FUND MANAGEMENT DIARY

Meeting held on 18th September 2018

Turkish crisis leading to recession

- Falls in the lira have caused a sharp pick-up in inflation which, coupled with a severe tightening of financial conditions, is filtering through into an abrupt slowdown in economic growth

- Sentiment towards emerging markets has deteriorated in the wake of the crisis. The threat of macroeconomic contagion from Turkey is small, but there are greater risks on the horizon

- Overall, the lira will likely remain weak and volatile and gross domestic product is expected to fall by around four per cent at the start of 2019 compared to the previous year

Financial turmoil in Turkey is likely to push the economy into a deep recession

Major vulnerabilities have been building in Turkey's banking sector over the past several years. These have mainly been because of quick credit expansion and high levels of corporate borrowing, which resulted in inflated property prices and an increased reliance on foreign financing. Consequently, Turkish banks have become exposed to roll-over risks and wider credit conditions have become more vulnerable to swings in global risk appetite.

There are several ways to assess external financing vulnerabilities, but the broadest is to look at the gross external financing requirement as a share of foreign exchange reserves[1]. The latest data show that Turkey has one of the largest gross external financing-requirement-to-foreign reserve ratios in the emerging world. As a result, it's no surprise that Turkey was hit particularly hard in the emerging market sell off earlier this year, which was caused by weaker sentiment following the tightening of monetary policy in the United States.

The Turkish lira has fallen by 40 per cent against the United States this year as a result of the crisis and this is now feeding through into a sharp pick-up in inflation – the headline rate reached a fifteen-year high of 17.9 per cent in August. Higher

[1] The gross external financing requirement is the sum of the current account balance plus external debt that is due to mature over the next twelve months. By comparing this to foreign exchange reserves we can get a sense of external financing needs against a country's foreign exchange assets.

inflation, coupled with a severe tightening of financial conditions, is filtering through into an abrupt slowdown in economic growth.

Various macroeconomic indicators point to the strain that the currency crisis has caused. Labour productivity has stagnated and unemployment is rising. What's more, confidence in the construction, retail and services sectors have plunged to record lows, vehicle sales are declining at a rate of 30 per cent compared to the previous year and Turkstat's Economic Confidence Index recorded its weakest reading since 2009 in August.

Will Turkey's crisis affect other emerging markets?

Turkey's problems and the fall in the lira appear to have caused a deterioration of sentiment towards financial markets in the emerging world. Most emerging market currencies are down against the United States dollar and central banks in India and Indonesia have reportedly intervened in foreign exchange markets in response. It is possible that this could make financial conditions more difficult for emerging economies in the coming months.

Nevertheless, aside from the impact on a few small neighbouring countries, most notably Bulgaria, the direct economic impact of the crisis in Turkey on other emerging markets should be limited. Concerns have flared up about European banks' linkages with Turkey, but financial ties between Turkey and other emerging markets are small. Trade ties with Turkey are not large either, so a sharp downturn in Turkey shouldn't be damaging for emerging market exports. Aggregate emerging market exports to Turkey amount to just 0.3 per cent of emerging market gross domestic product.

A potentially bigger threat to emerging markets lies in contagion. History suggests that a crisis in one emerging market can spread to others which share similar vulnerabilities. However Turkey's vulnerabilities appear to be unique. Most emerging markets' current account deficits have narrowed significantly since the so-called 'taper tantrum' in 2013. As such, it isn't surprising that that the macroeconomic strains resulting from recent currency falls have been contained to Turkey and Argentina – these two emerging market countries have the greatest external financing vulnerabilities.

That said, other headwinds facing emerging markets have arisen in the past few months. China's economy is now slowing, the United States economy is likely to slow next year as the Federal Reserve's rate hikes start to bite and the boost from fiscal stimulus fades, emerging markets are now tightening monetary policy and the

trade war is escalating. These could have a broader impact on risk appetite, which would cause investor sentiment towards emerging markets to deteriorate further.

What is next for the Turkish economy?

The lira is likely to remain extremely volatile in the short term, however it should recover some lost ground by the end of the year. Lower imports and higher exports should help the current account deficit narrow to a more sustainable level – perhaps to around three per cent of gross domestic product, compared with about six per cent now.

Meanwhile, the fall in the lira is likely to push inflation up sharply over the coming months and monetary policy is likely to tighten as a result. The Turkish central bank raised all of its main policy rates by 625 basis points last week, which put some upward pressure on the lira.

However, the scale of the hike fell short of the 700-1,000 basis points hike that was considered the minimum needed to re-establish credibility. And although it helped to soothe financial markets, the reaction of President Erdogan to the rate hike will be critical. Any sign that the President will try to reassert his influence over monetary policy decisions could quickly cause market sentiment to deteriorate again.

Turkey's public finances have been the one part of the economy in which investors have found reassurance. The general government budget deficit averaged a modest 2.3 per cent of gross domestic product over the past decade and the primary budget balance has been in surplus for twelve of the past fifteen years. Public debt is low at under 30 per cent of gross domestic product and is unlikely to be a major problem in next few years.

The main risk is that the weakening of the lira and tightening external financing conditions make it difficult for banks and corporates to roll over foreign-currency denominated external debts, which could be a trigger for the government to turn to the International Monetary Fund and adopt more orthodox policymaking.

Even if this more severe crisis does not occur, Turkey may suffer from investor caution, lower capital inflows and permanently higher inflation.

