HARPSDEN
WEALTH MANAGEMENT

Q4 December 2018 Commentary

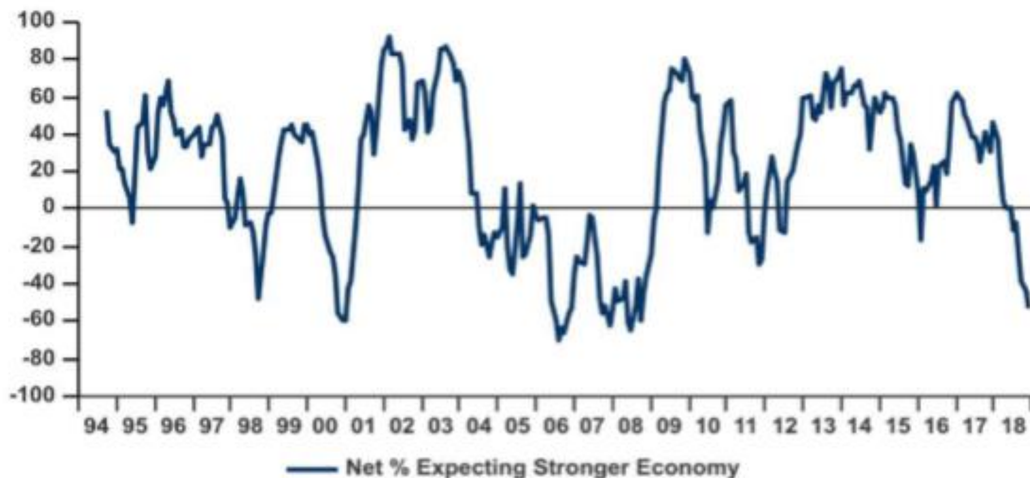
Macro Overview

''It's the politics, stupid'' perfectly sums up the last three months and indeed the year, just as Mr Clinton summed up well the angst of American voters as he first swept into the White House using the word economy instead of politics.

As the quarter progressed there have been increasing signs trade frictions are affecting global trade as well as business, investor and consumer confidence. From UK airlines and holiday companies to European car makers to US semiconductor companies and Chinese internet behemoths, we have witnessed a slew of companies at least partially blaming politics for short term travails.

The chart below shows how investor sentiment has followed markets lower year to date from the very high levels of 2017.

Chart A: How do you think the global real economy will develop over the next 12 months?



Source: Bank of America Merrill Lynch Fund Manager Survey December 2018

As you can see, pessimism has reached levels seen at the bottom of the 2001-02 recession. It should also be noted the line has also recovered from this level within twelve months, usually dramatically so.

Many commentaries have been written about how long this economic expansion has been and therefore a recession is just around the corner. I think this is very simplistic thinking that deserves critique. Whilst I wrote in my December 2017 Commentary that ''I fully expect investors to be talking about a meaningful slowdown in Chinese activity over the next twelve months'' and ''we should be

prepared for disruptions in all asset markets as these huge changes in ownership (due to the end of QE) take place'', I now think the pessimism is overdone.

Here is why. Only the Services part of the US economy has been in this unbroken uptrend since 2009. US manufacturing and almost all other parts of the global economy have had at least one meaningful slowdown since then. Asia, Japan and Europe have had more. Similarly, despite QE many parts of Asia and Europe have actually invoked tight fiscal policy at times over the last nine years.

Chart B below shows how sharply the global Purchasing managers Index dropped in 2015-16 and is indicative of the contraction. Chart C shows that the contraction in world trade over the period was on a par or indeed worse than what occurred in recent recessions ex-2008-09. So there is no ten year build-up of excess across the globe, although some specific idiosyncratic pockets are likely to exist.

