4 SHIRES

ASSET MANAGEMENT

Investment Commentary

4th Quarter 2018 & 1st Quarter 2019

Please join us for the

4 Shires Investment Seminar

The Army & Navy Club, 36 Pall Mall,

London SW1Y 5JN

Followed by our

Garden Party

St. James's Square

17:00 - 21:00

Thursday, 4th July 2019

Introduction

Welcome to the 4 Shires investment commentary for the final quarter of 2018 and the first quarter of 2018.

The world of investment has been more volatile over the past six months than since the large sell off in 2016 (see below). Shares have recovered nervously since the dual clouds of the US trade dispute with China seemed close to being lifted and the change in direction of US interest rates from a tightening stance to a more accommodative one.

Britain has faced its own self-inflicted Brexit related damage and UK focused stocks were unpopular during the last three months of 2018. However, as it has become clearer that a no-deal Brexit is unlikely, sterling rallied alongside selected domestic focused stocks.

The outlook for the rest of the year will depend on several factors including clarity over the medium term direction of US interest rates, China trade dispute resolution and a mild Brexit, or no Brexit at all, outcome.

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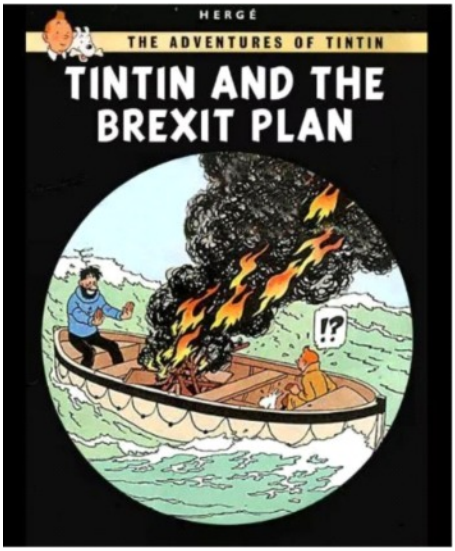
The whole of Europe has been gripped by the voting in parliament as Theresa May's negotiated departure was torpedoed by her own party and the Democratic Unionist factions. These nominally allied factions have split for many reasons, including a desire to ensure the integrity of the United Kingdom, a desire for a hard Brexit and also a desire for power via a parliamentary coup d'etat. The result is that a smooth path to a Brexit lies in tatters and the cross party negotiations that would have easily delivered Brexit two years ago are now beginning in earnest.

Unlike nearly everyone in Britain, we read and analysed Theresa May's and the EU's negotiated Brexit deal. Our views were that the deal enabled a departure from the EU which was not in the economic interests of the UK. It restricted free movement of people that was an obsession of the previous anti-immigrant home secretary, Theresa May. This would cause staffing and skills shortages in the NHS and other sectors. This is of course very different to the £350m extra money promised to the NHS. The decision to restrict movement of capital caused UK banks to set up overseas operations in the EU that has caused a considerable part of the estimated GBP 1 trillion of capital flight from the UK. The UK was the destination of choice for overseas investors, which has protected our currency from some of the full impact of our very large (as a percentage of GDP) trade deficit. The Netherlands has been the largest beneficiary of UK corporate HQs re-domiciling in the EU.



The free movement of goods and services were also not guaranteed in the declaration as it was to be part of a future trading relationship with the EU. This relationship was to be negotiated after the terms of the divorce, and the £39bn bill, were agreed. As Britain has discovered since the rejection of Theresa's deal, the free movement of goods is only part of the equation. However Britain's trade with Europe, circa 60% of our total external trade, was dominated by services at circa 70% of the total value. Even the movement of goods is not simple from the other side of a trading bloc as powerful as the EU.

For example, to transit the EU a certain number of licenses are handed out, apart from logistics companies of EU members who do not require them. These licenses would have fallen by 90% without a negotiated deal and companies would have become immediately unable to transit the EU, leaving to significant job losses. The free movement of services would have been curtailed significantly by the EU that has been looking to take advantage of Britain's exit to bolster and improve its own EU-domiciled service businesses, particularly financial and professional services. We continue to believe that the EU will grant free trade to the UK along Canadian or Japanese lines even with Theresa's deal, but that that free trade would not include the service sector.

The Irish backstop, in our view, was less of an issue that it was made out to be, and was contingent on the future trading relationship that has yet to be negotiated. Without successful negotiation of a trading agreement, particularly in services, it would have been possible that Northern Ireland would have had preferential trade with Ireland to protect the economy of the south due to the dominant trade with the North. It would have also protected parts of the Good Friday agreement. But what the negotiated deal highlighted was that Theresa May's red lines (immigration and border integrity and no customs union or single market membership as it would preclude 3rd party trade agreements) caused the EU's need for a backstop to protect the interest of its member, Ireland.

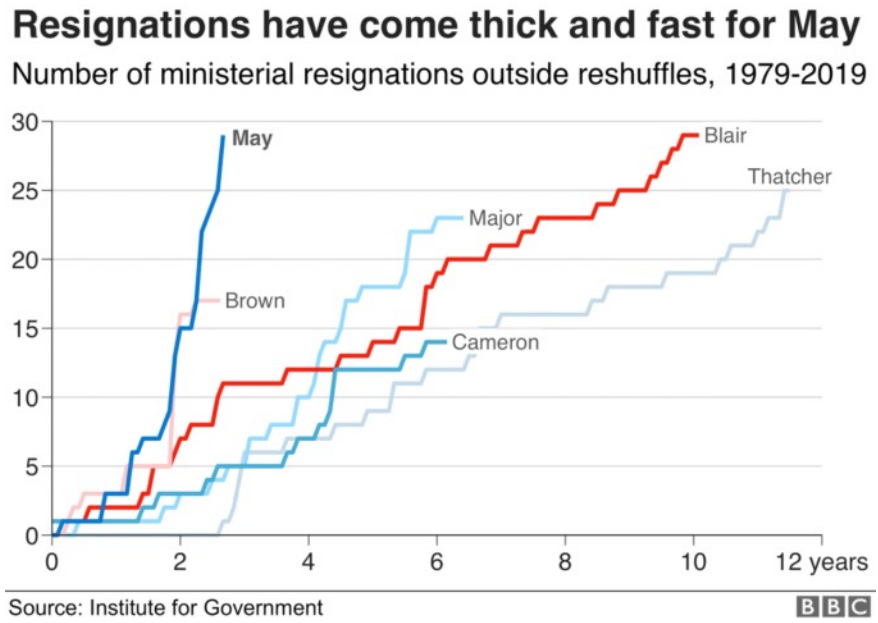
The mirage of external trade agreements in Britain's favour was shown by both the failure to negotiate any meaningful free trade deals apart from Switzerland and also the subordinate reality of how the US would have dictated the terms of its "free trade deal". It highlights why countries have moved into trading blocs (ASEAN in South East Asia, Mercosur in Latin America, ECOWAS in West Africa, NAFTA in North America and the EU) to use their combined market strength to negotiate better access to each other's markets. Britain's population of 65 million consumers is not as attractive as a market of 440 million (the EU

without Britain) and that Britain in such negotiations would almost certainly be in a weak negotiating position.

Brexit Update – Politics

The inconsistencies in the government's Brexit plan and parliament's desire to avoid a hard Brexit have led to some historic parliamentary votes, a collapse in cabinet discipline and cross party coalitions. The government suffered the largest defeat in parliamentary history on the first reading of the Brexit bill. Since that momentous vote the government has simply run out of time due to the prime minister's deliberate decision to delay the Brexit vote thereby putting pressure on parliament to agree to its terms or face a hard Brexit. Parliament has worked hard and quickly to ensure legislation to avert such an outcome could pass through in record time.

