4 SHIRES

ASSET MANAGEMENT

Investment Commentary

2nd & 3rd Quarter 2018

Introduction

Welcome to the 4 Shires investment commentary for the second and third quarters of 2018.

At the beginning of the year we talked of the risk of a correction in equity markets, but remained optimistic for shares. There has been a correction, followed by a strong rally which has recently run out of steam. 'Value' shares are beginning to exhibit considerable attractiveness relative to 'growth' shares. Sterling rallied over the period, but recent remarks by Mark Carney, governor of the Bank of England, imply a slower pace of interest rate rises. Notwithstanding the UK environment, the rest of the world remains in the midst of an economic boom. However rising US Treasury bond yields are causing a re-pricing of all financial assets at the same time as the US/China trade war has been intensifying.

Please join us for the

4 Shires' Christmas Party

Shires House, School Lane, Gillingham, Dorset SP8 4QW

18:00 - 21:00

Wednesday, 12th December 2018

4 SHIRES
ASSET MANAGEMENT

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Compliance & Regulation

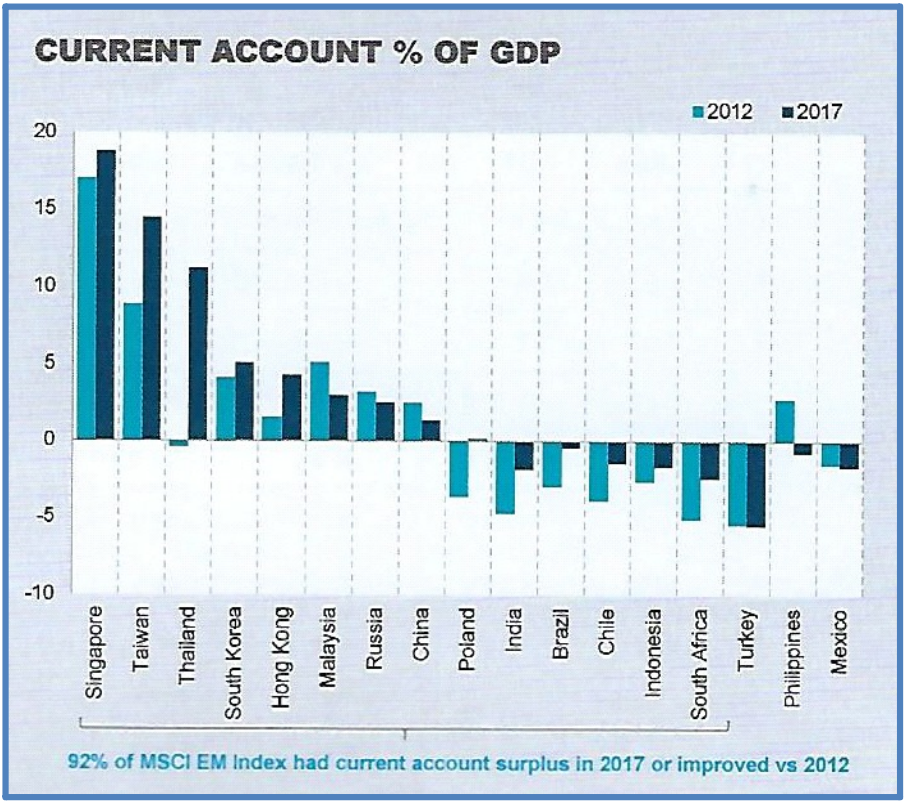
US bond market and global valuations

The stock markets have entered a more volatile period since the first quarter of the year for several reasons. But the main cause of the rise in volatility has been the increasing effect of rising US Treasury bond yields. Since the beginning of December 2017 10 year bond yields have been creeping up from circa 2.35% to current levels of circa 3.2%. This increase in the world's 'risk free rate' has implications for all assets around the world, not just the US.

(*Graph: source Ycharts*)

The risk free rate in finance is the lowest risk asset, and as it increases in value, all other assets will have to re-price. US Treasuries are considered to be the closest asset to the theoretical risk free rate. A dividend stock that yields 3.5% now seems less attractive when the lowest risk asset is only yielding 0.3% less. So the dividend paying stock ought to see its yield rise to reflect the risk differential. US Treasury bond prices will fall as their yields rise as there is an inverse relationship between bond yields and their prices (and vice versa). But have bond yields risen enough to cause a major correction, and if not now, when? We wrote about this at the beginning of the year, but the same holds true today.

Global stock markets have fallen to reflect the increasing attractiveness of US Treasury bonds, and have caused a re-pricing of risk as the risk free rate increases. Stocks need to yield more and be better value (i.e. cheaper) to reflect the re-balancing of risk. For emerging markets with external US$ debt, those repayments can increase substantially following dollar strength and higher interest rates. Traditionally those emerging markets with high external current account deficits were vulnerable. However, bar a few countries such as Turkey and Argentina, emerging markets have lower current account deficits than they used to have. Indeed many such countries have sizeable surpluses. The graph on the next page shows that 92% of trade balances in emerging markets have improved over the past 5 years:



(Graph Source: T Rowe Price)