Chart B: Global Purchasing Managers index of new export orders, January 2012 – February 2017

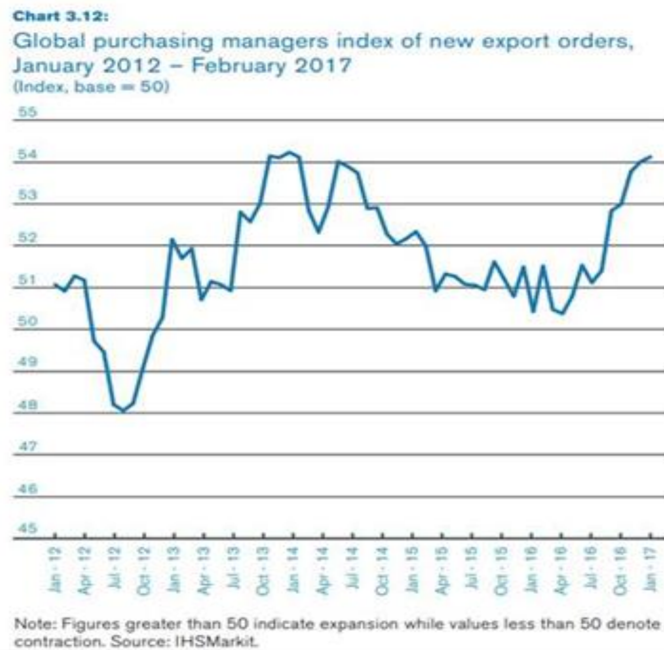


Chart C: Contribution to trade growth, in volume and unit price terms, 1981-2015 (per cent)

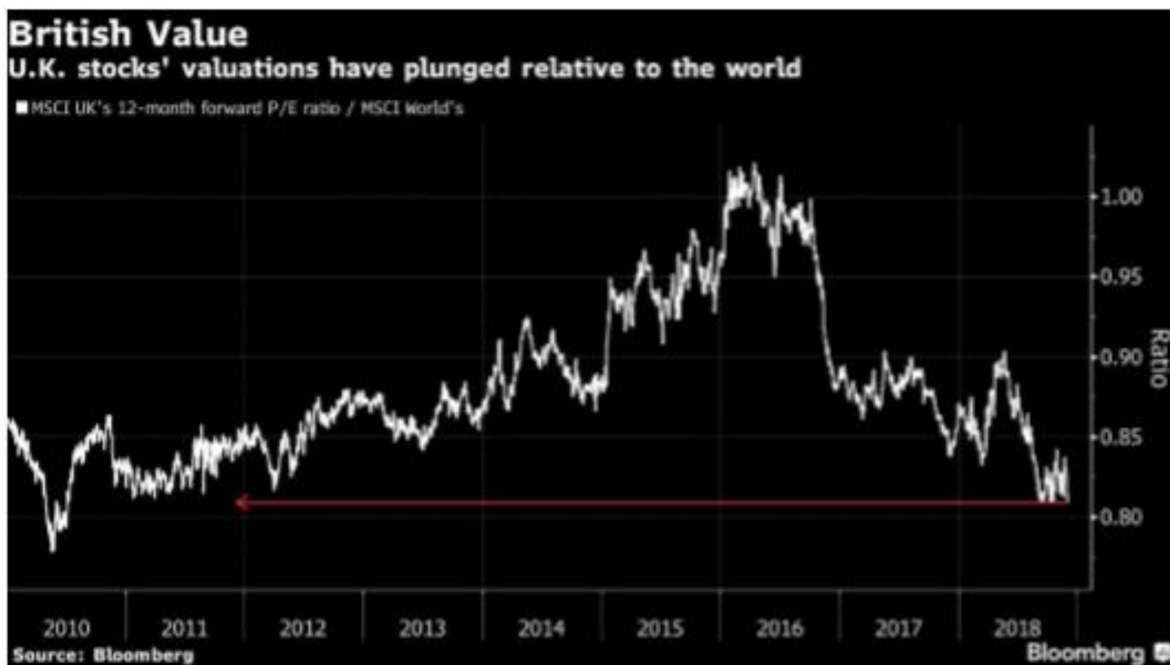
Source FT.

