For Professional Investors and Advisers Only

RWC UK Focus

Extended Commentary

Autumn 2017

RWC

Executive Summary

Introduction

"It would be imprudent to keep monetary policy on hold until inflation is back to 2%... In my view, it strengthens the case for a gradual pace of adjustments."

Janet Yellen

The last two Extended Commentaries for the RWC UK Focus Fund (The Fund) expanded on the theme of investing in a period of extended prosperity. This was a remarkably unfashionable view a year ago. Now, however, the prediction of synchronised global growth is becoming more accepted as both the developed and emerging economies are expanding together for the first time since the Global Financial Crisis in 2008. This Extended Commentary will attempt to move the debate forward again with sections on this growing optimism, monetary normalisation, inflationary expectations and the effects of new technologies such as electric vehicles. The Commentary will also address the difficult position of the UK economy given the political shifts over the past 18 months.

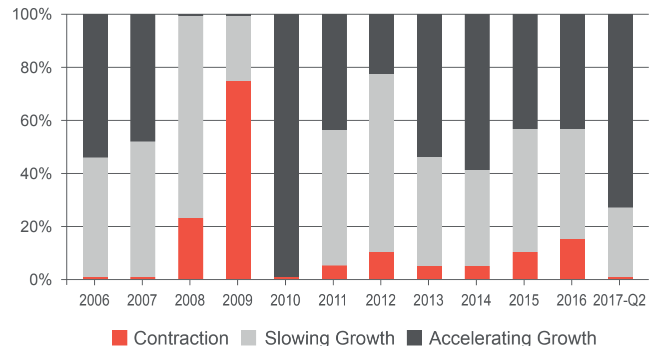
As usual this Extended Commentary is intended to set the general investment background which is essential in building the bottom-up process for stock selection. Regular monthly factsheets are also produced which provide more current details of individual stock holdings, purchases/sales and the portfolio performance.

Synchronised Global Growth

For the first time since the Great Financial Crisis (GFC) the world is experiencing synchronised growth both in the developed and the emerging economies. As these Commentaries have remarked many times, although the current expansion is long in duration there is no sign that it is reaching a late cycle phase. The expansion still has many early to mid-cycle characteristics.

FIGURE 1

OECD growth trends



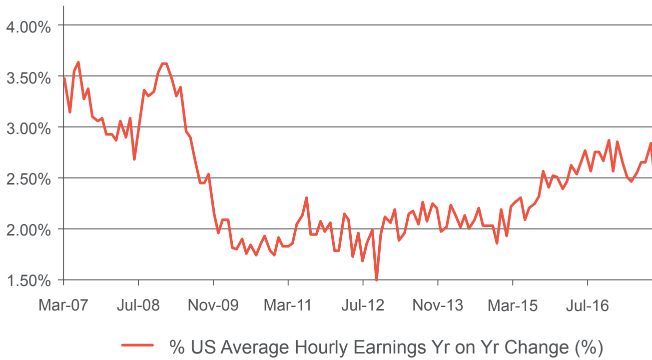
Source: OECD, 2006 - 2017

The work by Reinhart/Rogoff suggests that it takes 10 years to get back to normal after a financial crisis. Here we are. The economic background for investing is not one of over-heating or recession, it is mid-cycle. After all the gloom of the past 10 years this takes some getting used to by “opinion-formers”. Of course there are numerous uncertainties, but that is normal.

The leading economy, as usual, is the US and this gives an insight of what normalisation looks like. Even without the Trump tax cuts and promised infrastructure bonanza US real growth is returning to a healthy level. Although there has been some disruption from this summer’s hurricanes, wages are finally accelerating, albeit uncertainly, as the low unemployment statistics start to impact the participation rate and the output gap closes.

