Vista

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Inside:

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The outlook

Readers may be forgiven if they are confused about recent financial market and economic developments. I feel a tad confused myself. Although, as we suggested last time, the media reaction to the equity market volatility of the first quarter was shown to have been overdone and markets recovered their poise, helped by continuing strong economic data, recent moves have been driven by political developments of a most confusing kind. Many of which were caused by that most maverick of politicians, Donald Trump.

Strangely, the agreement reached in Singapore between the US and North Korean leaders – to achieve the complete denuclearisation of the Korean peninsula – had very little wider market impact. Probably because there was a good deal of scepticism in the aftermath about whether the deal would hold and also because of the limited impact of the deal outside of the region.

Far more meaningful have been the US President's trade decisions - starting with the tariffs imposed upon imports of aluminium and steel, irrespective of their state of origin. Since May, hardly a week has gone by without the announcement of at least an intention to impose tariffs upon yet another range of goods, either by Trump himself or by one of the trading 'partners'.

These moves have certainly aroused diplomatic tensions – as evidenced in the by now famous picture of Trump seemingly being harangued by the assembled members of the G7 at their summit in May. The random nature of threats has been disturbing. The use of the 'national security' pretext is spurious. Markets just don't know how far this could go but, on the other hand, in some ways the reaction has been surprisingly muted. This is partly because it is becoming clear that the main object of Trump's ire is not the global trading community, but China. China is the source of the largest component of his trade deficit and becoming a major global military power. Trump has shown himself very capable of reversing policy in respect to China if it suits him. Partly too, it is because markets recognise that while the progress of globalisation may be in the process of being reversed, it is far too late to turn back the clock now. Effective tariffs on goods in the developed economies are extremely low by historic standards – this is what successive rounds of World Trade Organisation talks and deals have achieved. The limited measures that have been announced so far would not have a meaningful impact upon overall trade volumes.

Finally, in recognition of the fact that the trade measures are likely to have a more damaging impact upon the US economy than positive, business is beginning to fight back and lobbying for their reversal. While it is unlikely to have much effect, given that Trump is only putting into effect campaign promises made to his narrow support base, this should halt further expansion.

Italian coalition creates euro uncertainty

Two other factors have demanded investor attention in recent weeks. First was the result of the Italian election and the continuing search to find a viable coalition. That the first manifestation of that coalition, a combination of the far right and left, could only agree on one thing – their

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opposition to the Euro was not a good sign when the President tried to avoid a rerun of the 2011-12 Euro crisis by vetoing their choice of Finance Minister, that only served to indicate to investors that a rerun was more likely. For now, calmer counsels have prevailed but peripheral Euro yield spreads have widened as markets prepare for further potential instability.

Impact of oil price & US dollar strength

The second is the behaviour of the oil price accompanied, unusually by US dollar strength. A number of factors were behind the former – global demand growth, OPEC restraint, crisis in Venezuela, compounded by Trump's declaration of full-scale commercial war against Iran. This accompanied by dollar strength was damaging for emerging markets where we saw signs of stress in Argentina and Turkey, but very positive for oil exporting economies and commodity-rich equity indices, notably the UK.

This factor, plus the excessive reaction to Q1 news, was behind the very strong performance of UK equities in Q2. In the middle of all this, the UK scene continues to be dominated by Brexit. I recognise that, given the strong views held by many on this subject on both sides of the argument, that the following is inevitably going to offend more than a few. But the picture is becoming a little clearer – but increasingly fraught given the pressure of time. Frankly, the UK conceded any kind of bargaining power it had when it triggered Article 50 early. Various Parliamentary debates concerning the extent of that institution's continuing influence upon the process have come and gone, inconclusively. Leak and counter-leaks have emerged from both wings of the Conservative party. The Labour opposition too is almost as divided. But the Irish question holds the centre stage. As soon as UK politicians concede the EU position that placing any kind of customs infrastructure at the Irish border is a non-starter, then they also concede our continuing membership of the Customs Union and some aspects of the Single Market. Failure to recognise this is having a damaging impact upon business and the economy as time marches on – which the recent warning from Airbus has indicated. However, the Brexiteers are unwilling to do so and the response of the Prime Minister is not to stand up to them, but to fudge. In these circumstances, the danger is that we have an almost permanent Brexit process, one in which uncertainty about the future is so pronounced that business investment and employment decisions are permanently put on hold – or businesses relocate. That is why we are not optimistic about the medium term performance of UK assets and are increasing overseas exposure at this point.