Markets

The quarter has been terrible for equities around the globe and commodities ex-gold were similarly beaten up as recession fever gripped investors. Despite ongoing wage acceleration government bonds performed their safe haven function, regardless of whether real interest rates were positive (as in the US) or negative i.e. Japan, Europe and the UK. Sterling has been weak, as one would expect given the political impasse and the Yen has once again been strong during tough times. The Dollar has not been as strong as expected due to consensus on future interest rate rises being pared back. This, as well as the overall risk off sentiment, has seen bond yields fall by over 30 basis points in both the US and UK.

As can be seen below, Brexit uncertainty has exerted significant downward pressure on the valuation of UK equity valuations relative to global peers. They have been cheap for a while now and we have been adding a little at a time throughout the year, with the exception of reducing just prior to the October sell off. This is especially true of less internationally focussed companies and many now can be bought on single digit PE ratios with yields significantly above their own corporate bonds. Given investor reactions over the last year it would be very presumptuous to assume such valuation gaps are going to change before we have increased insight into how Brexit will play out but when it does happen it is likely to be a very quick move given how much money has deserted the UK.

Chart D



The table below depicts the change in price of selected asset classes since 30th September to 27th December 2018.

FTSE 100	-11.57%	**Euro : £**	+1.63%
S&P 500	-14.29%	**Euro : US $**	-1.53%
CAC 40	-15.97%	**Yen : £**	+5.89%
DAX 30	-15.23%	**US $: £**	+3.20%
Hang Seng	-8.06%	**UK 10 Year Gilt Yield**	- 28 Basis Points
NIKKEI 225	-16.76%	**US 10 Year Bond Yield**	- 35 Basis Points
Brent Oil	-33.62%		

All prices are in local currency.

Activity & Positioning

We have been active this year as volatility has returned to financial markets. Depicted below is the way we have dealt with the volatility.

As you can see we have stayed true to the intention we set out at the beginning of the year whereby we generally trimmed positions as markets went up and added when they fell. As markets were weakest in Q4 we will end the year with more in equities than we had at the end of 2018, as shown below. This seems logical to us and follows our thought process that volatility, both up and down, provides opportunity.

Chart E: Equity allocation in Harpsden portfolio strategies

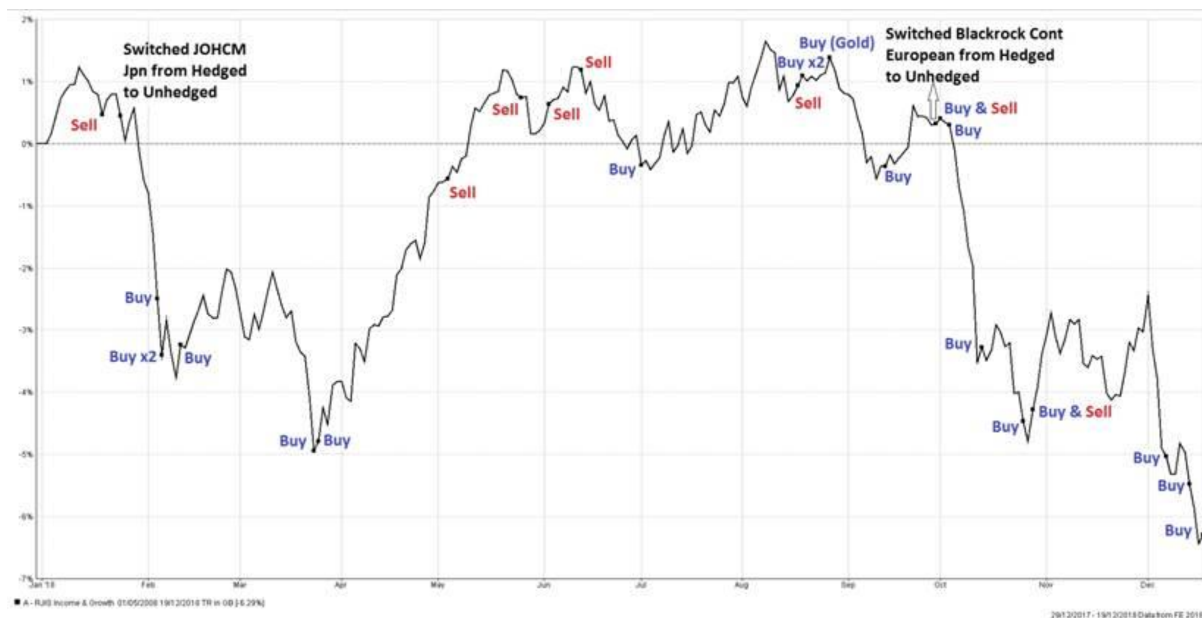
Portfolio	Growth		Income & Growth		Income	
Timeline	1 year ago	20.12.18	1 year ago	20.12.18	1 year ago	20.12.18
Equities	70.50%	80.75%	61.00%	70.75%	50.50%	54.25%
UK Equities	22.50%	32.25%	22.00%	28.75%	33.50%	33.25%
Cash	20.50%	8.25%	23.00%	12.50%	25.00%	21.75%