Many members of the cabinet have now openly admitted their decision to vote on their own conscience in the Brexit debates. This has led to a near complete loss of cabinet discipline, and this can be seen in the record number of cabinet resignations during Theresa May's premiership.



(Graph Source: BBC)

The true cause of the breakdown in cabinet discipline is that the Conservative party has been riven by dissension over Europe for decades. As Abraham Lincoln said, "A house divided against itself cannot stand", and this holds true for the Conservatives. Perhaps we are now witnessing the end of the broad church and, in line with other European states, the creation of a far right party based on Euroscepticism and anti-immigration (see our later article on Europe's far right). Ironically this is exactly what David Cameron's EU referendum was supposed to have cured as he fought a surging UKIP. Indeed Lincoln's pre US civil war speech in 1858 went on to say "I do not expect the house to *fall*—but I *do* expect it will cease to be divided. It will become *all* one thing, or *all* the other". This is an unlikely outcome for the Conservatives as they still cannot agree on Europe and the divisions are deeper now, more clearly defined, than ever before.

Parliament has now taken back control of the Brexit process as the thin veil of government discipline has been rent asunder. The current potential solutions have dissolved into three attitudes:

- Customs union with the EU and labour market protections. This is Jeremy Corbyn's favoured outcome and is the negotiating position of Labour

- EU 2.0. This is really membership of European Free Trade Association (EFTA) and participation in the European Economic Area (EEA)

- No Brexit

The list no longer includes a hard Brexit as parliament has firmly, and probably finally, rejected this outcome. Europe has allowed an extension until October 2019 for Britain to now complete the parliamentary process of finding a compromise deal.

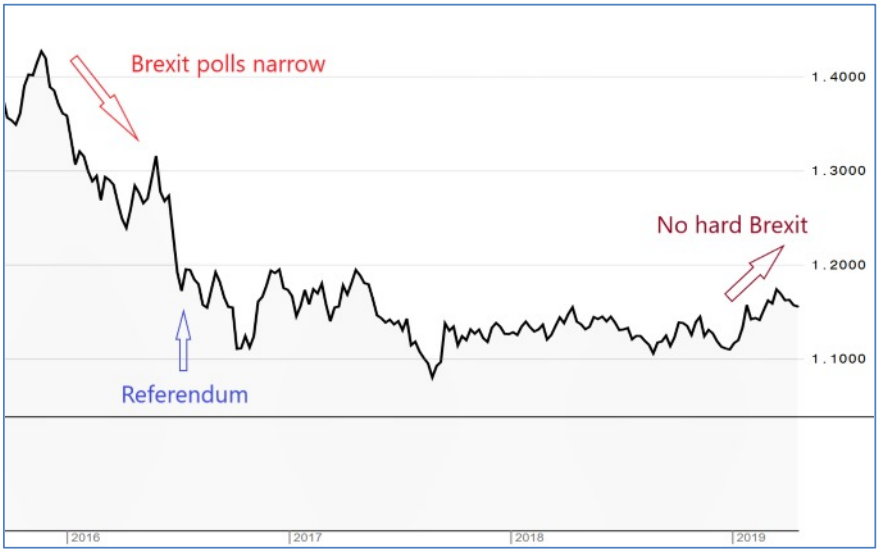
Our house view has always been that any decision made by parliament would have to be subjected to a second referendum and the Labour party has made it a condition of their support for a compromise. Despite Theresa May's inability so far to accept compromise, or indeed any way forward apart from her own, it is likely that cross party talks will produce a proposal along the lines of a customs union with the EU. However it is currently not certain that this proposal will gain a majority in the Commons. It also lacks the economic certainty of EU 2.0 whereby we are effectively party of the single market, pay into the EU budget, adopt EU laws relating to the single market BUT have no political influence.

This is unlikely to pass the Commons either as it would effectively leave Britain in the EU with no influence, and remaining in the EU *with* influence would be preferable to this option. The final option is no Brexit at all. Currently the country remains split into leave and remain camps although recent polls show an 8% to 10% lead for remaining.

Everything is still to play for as Britain decides its future in parliament and outside.

Sterling and Brexit

Since the beginning of Brexit negotiations the putative economic benefits of being outside the EU have been shown to have been almost completely illusory. There will be no Brexit dividend, trade terms with other trading blocs will be poorer than we currently enjoy with the EU and that a lack of inward investment will damage our balance of payments given our large trade deficit. It is the latter point that has been behind much of the damaging fall in sterling against the Euro since the Brexit vote:



(*Graph source: Bloomberg*)

The graph clearly shows that the financial markets' view of leaving the EU ahead of the vote and after the vote saw sterling drop from 1.40 Euros to the pound and drop further from 1.18 to the pound to 1.12 after the vote respectively. Since the beginning of 2019, and particularly since Theresa May's Brexit bill's defeat, the pound has rallied to its current level of 1.16 Euros to the pound.

We expect this trend to continue assuming there is compromise in parliament and consensus sufficient to a) approve a softer Brexit, b) a referendum on the Brexit solution agreed or c) no Brexit. However this is heavily laced with the caveat that any vote that puts a hard Brexit back on track would reverse these sterling gains.

UK Bankruptcies

There has been a disturbing rise of corporate insolvencies in the UK that have come in three particular areas (there may well be others). The first is where fraud has sunk a business, the second is where construction companies have faced tougher government contract criteria and finally where retailers that have weak business models have been smashed against their lenders loan agreements.

Patisserie Valerie was the highest profile victim of accounting fraud, where a net cash balance of £28m confirmed by accountants Grant Thornton transformed into a group where the company had overstated its assets and understated its liabilities by a massive £94m. This failure of management (including the board) and the auditor has left shareholders nursing a total loss of over £400m. Since the case has come to light the chief executive of Grant Thornton has resigned. However it is almost certain that shareholders will seek redress from the accountants for not performing their audit role correctly.

The bankruptcy of UK, Canadian and Middle Eastern construction company Carillion stunned investors due to the scale of the bankruptcy. Unlike Patisserie Valerie the signs of impending insolvency were everywhere in the financial statements, including a pension deficit at 30/6/17 of over £587m, high bank debts (over £690m at the same date) and inconsistencies from higher turnover not leading to higher profits in the 2016 annual report. The company had been under-bidding on contracts for many years and had been incurring debts it had no ability to repay from future profits. Carillion's finance director realised nearly £800,000 from share sales after his voluntary 'retirement' from the company.

The effect of the bankruptcy of Carillion has been for the government to require tougher financial strength before companies can bid for and be awarded government contracts. This has caused fund raisings via the issue of new shares at Kier and Galliford Try, but most damaging it presaged the insolvency of Interserve. Kier and Galliford Try also suffered from the hangover of a Carillion led contract to build a road in Scotland that went significantly over budget. Interserve simply could never meet the government's criteria for balance sheet strength. It was therefore only a matter of time before it went under.

The final category are retailers such as Debenhams, House of Fraser, LK Bennett, Evans Cycles (and the list goes on and on) who have suffered as the trend of bricks to clicks, or physical stores to sales via websites, continues. Most have simply failed, but some have been reborn as part of the process of Complex Voluntary Arrangements, or CVAs, that allow retailers to shed stores that are unprofitable. This has, in turn, shone the spotlight on property companies with high levels of retail exposure. Shopping mall companies are the most exposed, and Intu properties is viewed as the most exposed to such concerns:

(Graph source: Alpha Terminal)

The share price of Intu has fallen by 2/3rds over the past 5 years as it has struggled with high debts. It has now abandoned the dividend so that it can reduce its debts this way. Surprisingly occupancy has remained high at Intu over the period. The absolute level of debt is high at over 50%, but we consider that curtailing the dividend and the potential sale of its Spanish interests (in whole or part) could reduce debt to a level that ensures its survival.

