FINANCIAL PLANNERS
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lumin Wealth Management

Investment Review

July 2018

Contents

Introduction

As per always, plenty of interesting developments and events around the world over the course of this last quarter. A definite highlight though undoubtedly being the much anticipated coming together of two people from different countries and very different backgrounds – one from a long lineage of leaders, the other having made their name on television.

After a vast amount of very careful preparation, in front of an expected global audience of hundreds of millions and amid exceptionally tight security at a location away from the City centre, the world watched and waited for that first physical contact that would confirm the harmonious relationship between the joyous couple.

And so it was that Prince Harry and Meghan Markle thrilled the assembled crowd and worldwide television audience on the 19th May with a kiss on the steps of St Georges Chapel in Windsor. And so it was also that just over 3 weeks later on the 10th June, Kim Jong Un and Donald Trump shook hands in front of the world's media on the Singapore resort island of Sentosa. Two very different occasions, both hopefully though with the same happy and lasting outcome. The sun shining brightly on both occasions suggesting divine approval at least.

The latter event represents an unthinkable outcome to a story that has long been in the making with relations between the two principal characters sinking to what appeared an irretrievable low in September last year when Trump described Chairman Kim as 'little rocket man' and Kim described Trump as 'the mentally deranged US dotard' – not your usual diplomatic language!

Whilst this was an unthinkable outcome and very welcome (albeit early days) to a potential risk issue that we have talked about in earlier investment reviews, developments relating to two other risk issues that we have previously flagged have taken a marked turn for the worse.

For a while now, we have cautioned about the massive growth in emerging market (EM) debt since the global financial crisis, a lot of it US dollar denominated. Less of a problem in 2017 with the dollar weakening throughout the period, adding to a favourable environment that saw EM equity soar by 25%. But the recent sharp recovery in the dollar's fortunes combined with continuing US interest rate rises have conspired recently to spook debt markets in some highly leveraged EM countries, Argentina and Turkey in particular suffering a massive spike in the cost of their sovereign debt and a collapse in their respective currencies. A sign of things to come or isolated incidences – we discuss further in Market Developments.

Similarly, we have cautioned in recent quarterlies about the potential risk associated with an election in Italy. This took place in March and despite the outcome being every bit as bad as feared in terms of two populist groups trouncing the prior establishment party, we noted in our last quarterly that "markets have thus far greeted the election result with remarkable calm". This however, came to an abrupt halt when in late May, President Mattarella vetoed the appointment of a Eurosceptic finance minister, forcing the country's populist prime minister-in-waiting to abandon attempts to form a government. This has plunged the country into fresh political chaos with the prospect of a new election that many now fear inevitably becomes a referendum on continued membership of the EU. More on this again in Market Developments.

Both of these two occurrences have had a detrimental effect on the investment appeal of their respective asset markets. They are good examples though of the importance of proactively positioning portfolios rather than reactively responding to events as they unfold.

Whilst both have been a while in gestation, the negative consequences when they come, come quickly and faster than investor portfolios can act upon. We would reiterate the point therefore that whilst we cannot predict precisely when risks become reality, we can prepare and that in an era when market response to news appears ever quicker and ever more pronounced, better to move early than to move late and be trampled in the stampede.

At the same time, the fickle nature of investor sentiment towards any one market or asset class reinforces the attraction of broadly diversified portfolios that, helped by regular rebalancing back to carefully considered long-term strategic asset allocations, ensure that investors avoid being overly exposed to any single market risk. This is our approach at Lumin and the method by which we seek to deliver strong returns to our clients over the long term.

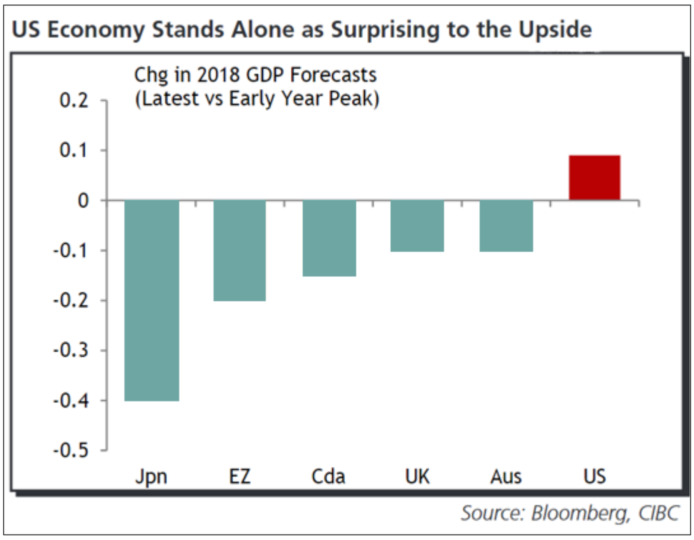
We hope that you enjoy reading our thoughts here and as always, please do get in touch with any questions you may have.