FIGURE 2

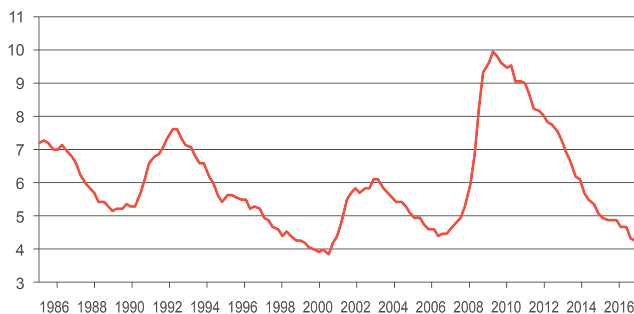
US wage growth



Source: Bureau of Labour Statistics, 31 March 2007 – 31 October 2017

FIGURE 3

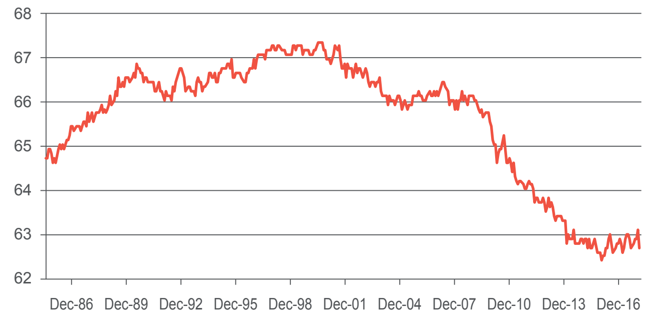
US unemployment rate (%)



Source: Bureau of Labour Statistics, 29 March 1985 – 29 September 2017

FIGURE 4

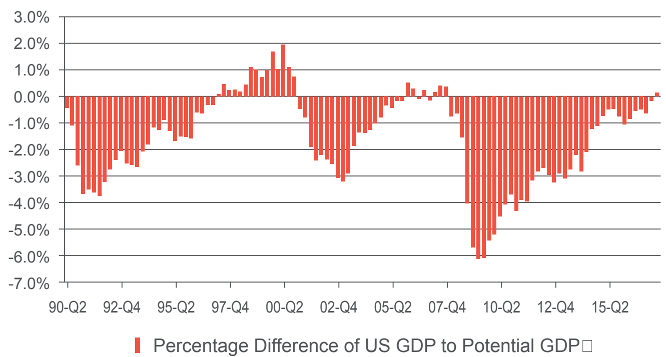
US labour force participation rate



Source: Bureau of Labour Statistics, 31 January 1985 – 31 October 2017

FIGURE 5

US output gap

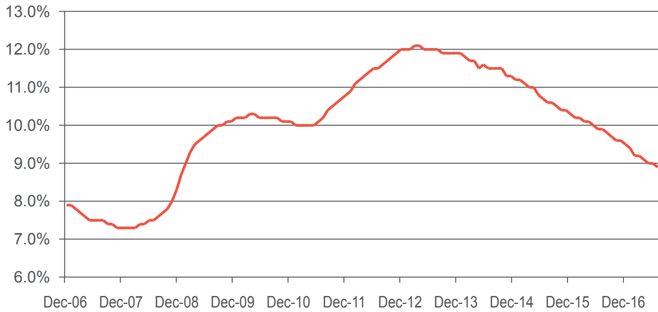


Source: Congressional Budget Office/Bureau of Economic Analysis, Q2 1990 - Q3 2017

Europe, of course, is behind the US, but again it is improving and some of the earlier concerns such as the level RIItalian non-performing loans are being left behind as “a rising tide lifts all boats”. The German economy, at the centre of the system, is booming.

FIGURE 6

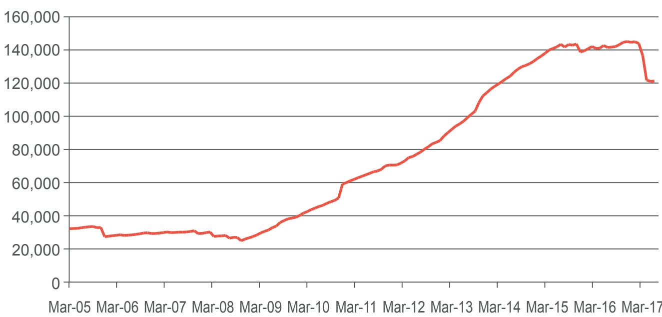
Eurozone unemployment rate (%)



