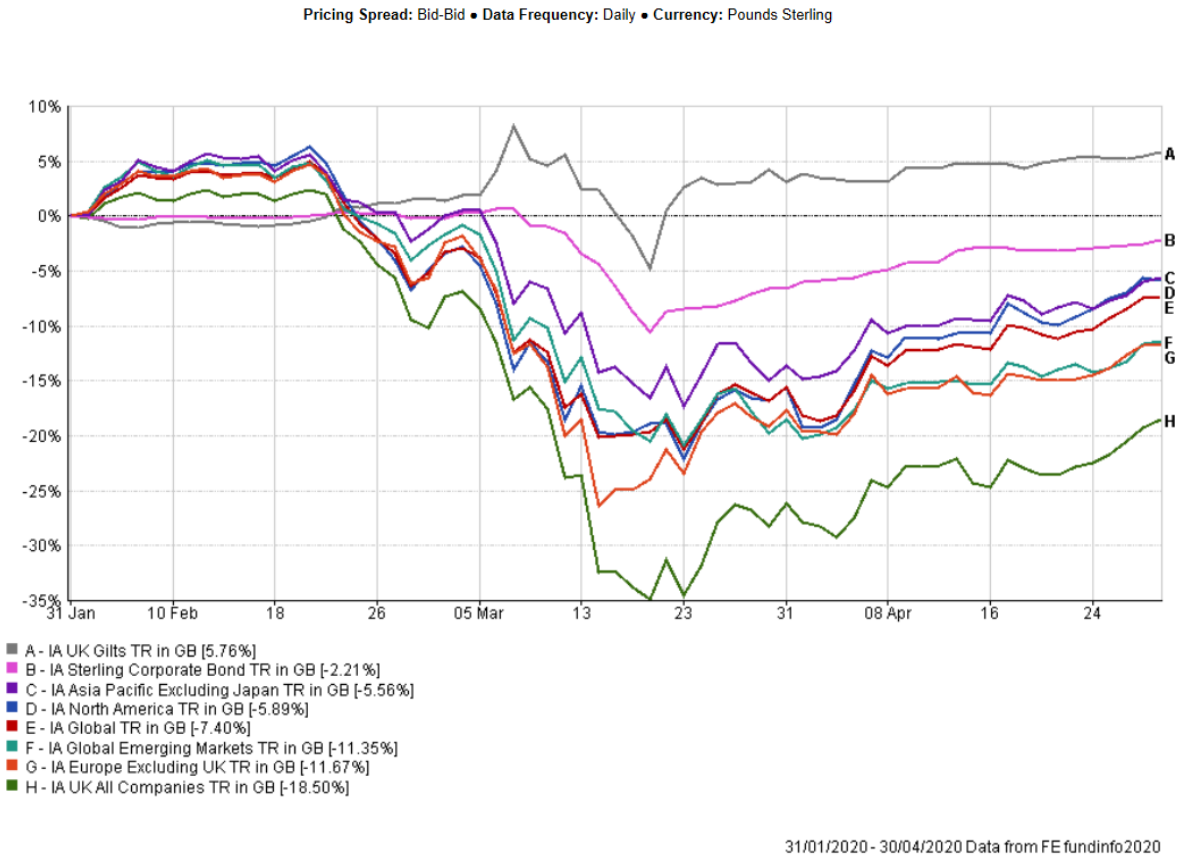
Future Money Quarterly Commentary

31st January – 30th April 2020

This reporting period has witnessed historic events as Covid-19 spread outside of China and became a global pandemic. Efforts to contain the virus have led to economic shutdowns in Asia, Europe and the US with unprecedented fiscal and monetary stimulus applied by central banks and governments to compensate for the loss in productivity.

These events have impacted investment markets with significant falls in equity markets, peaking at around 20% on average, followed by a partial recovery to date. The graph below shows the performance of various Investment Association (IA) sectors over this reporting period, with the IA Global sector falling 7.4% whilst the worst performing developed market , the IA UK All Companies sector, has fallen 18.5%. The IA UK Gilts sector has recorded a profit, although the IA Corporate Bonds sector has fallen in value.



The key developments driving markets at the beginning of the year were US/China relations internationally, and Brexit domestically. Whilst both issues are expected to be prominent in the minds of investors again in the future, the impact and consequence of Covid-19 will mostly determine market movements until the associated risks have been successfully managed within the global economy.

In recent years there have been several outbreaks which threatened to become global pandemics. SARS (Severe Acute Respiratory Syndrome) broke out in China in 2002, H1N1 (Swine flu) was first detected in Mexico in 2009 and Ebola was first identified during 2013 in Guinea. In each case, the global response was sufficient to trace, contain and eradicate the outbreak without a significant impact on the global economy. Initially, Covid-19 appeared to follow a similar path, as Chinese restrictions showed evidence of containing the spread of the virus within China, whilst infections outside of China were relatively low.

