1	18.4
Japan	15.6	17.9	14.2	16.3	13.2	15
Korea	13	13.9	8.5	11.9	8.2	10.5



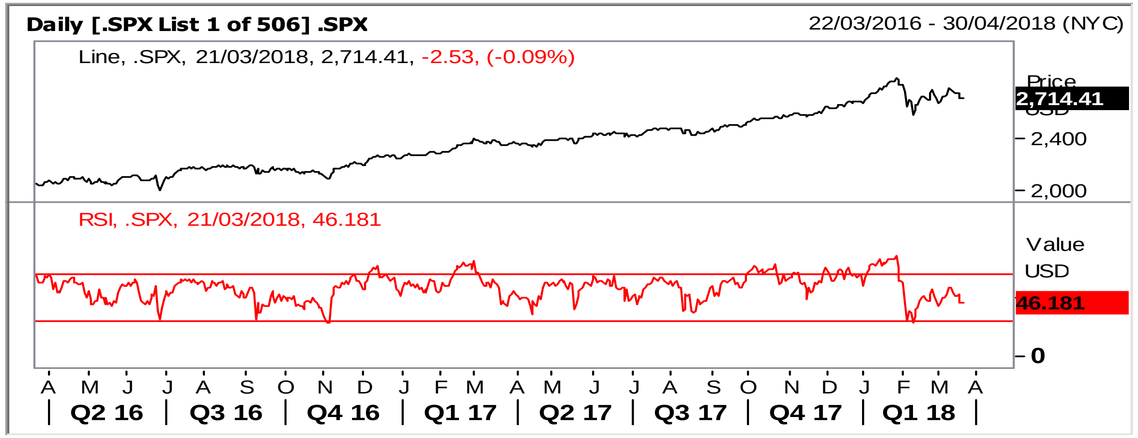
VALUE - ALPHA

TECHNICAL POSITION KEY MARKETS – Main Index & RSI

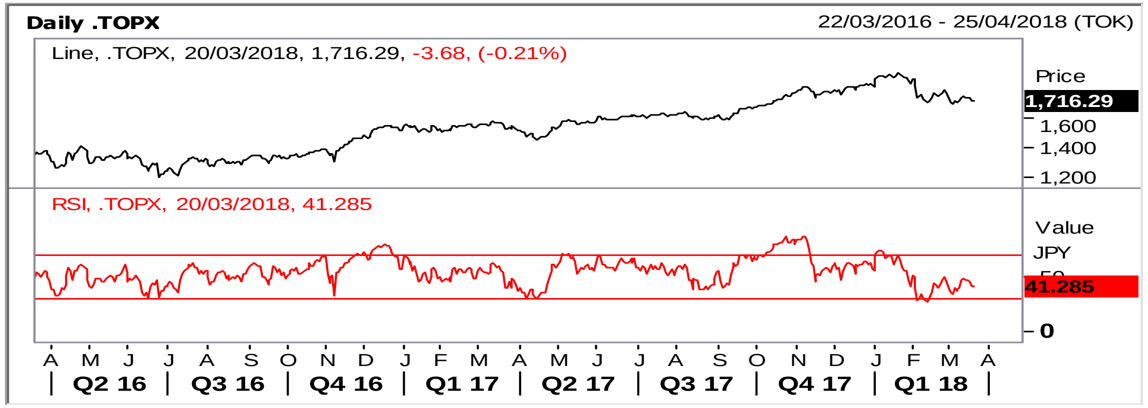