Source: Eurostat, 31 December 2006 – 30 September 2017

FIGURE 7

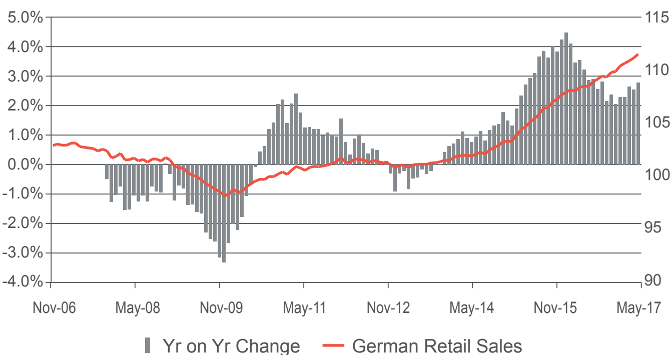
Italian Banks – Bad debts to non-financial corporations



Source: Bank of Italy, February 2005 – September 2017

FIGURE 8

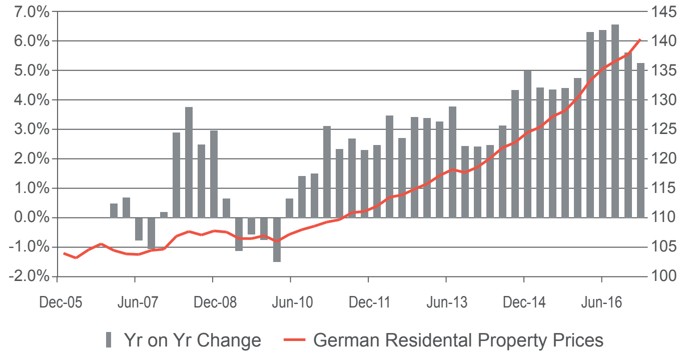
German retail sales



Source: German Federal Statistics Office, 30 November 2006 – 31 August 2017

FIGURE 9

German residential property prices

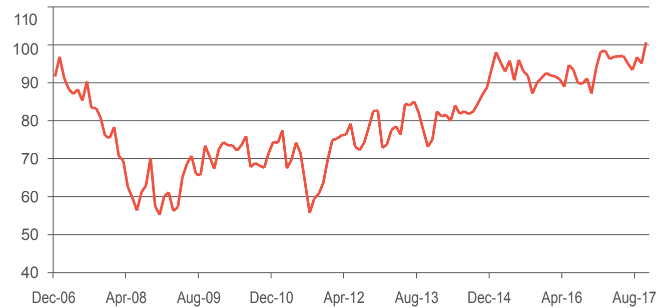


Source: Bank for International Settlements, 30 December 2005 – 30 June 2017

The great thing about growth and the accompanying increase in confidence is that it is self-reinforcing. Without constricting moves by the authorities or some significant geo-political event the environment will continue to strengthen. The Fund is therefore, still comfortable to be invested in good quality global cyclical stocks, such as CRM and Ferguson.

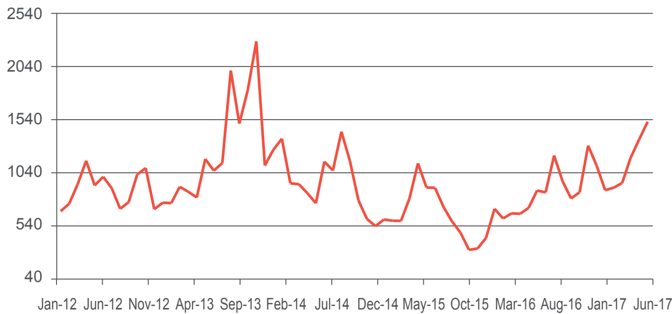
FIGURE 10

US consumer sentiment



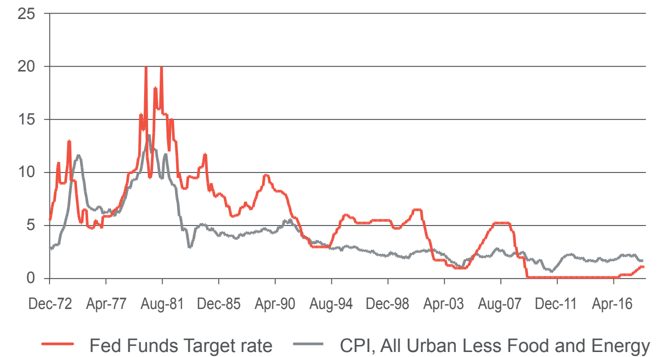
Source: University of Michigan, 31 December 2006 – 31 October 2017