However, with many Chinese tourists spending the Chinese New Year in Milan, drawn by the popularity of the fashion industry, a new infection hub was created. The tactile nature of the Italian culture may have accelerated infections and, due to the two-week incubation period, the number of infections jumped before officials became alerted to the situation. Italy shutdown its economy as an emergency measure to contain Covid-19 transmission on 8th March, with most of the EU and US following shortly afterwards. This signalled a change in nature from a Chinese problem to a Global challenge with over four million infections now recorded globally.

Central banks and governments have moved to offset the effect of the economic shutdown with unprecedented measures. The combined actions of interest rate reduction, market liquidity measures and government spending have created a stimulus estimated to be between 10% and 15% of the annual global economic output, with further escalation of these measures expected. For example, the UK has reduced interest rates to 0.1%, provided emergency business loans, stood behind the salaries of people who would otherwise be made redundant and pushed significant amounts of liquidity into markets through the Bank of England. These measures already exceed the total stimulus applied in the wake of the credit crisis and the fiscal stimulus applied by the government is in stark contrast to the austerity policy adopted at that time.

These policies will not fix the damage caused by the global economic shutdown, but they will allow time for activity to re-start. It is our estimate that most of the global economy can withstand approximately one quarter of disruption and be able to re-start quickly. After this period, the economic scarring will be more significant, and the re-starting process will become progressively more difficult.

China, where the outbreak began, commenced lockdown on 23rd January and was able to largely re-open after 76 days having controlled the spread of Covid-19. Italy began lockdown on 8th March, the UK on 24th March and the US at the end of March.

The graph below shows the progress of Covid-19 in key economies after the first 100 cases had been detected, with the approximate 90 days post lock-down point marked. The data shows that all developed economies are flattening the curve and are likely to ease restriction within this important time frame.

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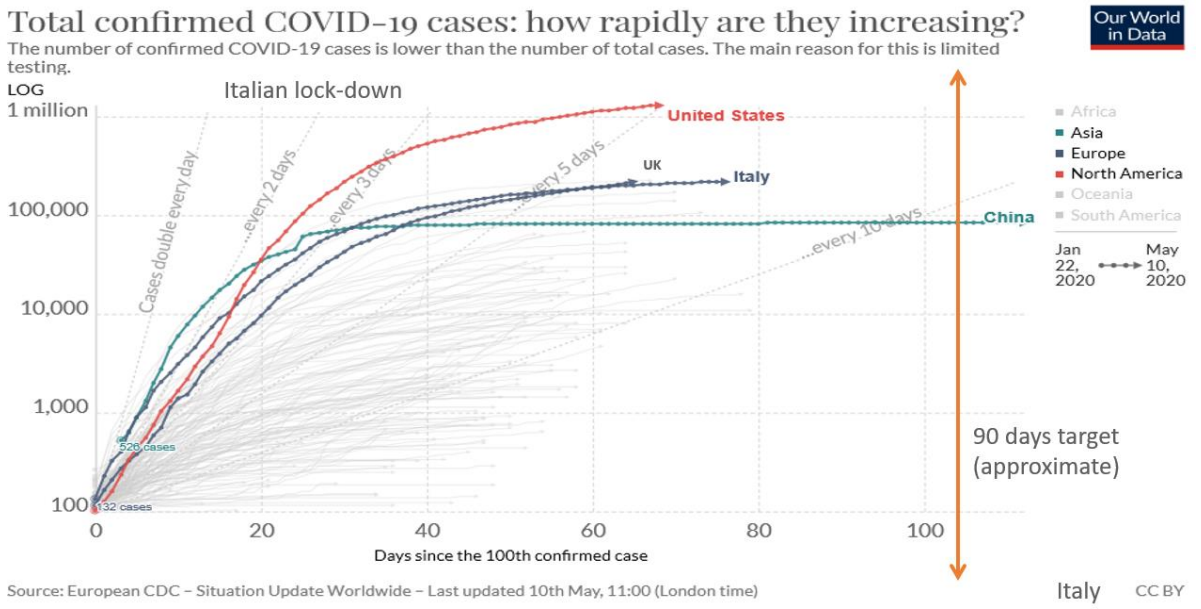


The UK has now announced a potential path to lifting restrictions with people encouraged to return to work as soon as possible, schools and shops potentially opening from 1st June and entertainment venues being considered from 1st July. There is concern that further waves of infections could occur after easing begins but the experience of South Korea and Sweden, who were able to control Covid-19 without a full economic shutdown, provides some evidence that containment can be successful after restrictions are lifted.