FTSE 100



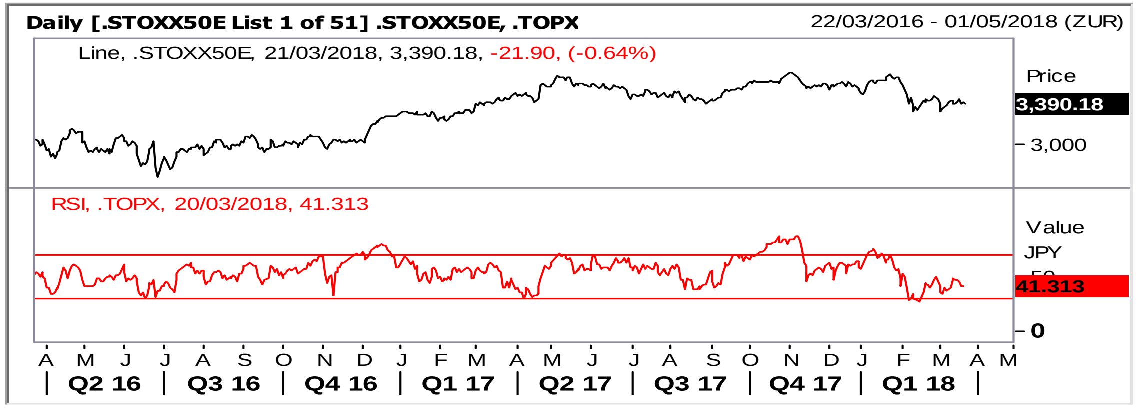
S&P500



Topix



EuroStoxx



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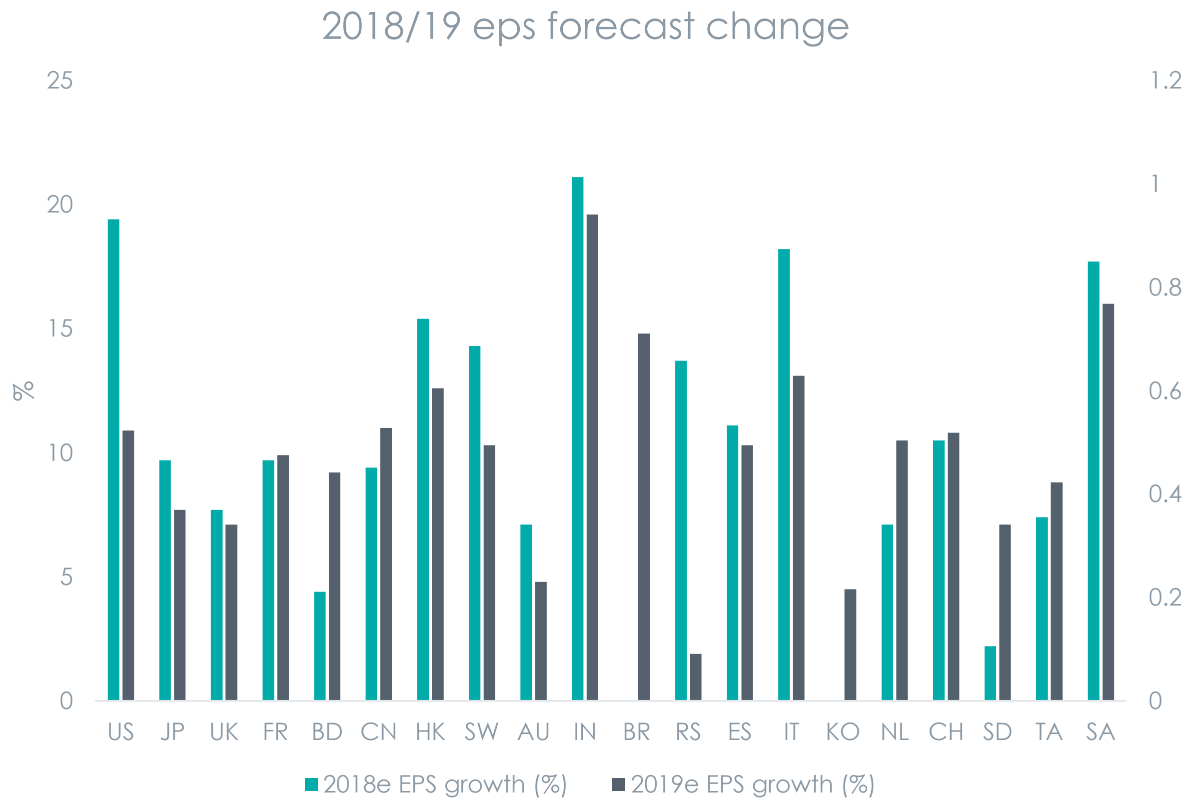
Source: Thomson Reuters, Tacit Investment Management