Yours Sincerely,
The Lumin Wealth Team

In this quarterly, rather than adopting our usual practise of traversing the world's principal asset markets by geography, we will instead divide up this last quarters major developments into just three areas; currencies, politics and tariffs. The first two ever present but with significant and impactful consequences over the period, the third thankfully absent for many years but again now raising its ugly head and with the power to cause severe economic disruption.

Currencies

A lot of the market action witnessed over this last quarter has its roots in significant currency moves. Most notably, a reversal in the US dollar's (USD) fortunes after a period of weakness from late 2016. This reflects the way in which the US economy has pulled away from others, with Trump's much vaunted tax cuts providing a late turbo boost. Macro surprise data (of outcomes vs forecasts) shows every country and region other than the US missing expectations.



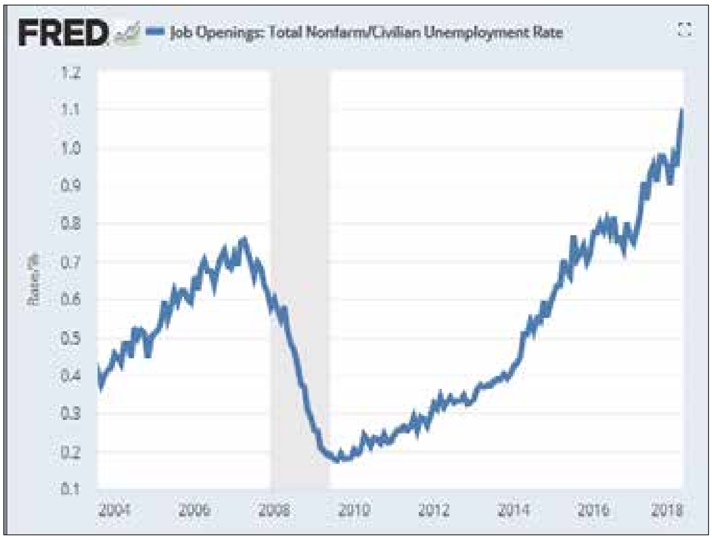
Source: Bloomberg, CIBC

The base economic data highlights that regions of the world are at different stages of the cycle, meaning that global central bankers are no longer singing from the same hymn sheet, increasing the risk of policy error. The Federal Reserve (Fed) has let it be known in unequivocal terms that policy will not be deflected by the consequences of their action (on currencies primarily) on the rest of the world – adopting the 'America First' mantra of the President. They are intent on pressing ahead with the normalisation of monetary policy, simultaneously cutting rates and shrinking the FED's balance sheet, for the purpose of providing some ammunition next time the economy goes into recession.

The urgency is understandable. A number of indicators suggest that this may be as good as it gets before an overheating economy rolls over and heads for the next recession.

Corporate earnings growth (boosted by the tax cuts) is forecast to have peaked in the first quarter, the yield curve is the closest it has been to inverting (traditionally the very best leading indicator of impending recession) since before the global financial crisis (GFC) in 2007, a FED gauge of underlying inflation reaching the highest point in 13 years and the number of job openings has never been higher.

Ratio job openings to unemployed – more than one job opening per each unemployed person



The USD has strengthened versus the euro as the Eurozone economic recovery shows signs of stalling. Composite PMI (a good leading indicator) data has been poor reflecting weakness at the core of the region, Germany in particular seeing business conditions deteriorate since the start of the year (see fig 1 on page 5))

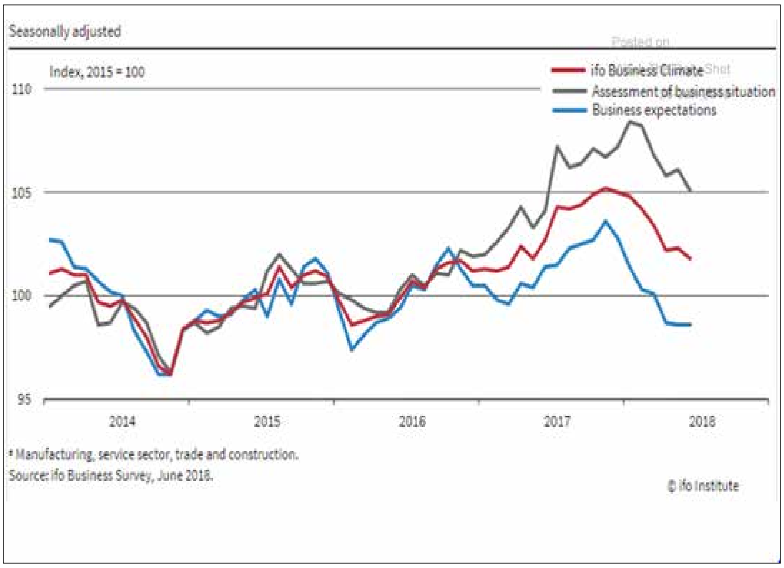
Hopefully this is a delayed reaction to last year's relatively strong euro with the weakness seen over the last quarter being a good thing for a heavy export economy like Germany, enhancing its competitiveness on the world stage.