FIGURE 11
Baltic Dry Index



Source: Bloomberg, 31 January 2012 – 31 October 2017

FIGURE 12
Fed funds rate vs. inflation



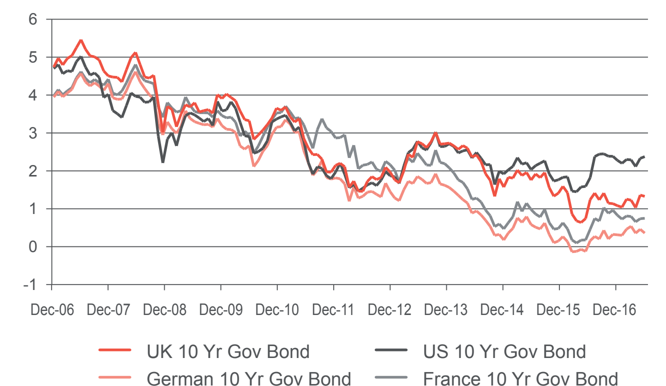
Source: Bloomberg, 31 December 1972 – 30 September 2017

Monetary Policy Normalisation

In the Spring 2017 Extended Commentary there was a section on monetary policy normalisation. This is still in train. The process, as predicted, remains glacial. US interest rates are gradually rising and an initial run-off of the QE stock of bonds has been signalled. Those commentators who thought the equity bull market was all about QE and predicted a crash as soon as it was ended/withdrawn are still waiting. The view of these Commentaries has consistently been that monetary normalisation is not a negative, but rather confirmation that the background is benign. The recent UK interest rate increase might be different, but the UK economy is in a difficult situation which is addressed later. QE tapering by the ECB and eventually by the Bank of Japan, however, should be seen in the same light as the US monetary moves of recent years. What is key is that monetary policy is still "behind the curve" and is not restrictive. It will only be when US interest rates get to some 2% (ie the level of targeted inflation) can they be regarded as no longer heralding an easy money policy. Europe/Japan/UK are years behind.

The implications for stock selection of these views is clear. Bonds have many years of rising rates to contend with. UK gilt yields in particular at 1.3% with inflation of some 3%, a currency weakened by Brexit and politics threatened by Corbyn look remarkably mis-priced. The same is true of most of the government bond markets distorted by the huge level of QE buying. This was detailed in the Spring 2017 Extended Commentary.

FIGURE 13
10 year government bond yields



Source: Bloomberg, 29 December 2006 – 31 October 2017

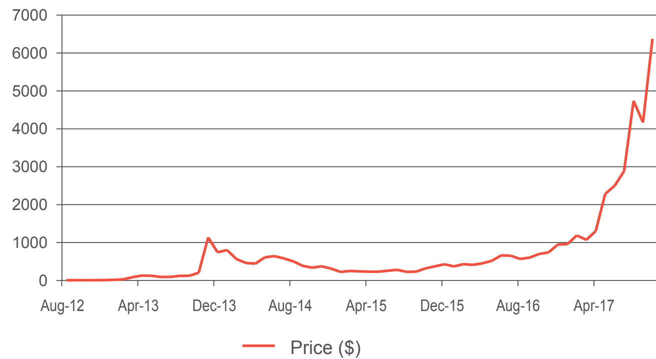
The Fund remains invested in those stocks whose valuations have been depressed by pension deficits swollen by low interest rates despite robust underlying trading. New purchases this year have also included life assurance companies such as Legal & General and Just Group which should benefit from rising interest rates. The Fund has little exposure to those stocks whose valuations have been boosted by low discount rates or whose profits have been materially enhanced by ever lower refinancing rates.

Inflation

Ever since the start of QE, or money-printing as some persist on calling it, commentators have been predicting an inflationary surge. These Commentaries have been consistent in their view that although QE might boost statistics of narrow money growth, the broad money growth has been heavily restricted by the regulatory increase in bank reserves. In the US virtually all the new money created by the Federal Reserve has been offset by restricted bank lending as the banks build up their reserves. The result has been a stronger banking system with little inflation. With the regulatory push to increase reserves now fading, and possibly going into reverse under the Trump administration, the inflation risk is rising. Although this is not showing up in the CPI statistics yet it is increasingly reflected in asset price inflation and speculation in such products as Bitcoin. Because inflation is a lagging indicator and monetary policy takes time to have an effect it is important that the normalisation of policy continues and policy makers do not become seduced by the theory of a permanently lower level of inflation.