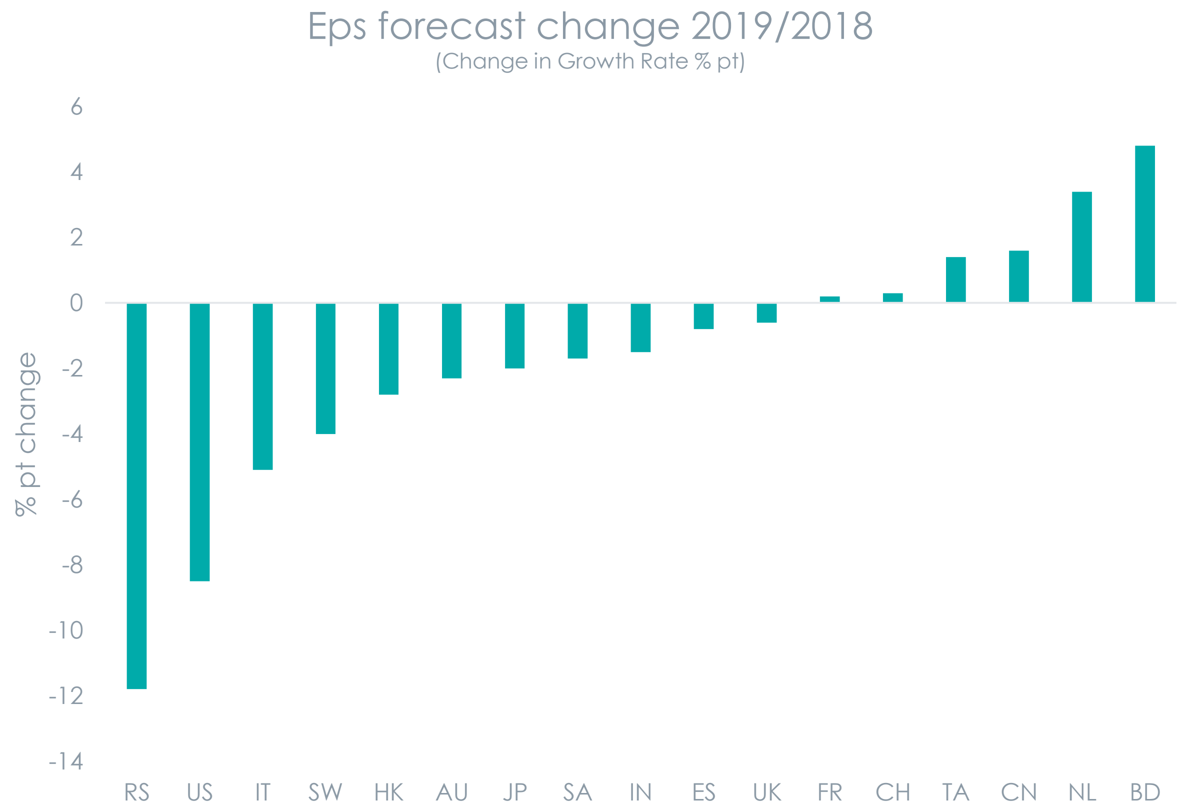
WORLD GROWTH / VALUATION

VALUE – ALPHA: EARNINGS GROWTH IS EXPECTED TO MODERATE IN 2019 AS COMPARED WITH 2018.