All in all, in spite of the growing influence, albeit temporary, of geopolitics, we see nothing to divert us from our central investment thesis of 2018 – that monetary policy normalisation against a background of elevated investment markets will make for a volatile and uncomfortable ride for investors for a while to come.

Kevin Bowhay
HEAD OF BRISTOL DISCRETIONARY

The science of sterling

> As sterling weakens, the future profitability of companies with large overseas earnings rise and therefore their stock market valuations are also likely to rise.

We are all far too aware of Brexit and many of the implications that we face with regard to leaving the European Union. There remain deep disagreements within the UK Parliament and as the deadline looms, without agreement of fundamental issues like the Northern Ireland border and customs arrangements, there is a possibility of a no deal scenario which is putting the government under intense pressure. This is likely to have the biggest influence on sterling from day to day, along with world economic news and political tensions. As sterling weakens, the future profitability of companies with large overseas earnings rise and therefore their stock market valuations are also likely to rise. In the chart below it shows the relationship of the FTSE100 against the pound versus dollar since January 2016. I am sure you will note the move in the currency shortly after the referendum on 23rd June 2016 and the subsequent move on the FTSE100.

Source:
FE Analytics 2018

Normally, the weaker sterling becomes, the more the companies contained in the FTSE100 should see their earnings rise, leading ultimately to an increase in their share prices. The reverse is also true.

This is because such a large proportion of profits for FTSE 100 companies are made in dollars. If sterling weakens then dollar revenues, once converted back into sterling, are worth more. If the exchange rate was $2 to the pound, then every $1,000 of revenue would be worth £500. However, if sterling weakened and the exchange rate moved $1.5 to the pound, then every $1000 of revenue would be worth £667. The outcome is that revenues increased 33% as a result of the fall in sterling.

Around three quarters of revenues generated by FTSE 100 companies come from outside the UK. The strength of sterling against the euro is also important given the large chunks of revenue accounted for by France, Germany, Italy and other Eurozone countries. An example of an economic impact would be weaker than expected UK GDP data, triggering a slide in sterling and therefore pushing the markets higher. The view would be taken that interest rates would be less likely to rise if economic growth was weak therefore keeping more pressure on sterling.

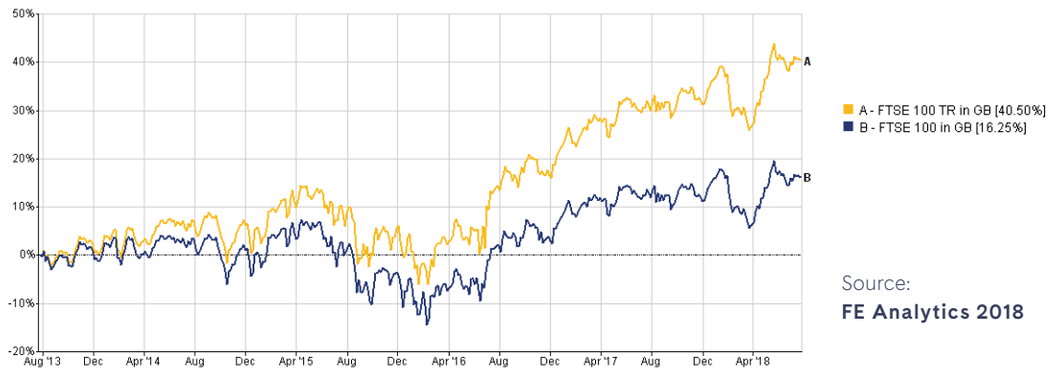
One has to think that as the Brexit deadline nears, there will be more bouts of weakness, possibly caused by a lack of business investment and political uncertainty and therefore GDP growth or interest rates rising at a much lower rate than first forecast. This, with American rates rising, may well have the impact of a weaker sterling rate which will maintain the FTSE 100. Clearly the reverse is true and as America started to raise rates in the last economic upturn, it is notable that the dollar weakened which one wouldn't have expected bearing in mind rates were increasing. Currency as we have noted in previous articles is notoriously difficult to predict and with so many impacts, it is clear that this is not an exact science!

Tim Cockerill

INVESTMENT DIRECTOR

Investing for equity income

Investing in shares to generate income has never been the most glamorous area of investment; that accolade goes to the emerging and frontier markets. It is perhaps viewed by most as an essential ingredient in portfolios particularly suited to older investors who are nearing or in retirement. For this reason the value of income from equities can be over looked. The chart above shows the return from the FTSE 100 index over the last five years with and without income being reinvested. This clearly shows the significant value of income and its impact on equity returns.