FIGURE 14

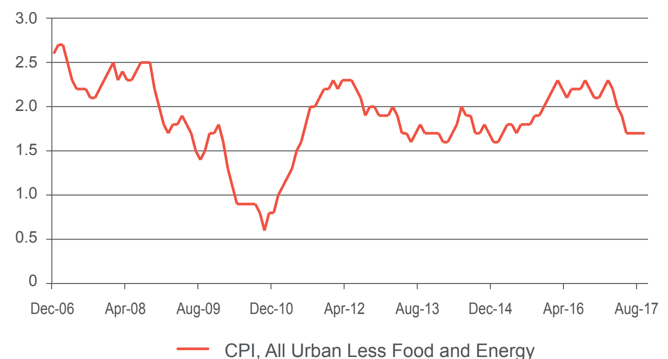
Bitcoin



Source: Bloomberg, 31 August 2012 – 31 October 2017

FIGURE 15

US inflation



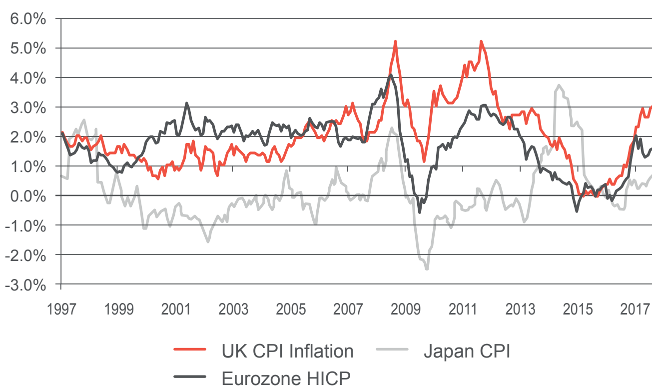
Source: Bureau of Labour Statistics, 31 December 2006 – 30 September 2017

This commentary is for illustrative purposes only and is not intended to be, and should not be interpreted as, recommendations or advice.

The Eurozone has always been more complicated owing to both the deflationary tendencies of the Bundesbank and the lack of integration and risk-sharing of the national banking systems. For a stable system overall it often seemed like you have to have either severe deflation in the periphery or inflation in Germany. The Eurozone authorities currently are lifting the periphery at the expense of German inflation, but the pushback from the German authorities will more than likely grow, particularly if the periphery economies return to reasonable growth. The overall output gap, however, seems sufficiently large at the moment to restrain inflation. In the UK this is not the case and given the Brexit induced currency fall, inflation is now at a level that a reluctant Bank of England has run out of excuses not to tighten policy and raise rates. The Bank of England cannot afford to allow inflationary expectations and wage increases to become embedded at higher levels. The surprise may be in Japan where the stated objective to lift core inflation to 2% may finally be starting to be achieved (the spike in 2014 was the result of a sales tax increase). As in the section above, bond yields are too low to achieve an acceptable return in this environment.

FIGURE 16

UK, Japanese and European inflation



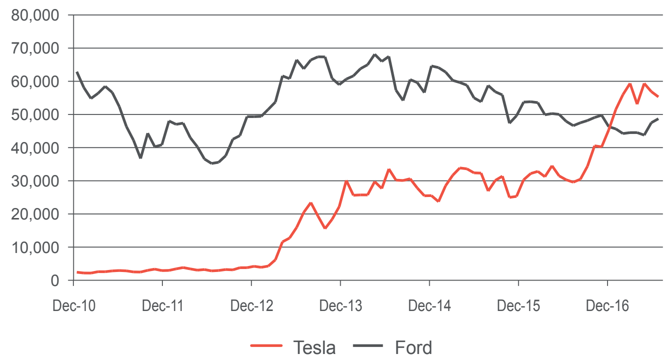
Source: Bank of England/Eurostat/Japan ministry of Internal Affairs and Communications, 1997 - 2017

Oil Demand and Electric Vehicles

The past 30 years has been a phenomenal period of technological change with the birth of cellphones, the internet, smartphones etc. The next big product change clearly seems to be electric vehicles (EVs). This development will have far reaching consequences for many facets of our society. For example they have some 70 -80 moving parts as opposed to over 1,000 in a current internal combustion engine vehicle. Just consider the scale of redundant skills, jobs and technologies that this major industry and employer will face, not only in the manufacturing process, but also in the servicing and refuelling processes. Given the difficulties of change for incumbents and the legacy costs it is often not the existing companies that are able to make the leap. It is hard to identify the winners of change, but the market is already making its bets by bidding up the price of Tesla ahead of the existing motor manufacturers such as Ford. The switch-over will obviously take time, but the trend is clear and decision-makers should take note.