Much of the developed world is suffering from High street retail problems. In the the far right damaging increase in business rates following the recent review. The end product may also be felt by the property companies, whose 'upward only rent review' clauses are clearly yesterday's contract. If these were to change significantly, and we think the clause may have to change or be abandoned, then the solvency of retails focused property companies could also be called into question.

Private Equity problems

The industry that has made some of the largest returns for its investors, and above all for its business owners/partners, has been private equity (PE). Its success has attracted many investment managers to the profits and tax advantages of its funds. However it is facing issues that make the assets it owns and sells to public markets of questionable value.

The insolvency of Debenhams has highlighted previous short-termism under private equity ownership that left Debenhams no longer owning its freehold estate. Private equity funds stripped out its freeholds and left it unable to cope with rising rents as it revenues fell due to the pressure from the internet on pricing.

But there are more worrying signs in private equity valuations. When funds bought companies they would value the businesses when obtaining bank debt based on current profits. Now this has changed to reflect all the cost savings that will be achieved over a five year period. This has pushed leverage in these companies to nearer 9 times from 6 times previously. This might sound like a clever way to improve returns given low interest rates. But when you realise that there is $2trillion of unallocated private equity funds raised in the world and that this could be deployed at 9 times leverage multiples, the source of the new crash could be right under our noses. Many private equity companies are buying other private equity companies, and a side effect of this is to keep valuations at high levels far above what is sensible. Scout24, a German online advertising company was sold back to the buyout firm that floated it in 2015 for a 50% premium!

And what of the private equity businesses that have been floated on the stock market? There is a long list of companies that were floated by private equity companies with far too much debt. The AA, Saga and Debenhams (and there are more examples) have all seen their shares fall dramatically as they laboured under a debt burden gifted to them from these 'wizards' of private equity.

What has sunk these businesses, and may sink those in private equity ownership, is a fall-off in their profitability. This has triggered administration and insolvency as the banks seek to recoup their investment in the debt. But at leverage multiples of circa 9 times, it may be the banks writing off their loans extended to these businesses.

Europe and the Far Right

In September 2017 Europe and was stunned when the Alternative fur Deutschland (AfD) party came third in the Bundestag elections. France has long had to deal with the Front National under Le Pen father and daughter. Viktor Orban runs Hungary with a high hand and blatantly blames Jewish philanthropist George Soros for the country's troubles. George Soros has promoted liberalism, education and a free press, none of which seem to suit the authoritarian, anti-immigrant Orban.

Can these parties take power? Viktor Orban has been in power for generations and in Austria the Freedom party, a far right party, are in a coalition government. Anti-immigrant, populist Matteo Salvini is in coalition with other parties in Italy. But were such parties like the AfD enter government in Germany or other major European countries what might happen?

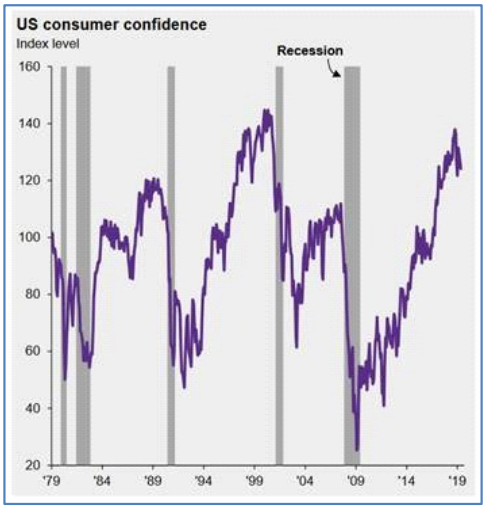
So far, major countries have avoided a lurch to the right that endangers civil liberties, bar in Hungary. There is certainly a fight back underway to return Europe to a more moderate European ideal and the example of Britain's attempt to leave the EU will have been noted by the member states and their populations.

The thought of a more fragmented EU and a drift to the far right should of course be taken seriously by those committed to a peaceful, coexistence in Europe. But perhaps the example of Brexit may convince many to move back to the centre ground. Recently, Slovakia has elected a liberal, centrist president into power. However, if this reaction to the far right doesn't continue, the future could look bleak for Europe.

The knock on effect of these disruptive politics has been concern over EU political stability amongst investors, and this has put pressure on the performance of EU stock markets.

American exuberance

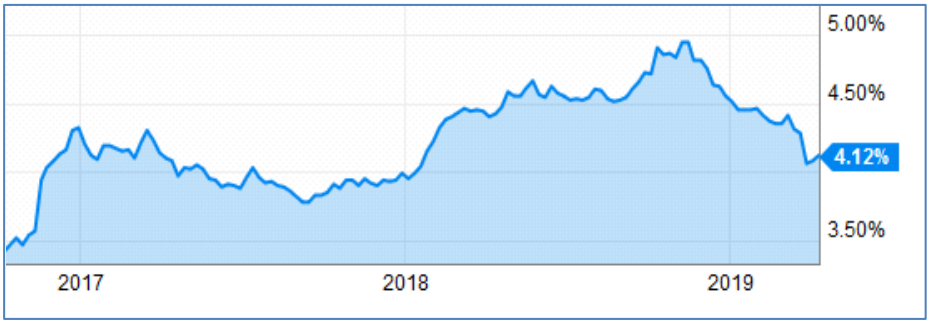
Since the global financial crisis of 2007 and 2008, the American consumer has undertaken a massive deleveraging of their household debt, which peaked at nearly 100% of GDP immediately before the crash. At the time, this exceeded US government indebtedness. Now, however, the positions are reversed, with government debt stubbornly high whilst household debt is now circa 75% of GDP (see below). This is a significant fall after decades of consumer credit growth. The deleveraging since the recession has coincided with a spike in US consumer confidence, a remarkable recovery since the doldrums of 2008.



(*Charts source: JPMorgan*)

The health of the American economy will continue to be a key part of President Trump's message running into the 2020 election campaign. His distaste for Fed Chairman Jay Powell's series of interest rate rises since his appointment is well known, and could be responsible for consumer confidence coming off its peak (see chart above). However, the Fed has now adopted a more dovish tone, helping bring down the 30 year mortgage rate from a high of 4.9% in November 2018, to 4.1% today. Unemployment is at historically low levels, below 4% - a level that often sees an inflexion. However, whilst it remains low, wage growth should continue to be strong. Cheaper mortgages and higher wages will improve disposable incomes and put the wind back in the sails of consumer confidence.

US 30 year mortgage rate



(*Chart source: Ycharts*)

This sounds good, but whilst pricing pressure at US companies remains weak, and companies' staffing costs increase, margins will be squeezed. Corporate earnings are forecast to be slightly negative in the first quarter of 2019, and expectations of full year earnings growth have been coming down since January (*source: Factset*) before picking up again in 2020. This does not bode well for US share prices. At most of Trump's rallies, chances are he will ask his constituents how their 401(k)s (a type of defined contribution pension scheme) are doing. If US corporate earnings and share prices fall, Trump may not like their answer.

In any case, we continue to feel that above average price-to-earnings (p/e) ratios make US stocks look pricey. The p/e ratio could become compressed if share prices fall faster than corporate earnings. This might occur if there are lingering uncertainties over the earnings trajectory at US companies. This is particularly true of high growth stocks.

There are some bright spots though. A dovish Fed will help companies refinance their debt at lower rates, reducing their debt-service costs (just like falling mortgage rates do for the consumer). If an inflexion in unemployment does occur, this could be supportive for share prices, depending on the reasons for it. If companies begin to shed staff to cut costs as wages increase, they could defend their bottom line. However, if it is seen as a sign of a weakening economy, those 401(k)s won't be looking so healthy.