2018/19 EPS FORECAST CHANGE



EPS FORECAST CHANGE 2019/18 (CHANGE IN GROWTH RATE % PT)



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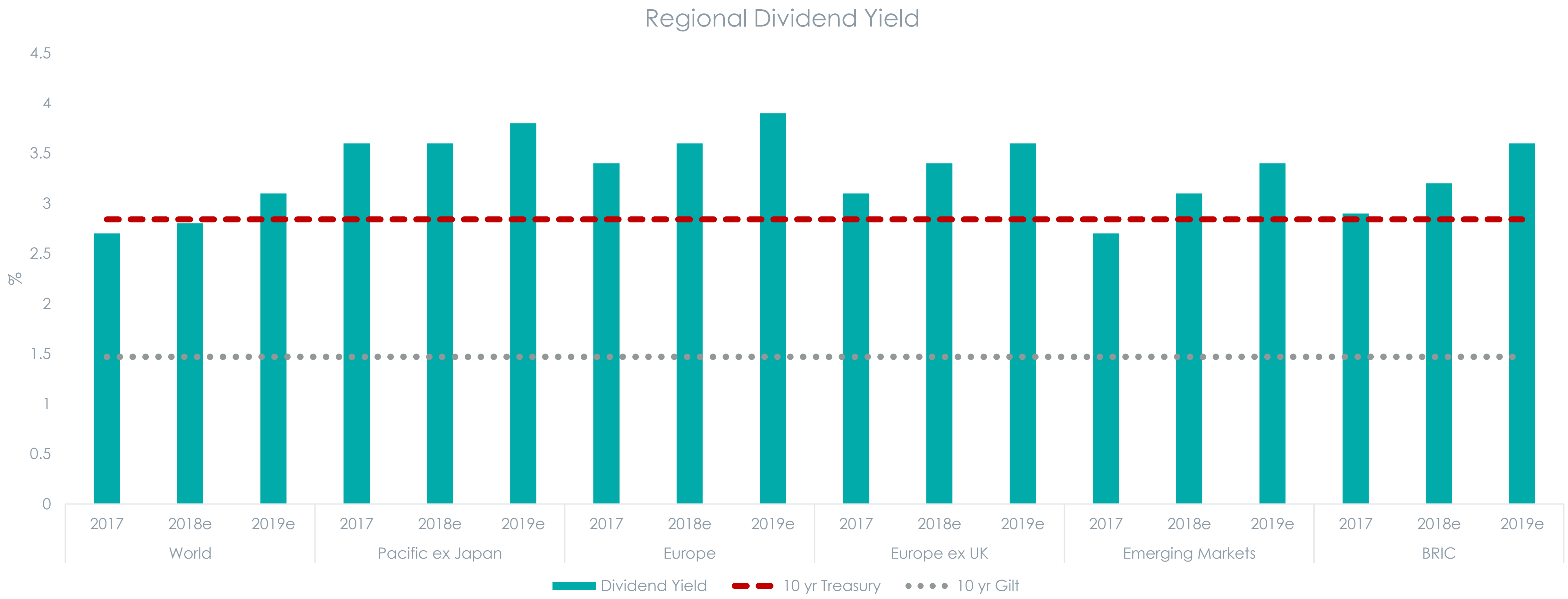
Source: IBES, SG Research, Tacit Investment Management

WORLD GROWTH / PRICE TO BOOK

VALUE – ALPHA: EMERGING MARKETS HAVE TENDED TO DERATE RELATIVE TO DEVELOPED AND ARE NOW CHEAP RELATIVE TO THE US AND EUROPE.