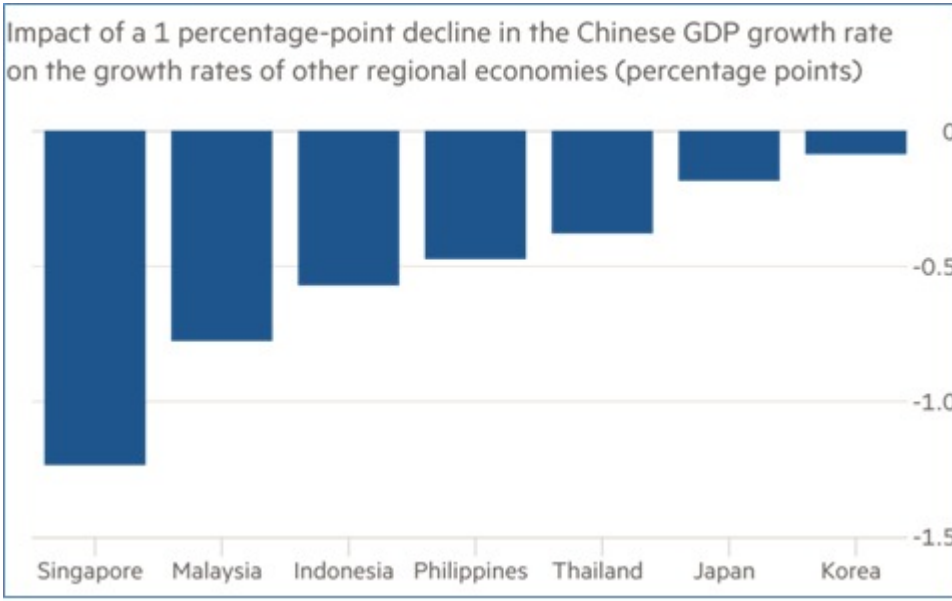
This improved trade picture will make emerging markets more resilient against US interest rate rises. Higher growth rates and better demographics than developed markets will help these emerging economies to weather the pressure of higher US interest rates.

Trade War – Will Trump settle with China?

The heat has been going up and up in the rhetoric of President Trump in his battle to reset the world's trade environment in what he perceives as the interest of the US. Recent tariffs on Chinese trade have risen to $250bn worth of products. In retaliation the Chinese government has placed a similar amount of tariffs on American products. These tariffs don't just hurt the Chinese economy, but they are also affecting the Asian regional economies including American allies that neighbour China.

Gary Cohn, one of President Trump's former advisers, has said that it was right to go after the Chinese for theft of intellectual property. This has widespread support amongst US allies. He left the White house in March of this year, but has recently said that the tariffs are effectively a tax on consumption, taking money out of American consumers' pockets. He also said this was money that Americans needed to save as they have one of the worst savings rates in the developed world.

Despite the evident harm tariffs will have on US consumers, Trump has continued with these punitive measures. China's retaliation is reluctant and they are keen to do a deal with America. Given that Trump has agreed deals with Europe and Kim Jong Un, rumours of resolution of these tariffs is likely in the short to medium term.



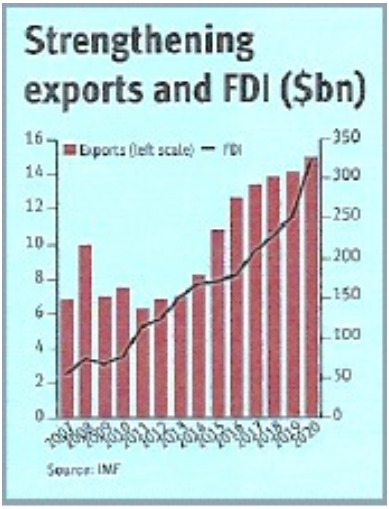
(Source: The Economist)

Vietnam update

Our favourite Asian emerging market is Vietnam, which we have exposure to via the VinaCapital Vietnam Opportunity Fund. The Vietnamese dong hardly moved against the US dollar during the past two quarters. It should be noted though that Vietnam operates a "floating peg" – the central bank sets the exchange rate, but since January 2016 resets this daily using a market-based methodology and allows price volatility within a pre-defined range.

The current account surplus is estimated to be a healthy 3.7% of GDP in 2018, and the US-China trade war will help accelerate a shift of manufacturing from China to Vietnam (where the labour costs are already 50% lower). As China transitions to a consumer led economy (rather than an investment led one), Vietnam will be well placed to export goods into China. One downside here is that with the renminbi devaluing and the dong remaining firm, it will be more expensive for the Chinese to buy Vietnamese goods.

The population is both educated and young. Currently 60% of Vietnam's 92m people are under the age of 35. Over the past 34 years, the population living in poverty has declined from 74% to 5.8%. This young and newly wealthy population is flexing its consumer muscles, helping to drive domestic demand. But the addressable market for Vietnamese manufacturing is global. At the moment, manufacturing is only 16% of the Vietnamese economy, compared with China's peak in 2007 of 30%. It is also lower value-add (e.g. more clothing than electronics). With multinational companies pouring in investment, Vietnam's exports should rise and we think the future continues to look bright for Vietnamese stocks.



The Vietnam Opportunity fund is a mixture of listed stocks and state privatisations, in which they take a stake prior to flotation. The current split in the fund is circa 70% directly listed equities and the balance in private companies (usually privatisations) and small holdings in property. The largest holding is Hoa Phat, a steel group trading on 8x earnings with a current 20% growth rate.

Bolsonaro and Brazil

The election of Jair Bolsonaro as Brazil's president, an ex-military officer and seven times congressman for one of Rio de Janeiro's districts, will have a wide-ranging impact on Brazil and Latin America. He has expressed homophobic and sexist opinions, remembers favourably the oppressive military rule of Brazil, admires dictatorship and endorses torture. His running mate, Hamilton Mourao, is an ex-general, who has not disguised belief that Brazil would benefit from the Army's direct involvement in politics. Many Brazilians believe Bolsonaro will open up Amazonia to indiscriminate logging and environmental catastrophe. He has promised to exit the Paris Climate Change agreement and shut down the environment ministry.