US politics and the 2020 presidential election

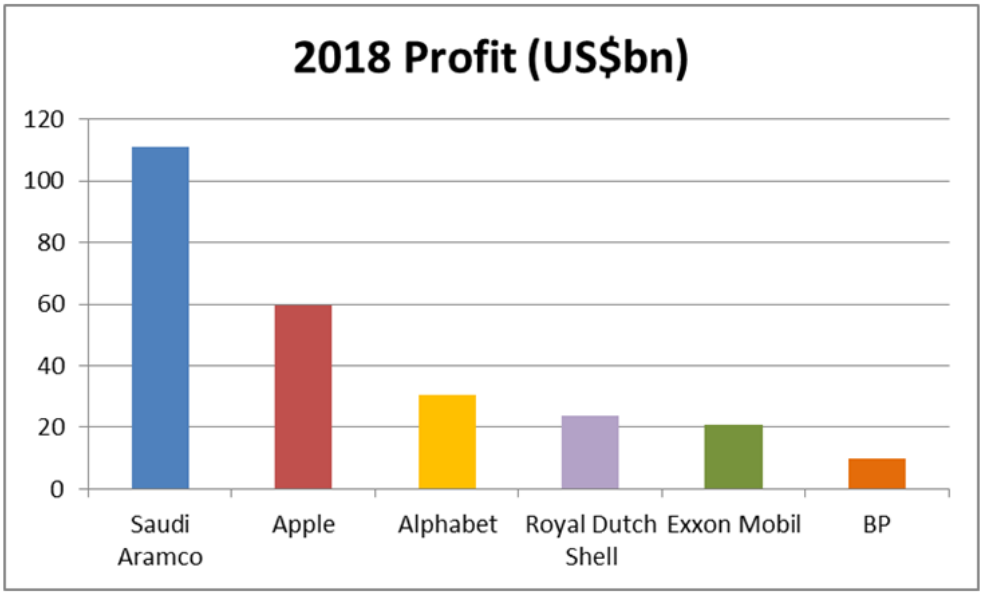
What course then, will the President take in his bid to be re-elected? It seems that two core parts of his electoral base are opposed to each other economically. If you have watched Ed Balls' insightful BBC2 programme "Travels in Trumpland", you will have seen Obama-turned-Trump voters from among the 'forgotten' white working class lauding their additional $100 per month salary. This was thanks to the Trump tax cuts, where US companies passed through some of their bumper profits to workers. Wealthier Trump supporters, his other main core supporters have benefited from the rise in the value of the stock market over his presidency and are unlikely to desert him now.

Trump faces a crowded field of Democratic Party hopefuls for the 2020 election. It is by no means certain which challenger Trump will face to win the Presidency. Depending on who this is, Trump's message may change as the campaign progresses. On 6th February, he said "we need people in our country because our unemployment numbers are so low and we have massive numbers of companies coming back into our country … we need people to run the factories and plants". Good for the wealthy Trump supporters, but not the "Trumplanders". But this apparently soft rhetoric comes amid continual hostility towards illegal immigration from Mexico and other Central American countries, and threats to either close the border or bus illegal immigrants to so-called "Sanctuary Cities". These seemingly contradictory policy stances can be explained by the dichotomy of Trump's electoral base.

The question marks remain over the Mueller inquiry and the lack of full publication has created considerable suspicion over its contents amongst the populace. A lack of criminal charges may be more damaging for Trump during the upcoming election campaign while suspicion remains over his involvement in Russia, which he denied despite his desire to build a large Trump tower in Moscow.

The world's biggest corporate profit

Apple, Alphabet, Exxon Mobil, which one has the world's largest profit? The answer is none of them. That accolade goes to the world's largest oil company, Saudi Aramco who made US111bn in 2018. Ahead of a large bond issue by the company, a 470 page prospectus for the bond detailed interesting facts about the company.



(*Source: The Telegraph*)

The profit per barrel to Aramco is only US$26 as a result of high corporate tax rates used to fund more than 60% of the Kingdom's income. Royal Dutch Shell made US$38 per barrel, which we hold for our clients, and Exxon Mobile US$34 per barrel.

The key Ghawar field, the largest oil field in the world, once produced 5m barrels a day. The prospectus shows that this production has dipped now to 3.8m barrels a day. It is not certain how long this production can be maintained.

To balance the books of the government, the Saudis require an $80 oil price, but this means keeping a very tight lid on production. It is able to do so at the moment due to the falling production in Venezuela and the resumption of harsh Iranian sanctions. In addition, Russia is cooperating in choking off supply into the oil market.

However, against this backdrop of tight control over OPEC production, the oil market remains well supplied with healthy inventories. However problems have come from the redesign of refineries that take Saudi heavy crude which no longer receive sufficient cargoes to optimise the economics of the refineries' output. Any breach in control in OPEC, a change of government in Venezuela, a change to the Iranian sanctions or Russia abandoning its pact with OPEC could see the oil price come down quickly. But it is worth bearing in mind that oil usage could start to decline soon as the world moves away from fossil fuels. If that were to take place at a quicker pace than expected, the oil supply glut could see the oil price collapse closer to its recent low of US$28 per barrel.

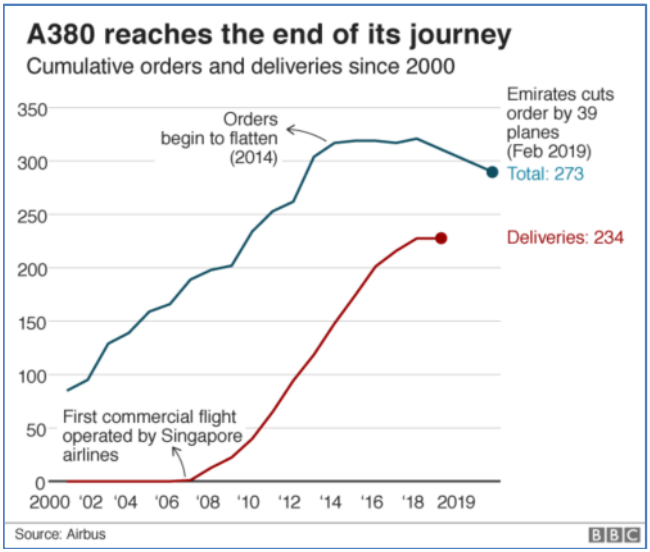
Portfolio Activity and Investments

The fall in the world's stock markets in the fourth quarter of 2018 was mirrored by a powerful rally in the first quarter of this year. As always, it is best to remain invested to benefit from the powerful rally that comes after a market drop. We were defensively positioned in the fourth quarter, and as soon as the Federal Reserve relaxed its tightening bias on US interest rates, we slightly changed our holdings in favour of stocks that would benefit from a market rally.

In this edition we will talk about the effect of the Boeing 737 800 Max crashes and Airbus' ending of production of the A380 superjumbo and we also look at the following stocks: Fidelity China Special Situations, Ten Lifestyle, Hurricane Energy, RBS, GVC. (*Price graphs source: Alpha Terminal*).

Boeing and Airbus update

Neither of the two largest civilian aircraft manufacturers have been having an easy time recently. Boeing's newest version of the most successful commercial plane, the 737, has had several accidents linked to anti-stalling systems in the plane. The 737 800 Max planes in Asia and in Africa both suffered cataclysmic crashes just after take-off that took the lives of all on board the plane. The similarities between the accidents implied that the cause might be linked. Initially Boeing denied this, but quickly admitted that there was a problem, most likely with the anti-stalling system. Boeing has recently been doing its own safety regulation, encouraged to do so by the Federal Aviation Authority (FAA), which commentators have suggested may not be appropriate. The questions over compensation remain. Boeing has since cut production from 52 planes a month to 42. The intention to ramp this up to 57 planes a month from mid-2019, although this has been put on hold.