FIGURE 17

Tesla market cap. vs. Ford ($)



Source: Bloomberg, 31 December 2010 – 31 October 2017

Copper is the major commodity most likely to benefit from the technological shift and Glencore is the Fund's main exposure to this trend. The Fund also currently has an exposure to oil companies of some 20% of assets with Shell the largest absolute holding and BP in the top 5. This has been working well recently as the oil price has firmed up and corporate cash generation has improved, but many commentators are fretting that given the shift to EVs and the rise of renewable energy then the oil-age is coming to an end and the companies will be left with redundant, stranded assets. Although EVs are more than 3x as efficient and more than 4x cheaper to fuel than gasoline vehicles, electrification will, however, still probably take many decades and transportation only accounts for some 45% of the oil market. Renewable energy is a growing part of the national energy mix, but in a temperate climate such as the UK it is unlikely to take over. Fossil fuels will still be a vital energy source, particularly if electrification increases demand, as automation generally does. If electrification does lead to a reduction in the price of oil then surely alternative demands will be found. An example is air travel. Faster and further air travel will significantly increase energy demand, particularly from the emerging economies.

FIGURE 18

Air travel

GDP per Capita	Flights per Capita	Population (m)
<5,000	0.20	3,618
5,000-10,000	0.67	2,191
10,000+	2.90	1,283
Total	1.27	7,092

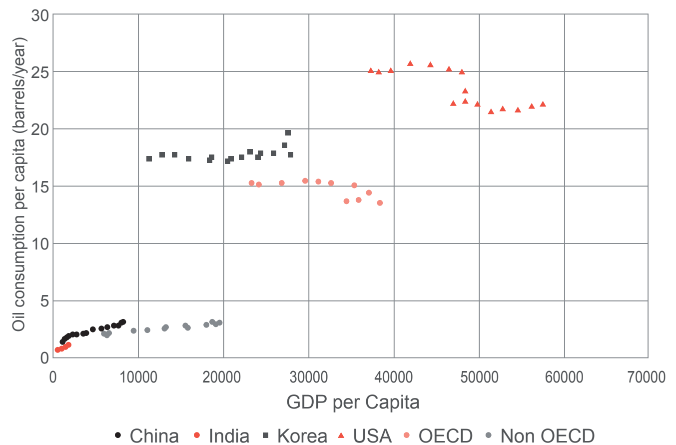
Source: World Bank, as at 14 November 2017

This would be a great additional support for travel companies in the portfolio such as Thomas Cook that are looking to take advantage of these trends, as is Carnival in cruising. One round trip to Australia on a Boeing 747 consumes more fuel per passenger than the average UK consumer's annual car mileage. As economies such as China develop into more consumer-led economies this is only going to become more relevant. Although still small for the group, Thomas Cook China is aiming to grow by more than 10 times over the next 12 months.

When considering the rise of the emerging economies these Commentaries have a number of times pointed to the billions of people in the emerging economies reaching for the lifestyles of the developed world. Ten years ago in the commodities boom this was a common theme and many people pointed out the increased need for energy as economies matured. With or without EVs the basic fundamental has not changed. Oil and gas are not going away anytime soon.