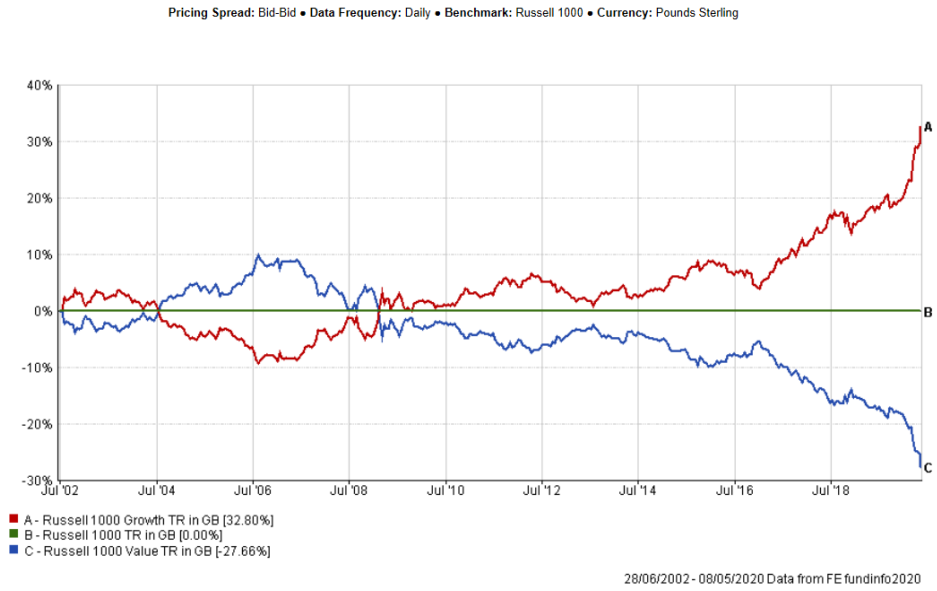
In addition, there are continual benefits due to innovation and research related to Covid-19. Smartphone applications to assist with tracking and tracing infections, a better understanding of the virus transmission mechanism, use of existing and new drugs to reduce the symptoms and numerous vaccines in development will all assist to reduce the impact of Covid-19 and ultimately eradicate the threat. The timing and impact of this work is unknown but is expected to accelerate the ability of the global economy to manage this crisis and the subsequent recovery.

The strong performance of the US market relative to the UK has been particularly striking during this recent period and continues a decade long period of US equity dominance, with the S&P 500 index outperforming FTSE 100 in 9 of the previous 10 calendar years in dollar terms. The only year when this did not occur was 2017, where the difference was negligible.

We have recently become concerned by the dominance of the largest companies within S&P 500, noting that Apple, Microsoft, Alphabet, Amazon and Facebook now account for nearly 18% of the index. The level of index concentration echoes the late 1990s, where Vodafone exceeded 10% of the FTSE 100 index, which was preceded by a period of strong performance. The increased reliance of the entire index on a few stocks increases risk and portfolios can unconsciously become over exposed to a few closely correlated stocks, given the influence of the benchmark itself has increased in recent years, partly due to the popularity of tracking funds.

In the late 1990s, the failure of technology stocks caused pain for many investors. Whilst the same 'bubble' conditions are not apparent, the benefits of diversification learnt from the falls remain

valid. The UK market is more naturally suited to 'value' stocks whilst the US market has more 'growth' style businesses. The differential in the two styles has never been further apart and the graph below, based on the Russell 1000 index, also explains much of the UK/US performance divergence. The disparity in both persistence and magnitude is significant and the concentration risk of narrow 'growth' portfolios in the event of a reversal is apparent.



Due to the further stimulus, the yield from government bonds has fallen even lower. As an example, the 2.75% Treasury 2065 is trading at £182.80. This will eventually mature in 2065 at a value of £100, having paid out £2.75 per annum through the intervening period, equating to an overall yield of 0.47%.

If the Bank of England are successful in achieving their 2% per annum inflation target, the erosion of spending power, after accounting for the yield, will be very close to 50%. This does not meet the primary goal of most investors to achieve a real return on capital, i.e. adjusting for inflation. Given the level of stimulus being applied both monetarily and fiscally, the long-term inflation outlook is increasing despite the short-term deflationary factors driven by falling demand.

Although the value of government debt can remain at current levels, or go even higher, due to central bank stimulus, the investment rationale has been undermined, in our view, since 2016 when yields fell below inflation targets. In common with the 'growth' / 'value' point made above, the duration and magnitude of over-valued government bond prices has also been longer than during normal cycles. Nevertheless, the maths provides certainty about the returns available from here.

The Federal Reserve has released information about their future debt issuance to fund the $3 Trillion, and rising, cost of Covid-19. Interestingly, they are looking to issue longer dated debt, which will increase the duration and interest rate sensitivity of the entire US debt book. This reflects both the lower yields, even on longer dated debt, and the opportunity to remove the need to re-finance in the short term. It could also encourage inflationary policies as higher inflation, coupled with real economic growth, will be an attractive strategy to reduce the currently rising debt to GDP ratio without the pain of austerity.

The immediate question is 'Can Covid-19 be controlled to allow the global economy to substantively re-open?' We believe this will be the case and, whilst 2020 company earnings will be written down, markets will see potential for 2021 and beyond to recover. This should lead equities to generally recover from current levels, but volatility will remain high due to the level of market anxiety. If Covid-19 cannot be controlled effectively, then further downside risk to equities and bonds will emerge, as further government stimulus will become inflationary rather than economically supportive in effect.

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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.

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