In contrast, weakness in EM (emerging market) currencies versus the dollar is a bad thing. As we have warned before, much of the growth in EM economies since the GFC has been credit fuelled. The Bank for International Settlements estimates that offshore dollar debt has jumped five-fold to $11 trillion since the early 2000s, plus a further $13 trillion in derivatives (financial securities priced off an asset). [Note: there is some debate about the precise numbers, suffice to say they are large.] Much of it borrowed by private companies in East Asia, Latin America and such places as Turkey. As the dollar rises relative to the local currency, the already large liability is further exaggerated (See Fig 2)

Argentina and Turkey have been badly hurt in this latest quarter and the concern is that they are the tip of the iceberg and that other heavily indebted EM countries with unreformed economies and/or unhelpful politics will suffer a similar fate. To protect their currencies, several have been forced to increase rates to levels that would otherwise be inappropriate, so making financial conditions even worse. We warned in January that 'Wall Street strength and dollar weakness in 2017 represented something of a Goldilocks scenario, but the reverse is not impossible in 2018.' Only the latter of these has happened (so far?) but EM equities have been weak and outflows large.

Finally to sterling. Strong versus the USD in the first quarter, it has since mid-April tumbled: the flip-side of dollar strength but also frustration over the seeming lack of progress on Brexit. Currency weakness is a good thing for UK equities given 70% plus of FTSE100 revenues are earnt abroad - indeed the index has performed well over quarter two. We remain positively pre-disposed towards the UK: it has underperformed, it is unpopular (big international outflows), it is relatively defensive (large value component, smaller in technology and cyclicals) and has a big exposure to commodities, oil in particular through titans Shell and BP [see Oil note later].

German Business Climate - Fig 1



JP Morgan Emerging Market Currency Index - Fig 2

Politics

Major asset markets have shown remarkable resilience over recent years to the many and varied political shocks thrown at them. The stakes are getting higher though and there are two big unresolved political issues that face markets near term, notably Brexit and Italy.

First though to the US where Trump is noticeably gearing up for mid-term elections in November, the tone of his aggressively 'America First' tweets playing to the crowd. It was with an eye to the mid-terms that he was so keen to secure the meeting with Kim Jong Un and to come away with an agreement big on promises (albeit short on detail) that he could showboat in front of an American audience as evidence of the success of his own unique style of global diplomacy. The Mueller probe into possible collusion between Trump and the Russians is yet to report and could still deliver a hammer blow, but for the moment the Trump White House appears on a slightly less chaotic footing.

And so (reluctantly) to Brexit. We have deliberately avoided talking about this in previous reviews because we doubt that we can add much to the sum total of monumental debate already expended on the subject and moreover, with seemingly so little progress, what is there to talk about?

Sadly, we cannot avoid the fact that the crunch point is rapidly approaching with a detailed plan of the future relationship with Europe needed to be presented and agreed upon by the time of key EU summit in October or, more likely, December. The Irish border a particular sticking point at present.

With PM May struggling to find agreement amongst the 21 ministers in her own cabinet, expectations for agreement with the 27 countries of Europe cannot be high. Bearing the brunt of bad case scenarios would be sterling and whilst to an extent a weak currency is good for our big businesses, a proper run on the pound would force the Bank of England to step in and restore some order via interest rates, with negative consequences for consumers and small business.

We have long cautioned about the political situation in Italy. President Mattarella's rare intervention to block Prime Minister designate Conte's pick for economy minister leaves the country without a government – they have had 64 since the last war. The loose populist party coalition though has still managed to say enough to upset the EU, threatening increased spending and tax cuts that would put them in further contravention of the rules.

The fear is that the next election becomes a referendum on EU membership with the populist coalition depicting the EU as the bogeymen barring them from doing what the people want. 'The way things are going' wrote Jeremy Warner in The Telegraph 'Italy could be out of the European Union before Britain.'

Italy is a far bigger issue for the EU than Greece, it is 'too big to fail, too big to bail.' It has the third largest bond market in the world, one of the highest debt to GDP ratios anywhere and colossal liabilities to the rest of Europe (Germany primarily) via the Target 2 payment system of €465bn. This latter a technical accounting adjustment as long as the euro holds together but would become payable if Italy was to leave. Problems for Merkel in Germany and Spain's new interim socialist government are to be watched carefully but are for the moment sideshows to the main event in Italy. Reflecting our concerns here, we trimmed our European equity exposure in the April rebalance.