Source: Harpsden Wealth Management

Our internal portfolio parameters limit our exposure to equities at 85%, 80% and 60% for Growth, Income & Growth & Income respectively.

Given the extent of the volatility we tended to add in smaller increments but as of the time of writing (December 20th) equities are at their lows so buying has not borne fruit as yet.

Chart F: Harpsden Income and Growth Buys and Sells



Source: Harpsden Wealth Management

The above chart relates to the Harpsden Income & Growth strategy only but is indicative of what we have done across all our portfolio strategies. The two Buys in August were due to the fact we took profits in the outperforming and more highly valued US market and bought two smaller positions in the UK and Asia with the proceeds. Switching Japan and Europe to unhedged was to protect clients against a collapse in Sterling if investors took a dim view of Brexit developments.

However, with the UK, France, Germany and Italy increasing Fiscal spending next year, China easing policy considerably and the pace of US rate increases to moderate we remain confident this policy will prove correct over the coming year. As shown above, UK equities have been de-rated as foreigners deserted en masse. We have gone from underweight to neutral and would like to be considerably more exposed as many well capitalised, dividend growing companies are on multi-year low valuations. However, even though we feel strongly this value will out over time in any scenario, we are proceeding very slowly until we receive clarity on our future relationship with Europe. However, even a crash out is not the shock now it would have been twelve months ago so I would imagine the negative impact on financial markets to be short lived, even if it is quite sharp on a knee jerk basis.

In many ways investors and markets are positioned the polar opposite of last year. Back then market levels and sentiment were sky high and retail investors were pouring money into equity funds. Now we have seen sustained outflows from equity funds with December witnessing the second biggest weekly outflow on record from US equities, whilst Europe has suffered six consecutive weeks of redemptions and over $20 billion has been taken from UK funds since Brexit. US Money Market funds, on the other hand, enjoyed the biggest weekly inflows since 1992. It will be no surprise then that Investor Sentiment (AAII Bulls: Bears) is at its lowest level since 2009 and the word ''recession'' is being picked up on internet traffic more than at any time since just after the collapse of Lehman Brothers (*Source Raymond James*). Yet in the real world all that is happening (ex UK) is that growth is slowing from unsustainably high levels (US, Europe and Japan) or is being engineered lower (China and even there they have stopped this process). Italy has also managed to reach a compromise with the EU over the Budget so there is light at the end of the tunnel. Investors have also largely ignored

