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Technical Analysis Comments – 9th August 2019

These comments have been written on 14th August and while the Technical Analysis reports referenced are dated 9th August, there are two big stories in today's news that we believe are worth including in our discussions. The first relates to the Financial Time's coverage of large losses in Emerging Market bond funds run by Franklin Templeton, while the second relates to the inverted yield curve, as picked up across many news platforms. Emerging Market bonds will be covered in Future Money Income's section, yet we will address the yield curve in this opening section.

The yield curve, a indication of borrowing costs across multiple time periods, has been inverted between 3 month and 10 year US borrowing rates for a number of months, however, today an inversion has developed between 2 year and 10 year borrowing rates in both the US and UK. This means it is cheaper for the US and UK governments to borrow over 10 years than it is to borrow over 2 years. This shows that bond market believe economic growth is likely to fall over the coming years.

Such inversions can be found prior to many recessions historically and therefore it is seen as a bearish signal. The scale of the inversion is very small at this stage with the cost of borrowing hovering between a fractional inversion and flat, i.e. in truth, the cost of borrowing is nearly the same over 2 and 10 years, at the time of writing. Nevertheless a technical inversion has, at least temporarily, occurred.

What does this mean for markets? It means that we must proceed with vigilance and caution. Yield curve inversions have historically been extremely good at predicting economic slowdowns and typically also recessions. Therefore the occurrence of the inversion should not be ignored. However there are a number of factors to closely consider.

While markets reacted with heavy losses at today's development, looking at historic instances of inversions the subsequent recession has not materialised instantaneously, with an average lag of nearly two years after the inversion, according to Credit Suisse. Stock markets have also been found to perform strongly after the inversion, typically peaking around 18 months after the inversion.

A further consideration is the factors that have driven long term yields downwards; quantitative easing (QE) and the US/China trade war.

By design, QE has manipulated markets to drive down long term borrowing costs. In the western world, QE is a policy tool which was first used in this economic cycle, since the financial crisis. As such, the strong link between previous inversions and recessions has not been tested in the context of QE. This question raises the possibility that with long term yields artificially supressed, the true relationship between short and long term borrowing rates may not be quite as negative as in previous instances.

Turning our attention to the second factor and the US' trade war with China has been a major factor in the deterioration in global economic confidence. As the two countries apply tariffs to each other's imports, the cost of goods go up and trade levels fall. Predicting the tone of Donald Trump's next tweet may be a fool's errand, but there are strong arguments as to why an agreement is in both the US's and China's interest. This is especially the case for the US, given it will be significantly damaging for President Trump's re-election campaign should the US economy be facing recession going into the 2020 election.

As such, the incentive for successful negotiation between the US and China exists and therefore there is the potential for the slowing effects of the trade war to reverse. While this is far from guaranteed, should it occur, then the global economy will receive a major boost, likely making the yield curve's negative warning overly pessimistic. Should it not materialise, however, and tensions do build further, then the slowing effect on the global economy is likely to continue.

The shape of the yield curve is a topic that we are giving careful consideration to. Today's developments have not caused us to take any reactionary moves, however in recent months we have been holding a more cautious outlook, given the economic impact of political volatility, with the decision taken earlier this summer to reduce equity allocations such an example. The yield curve inversion and the direction of the global economy is a crucial subject and is one that we are monitoring closely.

FM Real Value

In the final days of the reporting period the decision was taken to sell Schroder European Alpha Income and replace it with Fidelity European. This switch will be reflected in next month's technical analysis reports. This move represents a shift in exposure style in the European portion of the portfolio. Given an increasingly uncertain economic picture, the focus of the Fidelity fund on those companies with the ability to deliver growth regardless of the macroeconomic background is considered a more attractive prospect than the more cyclically focused position of the Schroder fund.

FM Real Growth

In the final days of the reporting period the decision was taken to sell Schroder European Alpha Plus and replace it with Fidelity European. This switch will be reflected in next month's technical analysis reports. This move represents a shift in exposure style in the European portion of the portfolio. Given an increasingly uncertain economic picture, the focus of the Fidelity fund on those companies with the ability to deliver growth regardless of the macroeconomic background is considered a more attractive prospect than the more cyclically focused position of the Schroder fund.

FM Dynamic Growth

Fund selection has been mixed over the month for Dynamic Growth. The likes of Jupiter UK Special Situations and BMO Select European Equity are both delivering pleasing results, continuing strong recoveries from weaker performances over the past year. However on the negative side, JPM UK Dynamic has suffered during the recent falling markets again while Royal London Short Duration Credit has fallen in value over the month, despite its peers gaining. The reasons behind these losses are being investigated.

FM Income

Following a poor result for Argentina's pro-market incumbent President over the weekend in a pre-curser to upcoming Presidential elections, Argentinian assets fell heavily on Monday 12th August. Michael Hasenstab, a prominent emerging market bond investor at fund group Franklin Templeton has large positions in Argentina and consequently experienced large losses, which have since been highlighted by the Financial Times.

Future Money is not invested in any funds managed by Mr Hasenstab, yet we raise this issue given Future Money Income's investment in the M&G Emerging Markets Bond fund which also operates in this area and therefore also has the potential to experience such large losses, even though it has not been affected by the current problems. On Monday, Mr Hasenstab's Emerging Market Bond fund fell around 3%, which, for a single day's movement, is very large. Our holding in this area, M&G Emerging Markets Bond, which has a much smaller allocation to Argentina, fell by just 0.22%.

The M&G fund was selected due to its process and style that we feel are likely to minimise the risk of sharp movements, such as those experienced by the Franklin Templeton funds, however, given the exposure to emerging market borrowers, such a risk is real and much be considered alongside the potential for significant returns. Bonds issued by companies in, and the governments of, emerging market countries offer high levels of yield relative to developed market counterparts. This higher yield is available as reward for taking on the greater default risk that exists in lending to less stable borrowers. As such, while bonds are often considered to be lower risk holdings, emerging market bonds should be considered as higher risk, with significant potential for high levels of volatility.

Given the higher yields and the current presence of attractive valuations, the M&G Global Emerging Markets Bond is a favoured holding of the Future Money fund managers, yet given the high risk inherent in the sector, only a relatively small position is warranted, with the M&G fund the smallest bond holding in the Future Money Income portfolio.

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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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