Airbus has been struggling with new orders for its Airbus A380 superjumbo which has suffered from the improved economics of twin engine competitor wide-body jets, the A350 and the Boeing 777 and 787.

The A380 needed to garner 700 orders to be profitable, it only made it to 312, until the recent cut in Emirates' order. The superjumbo had been designed for long haul routes, and it was no surprise that long haul airlines bought the plane, and Emirates were circa 40% of all orders received.

The problem has been that engine maintenance and fuel consumption do not justify the increased cost of the plane. It is a case of two engines good, 4 engines bad for the long haul airlines. The Boeing 777 can carry between 314 and 396 passengers making the economics more favourable than the Airbus A380.

Fidelity China Special Situations

The recent rally in the Chinese economy since December last year has caused some good gains in our two main stocks with exposure to the area, Henderson Far East Income and Fidelity China Special Situations (FCSS). These do remain vulnerable to the trade negotiations with the Trump administration, but we believe both countries need to settle their differences, particularly on intellectual property.

We have met the fund manager of FCSS on a visit to London and feel confident in his investment strategy. China's economy is moving to a service economy and away from a manufacturing dominated economy. The fund is well positioned for this. It also trades at a small discount to net asset value, or NAV (the red line on the chart below), enabling us to pay 92p for 100p of assets (as at 3/5/19).

Ten Lifestyle

Ten Lifestyle is one of the pioneers of the remote concierge industry. Wealthy people, primarily customers of private banks, seek access to travel organisation, hotel and restaurant bookings. They may also need a good plumber or electrician for maintenance of their flat.

The business floated on the AIM market in November 2017. They raised new money for two main reasons, to further develop their in-house IT software systems and to finance the losses of operating in America. The former gives them a competitive edge in their operations, and once it is finished costs will begin to fall away and cash flow increase. The business currently operates in Europe, Asia Pacific and USA. Europe is profitable, Asia Pacific is close to profitability and the USA will be loss-making for several years to come.

The business had several profit warnings after flotation, mainly related to the computer system being delivered later than anticipated and slightly over budget. The shares are tightly held and so they fell considerably. However we could see they had circa £20m of net cash on the balance sheet and the business was likely to break even within two years. We bought into the shares below 30p in Q4 2018 and traded out of half our holding at 76p in Q1 2019. We intend to hold the balance as we perceive the company is wining contracts, expanding their addressable market and still has further upside.

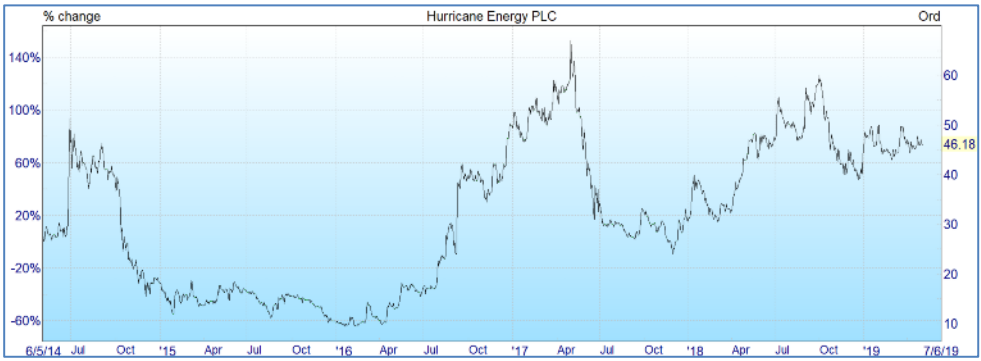
Hurricane Energy

Hurricane Energy is an oil and gas exploration and production (E&P) company which has made oil discoveries in the highly prospective area West of the Shetland Islands. Its discoveries are close to the Clair, Schiehallion and Foinaven fields operated by BP, which are already in production.

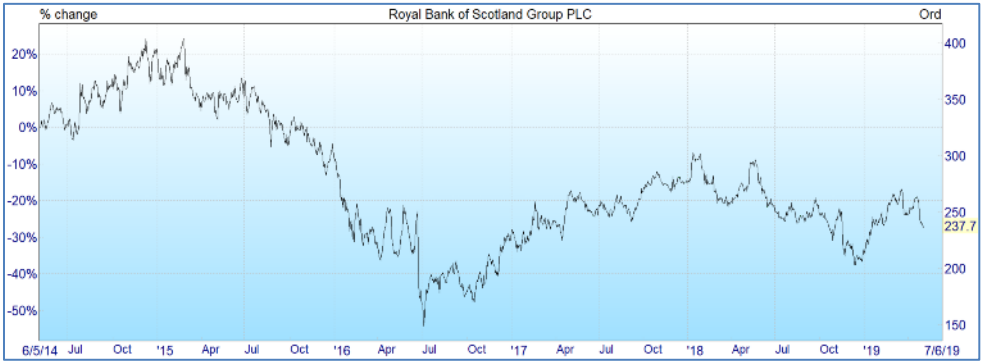
Hurricane is moving to an early production system from their 100% owned Lancaster field. This means getting oil out of the ground earlier than a normal field development plan might take, with first oil expected before July this year. This ought to be circa 17,000 barrels of oil per day (BOPD), and there are plans to double this production over the coming two years. At the initial level of production and with a US$60 oil price Hurricane ought to generate circa US$200m of gross operating cash flow.

The company has sold a 50% stake in the nearby Warwick and Lincoln development area to Spirit Energy in exchange for US$340m of drilling costs on the block. This drilling programme started in April 2019 and this should firm up the structure of the oil and gas field on the back of the previous Lincoln discovery on the block. The block is estimated to hold between 228m and 2.7bn barrels of oil, with an estimated assumption that 40% to 50% of the oil is recoverable. Any good news here ought to feed through to the share price of Hurricane.

The presence of oil majors BP, Exxon Mobil, Statoil and Shell in neighbouring acreage as well as Hurricane's partner Spirit is very encouraging, as is the scale of the discoveries made to date. This could lead to a bid for Hurricane Energy in the coming few years if Hurricane can prove it can extract oil successfully in line with its plans and also convert 'resources' into reserves. We have bought some shares in Hurricane around 47p and will be watching events closely.