FIGURE 19

Oil consumption



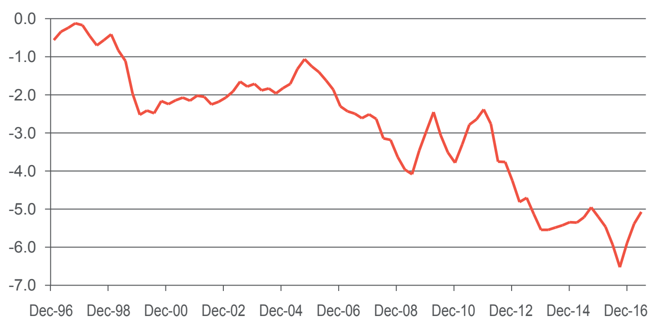
Source: Bloomberg, as at 14 November 2017

The UK Economy

These Commentaries have sometimes been criticised for being consistently optimistic. This is true, but it has been the right way to be for the past few years. It is increasingly hard, however, to be enthusiastic for the domestic UK economy. The supporters of the Remain vote have been lampooned for their gloomy predictions over the past year, but it has to be admitted that the referendum decision and the resulting uncertainty has cast a pall over the government and the economy. The lack of direction and infighting has also boosted the chances of the hard left Jeremy Corbyn coming to power. A certain amount of the uncertainty can be placed at the door of the unhelpful negotiating tactics of the EU, but it was naïve to think it would be easy. In last autumn's Commentary it was stated that a "hard Brexit" was the most likely outcome, but there would be many years of transitionary and temporary arrangements in order to get there given the many complications. This still looks like the most likely outcome, but also increasingly "best case". If the UK wants to be a Sovereign Nation with control over its borders, currency and laws there seems little alternative when dealing with the EU and there seems little desire on behalf of the EU for this to work out well for the UK. Given their mercantilist leanings it is perfectly logical for them to regard the UK's loss of energy and wealth as their gain. This is likely to expose some structural weaknesses in the UK economy. The clearest manifestations of these are the twin deficits of trade and government spending.

FIGURE 20

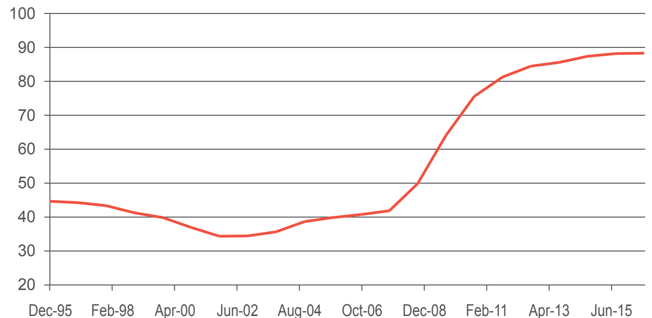
UK current account balance (%)



Source: Bloomberg, 31 December 1996 – 30 June 2017

FIGURE 21

UK government debt (% GDP)



Source: Eurostat, 29 December 1995 – 30 December 2016

FIGURE 22

Budget balance

Source: Bloomberg, 31 December 1999 – 30 June 2017

FIGURE 23

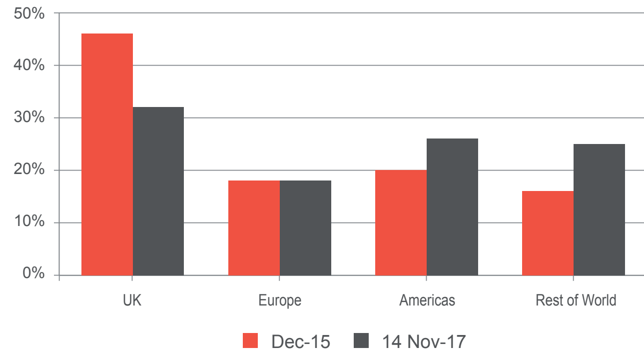
Sterling vs. US dollar

Source: Bloomberg, 31 December 1996 – 31 August 2017

These make depressing reading. Despite years of so-called “austerity” there has been little improvement in the government stock of debt to GDP. This is with virtually full employment and after a number of years of reasonable growth. The cost of financing the debt has also been depressed by the current abnormally low interest rates. If the UK does have a period of economic weakness the deficit is going to balloon again. Even Greece has done a sounder job of bringing their annual deficit under control. In previous times the deficit has been readily financed by capital flows as the UK has been seen as a sound credit, but the question will be asked whether the Brexit issues might undermine this confidence from the international financial community. This will be particularly so when combined with the other severe deficit in trade. It is disappointing that the post Brexit currency depreciation has not had a more noticeable impact on this deficit. The only way of correcting it is for the UK economy to have a period of lower growth than its trading partners so that exports can grow faster than imports. On the one hand this is likely as the Eurozone and elsewhere are going through a growth pick-up, but again the Brexit trade disruptions are an opposite influence. The most likely outcome seems to be that the UK will underperform economically with a structurally undervalued exchange rate. Inflation will be a bit higher and interest rates will be higher to constrain it, depress the domestic economy and attract foreign capital. If the government, however, shifts leftwards towards nationalisation, dislike of the rich, “Peoples’ QE” and other stated ideas of the current Labour Party then the outcomes will be considerably worse and longer lasting. After taking advantage of some of the post-Brexit price collapses in UK orientated companies the Fund has been cutting back on UK domestic consumer exposures in recent months.

