FUND MANAGEMENT DIARY

Meeting held on 4th September 2018

Outlook for Emerging Market consumer spending

- Gross domestic product growth is expected to slow overall in the emerging world over the next decade, which will weigh on household income growth

- Other factors, such as the extent to which consumers spend or save their additional income will also affect the rate of consumption growth

- Overall, annual consumer spending growth in the emerging world will slow from around 5.5 per cent over the last ten years to 3.5 per cent over the next decade with the main cause being a slowdown in China

In the long-run, the key determinant of how much households spend is their income

The emerging world has entered a period of permanently weaker growth, which will reduce the rate at which household incomes can grow and therefore weigh on consumption growth, yet it is still expected to beat that of developed markets. Looking back at history, the much faster growth after 2000 owed less to a lasting break in emerging market performance than to a number of one-off factors that provided a temporary boost. For example, policymakers across the emerging world adopted more market-friendly policies in the 1990s and 2000s that provided step gains in productivity that cannot be repeated.

It remains the case, though, that growth rates over the next decade or so will differ significantly between countries. India, with its favourable demographics and improved policymaking, has many of the characteristics of a fast-growing economy. In contrast, Brazil (commodity-intensive) and Russia (rapidly ageing population) are likely to lag behind the rest of the pack over the next decade. China sits somewhere in the middle. On the face of it, China has many of the characteristics of an outperformer but the past decade's credit boom and the associated misallocation of resources casts a long shadow over the medium-term outlook.

Admittedly, if there is a big change in the share of total income that goes to the household sector, gross domestic product growth might not be not be an accurate gauge of household income growth. This share has fallen since the mid-1990s for most countries where we have data. This fits with global evidence that labour's share of income has fallen. However, on an emerging market-wide level, the fall has been relatively small – just four percentage points over a twenty year period, or less than

0.2 percentage points a year. In other words, household incomes have grown at a similar rate to overall gross domestic product growth over this period.

There are a number of potential explanations behind the fall, including the entry of China (with its abundance of low cost labour) into the global economy, the erosion of labour's bargaining power as capital has become more mobile, and the weakening power of trade unions. The impact of these factors may have run their course. The upshot is that gross domestic product growth forecasts are likely to be a reasonable indication of household income growth over the next decade.

Consumers can choose to save or spend any increase in income

The extent to which increases in income translate into higher consumption will depend on the degree to which consumers choose to save or spend any increase in income. Households can spend beyond their income by borrowing more. However, economic history shows that rapid surges in household credit are unsustainable, and can often lead to a rise in bad debts and broader financial sector problems.

The authorities in some countries, namely Korea, Thailand, Singapore and Malaysia, have taken steps to slow the build-up in household debt. As these measures have taken effect, an important prop to consumer spending has begun to fade. China has also seen a rapid increase in household debt over the past few years. While the authorities so far do not appear especially worried, it risks storing up problems for the future. On the other hand, there are still a number of places, including India, parts of emerging Europe and some countries in Latin America, where consumer debt levels are low, and where there may be scope for households to borrow more.

Several other factors will determine saving rates. One is the quality of welfare provision. Weak welfare provision in Asia, for example, has encouraged precautionary savings by households. In contrast, Brazil's over-generous pensions system has often been blamed for the country's low savings rate.

Demographic factors can also be important in determining saving rates. People over 65 typically run down their savings to maintain their standard of living in retirement, while adults with more children typically save less than those with fewer children. Holding everything else equal, a decrease in the share of dependents (children and those over 65) to the number of workers, also known as the dependency ratio, should boost saving rates.

According to projections from the United Nations, dependency ratios are likely to rise sharply in East Asia and emerging Europe over the next decade or so. In contrast, India, the Middle East and Africa look set to see continued rapid population growth and big rises in the share of the population of working age. Latin America lies

somewhere in the middle. The upshot is that over the coming decade demographic factors should help to drag saving rates down in East Asia and emerging Europe, but push them higher in India, the Middle East and Africa.

Emerging market consumer spending growth is likely to slow

Putting all this together, in aggregate terms, consumer spending growth across the emerging world is likely to slow from around 5.5 per cent over the past ten years to around 3.5 per cent over the coming decade. The main cause of the emerging market slowdown will be weakness in China, where the pace of consumption growth could halve over the coming decade as the economy slows. Admittedly, consumer spending is likely to grow faster than gross domestic product in China as households' income share rises and the household savings ratio falls – but this won't be sufficient to offset the slowdown in the overall economy.

Although consumer spending is likely to grow faster in emerging Asia than any other emerging market region, spending growth there is also likely to experience the sharpest slowdown. Most of the slowdown is likely to be led by China, while high levels of household debt and ongoing deleveraging will hold back spending in countries such as Malaysia and Thailand. India is set to remain a relative bright spot, and it is likely to overtake China as the region's fastest growing emerging market consumer market.

Meanwhile, in large part because of the poor prospects in Russia and Brazil, consumer spending growth in both emerging Europe and Latin America is forecast to remain weak over the next decade. However, both regions are likely to contain a few bright spots. In emerging Europe, an improvement in household finances should help to support strong consumer spending growth in a few smaller economies. In Latin America, consumer spending growth is likely to accelerate in Mexico.

Of the three main emerging market regions, emerging Asia will remain by far the biggest consumer market, followed by Latin America and Emerging Europe. China will remain the biggest single emerging market, but will still lag behind both the United States and the Euro-zone in ten years' time. India will be the second biggest emerging market consumer market, which will roughly follow the size of Japan. Brazil is likely to remain the third biggest. However, both Mexico and Indonesia are likely to overtake Russia, to become the fourth and fifth biggest markets respectively.