RBS

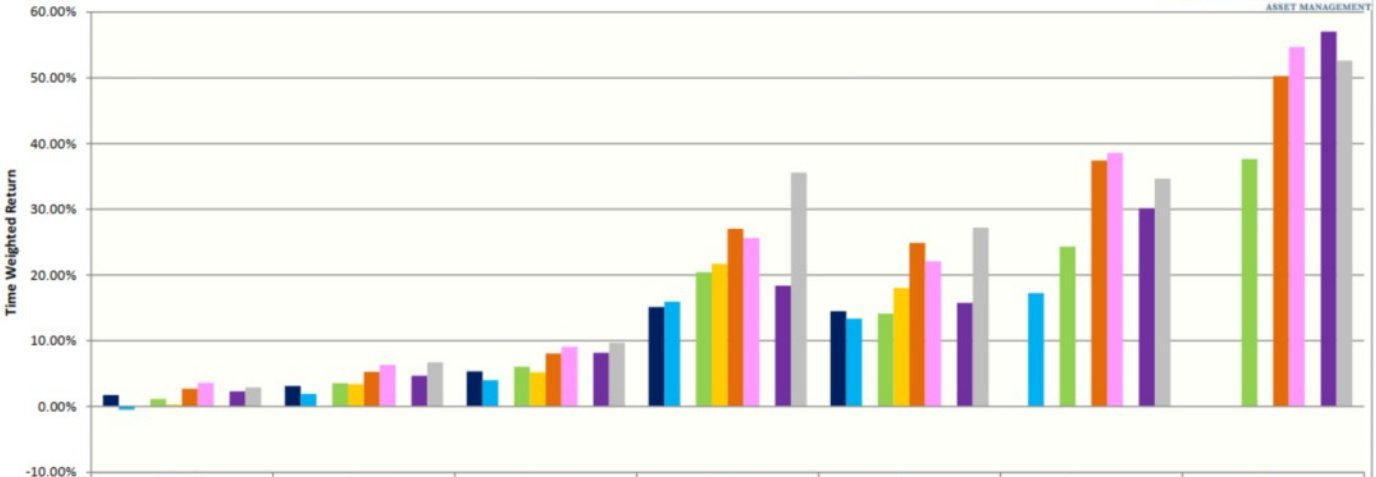


Royal Bank of Scotland has finally come out of the problems that have beset it since the global financial crisis. The capital adequacy has been rebuilt to a tier one ratio of 16.2% and the bank recently paid a large special dividend to shareholders. The stock trades on an undemanding Dec 2019 9x earnings and a prospective dividend of 5.9%, falling to 7.7x the following year with a 7% yield. The yield is well supported by the surplus capital. The recent announcement of a slowing lending market is a Brexit related problem that we are optimistic will temper over the coming twelve months.

GVC

The internet gaming business, GVC, has had a difficult twelve months following the acquisition of Ladbrokes in March 2018. However the stock has rallied recently and we are hopeful that the problems of the company from increased regulation and taxation are behind it. The stock trades on a modest 10.5x December 2019 earnings with a prospective yield of 5.5%.

4 Shires Performance Chart



	6 months	1 year	2 years	3 years	4 years	5 years	6 years
Risk A	1.74%	3.11%	5.36%	15.15%	14.51%		
Risk B	-0.47%	1.91%	4.03%	15.96%	13.37%	17.27%	
Risk C							
Risk D	1.14%	3.55%	6.06%	20.43%	14.15%	24.33%	37.64%
Risk E	0.30%	3.40%	5.23%	21.70%	18.04%		
Risk F	2.71%	5.28%	8.08%	27.04%	24.89%	37.44%	50.29%
Risk G	3.63%	6.35%	9.11%	25.65%	22.11%	38.59%	54.72%
Risk H							
Risk I	2.32%	4.67%	8.17%	18.39%	15.76%	30.15%	57.05%
FTAS TR	2.91%	6.74%	9.68%	35.59%	27.22%	34.66%	52.63%

Notes: Performance is measured to 05/04/2019. 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

Equities

Global equity markets had a significant rally in the first quarter of 2019, following on from a correction in Q4 2018. In this section we will highlight the UK and the Chinese/US trade war.

UK Market Review

(*Graph source: Alpha Terminal*)

The FTSE 350 total return index fell by as much as 12% to its low point just after Christmas, and this year, up to the 4th May has regained all those losses. It was rather a lost period for UK shares in that the market went down and all the way back up again.

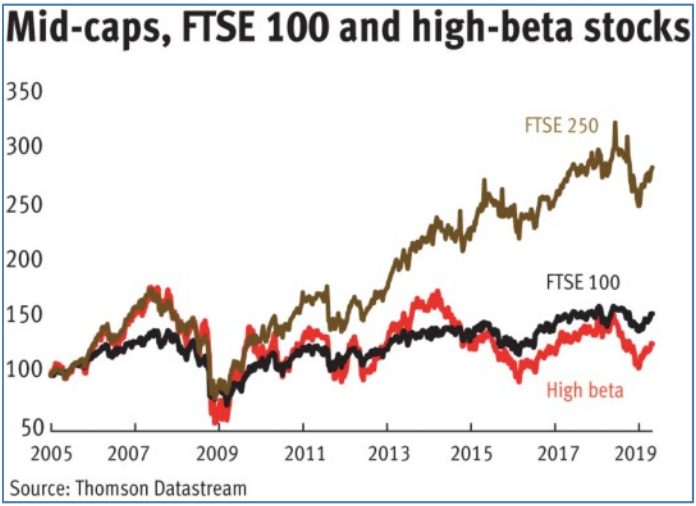
There was a trend in UK markets which continued over this period. Investors have preferred internationally sourced revenue over UK- sourced revenue due to domestic concerns over Brexit and the weakness of Sterling (which boosts earnings for companies trading overseas). This was reflected in the performance of the FTSE 100 (circa 80% international earnings) which rose 4.47% over the period relative to the FTSE 250 (circa 50% international earnings) which rose only 0.26% (including dividends). The chart below demonstrates that FTSE 100

earnings have outpaced the FTSE 250 since the autumn results season in 2016 – shortly after the Referendum and the sustained drop in Sterling's value.

Internationally focused consumer goods companies such as Unilever and alcohol producer, Diageo (who produce semi-premium brands such as Smirnoff, Captain Morgan and purchased George Clooney's tequila brand, Casamigos, for $1 billion in 2017), are prime examples of companies currently in favour. The ethical sector, such as renewable infrastructure funds (we hold The Renewables Infrastructure Group), also produced standout returns over the period as they were re-rated to premiums over the book value of their assets, partially reflecting their above market, inflation protected dividend yields.

(*Graph source: Thomson Datastream*)

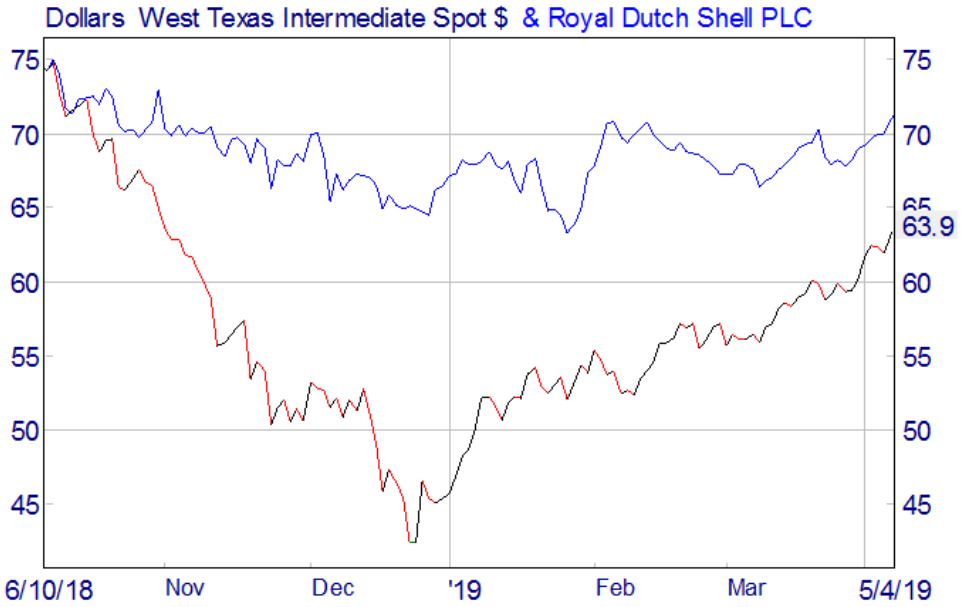
The depreciation of Sterling has encouraged overseas listed companies to purchase UK assets at lower price levels. This has provided UK shareholders with good returns. For example, Whitbread, the owner of Premier Hotels, sold their Costa Coffee brand to Coca-Cola for £3.9 billion – this crystallised circa 35% of the company assets in cash and £2 billion is being returned directly to shareholders via share buybacks.