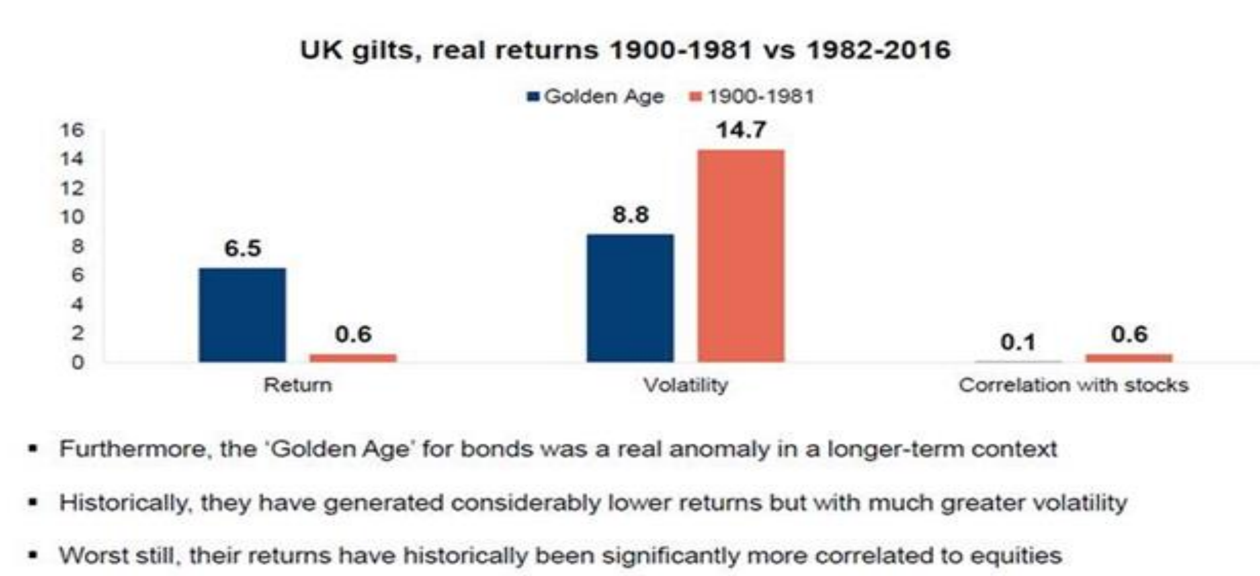
the production cut agreed by oil producers and the beneficial impact on consumers' purchasing power from the oil price decline already seen.

For many years we have been positive on dividend compounding equities as the long term solution to generating adequate risk adjusted returns and been bearish on gilts for just as long. The Charts below highlight why we think Gilts are far less compelling now than they have been and also why Government Bonds in general should not be considered absolutely risk free.