VALUE - ALPHA

10 year Treasury Yield now exceeds the World Dividend Yield



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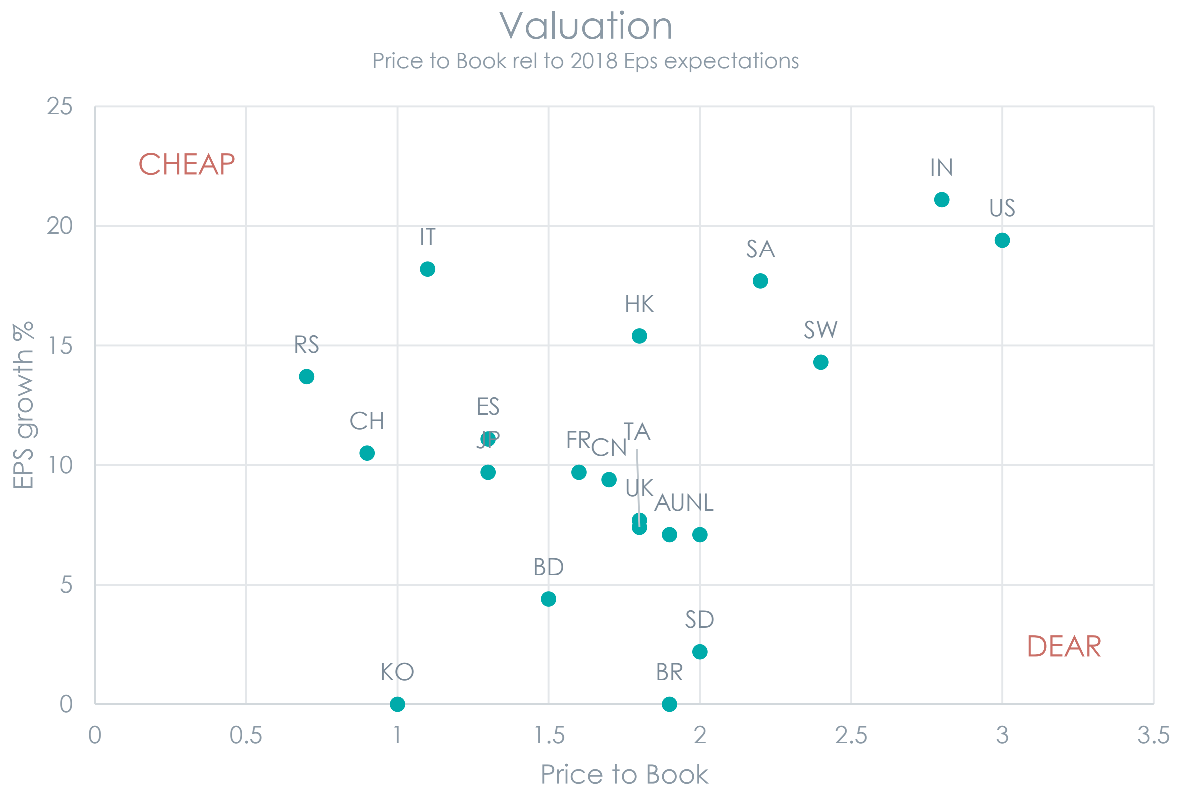
Source: IBES, SG Research, Tacit Investment Management