Tariffs

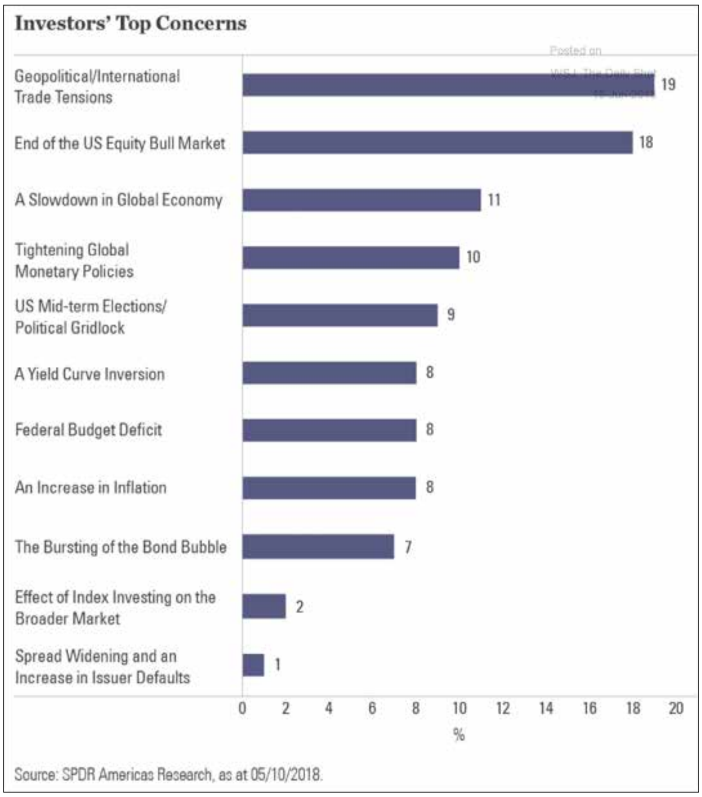
What felt at the start of the year like an empty threat from a President posting a typically combative and off-the-cuff tweet has morphed into becoming investors current top concern. (See Fig 3)

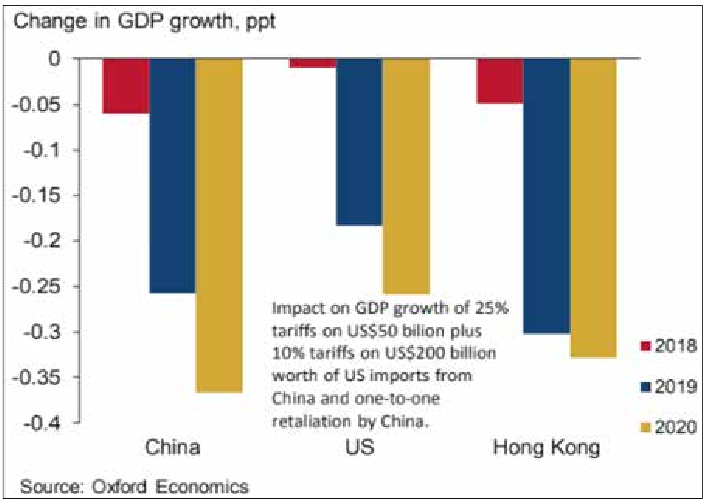
As we write, the US has just started imposing tariffs on $34bn of imports from China triggering the imposition of an equal amount from Beijing as the nascent trade war between the world's two largest economies gets serious and ugly. Add to this the tariffs and counter-tariffs imposed on neighbours Canada and Mexico and with the EU and the scale of the tariffs so far launched has already passed the $100bn mark. But it does not end there. Angered by China's tit-for-tat response, Trump has targeted a further $200bn of imports for a 10% tariff to which China has vowed to respond in kind. At these levels, the impact on growth becomes material (See Fig 4)

Dialling up the pressure further still, Trump now has imported cars and car parts in his sights, citing the interests of 'national security' as reason to target an estimated $600bn of global trade in this area – his tweet proudly labelling this 'the big one'. It would indeed be big for the German luxury car brands, BMW alone facing a 5 to 10% additional charge on a $8 to $9bn revenue stream.

It is no wonder then that the World Bank warn that a global trade war would have a 'devastating' effect on economic growth, with particularly severe consequences for emerging markets. This comes at a time when global growth is already moderating.

Fig 3





Economic impact of tariffs on $250bn imports - Fig 4

Conclusion

As you can see, plenty going on, plenty to worry about. But it is not all bad and World economies have traditionally found ways of muddling through and avoiding the worst-case outcomes. We are though 9 years into an economic recovery, the second longest in history (will become the longest mid-August) and there is a sense that some of the disruptive influences we talk about are being dialled-up. Accordingly, it feels right to be taking an overall more cautionary stance, exposed still to growth assets but judiciously shifting the balance of the portfolios to security and safety. Hoping for the best but preparing for the worst.

Equities

WHAT WE THINK

Plenty going on around the world in this second quarter. In general terms, we feel that developments witnessed in key areas such as currencies, politics and tariffs further challenge a continuation of the broad asset market recovery enjoyed since the global financial crisis in 2008. We remain therefore, relatively cautious on the outlook for global equities and stick with our tactically underweight position relative to a long-term strategic benchmark.