Despite these extremely worrying aspects of his character, he does favour a radical overhaul of the Brazilian state. He wants to privatise the whole of the state's companies, halve the number of ministries and introduce a simpler tax system. Bolsonaro was voted in due to the deep recession in Brazil and the similarly deep, ingrained corruption brought to light in the Lavo Jato ("carwash") scandal that linked Lula da Silva's socialist PT party with gargantuan bribes from the private sector. Brazilian GDP fell 10% from peak to trough in the recession, and growth is still only a meagre 1.4% per annum. Crime has also soared, and last year 64,000 people were murdered in Brazil, making it one of the most violent countries in the world.

However Brazil is not in trouble from a fiscal and economic position. It is the third largest emerging market in the world after China and India, has a small current account deficit (circa 0.5% of GDP) and its gross external debt is 38% of GDP. External reserves are $380bn, amounting to circa 20% of GDP. However the combined internal and external debt is high (circa 84% of GDP) and 10 year government bonds carry a 10.5% interest rate. The annual deficit is running at 7% of GDP. Most of the government's revenue goes on social welfare and pensions. The new government needs to reduce its deficit by 4% of GDP to stabilise the deficit

We have seen that when right-wing populists come to power, the economy and stock market have tended to do well. This happened in India with Narendra Modi, in America with Donald Trump and when Bolsonaro was elected the Brazilian index rose circa 7% in one day.

(*Statistics source: The Economist)*

Venezuela, Maduro and Oil

Nicolas Maduro inherited the presidency of Venezuela after the death of 'Commandante' Hugo Chavez. Chavez had led a political party, the 5th Republic Movement, and was elected president in 1998. He proposed a socialist, 'Bolivarian' revolution, named after the nineteenth century Latin American revolutionary Simon de Bolivar. Chavez instituted many socialist reforms and policies with the aim of benefiting the poor of Venezuela. Venezuela has the world's largest oil reserves, and with this wealth he hoped to transform the plight of the poor. Chavez died in 2013 and was replaced by his long term ally, Nicolas Maduro.

The political control of state oil company Petroleos de Venezuela (PDVSA) has been a disaster. In 2007 most foreign oil companies had to surrender control of their businesses in Venezuela to PDVSA. Chevron and Exxon refused to do so. All employees of PDVSA had to swear loyalty to Chavez and Maduro's party. To guarantee the money for the social programmes, Chavez and Maduro sold their oil production in a cash-for-oil scheme to the Chinese, whereby Venezuela received money up front in exchange for future production. As a result, the current production of oil has fallen to levels not seen since the 1950s. Of the circa 1.6m barrels per day of production, only 450,000 is available for sale by PDVSA outside the cash-for-oil schemes. The chart below shows the Venezuelan oil production figures since 2005.

Sadly the people of Venezuela are bearing the brunt of these failed policies. Shops are empty, employment has collapsed in tandem with the economy and many are fleeing across the border. Hyperinflation has taken hold of the economy, and is currently running at 830,000% per annum.

President Trump has said he is reviewing all options on Venezuela, including the military options. Could he intervene in the country under a humanitarian banner? We will have to wait and see. Meanwhile the country is mired in the chaos of socialism and repression.

Italy and immigration

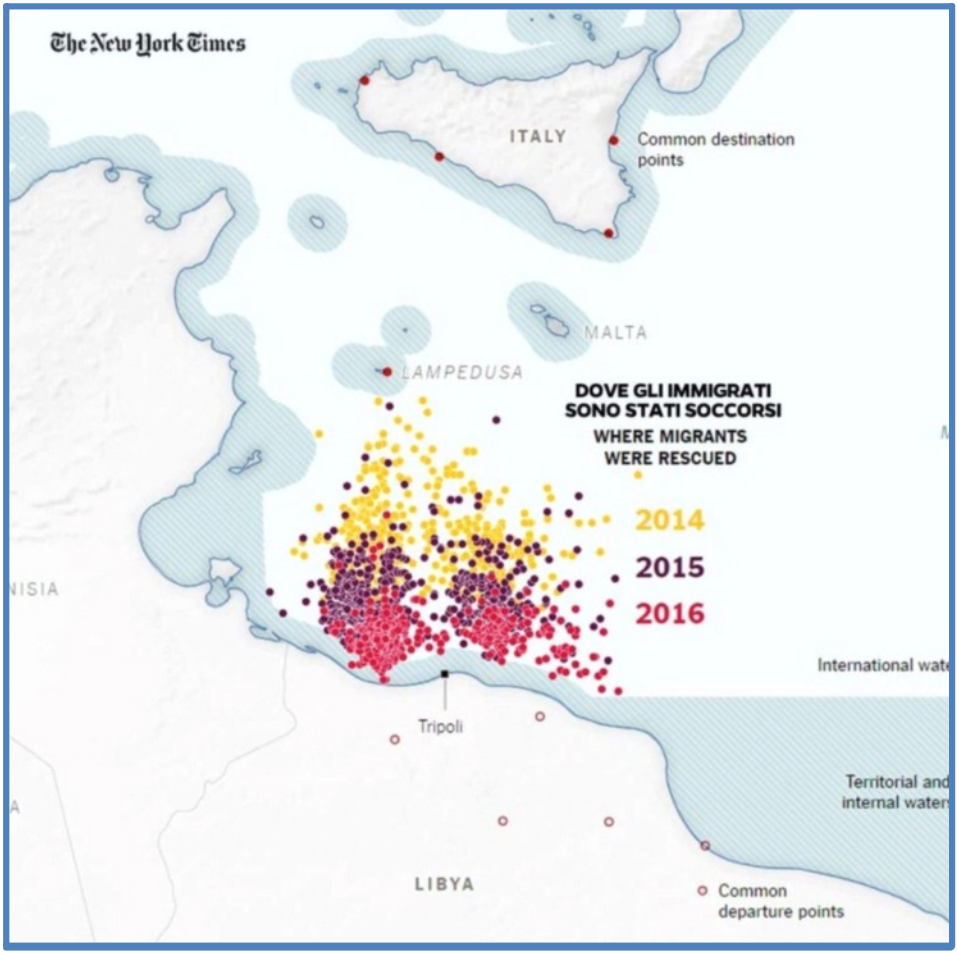
We looked at developments in the Italian elections in our March edition of Wealth Matters, and now take a look at how the political situation in Italy has evolved since then, plus the wider implications for populism in Europe and immigration. The Italian elections ended in deadlock, with Luigi Di Maio's Five Star Movement ("5 Star") and the right-wing coalition (consisting of Matteo Salvini's Lega Nord party, Silvio Berlusconi's Forza Italia party, and the Fratelli d'Italia party) each taking approximately one-third of the vote. After many weeks of political jockeying, Berlusconi eventually gave the green light in early May for Lega Nord to break with the right-wing coalition and form a populist government with 5 Star. Forza Italia did not form part of this new government, effectively ending Berlusconi's involvement in Italian politics.

