FUND MANAGEMENT DIARY
Meeting held on 12th June 2018

Slowdown around the corner

- Weakness at the start of the year in advanced economies should prove to be temporary

- The United States is expected to slow in 2019 as the cumulative effects of monetary tightening begins to bite and the boost from fiscal stimulus fades

- A reversal of monetary policy expectations in the United States next year could result in government bond yields across major developed economies starting to re-converge again

Growth in advanced economies was weak in the first quarter, but this should be temporary

The performance of major advanced economies was quite weak at the start of this year. Aggregate gross domestic product growth fell from around 2.5 per cent annualised in the fourth quarter of 2017 to around 1.6 per cent in the first quarter of 2018. This slowdown was partly a result of weak consumption growth. The drag was largest in the United States, even though overall growth there held up relatively well due to boosts from stock building and net trade. And in Japan, the consumer slowdown helped to bring an end to the longest uninterrupted economic expansion since the 1980s.

However, it is doubtful that the first quarter has set the tone for household spending for the rest of the year. First, the weakness was largely due to temporary factors. In the United States, consumer spending on motor vehicles dropped back after a post-hurricane spike at the end of last year. And in Europe, extreme cold weather discouraged consumers from hitting the shops.

Second, consumer confidence surveys generally point to a recovery in household spending. Admittedly, the relationship between the two has not been as close in the United States and euro-zone during the past couple of years as it used to be. But it is reassuring that consumer confidence indices in these economies have been at their highest levels since 2000. What's more, consumer sentiment is holding up fairly well in Japan by recent standards.

Finally, the fundamental drivers of household spending growth are still supportive. Strengthening labour markets are underpinning growth in disposable incomes in all

major advanced economies. The real pay squeeze has come to an end in the United Kingdom, and exceptionally-low unemployment rates and rising labour shortages have even begun to generate wage pressures in Japan. Moreover, surveys suggest that wage growth will pick up in the United States in the coming months, at the same time as households benefit from tax cuts. In the euro-zone, wage growth may be slower to gather pace, but employment is set to continue rising strongly, household balance sheets are in fairly good health, and credit conditions should remain accommodative.

But a slowdown is on the horizon in the United States

Rising employment will probably put further upward pressure on wage inflation and persuade the Federal Reserve to hike rates a further three times this year and twice more in 2019. Over the course of next year, however, the United States economy is likely to slow as the effects of the fiscal stimulus fade, tighter monetary policy begins to bite and jobs growth slows. Gross domestic product growth could fall from 2.8 per cent in 2018 to 2.0 per cent in 2019, and just 1.5 per cent in 2020. This in turn could cause the Federal Reserve to begin cutting interest rates in 2020.

However, the risks of a trade war with China or a United States withdrawal from the North American Free Trade Agreement have risen in recent months. Either of these would be a clear negative for the United States economy, at least in the short term. But with exports accounting for just twelve per cent of gross domestic product, the direct impact would not be enormous. Subjecting between ten and fifteen per cent of that trade to tariffs is going to hit exports equivalent to 1.0-1.5 per cent of gross domestic product at most. Similarly, any impact on inflation from import tariffs would be relatively contained, of the magnitude of 0.5 percentage points or less. Nevertheless, increased trade protectionism would risk an even sharper slowdown in the United States next year.

The economic outlook for the euro-zone remains reasonably good for 2018 and 2019. Domestic product growth of 2.3 per cent in 2018 and 2.0 per cent in 2019 could be achieved. Employment growth has remained healthy, investment intentions are strong and economic policy is supportive. There is also plenty of spare capacity in the labour market in many countries. Nevertheless, with underlying growth slowing, wage growth and inflation will probably rise only very slowly. Accordingly, the European Central Bank will be very cautious about normalising monetary policy.

In Japan the unemployment rate is at a multi-decade low and is likely to fall a little further in the coming year or two. But it would have to fall a lot further in order to generate enough wage growth to meet the Bank of Japan's two per cent inflation target, and that seems unlikely. Further ahead, the sales tax hike planned for

October 2019 is a potential headwind. What's more, with the economy running into capacity constraints, gross domestic product growth could slow from 1.2 per cent this year to 1.0 per cent in 2019, and down to just 0.3 per cent in 2020.

We hold a fairly optimistic view of the outlook for the United Kingdom economy over the next few years, notwithstanding the Brexit uncertainty. The British economy could expand by 1.6 per cent this year, accelerating to 2.0 per cent in 2019. Higher wage growth and falling inflation should boost real household incomes and business intentions remain upbeat. With headline inflation likely to return to target by the middle of next year, the Bank of England should be able to raise interest rates rather faster than markets expect. The central bank could raise its policy rate twice this year and two times next year, taking Bank Rate to 1.5 per cent by the end of 2019 from 0.5 per cent currently.

Interest rates to start converging in 2019

Following the scenario set out, monetary tightening in the United States could push yields on ten year Treasuries up to 3.25 per cent by the end of 2018, from around 2.9 per cent at the end of last week. And in the United Kingdom, monetary tightening could take yields up to 2.00 per cent by the end of next year, from 1.4 per cent now. Over the course of 2019 though, a sharp slowdown in the United States could trigger a revision of monetary policy expectations. This could cause ten-year bond yields in the United States to fall to 2.50 per cent by the end of the year.