We see value in the mid cap FTSE 250 space, it has outperformed the FTSE 100 and 'high beta' stocks (high beta means that a share price will be highly correlated with the performance of the underlying index) in recent years but has lagged since the Brexit vote (please see graph above). The recent bounce back in Sterling should help the FTSE 250 recreate some of this past performance as circa 50% of revenue is UK sourced versus only 20% in the FTSE 100. We currently balance our overseas and domestic currency exposure due to the imminent likelihood of a softer Brexit deal.

The cheapness of the UK market could be seen in February when the FTSE 100 was expected to yield 5% (Projected by Link Asset Services) as dividend payments reached a new record high when prices fell over the run up to the Article 50 withdrawal deadline. As of 8/4/19, share price expectations have broadly recovered and the FTSE 100 prospective yield is 4.7% (*source AJ Bell*). This still presents excellent value for income investors.

Other pockets of the market providing good returns were miners which are producing record amounts of cash and benefitting from lower oil prices. This includes our holding, Rio Tinto, which has returned a dividend of 8.61% over the year and committed $1.1 billion in share buybacks for 2019. Generally, UK listed miners have also been particularly cash-generative due to the depreciation of the dollar, iron ore production problems in Brazil and a lower oil price. The mining sector rose circa 24.78% over the period.



UK oil stocks have performed less well over the period but have perked up as military tensions rose in Libya and Venezuela – boosting the oil price at the beginning of April. The UK Oil and Services sector fell 28.7% over the period. Large oil companies, BP and Royal Dutch Shell, outperformed the sector (we hold Royal Dutch Shell). Their share prices fell 3.4% and 5.6% respectively due to their operational ability to handle lower oil prices (Please see the graph above for Shell's share price performance (top line) versus the West Texas Intermediate oil price).

UK-listed global asset managers such as Schroders and Jupiter Fund Management recorded share price appreciations of 11.9% and 26.25% respectively due to the improvement of market performance in Q1. The Life Assurance industry also recorded decent returns with Legal and General rising 21.73% and Prudential, which benefitted highly from the improved market conditions in Hong Kong, also rose 21.42%. UK listed international banks did less well due to the revised US interest rate outlook with HSBC, the most sensitive to rising global interest rates, falling 1.2%. UK focused banks such as Lloyds and RBS outperformed their international rivals, recording share price appreciations of 5.6% and 0.9%

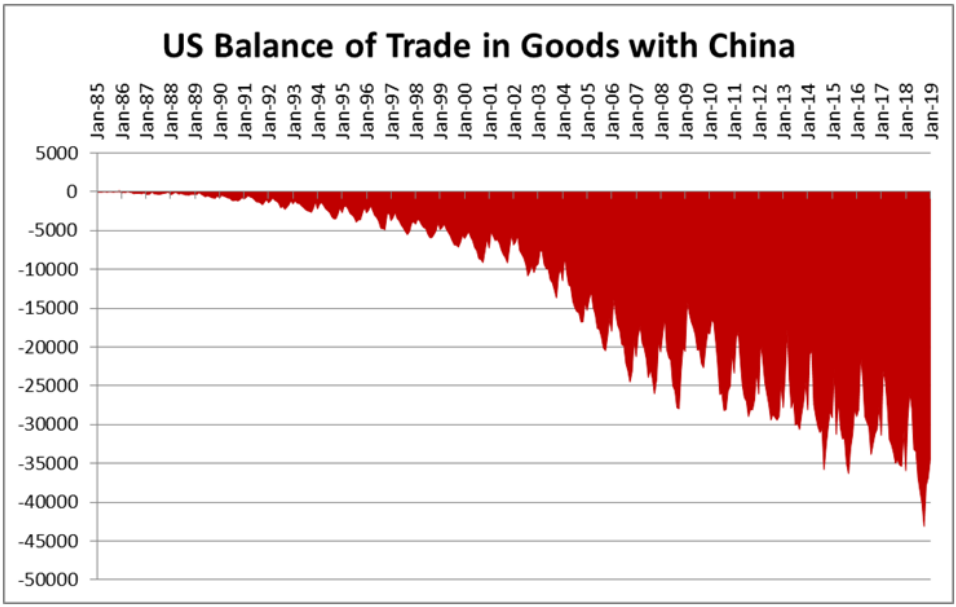
respectively. This was despite the Bank of England's decision to hold rates steady at 0.75% in February.

Capital goods stocks also performed less well due to China/US trade tensions, although Trump has been looking to complete a deal by May which bolstered sentiment toward the end of Q1. In particular, the automobiles sector performed poorly. Aston Martin Lagonda, which came out of private equity group 'Investindustrial', was floated. The IPO price range of £20 to £22.5 per share was valued on the same multiple as Ferrari whose cars, if you look at auctions of classic cars, depreciate at a far slower rate than the average classic Aston Martin. Furthermore, the IPO costs of £75m (not including share incentives issued of £61m) were almost the size of 2017's £84.5m profit (the first in 6 years). This was revealed in February's full year results and the share price declined 40.3% over Q4 -Q1.

China trade war, or Cold War two?

China is the workshop of the world, and the United States of America is their biggest customer. As we have discussed in previous investment commentaries, the USA therefore has a substantial trade deficit in goods with China. Although not enough to cancel it out, the USA does have a surplus in services. Despite the tit-for-tat tariffs imposed by Presidents Trump and Xi on each other's economies, the US monthly trade deficit in goods with China reached a record high in October 2018; of $43bn. 2018 as whole also saw the highest ever recorded annual trade deficit in goods, of $419bn.

For the moment at least, despite the tariffs, the numbers aren't showing a slowdown in China's export figures. Yet throughout 2018, the Chinese stocks sold off on poor sentiment. The p/e ratio of the CSI 300 Index (the largest 300 companies on the Shanghai and Shenzhen indices) fell from over 18x in February 2018, to just under 12x in October 2018. As at time of writing (17/04/19), sentiment has improved, with the p/e ratio having recovered to 15.3x. (*Source: CEIC Data, China Securities Index Co).* Year to date, Chinese markets have done well, although there has been fairly little change in the trade war news flow. Investors seem to be paying more attention to the numbers rather than headlines.



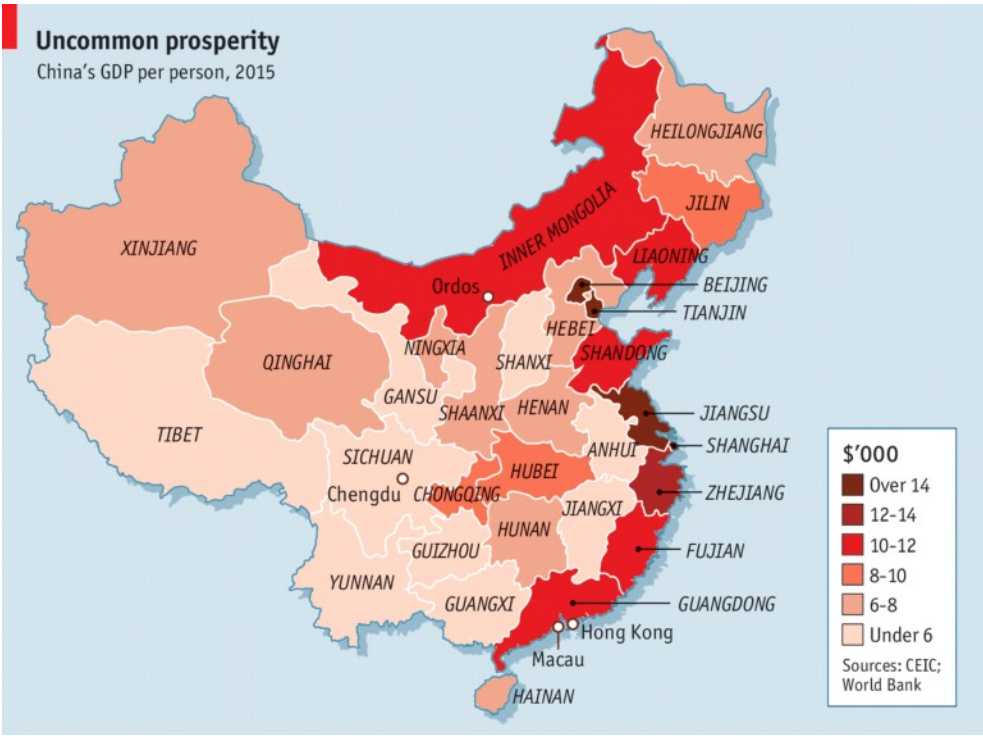
(*Source: US Census Bureau, scale in $millions*)