The two party leaders, Luigi Di Maio and Matteo Salvini jointly assumed office of Deputy Prime Minister on 1st June, with Di Maio also becoming Minister of Economic Development and Salvini becoming Minister of the Interior. Salvini has since upstaged his former coalition partner Berlusconi (and PM Conte) to become the new face of Italian populism.

Since his appointment, Salvini has been focusing his energy on attacking immigrants. In the most extreme cases, anti-immigrant sentiment in Italy (the same that propelled Salvini to centre stage) has turned to violence. Earlier this year gunman Luca Traini, a failed Lega Nord candidate, opened fire on African immigrants in response to the murder of a young woman in the town of Macerata. Salvini has recently blocked rescue ships operating in the southern Mediterranean from docking in Italian ports. Whilst Eastern European nations refuse to accept the EU's redistribution of immigrants and refugees from border states, Salvini, not wanting a build-up in Italy, has chosen to refuse admission to them. He has

accused NGO vessels such as the Aquarius, which was diverted to Spain, of operating a taxi service for immigrants. The map below from the New York Times shows the operations of rescue ships getting closer to Libya's territorial waters over time.

The irony of course is that before Colonel Gaddafi was toppled in 2011, Berlusconi's government was paying $5bn a year to Gaddafi for Libya to crack down on people smuggling, discouraging the journeys across the Sahara. New



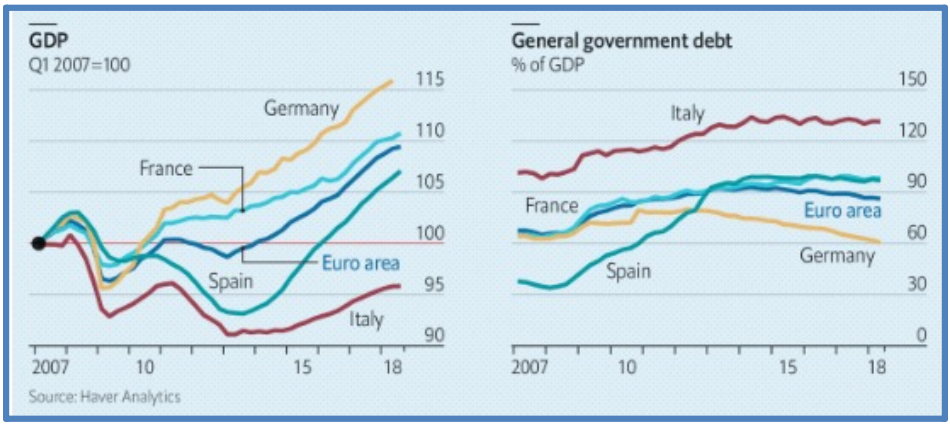
(Map Source: The New York Times)

Italian Foreign Minister Enzo Moavero Milanesi, is seeking to revive the deal, but the lawlessness in Libya's power vacuum will make it difficult to enforce. Indeed, the original deal was heavily criticised for its racist implications. In 2010, Gaddafi sensationally claimed that Europe would turn "black" unless it was more rigorous in turning back immigrants. The motives of the populist coalition in attempting to revive the deal are hardly different to the motive of the Macerata gunman.

Salvini and Donald Trump also have links to Vladimir Putin. Mr Conte has also aligned himself with President Trump's support for Russia's readmission to the G8 (currently G7). Salvini's Lega Nord party has a co-operation pact with Vladimir Putin's United Russia party, and has called Putin a key ally against "mobs and migrants".

The Italian budget

Italy has a high debt to GDP ratio – 132% in 2017 (source: Trading Economics), and only by restricting the annual deficit has Italy managed to issue bonds successfully over the past few years, and only with the implicit guarantee of the European nations, particularly Germany. However, the new coalition of 5 Star and Lega Nord want to increase expenditure to stimulate the economy after years of budgetary restraint. The graphs below show not just the stagnation and decline of the Italian economy but also the high levels of Italian government relative to GDP and in comparison to European countries. Due to its high level of indebtedness, Italy has the third largest government bond market in the world after the US and Japan.