We continue to be concerned about the rich valuation attached to the key US market. Trump's much vaunted tax cuts have boosted company earnings in the short term but not enough to offset near-peak levels of valuation by virtually whatever measure chosen. We are particularly concerned about the narrowness of performance with practically all this year's increase in the S&P 500 coming from the FAANGs (Facebook, Apple, Amazon, Netflix and Google). To reiterate, these are good companies, it is just the extreme levels of expectation built into their share prices leave zero room for disappointment.

In contrast, we are tactically more positive on the relative attractions of the UK equity market. The constant hum of Brexit anguish gives ample reason to be bearish, but we suggest a quantity of this is already reflected in relative underperformance and big outflows since the June 2016 referendum. In addition, a weak pound tends to be positive for the highly international FTSE100, the market is relatively defensive (a large value component, smaller in technology and cyclicals) and has a big exposure to commodities and oil in particular, where we have a positive view.

WHAT WE HAVE DONE

Our tactical liking of oil has prompted us to add modestly to the JPM Natural Resources fund on Lumin 50, 70 and 90 and introduce a new position on Lumin 30. We have funded this out of exiting (on Lumin 30 and 50) or trimming (Lumin 70 and 90) the position in Third Point Offshore Investors, a hedge fund that can take both long and short positions (the latter does well if the price falls) in global equities. A good long-term track record has proved more challenging of late, failing to justify the relatively higher cost of owning the fund.

The move to exit Third Point on some portfolios together with action elsewhere (and covered below) have together helped to modestly reduce the number of funds held on some portfolios where there has been an element of holdings creep over time; Lumin 70 for instance falling from 23 to 21. In contrast, Lumin 10 which had just 14 holdings now has 15. Broadly also, these actions will have helped marginally to reduce total fund costs.

Fixed Income

WHAT WE THINK

More of the same really in fixed income world. The US will carry on with rate rises as the incoming data is pushing the FED that way and despite Trump and his cohorts imploring them not to ahead of the November mid-terms. The latter is an unwelcome (although not wholly unexpected) development and markets do not like it when politicians attempt to cut across central bank independence.

Overall, we expect the key 10 year US Treasury yield to push through the symbolic 3% level in the near-term and carry on edging upwards which will prove painful for large tracts of the economy and move the US ultimately towards recession.

In the UK, we believe that the Bank of England wants to raise rates and are trying to look through soft data in the first quarter in the expectation of a bounce in the second and third quarters from the weather and football. [Yes, read that again, 'weather and football' – both better than expected which must surely represent some kind of first!]. We suspect then that there will be an imminent rate rise but only one as Brexit concerns and dull data result in a pause thereafter. Gilt yields will likely push a bit higher but not by much.

Credit spreads (the yield premium over the equivalent government bond) have broadened out a little, particularly in financials, and there has been some softness in the high yield (higher risk of default) market but absent a recession, we expect prices to remain range-bound.

WHAT WE HAVE DONE

The fixed income components of our portfolios are untouched in the quarter. We are increasingly attracted to the yields available in the US treasury market but they are still shy of what is required once currency risks and/or hedging costs are taken into account.

Property and Alternative Trading Strategies

WHAT WE THINK

These two asset classes represent areas of our portfolios that we have sought to gradually build up over recent quarters as we have become more cautious on the attractions of the two principal asset classes of equities and bonds as valuations have become ever more stretched.

We have noted before that property is typically less volatile and also carries an element of inflation protection. The sector faces a number of challenges, most obviously in the retail space as the shift to online is sadly leading to a continuous stream of high profile retailers (and with them restaurant chains) going into liquidation or announcing multiple shop closures. There are though still pockets of opportunity for property managers, for instance in the emerging 'gig' economy and the conversion of office space into residential.

The appeal of Alternative Trading Strategies (ATS) is the ability for these funds to generate non-correlated returns such that they can see an increase in their value even if broad equity and bond markets fall. We are conscious though of not having funds in this space that are too correlated to each other, meaning that a particular set of circumstances can impact two or more in a duplicitous fashion.

WHAT WE HAVE DONE

We have added modestly to our property exposure in our lower risk portfolios by acquiring a new holding, the F&C Property Growth and Income Fund. This is a hybrid property fund that invests in both pan-European real estate equities and in UK physical property. It has the benefit of lower volatility over an equity only fund and better liquidity characteristics – it has never closed to redemptions and they claim that 50% of the portfolio could be liquidated in 2 working days. Its aim is to provide income via a sustainable 5% covered dividend and growth via dividend and rental value growth.

To fund this purchase and in accordance with the desire to remove duplication amongst our ATS funds, we have exited our position (in all portfolios bar Lumin 10) the Jupiter Absolute fund. Performance has been a little disappointing of late and volatility over time a little greater.

