FUND MANAGEMENT DIARY
Meeting held on 5th June 2018

Could the financial crisis happen again?

- There have been substantial regulatory and institutional changes which aim to address some of the systemic weaknesses that led to the global financial crisis

- But risk cannot be entirely eliminated from the financial system and the effectiveness of the new regulatory institutions and policy tools has yet to be tested

- The crisis in Italy has the potential to turn into a systemic threat to the euro-zone economy

New regulations have reduced the vulnerability of the global financial system
The global financial crisis a decade ago was centred initially on the United States sub-prime mortgage market but broadened out to become a full-scale banking, financial and economic crisis enveloping large parts of the world. Accordingly, a number of factors ultimately played a part in both its origination and development. These include lax financial regulation, which was exposed by the development of new financial instruments, and inappropriate pay and incentive structures.

Some fairly substantial changes have been implemented over the last decade to tackle the weakness of the regulatory system, with the intention of reducing the risks of another systemic crisis developing. These include: (i) the establishment of new regulatory institutions; (ii) the ring-fencing of riskier financial activities; (iii) bank stress tests and increased capital requirements; (iv) bank taxes and levies; (v) increased savings protection; and (vi) altered pay/incentives structures.

Of course, these changes have varied in nature and extent across different countries and areas. In some cases, there have been substantial institutional reforms. In the United Kingdom, for example, the Financial Services Authority has been replaced with a veritable alphabet soup of new bodies, including the Financial Conduct Authority and the Bank of England's Financial Policy Committee. And in the euro-zone, banking supervision has been centralised under the European Banking Authority.

In other areas, the changes have arguably been more evolutionary. Nonetheless, there have been discernible effects on some aspects of the financial sector's

behaviour. Banks' capital ratios are well above their pre-crisis lows in most major advanced economies and there have been marked changes in financial sector pay and incentives in some countries. For example, the British Bankers' Association has estimated that the total bonus pool for bankers in Europe, the Middle East and Africa shrank by some 50 per cent between 2009 and 2015, with overall bank pay falling by some 35 per cent over that period. The result is that bank Chief Executives are now paid up to 30 per cent less than their peers at other FTSE 100 companies.

But it would be very optimistic to conclude that there is no danger of another systemic crisis

But despite these changes, it would be highly optimistic to conclude that the financial system is now "fixed" to the extent that there is no danger of another crisis. After all, the introduction of new banking supervision bodies and stress tests has clearly not prevented some individual financial institutions from running into problems – for example several in Italy. And the young life of some of the new macro-prudential bodies and their policy tools means that their effectiveness is as yet unproven. Meanwhile, it is not clear that changes in pay structures have entirely eliminated the incentives for bank executives to take what might turn out to be misguided risks inspired by short-term performance and potential rewards.

More generally, there is of course a limit to the extent to which regulatory and institutional changes can – and indeed should – attempt to eliminate risks from financial sector activity and from the overall system. Risk is, after all, an integral element of finance.

The response of policymakers will be crucial to preventing a crisis from becoming systemic

However, even if the financial system is still structured in a way that allows risks to crystallise, it does not mean that something on the scale of the global financial crisis is likely. One key issue is whether policymakers are better equipped than before to respond to the emergence of some sort of crisis. The evidence on this is mixed. The good news is that policymakers should have learned some important lessons from the last crisis and recognise the need to respond swiftly in a crisis.

They may also think twice before allowing major financial institutions to fail, at least without properly assessing the ramifications. Meanwhile, the institutional changes since the last crisis may mean that the lines of responsibility between different bodies are rather clearer now. And there are some new tools and instruments for policymakers to employ, such as the euro-zone's bail-out funds.

But there is one major cause for concern. As things stand, central banks have much less ammunition to respond to a crisis than they did last time, when they ended up cutting interest rates sharply. Some of them can undertake more quantitative easing, of course, or go a step further and drop the proverbial helicopter money, in which central banks print money that is distributed directly to firms or households. But these policies are less straightforward and surely less effective than cutting interest rates sharply.

The same can be said of fiscal authorities who are generally facing higher levels of outstanding public debt than they were a decade ago. Policymakers therefore face a tricky balancing act to build up their ammunition with which to fight the next crisis – which means raising interest rates and tightening fiscal policy – whilst avoiding inadvertently precipitating a new one in the process.

A renewed crisis in the euro-zone is a distinct possibility

Overall, there are some reasons to think that the probability of a repeat of the global financial crisis or something like that is relatively low in the foreseeable future. Regulatory and institutional changes have probably reduced the risks inherent in the financial system. However, risk has not been entirely eliminated from the financial system and, while there is no new sub-prime mortgage boom, there are other potential triggers.

One possible trigger would be a worsening of the situation in Italy. Although the risk of a renewed surge in Italian bond yields has diminished following the formation of the government, the new administration is on a collision course with the European Union and tensions may flare up again before long. No political party has proposals that might help the country overcome its structural problems, boost long run growth and help to reduce the public debt burden. Meanwhile, some of the policies may even make them worse. And as long as the likes of Germany refuse to contemplate changing the existing European Union fiscal rules, questions about Italy's future will continue to be asked both within and outside the country.

It is doubtful that a crisis in Italy could ever be an isolated incident. If a referendum on euro membership was called, it would pose a systemic and existential risk to the whole European Union 'project'. In this situation, contagion would become a key issue and the European Central Bank would have to engage in outright monetary transactions for the first time.