Chart G: Why Neptune Asset Management favour equities

Source: Neptune Asset Management

Chart H: Bond Risk Statistics: 'Golden Age' vs. 1900-1981

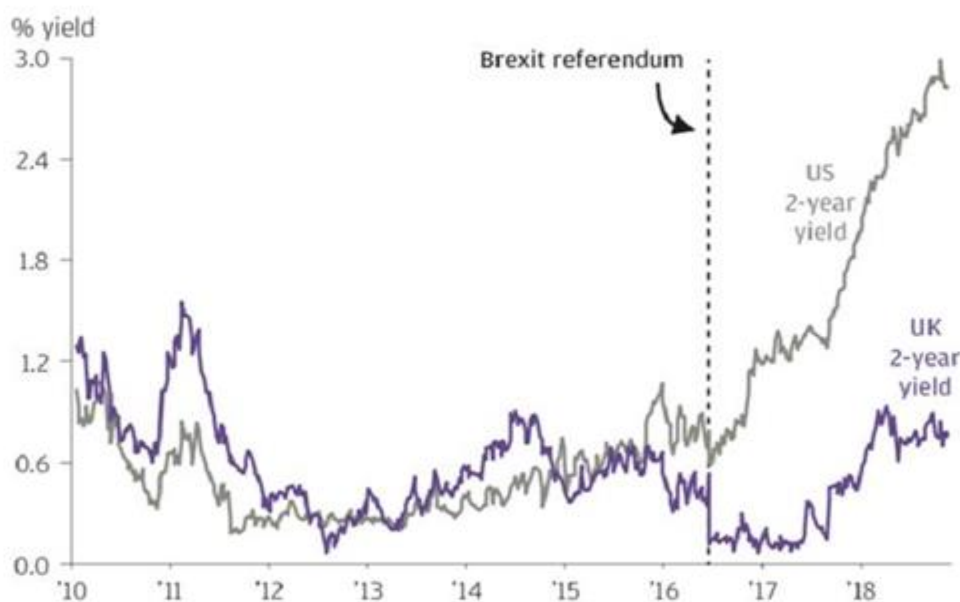


Source: Neptune Asset Management

Similarly, we can see below how the UK Gilt usually tracks the US Bond yield. We can see this stopped post the Brexit vote and broke down further as the US began to unwind QE. We will have more clarity on Brexit post March and Europe has now ended QE so we feel strongly that as 2019

progresses both European and UK Government Bonds will act like the US Bond has in the last 18 months.

Chart I: US and UK Government Bond Yields



Source: Thomson Reuters Datastream, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results. Data as of 30 November 2018.

Harpsden Ethical Strategy - update

Up until May, the Ethical strategy was in line with the sector and the competition, however, in the following period performance has lagged. This underperformance has been largely down to the UK Mid-cap bias in the portfolio, as well as the structural bias (present in most ethical funds) away from defensive areas such as Tobacco, some Consumer Staples and several of the Healthcare stocks. Traditionally defensive sectors are negatively screened out of ethical portfolios for reasons such as causing harm to human health, their carbon footprint and animal testing. Furthermore, we were unable to replicate our core position in Gold in our Ethical strategy, due to the uncertainty associated with extraction. Since we bought into the Gold fund, it has risen by more than 5%, the MSCI World in that time has fallen more than 12.5%, so this has been a considerable drag on performance.

Despite this period of underperformance, we believe that the portfolio is set up well for 2019 and we are constantly working on improving the strategy. We believe that there is room for economic growth to surprise on the upside and UK domestic facing mid-cap companies could benefit from some clarity in Brexit negotiations. This should put our selection of UK Ethical funds in a strong position moving into 2019.

In addition, we believe ethical investments should be considered over a longer term time horizon. Given they are light on defensive sectors we would expect the portfolio to suffer in periods such as this. However, the shift towards sustainability in the ethical sector and in companies across the world is happening. By definition sustainable companies should be the ones that prosper over the long term, and we believe that investing in ethical funds will, in the long term, provide us with strong financial returns, as well as having a positive effect on society.

Having a positive effect on society is something that we are working on furthering in our Ethical strategy. We believe that positive screening, rather than just excluding bad companies, encourages a

forward looking view and we have invested accordingly. We have added the WHEB Sustainability Fund, which attempts to have a positive impact on the world, so much so that you can visit their website and measure the impact of your investment for yourself. The growth in the sector means we have an ever increasing universe of funds to invest in. Examples include Positive Impact funds, as well as thematic funds that target companies who provide solutions to specific UN Sustainable Development Goals (SDGs) such as climate change, water scarcity and food & agriculture.