Discussion Topic - Oil

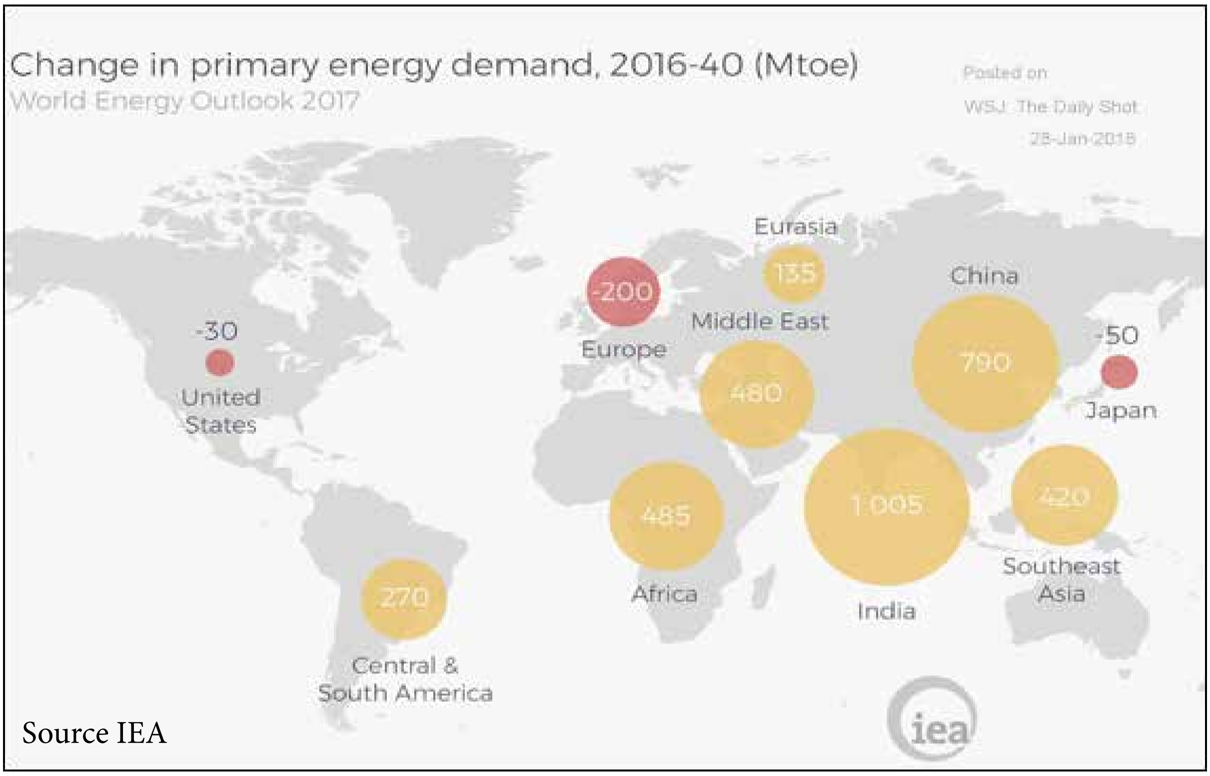
Predicting where the oil price will be in a few months time has a success rate on a par with predicting the weather. It is an inexact science, subject to chaos theory and dynamical systems that render it impossible to forecast with any degree of confidence. The price of oil is though considered one of the most key factors determining the path of global economies, prompting armies of analysts to spend a lot of time and effort speculating where prices are headed. Celebrated economist JK Galbraith said of people in his profession 'they don't forecast because they know, they forecast because they're asked to '- the same is true of oil price forecasters.

Notwithstanding this inconvenient truth, we return to the subject of the oil price because there have been some important developments in the industry since we last addressed the issue 2 quarterly reviews ago.

But before we consider some of these shorter-term developments, we set out the long-term (next 20 years) base case scenario as articulated in the highly respected BP Annual Statistical Review.