Elsewhere, the policy rate in the euro-zone will start to rise around September 2019, which seems to be what financial markets are expecting. As such, the yields on German bunds are likely to rise slowly to 1.00 per cent by the end of 2019, from around 0.45 per cent at the end of last week. Meanwhile, sentiment towards Italy is expected to worsen as the new government increases spending and concerns about Italy's future in the currency union continue. Italian bond yields could reach four per cent (up from three per cent now) by the end of 2018.

There appears to be no imminent prospect of higher interest rates in Japan. With inflation likely to remain well below two per cent throughout 2020, the Bank of Japan will probably leave its short-term policy rate and zero ten-year Japanese government bond yield target unchanged for the foreseeable future.

Turning to currencies, the dollar is expected to weaken against the euro and sterling over the next few years as ten-year government bond yields start to re-converge. The dollar could weaken to $1.20 per euro by the end of 2019 (from around $1.18/€ at the end of last week) and to $1.45 per pound (from around $1.34/£).

Strategy

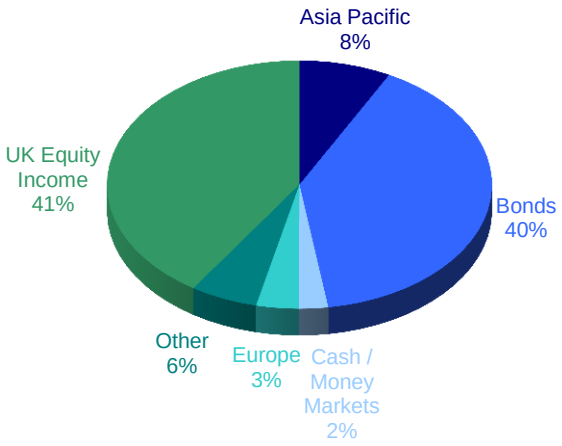
Future Money expect the rate rising cycle will be gentle, but negative for fixed interest investments. Interest rate sensitivity is increased due to the current historically low yields / credit spreads, and we have already limited our exposure to these areas.

Equities are favoured as continued economic growth will support valuations, however there are some valuation bubbles, particularly within the larger indices, and we expect active management may provide an advantage to tracking funds.

The UK is favoured on a valuation basis. We currently hold low allocations to Europe as the impact of interest rate normalisation could be more significant in Europe due to the lower starting position. We hold an underweight allocation to the US due to elevated valuations in this market.

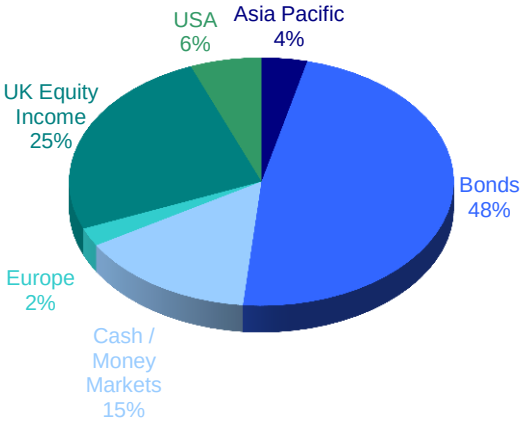
Income

The Fidelity Short Dated Corporate Bond fund was first added to the portfolio three months ago and has performed well in the short term since then. The fund has delivered 0.5% return over this period, when wider bond markets have been flat. The fund's attractive yield (nearly 4%) and short duration positioning are key reasons for the fund's inclusion in the portfolio.



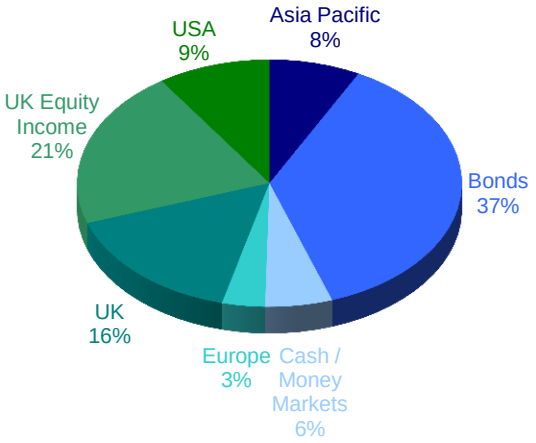
Real Value

No changes are currently planned for the Real Value portfolio. Fund selection is performing well with the exception of Invesco Perpetual Tactical Bond which is currently under review.



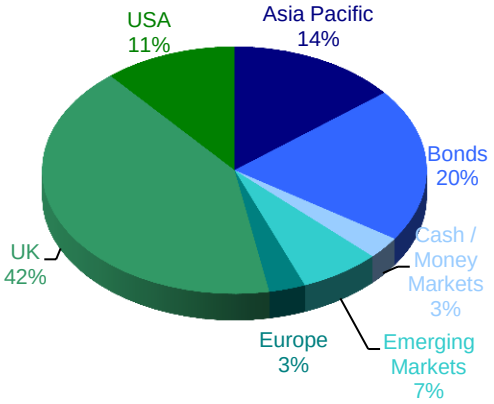
Real Growth

No changes are currently planned for the Real Growth portfolio. Fund selection is performing well with the exception of Invesco Perpetual Tactical Bond which is currently under review.



Dynamic Growth

Dyanmic Growth's equity allocation has risen above target and therefore small sales will be placed from the largest holdings in the Uk and US to rebalance the portfolio. No further changes are currently being considered.



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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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