(Source: The Economist)

The EU has warned Italy over its budget saying its deficit is approaching 3% of GDP. Italy is currently refusing to budge. Why does this matter?
This does matter because of the fiscal discipline put in place by the EU, and particularly Germany, during the financial crisis in Europe and the rest of the world. Deficits could be no higher than 3% of GDP so that the Euro was not undermined by excessive government spending. This policy has been a success in Europe, and is one of the reasons that the Euro has been one of the strongest global currencies over the past few years, albeit dwarfed by the strength of the German economy.

But Italy's government is also making noises about leaving the Euro, and this does worry the Germans as well as other Euro members. In fact one might see the other European countries' reactions to Italy's overspending as an attempt at disciplining and boxing in the coalitions more worrying intent. Many view Italy as having suffered as a result of not being able to devalue their currency to make their exports competitive with Germany. Italy has traditionally been a direct competitor of Germany in machine tools and light manufacturing. Many see the Italian economy in the Eurozone as artificially keeping the Euro undervalued relative to the strength of the German export-oriented economy.

Although most Italians want to remain in the Eurozone, a significant minority view it differently. We continue to view the chances of Italy exiting the Euro as being relatively high, albeit under 50%. Markets often react to events even though they are not certain. European markets have certainly expressed concern over the current situation, not least because there is a lot of lending by French and German banks to the Italian economy.

The UK Budget

Phillip Hammond released a budget that was what can only be described as a 'give-away'. The tight purse strings of austerity have been loosened. The main changes for the country are as follows:

<u>Personal Tax</u>

- Personal tax free allowance rises to £12,500 from £11,850, a year earlier than planned

- Higher tax rate threshold rises to £50,000 from £46,350 in April

- National living wage rises to £8.21 per hour from £7.83, a rise of 4.9%

Vice taxes and fuel duty

- Beer, cider and spirit duty to be frozen
- Wine duty to rise by 8p per bottle
- Cigarette duty up inflation + 2%
- Fuel duty to be frozen for another year
- Online gaming tax set at 21%

Stamp duty and housing

- Help to buy scheme extended until 2021
- First time buyers relief up to £500,000 if in shared equity homes
- £500m to help build an additional 650,000 homes

Welfare and benefits

- Allowances for universal credit to be increased by £1.7bn
- 2.4m working families with children to benefit on average by £630/year
- £1bn transitional benefit to help people transition to universal credit

Government

- 2018 deficit of 1.2% of GDP, rising to 1.4% in 2019
- Debt to GDP to be 83.7% in 2018, target 74.1% by 2023-24
- Extra £500m to plan for Brexit
- Extra £20.5bn over 5 years for the NHS, £2bn p/a for mental health services
- £700mm extra for social care

Business

- £30bn on potholes and road maintenance
- 30% growth in infrastructure spending
- 2% digital services tax, to target low tax-paying multinational tech companies
- PFI to be cancelled in the future, although existing contracts will be honoured
- Business rates relief for shops and small businesses

Overall the budget signified the end of austerity, particularly for the NHS. The change in personal tax rates was aimed at the JAMs, those just about managing. There was little if anything for savers, but no further cuts in savings allowances were mentioned. Debt to GDP has started to fall, and may fall further, economy permitting.

Portfolio Activity and Investments

In our last quarterly report we reported that we thought British utilities offered good value for the first time in a long time. I am delighted to report that our holdings of Centrica and National Grid have performed well over the past few quarters as the UK market has moved into a more defensive position.

In this quarter we will look at the international soap and general merchandise company PZ Cussons, the UK commercial property company Palace Capital and the car service and outdoor retailer Halfords.

(*Graphs source: Ionic Information Ltd*)

Individual Stocks

PZ Cussons

PZ Cussons owns soap manufacturer Cussons in the UK and Australia as well as other brands in markets such as Indonesia, Greece and Nigeria. The latter is their largest market outside the UK, and is different to most markets in that they have a distribution network in the country that is able to sell products to the markets and businesses throughout Africa's most populous country. These

products include fridges, milk powder (made in joint ventures) as well as washing powder and soaps.

At the time of the last financial statement the company reported negligible profits in Nigeria as a result of currency problems. However these profits ought to flow back over time, and the mere £6.3m of profit from Africa this year could return to near its peak level of £30.4m reported two years earlier. The company has a progressive dividend policy and a conservative balance sheet.

The business is owned by members of the original family who control just over 50% of the share capital. It is however a large family and as time has gone by their individual shareholdings are getting smaller. It is likely that at some point they will monetise this by selling the business. The stock trades on 16.5x prospective earnings and a 3.7% yield. We believe the earnings can recover to 18p or more per share over the coming few years, putting the shares on a bargain sub 13x earnings. It has always been rumoured that a large consumer products

business such as Procter and Gamble would love to gain access to the brands and distribution offered by PZ Cussons. Valuations in such a situation would probably start at over 400p per share versus the prevailing price at 226p (as at 9/11/18).

Palace Capital

Palace Capital specialises in buying and renting out UK commercial property. Whilst that sounds like a passive way to invest, the team behind the company are active asset managers of the properties, looking for upside in terms of undervaluation, redevelopment, rental uplifts and other ways to release value for shareholders. The business is headed by property expert Neil Sinclair. We first invested in the business at 200p a share and bought more shares at 332p. The recent pull back in the shares has been as a result of fears over the business environment post Brexit. But as they have very little retail exposure and they have nothing material in London, they are less affected by these two big negative drivers in the property market.

The business focuses on properties near railway stations in secondary towns and cities around the country. There has been practically no building of speculative offices outside London and developing newly constructed offices would require a letting price of £25/ft² to be economic. This has enabled the business to have leases renewed at big premia to their existing rents. They are also asset traders and will sell buildings on if they cannot see the upside.