Source:
FE Analytics 2018

The concept behind equity income is simple – if a company does well and profits grow, then it can pay out a bigger dividend. The opposite is true of course, and dividends can be cut or suspended altogether. This is where investing via a collective fund, such as an OEIC (open ended investment company), unit trust or investment trust comes into its own. By investing in a diversified portfolio, a dividend cut from one company will have a much reduced impact on the income generated, compared with holding the stock directly. There are a good number of investment trusts which haven't cut their dividend in over twenty years, and City of London hasn't cut in fifty years. A particular benefit investment trusts have is that they can build reserves over time, and this can be used to maintain or increase income when there is a period of reduced dividend payments, such as during a recession. Inflation protection is another significant benefit of income generated by equities. Quality collective income funds invariably increase their annual dividend by an amount greater than inflation, which means investors receive a growing real income. Whilst this ability to outpace inflation is not unique to equity income, asset classes like fixed interest (generally) don't have this feature. Some years ago equity income was centred on UK stocks, but in the past 15-20 years the benefit of paying dividends has spread around the world. Equity income funds are now available in all markets globally, which enables diversification geographically providing greater flexibility and options when constructing portfolios. As for the current yield on these investments, they range from 2.5% to over 4.25%, attractive against deposit rates and many fixed interest stocks.

In some ways investing for equity income is the perfect strategy – investors receive income, there is good potential for capital growth, there is inflation protection and a growing real income. And to cap it off, if taking the income isn't required today, income can be reinvested compounding returns.

High price for the high street

Donald Maxwell-Scott

TECHNICAL INVESTMENT MANAGER

Jeff Bezos, the Amazon founder is now the richest man in the world, with an estimated fortune of $141 billion. However, is this man responsible for the death of UK high-streets up and down the country? There is no doubt Amazon has changed the way we shop, however, I don't think it is fair to solely blame Amazon for the demise of the UK high-street.

Senior management across the retail sector are always keen to point the finger of blame at Amazon, but the truth lies closer to home. A failure to adapt to trends within the retail landscape is perhaps one of the biggest reasons for failure. However, it can be argued that the government should have done more to even the playing field between retailers and internet giants. High street shops are seemingly penalised while their online competitors face lower charges; one such example of this is on the business rates they pay. Business rates are based on the rental value for the store, so high streets and city centres which have large footfalls can expect to pay the most in business rates, whereas internet giants can setup their distribution centres in derelict and deprived areas, thus attracting the lowest business rates whilst also keeping wages low. In addition, many internet giants are able to domicile themselves in jurisdictions which will allow them to pay the lowest rates of tax. For the Amazon EU Group this is Luxembourg, whereby they are able to funnel profits from Europe whilst paying only 7.25% tax. Many UK retailers do not have this option, so are placed at an unfair disadvantage. Higher costs, coupled with higher taxation means you have to charge more for a product than your online competitor. This, coupled with the changing retail habits of UK consumers has led to the demise of the UK high-street. A week doesn't seem to go by without hearing of another retailer going into administration, whilst those still in business face having to restructure and close stores, however, this isn't the case for every retailer on the high-street. In fact, some have been very successful, and their share prices reflect this:

> **While it is easy to blame online giants, poor management and failure to adapt is equally to blame.**

Next and WH Smith are two such success stories, and as illustrated, over a ten year period their share prices have increased by almost 800% and 700% respectively. So why have they succeeded while others such as Mothercare, Debenhams and Marks & Spencer are struggling?

WH Smith reads like a bestseller in adapting to the high-street decline. If anything their business is more under threat from Amazon than many others. Books are the main bread and butter of their business, and selling books was the primary reason why Jeff Bezos founded Amazon. Of course, WH Smith has had to close many of their less profitable stores on the high-street. Their remaining stores are concentrated in areas with the highest footfall, but their strategic masterstroke has been to focus on airports. I can't remember the last time I went into a WH Smith that wasn't in an airport. Almost always, I go in to buy a book, but inevitably I buy two as the second book is half-price. Once you add the newspaper, magazine and a meal deal then you have departed with the best part of £30. In fact, airport and railway sales now account for 60% of group profits.

Next has also adapted. Their ground-breaking mail operation Next Directory launched in 1988, yet they were one of the first retailers to offer online shopping back in 1999. The Next directory is also now offered online in more than 70 countries. They have continued to improve by introducing new initiatives such as next day delivery and click & collect. They also offer excellent customer service, which in turn is an investment in customer loyalty.