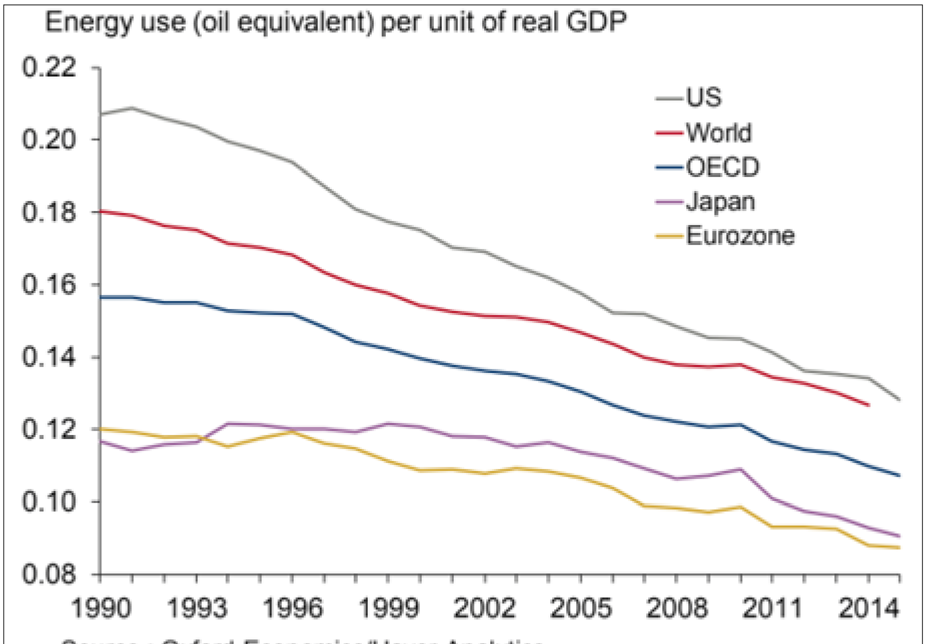
'Global demand for energy will continue to grow over the next two decades (see Fig 5) as prosperity increases and the world's population rises. However, the mix of fuels used will change, driven by technological advances and environmental concerns, and demand will grow more slowly than in the past as energy is used more efficiently.'

Where will the new demand for energy come from in the decades to come? - Fig 5



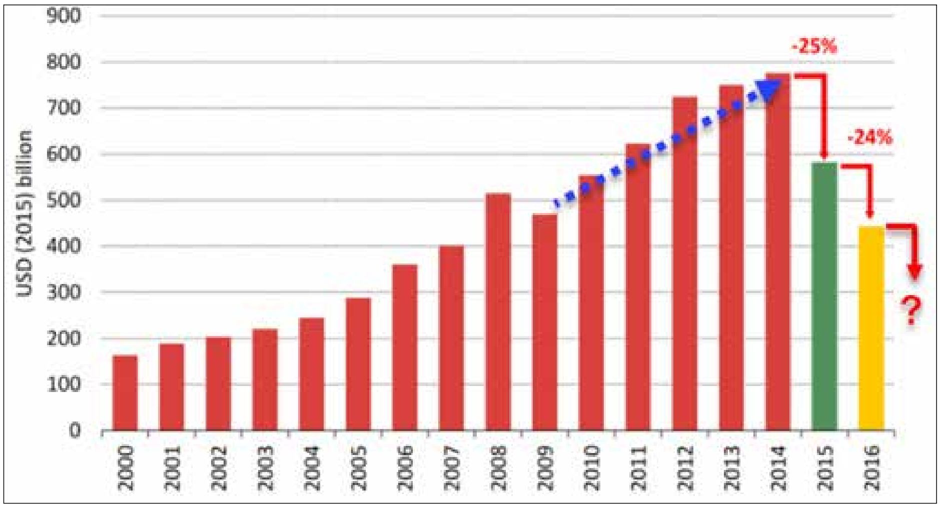
'Energy demand grows more slowly than in the past because energy intensity (the energy used for each unit of GDP) is expected to fall more rapidly (See Fig 6 on page 13). Global GDP doubles over the period whereas energy demand increases by only 30%.'

Energy efficiency has improved markedly, even since the late 1990s - Fig 6



Source : Oxford Economics/Haver Analytics

World upstream oil and gas investment - Fig 7



Over the next 20 years, energy demand will be met increasingly by nuclear, hydro and other renewables with technological advances in all these areas having a major bearing. Shorter-term though the burden of supply will continue to be met by the oil industry and it is here that we now turn our attention to.

The single most compelling argument for oil price strength in the near-term comes from the simple fact that production rates decline and fields deplete naturally over time – if you don't invest, supply will fall. The chart below shows what happened to investment in the two years post the oil price collapse in 2014 – the figure broadly flat in 2017 but still down nearly 50% from previous peak (See Fig 7)

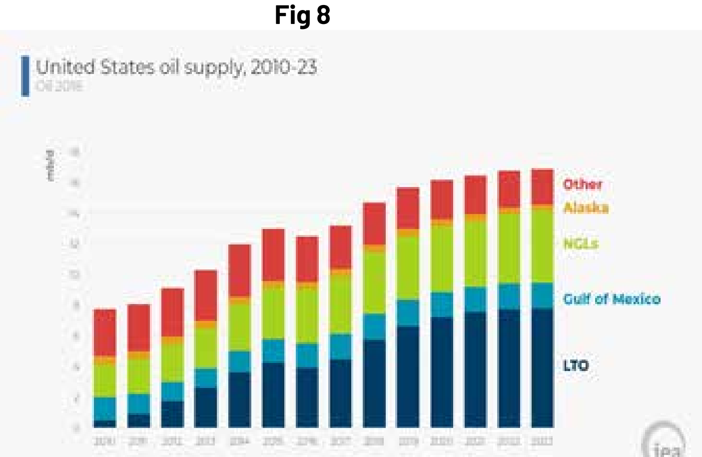
A lack of investment and political chaos in Venezuela has seen production from this important producer (2nd largest reserves in the world) collapse. US sanctions and the precarious state of national oil company PDVSA conspire to see no early end in sight here. Libya finds itself in a similar political and divestment predicament, whilst important producers Nigeria and Angola are also witnessing falls in production; the former due to security and supply disruptions, the latter corruption and cost escalation.