The biggest project in the portfolio is close to York railway station and has a gross development value of £70m and construction costs under £55m. The profits

from this project will be released over a two year period, and the money should have been received before the building is completed. Neil Sinclair said that is likely that several of the properties could be redeveloped in this way to release considerable value for shareholders.

The business trades at a circa 30% discount to NAV and yields 6.3%. We expect the shares to react strongly to the redevelopment of York and other asset management successes in the portfolio.

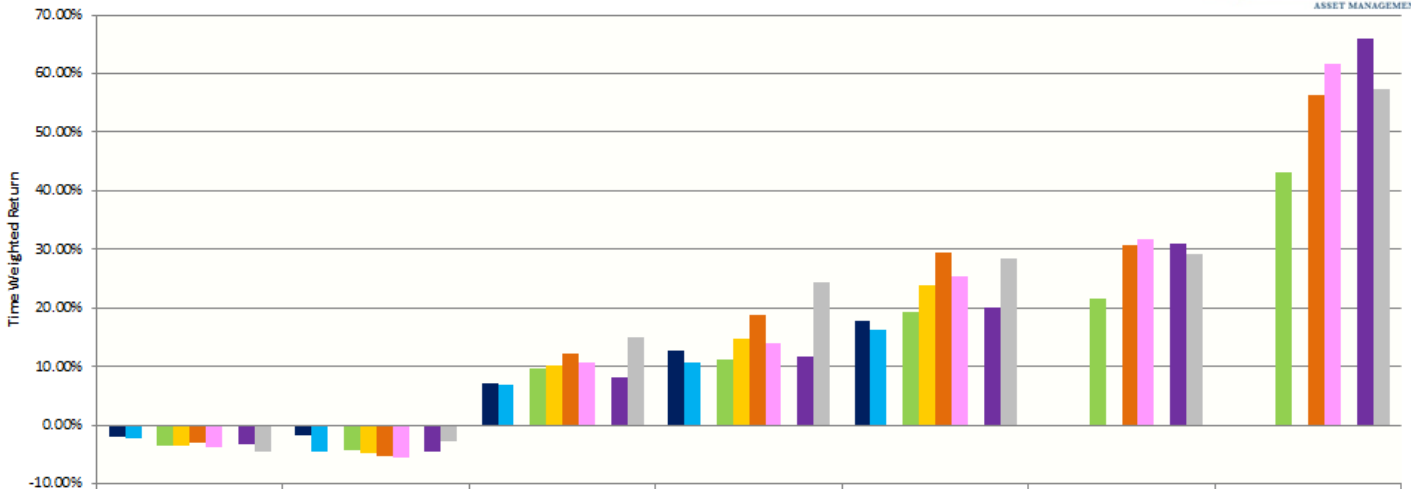
Halfords

Not all retailers are equal. Halfords is in a strong position as its services are driven by customers' needs for spare parts for their vehicles. They are also the largest seller of bicycles in the UK, which will no doubt be enhanced by the recent halving of the number of Evans Cycles stores following the purchase by Sports Direct.

Halfords also bought National Accident Repairs, a car servicing business. This plays to their strengths and helps to sell further car parts that are sourced centrally by Halfords. Branded car garages make most of their profits from car service and there ought to be room for a successful national chain focused on car servicing. If you don't need a full service but would like a headlamp fitted, Halfords offer a reasonably priced service to help you get back on the road.

The stock trades on a mere 10 times earnings and it has a yield of just under 6% covered 1.6x by net profits. The company has low levels of net debt, and will provide a steady income stream for patient investors.

4 Shires Performance Chart



	6 months	1 year	2 years	3 years	4 years	5 years	6 years
Risk A	-1.93%	-1.80%	7.18%	12.64%	17.72%		
Risk B	-2.22%	-4.54%	6.81%	10.71%	16.15%		
Risk C							
Risk D	-3.49%	-4.21%	9.62%	11.09%	19.31%	21.45%	43.15%
Risk E	-3.47%	-4.73%	10.23%	14.81%	23.91%		
Risk F	-3.11%	-5.32%	12.13%	18.88%	29.36%	30.61%	56.39%
Risk G	-3.90%	-5.62%	10.78%	14.00%	25.43%	31.78%	61.52%
Risk H							
Risk I	-3.18%	-4.45%	8.07%	11.59%	20.02%	30.82%	66.05%
FTAS TR	-4.58%	-2.66%	15.04%	24.46%	28.34%	29.14%	57.29%

Notes: Performance is measured to 05/11/2018. All 4 Shires performance figures are net of management fees, VAT, stamp duty and commissions. Total return measures include dividends and income received. Time weighted return measures consider deposits and withdrawals to/from the portfolio. The performance for each risk scale includes every portfolio in that risk scale at that time. FTAS TR is the FTSE All Share ex Investment Companies Index (Total Return). **Disclaimer:** The value of investments and the income you get from them may fall as well as rise, and there is no certainty that you will get back the amount of your original investment. You should also be aware that past performance may not be a reliable guide to future performance.

Markets

Investment markets throughout the year have been driven by the increase in the yield of the risk-free rate, the US 10 year Treasury bond, which has, in turn, repriced assets downward. Whilst the equity market rallied in the second quarter, the third quarter and beyond were mired in a correction caused by a reduction in risk appetite amongst investors as the risk free asset became more attractive. A yield of over 3% fixed for 10 years can look attractive when shares start to fall. Moreover, the US 2 year Treasury bond was yielding over 2.8%, and is less exposed to the effect of rising interest rates.

In this section we will look at the technology valuation correction, provide an update on emerging markets and Europe and give our outlook of our expectations for the coming year.