Strategy

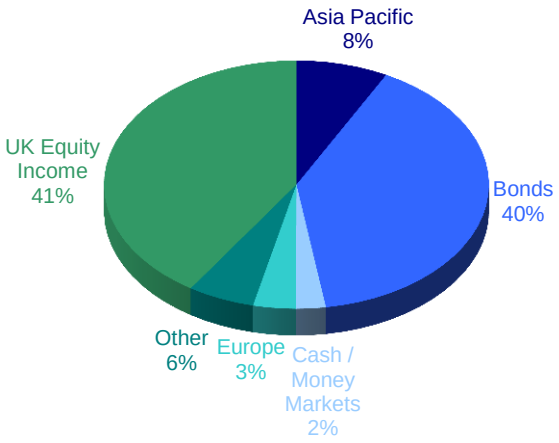
While we believe that the risks surrounding Italy described above are an unlikely scenario, the continued political instability in Italy could have a negative impact on

asset prices in Europe. Future Money have been mindful of political risk in Europe for some time, and our exposure to European equities is currently below neutral.

Last week the instability in Italy led to the widening of credit spreads, as investors required greater returns due to the perceived increase in risk, which lowered the valuations of lower quality, high yield bonds. Meanwhile, bond markets saw increased demand for higher quality (investment grade) bonds, which increased their valuations. This was broadly favourable for Future Money, as our bond allocations are predominantly UK investment grade bonds, and we hold no direct exposure to the Italian bond market.

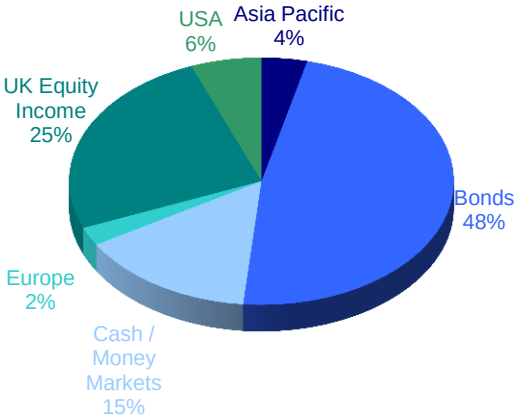
Income

No changes are currently planned for Future Money Income. Threadneedle UK Equity Income and Rathbone Income continue their recoveries from weaker performances at the start of the year, and all other holdings are performing in line with expectations.



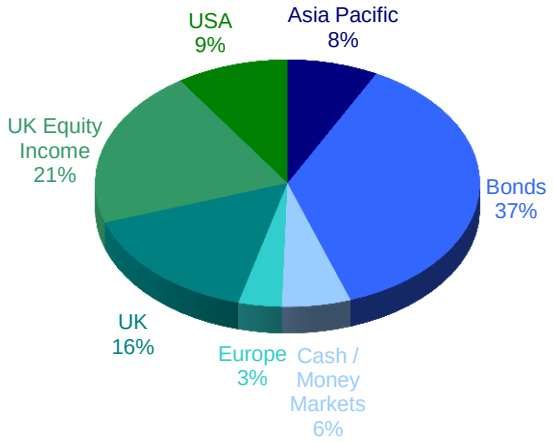
Real Value

The portfolio's bias towards to the UK and away from Europe within the equity allocation is proving beneficial in the current environment. No changes are currently being considered.



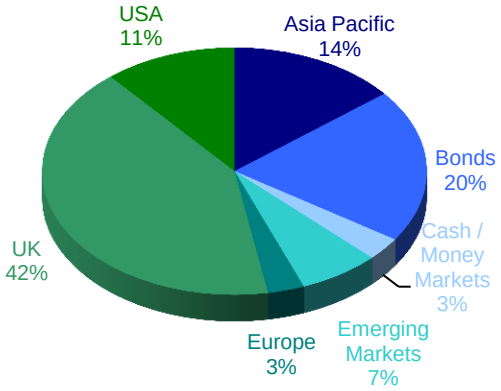
Real Growth

The portfolio's bond exposure is performing well with the bias towards short duration assets helping reduce volatility. Invesco Perpetual Tactical Bond is a slight exception and this will be closely monitored over the coming weeks.



Dynamic Growth

Threadneedle UK Growth & Income has been the weakest performing UK equity fund over the past year (delivering 2.6% against the 11.1% achieved by the best UK fund). A meeting was held with the fund's manager earlier this year and a review of the fund conducted. The weaker performance appeared due to the manager's avoidence of those areas of the market which had momentum but unattractive valuations. In recent months, this trend has reversed and the fund has improved significantly. Over three months the Threadneedle fund has been the portfolio's best holding, delivering 12.4%.



Important Information

Please note that the contents are based on the author's opinion and are not intended as investment advice. This information is aimed at professional advisers and should not be relied upon by any other persons.

Any research is for information only, does not constitute financial advice or necessarily reflect the views of the author and is subject to change.

It remains the responsibility of the financial adviser to verify the accuracy of the information and assess whether the fund is suitable and appropriate for their customer.

Past performance is not a reliable indicator of future performance. The value of investments and the income derived from them can fall as well as rise and investors may get back less than they invested.

Important information about the funds can be found in the Supplementary Information Document and NURS-KII Document which are available on our website or on request.

For any information about the Future Money funds please contact the authorised corporate director, Margetts Fund Management Ltd, on 0121 236 2380, admin@margetts.com or at 1 Sovereign Court, Graham Street, Birmingham B1 3JR. A copy of their Terms of Business which relates to investments into the funds can also be obtained using these contact details.

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