Other retailers are recognising that they need to adapt, but it may be too little too late. They are guilty of burying their heads in the sand, and if they are not careful they too could end up getting into further difficulty. Senior management are focusing on price, and whilst price is important they have to understand that it is not the only way to keep customers coming back. A large part of the reason consumers like to go shopping is often the experience of going shopping, and this is what the retailers need to sell. Competing on price against online retailers is a battle that can't be won. Retailers need to focus on how to sell their products, both online and on the high-street, with the latter focused on the wider shopping experience. An increased focus on the product and customer service that can be provided can also differentiate from competitors and online retailers. Another focus is how the product is being promoted and whether you are reaching your designated target market, however, it seems retailers are signing their own death warrants by continually focusing on price.

In the UK we have recently jumped on the bandwagon of Black Friday, a US-coined term intended to inject hysteria into shoppers and to increase footfall on the high-street. Nevertheless, I would be inclined to argue seeing grown adults beat each other up in order to buy as many televisions as possible, only so they can sell them themselves for an inflated price, is neither beneficial to the positive experience of going shopping or to the bottom line of the retailer. Yet all retailers are in a relentless race to the bottom on price. Come to think of it has anyone been to DFS when there hasn't been a sale on?

If anything, prices in some instances need to go up. It was recently announced that Poundworld entered administration. In a statement issued by the retailer it said it had suffered from high product cost inflation. However, we would argue that if you are aiming to sell everything in your shops at £1 without putting your prices up or taking account inflation, then administration should be a forgone conclusion. While it is easy to blame online giants, poor management and failure to adapt is equally to blame. The government should also act or we will see many more derelict shops, leaving our highstreets as simply a place to buy a coffee or visit charity shops. Apparently one Costa Coffee shop on every high-street isn't enough, we need four.

Kevin Bowhay

HEAD OF BRISTOL DISCRETIONARY

Inheritance Tax review

Inheritance Tax was introduced in 1986, replacing the Capital Transfer Tax. Since then, it's been the subject of a continuous process of evolution and despite the change in social landscape, it remains the fact that many estates are not subject to IHT. There is, however, the likelihood that more estates will become liable in the future. This is partly due to increases in residential property prices, but also asset prices in general.

In February 2018, the Chancellor and the Financial Secretary to the Treasury requested the Office of Tax Simplification (OTS) carry out a review of a wide range of aspects of IHT: how they function today, the economic impact and identify simplification opportunities. The review is in keeping with the remit of the OTS to provide advice on simplification of the tax system.

The overall aim will be to identify opportunities and to make recommendations with regard to simplifying IHT from both a Technical and Administrative standpoint.

We expect the report, due to be published in the Autumn of 2018, will provide an initial evaluation of the IHT regime, analyse and evidence opportunities for simplification and include specific recommendations. This will be based upon evidence and consultation with a variety of stakeholders.

The review will consider how key aspects of the current IHT system work and whether they might be simplified. This will include a combination of administrative and technical questions which would include:

- The process around submitting IHT returns and paying the tax due
- Gift rules including the annual allowance for gifts, small gifts and gifts out of income
- Other administrative and practical issues around routine estate planning and disclosure, including relevant aspects of probate work
- Complexity arising from IHT reliefs and how they interact with the tax framework
- The impact of any distortion this may cause to taxpayer's decisions, investments, asset prices, Trusts or the interaction with other taxes
- The perception of the complexity of the IHT rules
- The OTS will be guided to research widely with stakeholders, engage with HMRC and consider devolved tax powers, taking account of relevant implications of recommendations.

Recent examples of the complexity of inheritance tax planning would include the changes to pensions which resulted in certain Inheritance Tax benefits being increased and the introduction of the residence nil rate band (RNRB). This is very complicated and causes a lot of confusion and indeed, recent research indicated that over 70% of the people asked have no idea how the RNRB works.

It is difficult to speculate on what changes may well be made as we are only a few months into the tax review, however some areas muted by other professionals include changes to the seven year gifting rules, the annual £3,000 gift rule, the nil rate band and home rate band, pensions, capital gains tax rules, trust rules and the possibility of tax switching to the beneficiary and not the estate.

We will keep you informed of the results of the Autumn Review but in the meantime, it's important to think carefully before making a change to your financial planning in contemplation of a tax change because expected changes don't always happen! Should you require any advice your Investment Manager will be able to put you in contact with the appropriate adviser.