Technology valuation correction

The bull market in shares over the past nine years has been led by the technology sector. Valuations were pushed too high, and, in some cases, stratospheric levels. This was a different rally compared to the speculative 1999 tech bubble in that this time the companies actually had earnings and could be valued on their estimated growth in profitability. Facebook, Amazon, Apple, Netflix and Google, the FAANGs, rose with some excellent results and dominant market shares in social media, online shopping, mobile computing, home entertainment and internet search respectively. This had a halo effect on the whole sector, with valuations surging in other technology related shares including Uber, Tesla, LinkedIn (ride sharing, electric cars and business networking) amongst many others. Older technology shares also rallied strongly, particularly Microsoft who managed to reorganise their business into a subscription paying, cloud based business model with products such as Office 365.

This rally wasn't just linked to the US, and Chinese internet stocks also rallied in 2017. Their two internet giants, TenCent (social media and gaming) and Alibaba (online retail and payment systems) are also huge venture capital investment funds that dominate new technology company fund raisings, creating a near duopoly of new internet technologies through their ownership of these companies.

The cracks started to appear when Elon Musk's Tesla saw its debt pile rise rapidly as it started to gear up production to fulfil the large backlog of Model 3 electric

car orders. This caused, in turn, a crisis of confidence in the valuation of the group and its ability to complete the orders. The shares fell from $380 to under $260, although the recent production figures have seen the share price rally in November to over $350. This volatility was not just seen in Tesla shares.

Tesla Motors – 5 year share price graph

(*Graphs source: Ionic Information Ltd*)

Facebook suffered as well. Allegations of impropriety with customer data by its partner business, Cambridge Analytica, as well as the European Union's General Data Protection Regulations (GDPR) caused the shares to fall:

Facebook – 5 year share price graph

These are two examples of what has happened. Even the mighty behemoth of the internet shopping world, Amazon, was not immune. It is worth bearing in mind that over 50% of all US Internet shopping by value is done on Amazon, a truly incredible domination of that type of business. Again valuations were sent skyward until the sell-off took place.

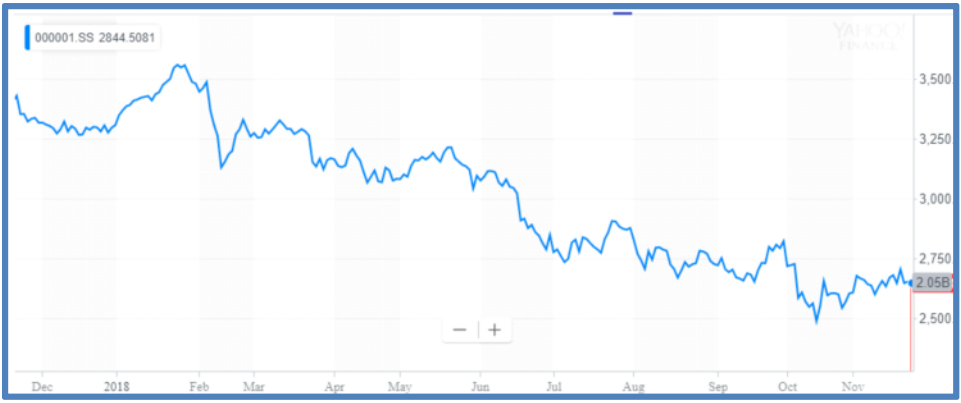
What is not clear is where valuations will settle. Facebook and Microsoft trade now on a modest 18 times and 23 times prospective earnings which some may now seem as attractive. Amazon trades on 77x prospective earnings. Tesla is yet to make a profit, but is projected to have $22 billion of turnover. This could be an attractive entry point for investors, but for the moment we feel there is slightly more downside than upside in technology shares. We reduced our exposure in 2018 but are attentively watching events unfold to see if an attractive entry point emerges for the sector.

Amazon – 5 year share price graph

Emerging market update

The recent falls in share prices in Emerging markets have been driven by the rhetoric from Trump's trade war, perception of Chinese economic fragility and also by rising US interest rates. China's share market's Shanghai Composite index has fallen considerably over the past year, and is back to levels not seen for five years. The economy has slowed down from the circa 7% trend growth rate, and expectations are that GDP growth will fall to nearer 5% over the coming few years.

Shanghai Composite index – 1 year share price graph



(*Graph source: Yahoo*)

However the structure of the economy is changing with recent announcements amounting to a tax break for lower income households and for those caring for older family members at home. China also faces a demographic bubble from its ageing population, and the latter change recognises the need to assist home carers financially.

There has also been assistance for major shareholders who have been turned into forced sellers of shares. In Asia it is common for large shareholders in businesses to borrow against the value of their shares to fund their lifestyles. This is all good when markets are rising, but in the current environment directors are receiving regular phone calls from their banks asking them to reduce the leverage on these loans. Directors are forced to sell shares, driving the share price down, and

reducing the value of their loan collateral, triggering further share sales. This creates a downward spiral. Xi Jinping, China's leader has said he will help these corporate executives, but there is little sign of assistance to date.

This weakening of the economy in China has started to be affected by Trump's trade war. Because China is one of the main engines driving Asian growth the rest of Asia's growth expectations have been reduced slightly. Our view is that this has been exaggerated and that emerging market shares are trading at an unjustified discount to developed market shares, possibly setting up a rally for 2019.

Europe

The recent problems facing Italy and the budget have put pressure on all European markets. This has not been helped by rising political instability in Germany as Angela Merkel's chancellorship comes to an end. The rise of the far right AFD (Alternativ fur Deutschland) has worried European allies. Macron's reforms in France have not progressed as fast as many had hoped, and resistance is building, most notably in the recent fuel protests. The French have been protesting against fuel price rises, particularly that of diesel, as Macron seeks to move the economy away from fossil fuels. Unfortunately this blunt tool has hurt poorer members of society who say that they are already struggling to make ends meet even before the proposed January price rise, the second in 12 months.