Strategy

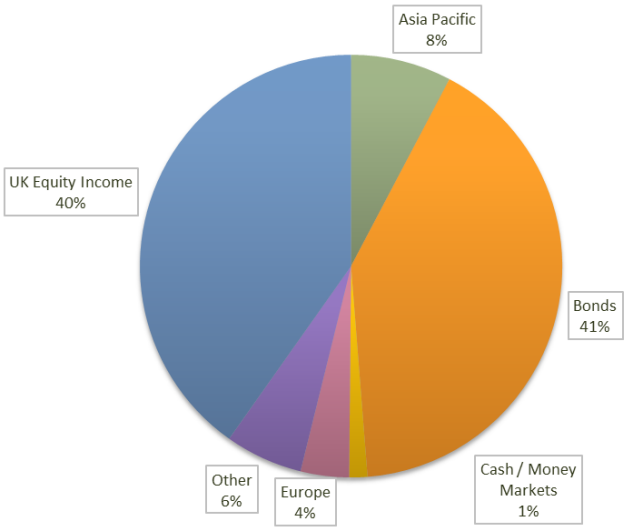
The Future Money funds have limited, indirect exposure to Turkey, however we have been monitoring events carefully. While in isolation, the economic issues in Turkey should have a limited impact on our portfolios, a broader impact on investor

sentiment surrounding Emerging Markets or contagion could have an effect on the funds.

We believe that contagion is an unlikely scenario, and continue to believe that Emerging Markets offer attractive valuations relative to the rest of the world. A fall in Emerging Markets could provide a buying opportunity, as we believe the long term investment case remains sound.

Income

Markets have experienced significant losses over recent weeks, triggered primarily by deteriorating sentiment based on political developments. We believe that the losses have been greater than justified by economic conditions and therefore see an improved valuation opportunity across equity markets. As such, the equity target level of each Future Money fund has been increased based on a tactical view of a medium term recovery.



Real Value

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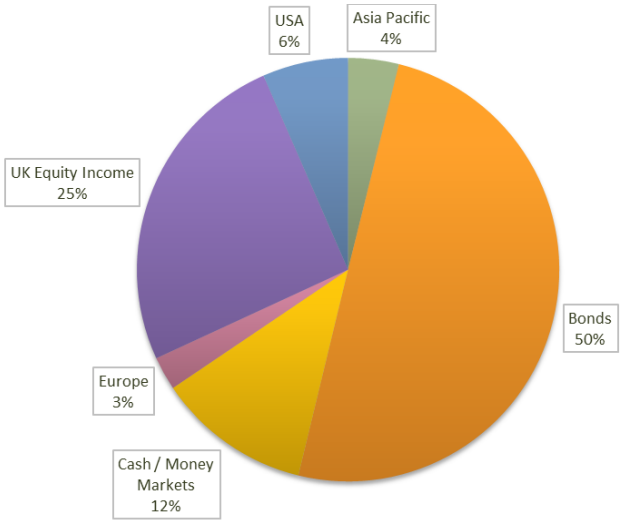

Real Growth

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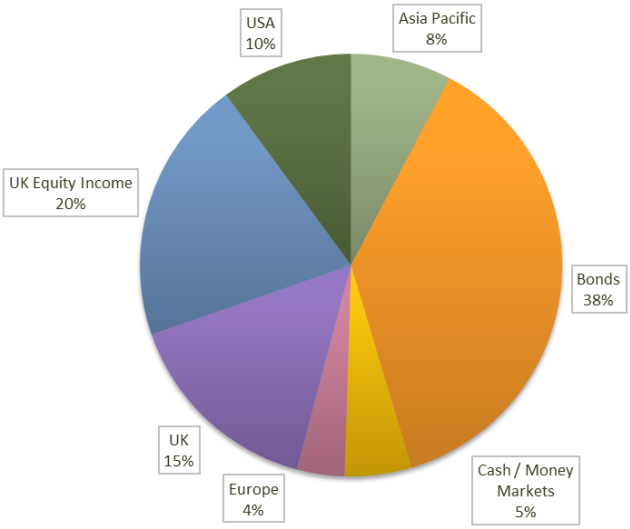
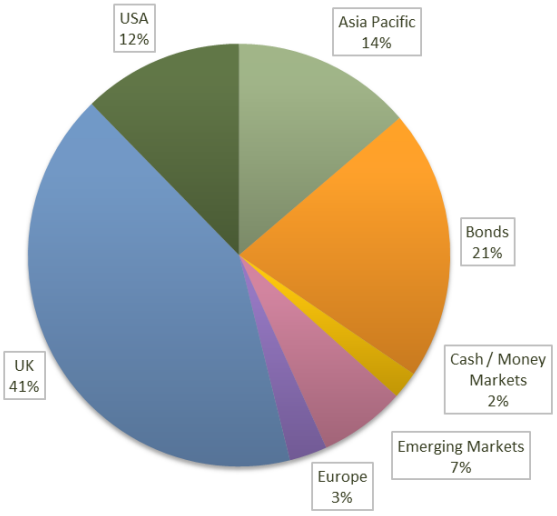


Dynamic Growth

As with the other Future Money portfolios, they equity target level has been increased following recent market weakness.

The decision has been taken to remove the Kames Investment Grade Bond fund from the portfolio and replace it with BlackRock Corporate Bond 1-10 year tracker. We feel that given the low yields now available on corporate bonds that the higher fees of the Kames fund are likely to impede future performance and therefore the cheaper, but similarly exposed, tracker fund is considered a more compelling option.



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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