Strategy

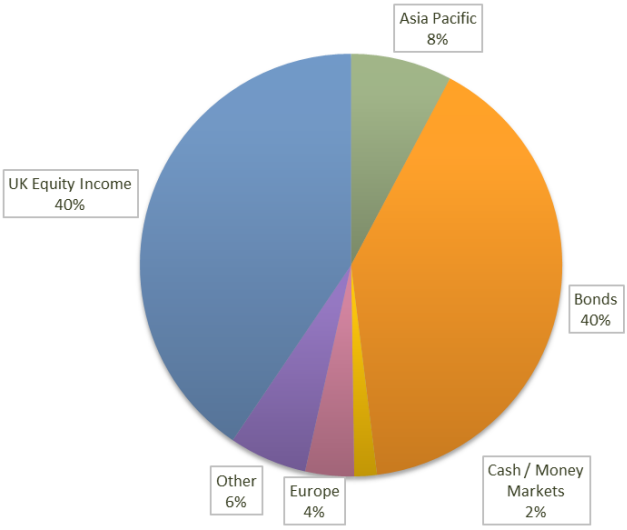
The potential for a slowdown in emerging market consumer spending is consistent with the maturing we expect to see in emerging economies, particularly China. Yet, we believe the outlook for consumer spending is still positive, and that there are

opportunities for strong earnings growth in emerging markets, which as discussed above should lead to household income growth.

As investors, we feel emerging markets offer attractive valuations, especially when compared to developed markets. However, recent events in Turkey and Argentina, which appear to be isolated at the moment, demonstrate the importance of active management and careful fund selection in this area.

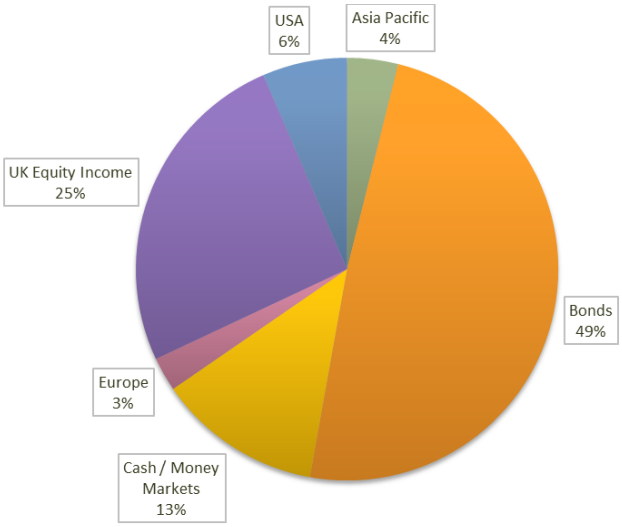
Income

The move into M&G Emerging Markets Bond continues, but at a staggered rate. This is being doing in order to smooth out the volatility currently being experienced in the region.



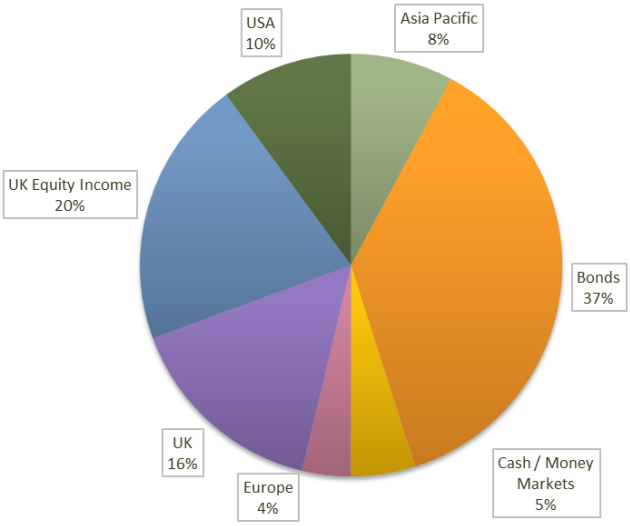
Real Value

The recent weakness of the Schroder European Alpha Income fund has been found to be caused by a combination of style bias proving unfavourable over the short term and stock selection issues. We expect these events to be temporary and so expect a recovery from this fund over the medium term.



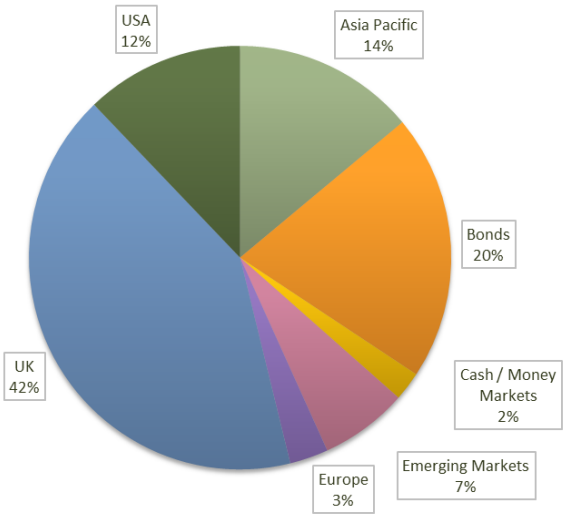
Real Growth

The recent weakness of the Schroder European Alpha Plus fund has been found to be caused by a combination of style bias proving unfavourable over the short term and stock selection issues. We expect these events to be temporary and so expect a recovery from this fund over the medium term.



Dynamic Growth

The allocations to the Asian and Emerging Markets are causing a drag on performance in the current environment of negative sentiment. We believe that the current period is one of politically driven volatility that will ultimately reverse given the strength of fundamentals underlining the global economy. No changes are currently being considered.



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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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