Yet we are sticking with our overweight position in European equities as we view the markets offering good value, particularly amongst smaller companies. The European economic recovery is continuing, unemployment is falling and consumer confidence is rising. Property prices also reflect this optimism, particularly in the primary cities.

We have exposure in Europe partially via **Henderson Eurotrust**, managed by Tim Stevenson and Jamie Ross. Stevenson plans to retire next year, and will be handing over control to Ross. They have recently trimmed their portfolio holdings number by 25%, focusing on their best ideas. Over five years the trust has produced a total shareholder return (including dividends) of 47.2%.

Investment Outlook

UK

With the UK's Brexit negotiations having ended, Theresa May now has to sell the deal to parliament. This is looking a tall order at the moment, and there is not a natural majority in parliament for the deal. Parliament will not endorse a hard Brexit, and an impasse has developed. If there was a free parliamentary vote, it is likely that Britain would not leave Europe at all. Given this gridlock, it is possible that a people's vote could be offered to the electorate, with three options: a) a hard Brexit, b) the current agreement with the EU or c) to remain in the EU. If the vote were to remain, sterling would rally considerably, and many of the underperforming UK focused stocks (e.g. utilities, retailers) would rally strongly. These stocks are on some of the lowest valuations in the developed world and are being shorted by hedge funds. This short position could reverse very rapidly.

Global Equities

These are likely to remain under pressure until clarity over the peak of US interest rates emerges. We believe that the current correction ought to end sometime in 2019 if US inflation comes under control. Emerging market equities look good value now, but will continue to be affected by the rising risk free rate in the US. Japanese equities are benefiting from good economic statistics and we believe shares can move higher as there is little restriction on monetary stimulus so far. The only cloud on the horizon remains a potential slowdown in China.

Bonds

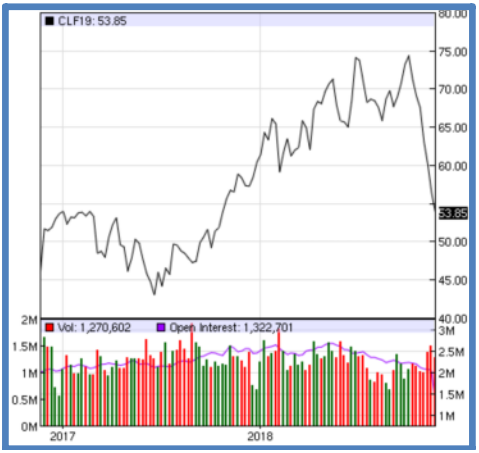
We are watching the US 10 year Treasury yield, and currently believe, based on the expected four to five Federal reserve rate hikes up to the end of 2019, that yields ought to peak between 3.5% and 4%, which ought to be a good entry point for investors.

We remain predominantly positioned at the short end of the UK bond market (under 5 years to maturity) and continue to view UK bonds as fundamentally unattractive as they yield less than inflation. With further rate hikes expected over the coming two years, we believe a rapid correction in the sterling bond market remains a possibility.

Commodities

The oil price has retreated sharply from $75 per barrel for West Texas Intermediate (WTI) in September to circa $54, and we expect some further downside due to expanding US production. This is despite US sanctions on Iranian production.

Metals are likely to remain depressed until the outlook for the Chinese economy becomes clear.



(*Graph source: Nasdaq*)

JLS – 21/11/18

Important

Compliance Section

In this section of the commentary, we would like to remind our clients and prospective clients of the following regulatory topics:

Risk Disclaimer

The value of investments and the income you get from them may fall as well as rise, and there is no certainty that you will get back the amount of your original investment. You should also be aware that past performance may not be a reliable guide to future performance. This document is not intended as investment advice.

Markets in Financial Instruments Directive II (MIFID II)

The MiFID II legislation came into effect on 3rd January 2018. It is a wide-ranging piece of legislation affecting the financial services industry. The aim is to increase transparency in the markets and further protect investors.

Here are the most significant changes that MiFID II will have on our clients:

(1) Client data – we may need to request further information from our clients if there are any gaps in the information we have for a client.

(2) Broker commissions unbundled from research costs – from January, 4 Shires will pay brokers separately for research. This means that trading commissions will reduce for our clients as the research component will be separated out.

(3) Quarterly reporting – 4 Shires will be obliged to send valuations quarterly. It will be a good opportunity to update preferences to receive reporting by email, if clients choose this method.

(4) Annual costs – 4 Shires will send greater detail about costs of managing portfolios, including the costs of the investments we make, broker commissions, stamp duty and other charges.

(5) Phone recording – we will be recording all calls to our Gillingham and Sherborne offices. As we will not be recording mobile phone calls, we will be asking clients to call our offices if we are providing advice or taking instructions from them.

(6) Suitability & appropriateness – the legislation enhances the requirement to make suitable and appropriate investments for our clients.

(7) 10% fall in portfolio value – MiFID II requires that we notify clients if the value of their portfolio drops by 10% or more in a particular quarter. Should this occur, we would like to remind clients that markets can, at times, be volatile, and it is almost always best to ride out the turbulence and benefit from any eventual recovery in share prices.

Suitability

It is very important that if your circumstances have changed you notify us. We need to ensure that your portfolios are managed in line with your

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4 Shires Asset Management Limited is authorised and regulated by the Financial Conduct Authority (FR3N number 557959). Company number 7657527

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