Harpsden Portfolio Strategy	Bought	Sold
90% Equity	3% Polar Capital North American 2% JOHCM UK Equity Inc	2.5% First Trust US Equity Inc ETF
Growth	1.5% Jupiter India 2.5% Neptune Japan Opps 4% Polar Capital North American 2% JOHCM UK Equity Inc 2% Invesco Asian Fund	2% RWC Nissay Japan Focus 1.5% Artemis Income 2% Allianz US Short Dur High Yield
Income & Growth	1.5% Jupiter India 1.5% Montanaro UK Income 2.5% Neptune Japan Opps 4% Polar Capital North American 1.5% Schroder European Alpha Income 2% JOHCM UK Equity Inc 1.5% Invesco Asian Fund	6% Artemis Income 2% Allianz US Short Dur High Yield
Income	2% Polar Capital North American 1.5% Schroder European Alpha Income 1.5% JOHCM UK Equity Inc	3.5% Artemis Income 2% Allianz US Short Dur High Yield
0-35% Equity	Nil	Nil
Ethical	Nil	Nil

Conclusion

In conclusion we opine that we are likely to see positive returns for 2019 with volatility lying somewhere between the low of 2017 and the high levels witnessed in 2018. And again I would like to remind everyone that even in years with strongly positive returns it is not out of the ordinary to suffer one, or even two, meaningful declines within this uptrend; this is just the normal wax and wane of liquid financial markets.

As demonstrated above, there is a palpable fear of recession out there as investors remain scarred by the memories of 2008-2009 (which was an existential crisis of the type that are very infrequent). This fear is highlighted even more by the dramatic underperformance of anything considered sensitive to economic activity and the corresponding massive outperformance of assets considered impervious to such, even ones where their outlook is under secular threat e.g. several consumer staple and utility companies.

So we think cheap valuations, overwhelming gloom and more stimulus from governments ex-US will make 2019 a more benign year. Our confidence is further boosted by the fact Mr Trump's beloved stock market has lost its immunity to trade and political woes, so he will need to engage with China et al in a way more supportive of US businesses.

As an optimistic outlook from a Scotsman is a rare moment I will end it there and look forward to a more profitable year ahead.

Best Regards

Ian Brady
Chief Investment Officer
28th December 2018

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Current Asset Allocation

Asset class	90% Equity	Growth Strategy	Income & Growth Strategy	Income Strategy	0% to 35% Equity	Ethical Strategy
Property	**0**	**0**	**0**	**0**	**0**	**0**
Cash/Dollars/€	**3.5**	**8.25**	**12.5**	**21.75**	**15**	**20**
Fixed Interest	**0**	**3**	**10**	**16**	**32**	**20**
High Yield	0	0	0	3	6	0
Index Linked	0	0	0	0	0	0
Corporate/Strategic	0	3	10	13	16	20
Government	0	0	0	0	10	0
Equities	**90**	**80.75**	**70.75**	**54.25**	**37.5**	**60**
UK	40	32.25	28.75	33.25	19.5	41
North America	18	17	13	9.5	0	0
Europe	8	9	10.5	5.5	4	0
Asia (excl Japan)	0	9	6	2	3	6
Japan	14	9	10	4	3	0
International	0	0	0	0	0	13
Emerging	10	4.5	2.5	0	0	0
Global Low Beta	0	0	0	0	8	0
Energy	0	0	0	0	0	0
Commodities	**1.5**	**1.5**	**1.5**	**1.5**	**1.5**	**0**
Gold	1.5	1.5	1.5	1.5	1.5	0
Absolute Return	**5**	**6.5**	**5.25**	**6.5**	**14**	**0**
Total	**100**	**100**	**100**	**100**	**100**	**100**

Important Information/Risk Factors:

Past performance is not a guide to future performance and investment markets and conditions can change rapidly. Investments in equity markets will be more volatile than an investment in cash or fixed deposits. The value of your investment may go down as well as up. There is no guarantee you will get back the amount invested. If you fund invests in overseas markets, currents movements may affect both the income received and the capital value of your investment. If it invests in the shares of small companies, in emerging markets, or in a single country or sector, it may be less liquid and more volatile than a broadly diversified fund investing in developed equity markets.

The views expressed herein should not be relied upon when making investment decisions. The article is not intended as individual advice and if you require advice or further information you should contact us.