The focus on the balance of trade by Trump is more of a sop to voters, who were sold the promise of the return of manufacturing jobs to America's heartlands. A rather more bipartisan concern in the US is that of forced technology transfer from US firms undertaking joint ventures with Chinese ones, and outright intellectual property (IP) theft. Clearly the USA is unhappy about losing its technological edge, but the reason for China wanting to take it in the first place is not entirely about becoming a prestigious superpower. There are also practical economic concerns.

Historically, China was the world's workshop primarily because they can sell their products competitively, thanks to a cheap and educated workforce. But the process of urbanisation is slowing as the fields empty, and wages are rising to a level where ASEAN countries (e.g. Cambodia and Vietnam) can undercut them, at least in basic goods. Without an edge on price, China is being forced to upskill its workforce, and begin exporting higher value-added goods. It also needs to stimulate domestic demand. This in turn is pushing up wages and making China less competitive for basic exports, e.g. textiles.

It is easy to think of China as a monolithic bloc, but this is not true. Whilst the country is over 90% Han by ethnicity, there are significant regional cultural, linguistic and wealth variations. Whilst the below chart is a little out of date, with the exception of Inner Mongolia province, high GDP per capita provinces are heavily concentrated on the coast line. The interior remains relatively poor. Why?

The reason is that China's Pacific coastline is its interface with the world, and where the money flows in from trade. China's other borders are relatively impassable – in the West, Xinjiang and Tibet are sparsely populated, high plateaus. To the South, the Himalaya Mountains block off India and Yunnan province's border with Burma/Myanmar is also difficult to traverse with hilly terrain and poor roads. To the North, the Gobi desert (and historically, the Great Wall) blocks off Mongolia.



(*Graphic source: Economist*)

The quandary for the Chinese leadership is attempting to raise the living standards of the 'have-nots' of the interior by redistributing export wealth, whilst simultaneously defending their export model from being undercut by other economies.

China is more dependent on the USA than the USA is on China. The USA can buy goods elsewhere, especially when they become commoditised. China would struggle to replace the buying power of the USA. By improving the technological complexity of its manufactured products, China can escape the competition of other economies and also increase the USA's dependence on its products. This will help it defend its export model until it can stimulate enough domestic demand for those products. The problem of course with raising the wealth of the interior is that it will cause wages there to rise, allowing further labour cost undercutting by neighbouring countries, and so on. When that happens, Alibaba CEO Jack Ma may struggle to find labourers willing to work 72 hour weeks.

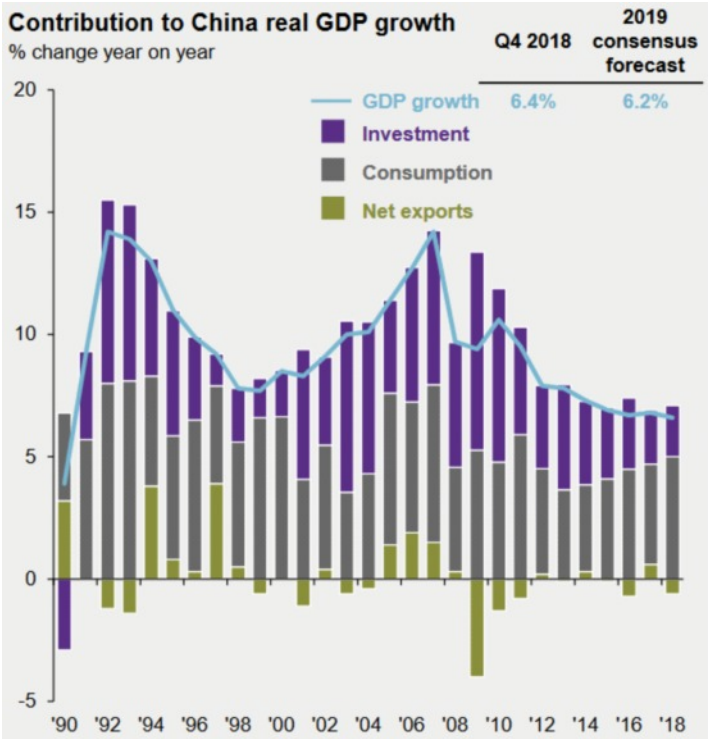
Naturally then, the USA has sought to stifle Chinese technology companies, for example with the arrest of the CFO of telecoms giant Huawei. Trump and his trade representatives have insisted that IP protection are included in any deal. More recently, China has seemed amenable to making concessions in this area. This may be simply because investment in domestic innovation has increased – China would rather be independent of Silicon Valley. Across Chinese companies, they are now creating significant IP that they would like to have protected. China would also like to avoid the US domination of "chokepoints" around key naval trade routes – hence China's South China Sea reef, and overland Belt & Road projects.

So what is the outlook for Chinese equities? As we have seen with the p/e ratios in 2018, they have a tendency to move with trade war sentiment among investors, rather than fundamentals. But this could be a red herring. The move to domestic consumption is further along than many people realise, with consumption now contributing the lion's share of GDP growth.

China has also been stimulating its economy by cutting its reserve-requirement ratio, encouraging banks to lend more to small and medium sized enterprises (SMEs). GDP growth for March 2019 came in at a better-than-expected 6.4%. Further cuts scheduled for 2019 may no longer occur. After a decent run, and at

a p/e of 15.3x, the Chinese market looks fairly valued compared to historical levels.

But it could get pumped higher by the Peoples' Bank of China, which has just injected another $6bn to the market by agreeing to buy securities directly. The MSCI Emerging Markets index is set to increase its allocation to China 'A' shares (listed domestically, rather than in Hong Kong) fourfold in 2019, by increasing the "inclusion factor" from 5% to 20%. This means that instead of scaling down the total market capitalisation of China 'A' shares to one-twentieth in the index, they will only be scaled down by one-fifth. The China 'A' share allocation will increase from 0.71% of the index to 3.3%. Analysts believe this could cause up to $125bn of inflows into China 'A' shares, which would be a huge boost for the market.



(*Source: JP Morgan*)

Outlook

The global equity markets have rallied strongly since January. The equity rally is likely to continue, but a slower pace from here. Technology stocks look overvalued, and UK domestic stocks look very undervalued (alongside sterling). We remain cautiously optimistic for returns in the rest of 2019.

JLS/DAL/ LH

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.

Senior Managers Compliance Regime

From December 2019 onwards, 4 Shires will be required to comply with this new regulatory environment for senior managers. We currently do not believe that this will impact you. If we discover that you need to be informed of any facet of these new regulations we will be in touch.

Suitability

Please contact us as a matter of urgency if you feel that you wish your portfolio to be run in a different way (for example on a lower risk level) or if your financial situation has changed.

It is vitally important that we look after your portfolio with a mandate that fits your personal requirements.

Know Your Client and Anti-Money laundering

We will be contacting you shortly to ensure that we have your correct address and any to check that any other details (e.g. passport, driver's license) have changed so that we have the most up-to-date information on your circumstances.

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