Perhaps of more concern are developments in the Middle East. Under a new, ambitious but untried/untested ruler, Saudi Arabia is engaged in proxy wars with both Yemen and Iran. Missile strikes on Riyadh emanating from the former have so far been unsuccessful but were one to land here or in one of the major oil fields it would inevitably prompt a spike in the risk premium attached to the price of oil.

Whilst this is a known unknown, what is certain to have an impact are new US sanctions imposed on Iranian oil post Trump tearing up the previous 'rotten and decaying deal'. Exports will quickly fall as both US companies and all those international oil companies with existing US interests pull back for fear of punitive fines. The export volumes at risk are sizeable and come at an inopportune time given the global production pressures already noted.

Bears of the oil price will point to the continued rapid growth forecast in US onshore shale (LTO) production – (see Fig 8). From practically nowhere prior to this decade, shale production has had a transformational impact on the industry's supply/demand dynamics, responsible for virtually all the increase in global supply during the period 2011 to 2016.

Fig 8



Source IEA

With such a brief history, the forecasts are super-normally subject to revision. There was great excitement about the supposedly monster new Monterey field in California until the EIA downgraded its reserve estimates by 96%! There is also a growing body of experts claiming that the highest quality drilling areas have already been drilled, leaving just Tier 2 and 3 geologic locations where there is a steep drop-off in the amount of oil per well. In the short term, infrastructure issues are hampering supply; the lack of pipeline capacity, a shortage of trucks and truckers to ferry the crude and the vast quantities of sand and water required in the fracking process. Instructive also that the heavily debt financed shale industry has largely grown up during a period of near zero interest rates.

We talk earlier in this review about the material consequences on global trade and hence economic growth of an escalating trade war between the US and everywhere else. The oil price has experienced momentary wobbles on this fear over recent months but has bounced back and the supply/demand dynamics outlined likely outweigh the tariff related global trading disruptions.

Finally, just in case there was not enough going on in the industry, Trump has got involved. Eyeing mid-term elections in the Autumn, the President has let it be known in his own inimitable style that he wants Saudi to increase supply to get the oil price lower.

Having said at the start of this piece that it is a fool's game to predict the oil price, you will sense from subsequent commentary that we have a constructive view of the oil price in the short to medium term. This underpins our favourable view of the oil sector's current investment appeal, the attractions of which were otherwise neatly summed up in a recent meeting we had with JPM Natural Resources manager Neil Gregson, who described the oil sector as:' underinvested, under-owned, unloved, cheap and hugely cash generative'. What is there not to like…?

Glossary

ALTERNATIVE TRADING STRATEGY (ATS)

A managed portfolio of investments that can use different investment strategies to generate high returns (either in an absolute sense or over a specified market benchmark)

CORRELATION

A statistical measure of how two securities move in relation to each other. The higher the number, the more related the moves.

DIVERSIFICATION

A way of reducing investment risk by investing in a variety of assets. Diversification aims to smooth out events that affect single assets within a portfolio so the positive performance of some assets neutralizes the negative effects of others.

DIVIDEND

A distribution of a portion of a company's earnings, paid to its shareholders. Dividends can be issued as cash payments, as shares of stock, or other property.

DIVIDEND COVER

A measure of the ability of a company to maintain the level of dividend paid out. The higher the cover, the better the ability to maintain dividends if profits drop.

EXCHANGE TRADED FUND (ETF)

ETF's are listed securities that track an index, but can be bought and sold during the day. By owning an ETF, you get the diversification of an index at a low cost.

GROSS DOMESTIC PRODUCT (GDP)

GDP is the total value of goods produced and services provided in a country during one year. It is commonly used as an indicator of the economic health of a country.

GILT

Fixed-interest loan securities issued by the UK government. Gilts are the UK equivalent of U.S. Treasury securities.

PURCHASE MANAGERS' INDEX (PMI)

An indicator of economic health for manufacturing and service sectors. The purpose of the PMI is to provide information about current business conditions to company decision makers, analysts and purchasing managers.

TOTAL EXPENSE RATIO (TER)

This figure gives the overall cost of a fund including the fund managers charges admin and dealing costs.

VOLATILITY

Volatility is the amount of price change a security experiences over a given period of time. Commonly, the higher the volatility, the higher the risk.

YIELD

The income return on an investment, such as the interest or dividends received from holding the security.

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