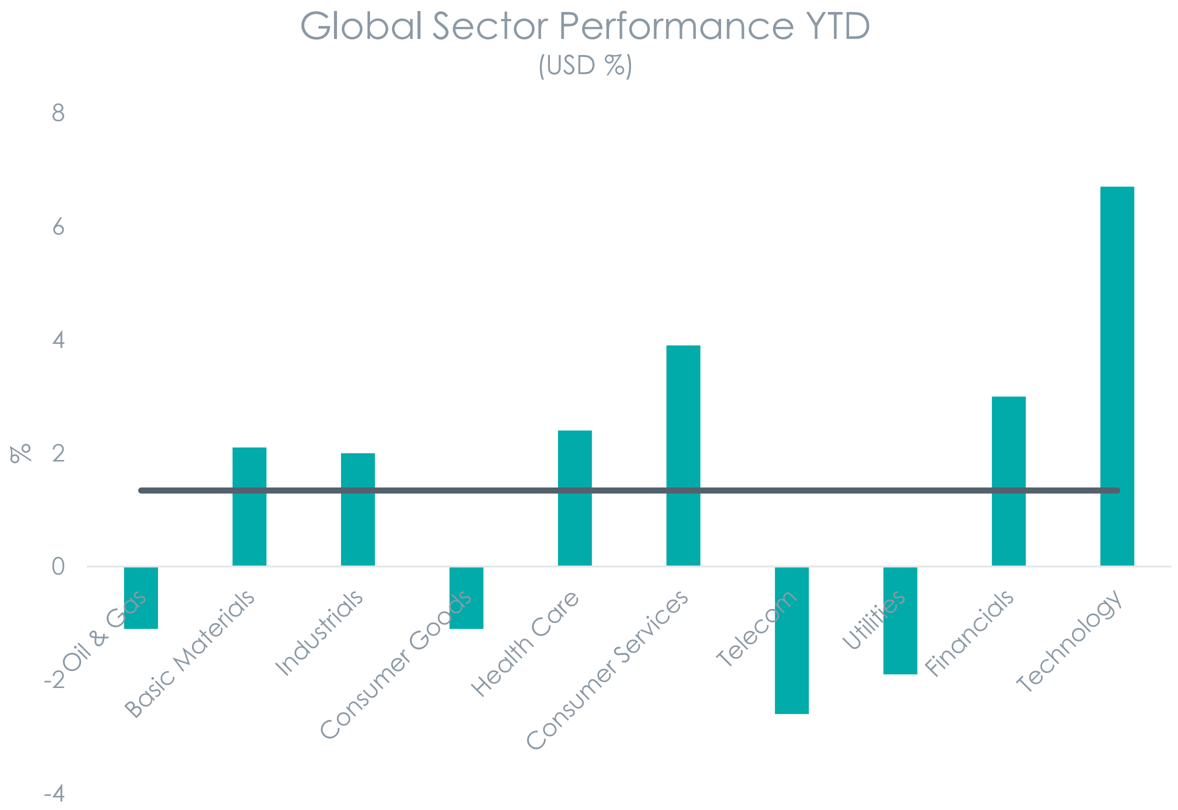
VALUE- ALPHA

INTEREST RATES SENSITIVE UNDERPERFORM GROWTH & FINANCIALS.

VALUATION



SECTORAL PERFORMANCE



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Source: IBES, SG Research, Tacit Investment Management

SUMMARY:

THE GLOBAL ECONOMY IS STILL IN EXPANSION MODE

- Bond yields and breakevens are beginning to anticipate the end of QE
- Stronger growth & higher inflation is key to a stable economic regime change
- As economies have recovered, distributional issues have come to the fore but there is some evidence of wage inflation
- Tightening labour conditions and higher rates will pressure inefficient “zombie” firms raising economy wide productivity
- Assets with a fixed coupon look unattractive but equities should be supported in a growth environment as long as Central Banks do not jump the gun and allow a rapid rise in real interest rates
- However, trade wars raise the possibility of slower growth and higher consumer prices – this would be a toxic combination for all risk assets

GROWTH / STABILISERS

EQUITY MARKETS REMAIN STRONGLY POSITIVELY CORRELATED ALTHOUGH JAPAN IS LESS SO THAN MOST AND EUROPE OFFERS SOME DIVERSIFICATION BENEFITS RELATIVE TO THE US. US TREASURIES & GILTS (NOT SHOWN) ARE KEY NEGATIVELY CORRELATED "STABILISERS," DESPITE LOW ABSOLUTE RETURNS.

	MSCI World $	MSCI Eur ex UK	FT Allshare	US Treasury	Dow Jones	S&P 500	Nasdaq	N225
MSCIWORLDU$	1	0.88	0.88	-0.36	0.93	0.96	0.9	0.63
MSCIEUROPEEXUKU$	0.88	1	0.81	-0.31	0.73	0.76	0.7	0.48
FTSEALLSHARE	0.88	0.81	1	-0.35	0.8	0.81	0.76	0.58
USTREASURY10YYIELD	-0.36	-0.31	-0.35	1	-0.43	-0.39	-0.36	-0.38
DOWJONESINDUSTRIALS	0.93	0.73	0.8	-0.43	1	0.97	0.88	0.56
S&P500COMPOSITE	0.96	0.76	0.81	-0.39	0.97	1	0.94	0.58
NASDAQCOMPOSITE	0.9	0.7	0.76	-0.36	0.88	0.94	1	0.57
NIKKEI225STOCKAVERAGE	0.63	0.48	0.58	-0.38	0.56	0.58	0.57	1

Source: Thomson Reuters Datastream, SG, Tacit Investment Management January 2016

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