FIGURE 24

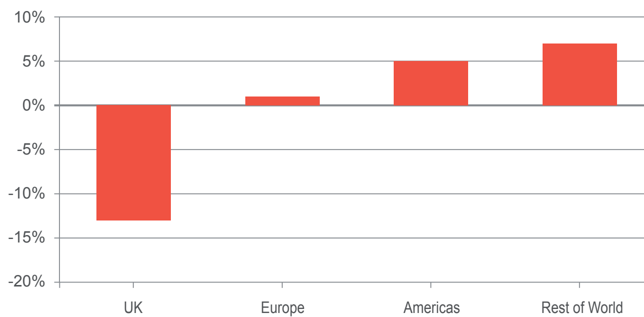
UK Focus Fund geographic weighting



Source: RWC Partners, as at 14 November 2017

FIGURE 25

Change in geographic weighting

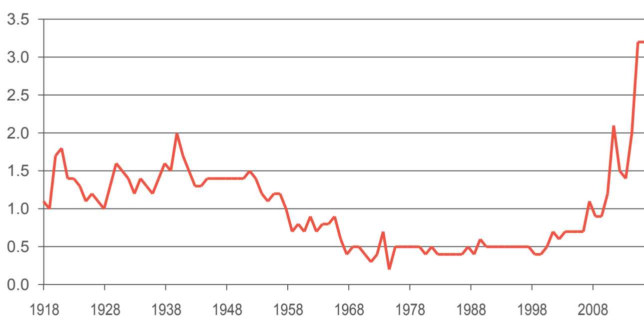


Source: RWC Partners, as at 14 November 2017

Back to Optimism!

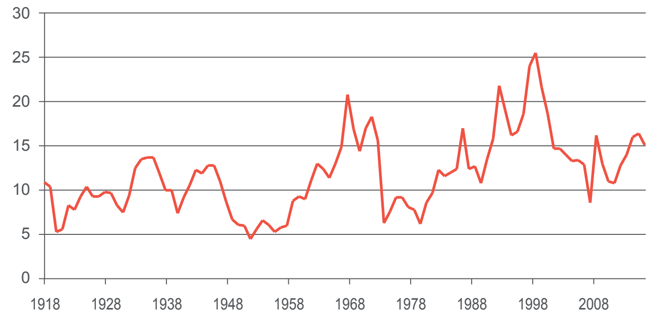
Despite the previous section it is the view of the Fund that the outlook for the UK stock market is robust over the medium term. It is important to remember that the majority of earnings come from outside the UK for UK quoted companies and the stock market has performed well over the past year despite political issues and a dull domestic economy. The UK equity market therefore still provides opportunity even if the domestic economy underperforms a strong international growth environment. This is particularly so if the currency is weak and the alternatives of bonds and cash remain unattractive. The valuation of the UK equity market is still generationally cheap against the UK government bond market that looks increasingly challenged by rising the inflation statistics and political risk. On an absolute valuation basis the market still looks fair value. As the Great Recession falls out of the 10 year statistics, measures such as the Cyclically Adjusted P/E (CAPE) will also become more attractive. As before, the long term chart of the US S&P market is also shown to demonstrate that previous bull markets have provided considerable and extended periods of gain.

FIGURE 26
UK dividend yield/10 year gilt yield



Source: Oriel Securities/Bloomberg, 1918 - 2017

FIGURE 27
UK P/E ratio



Source: Oriel Securities/Bloomberg, 1918 - 2017

FIGURE 28
FTSE All-Share Index price/book ratio

Source: Bloomberg, 05 January 2000 – 15 September 2017

FIGURE 29
S&P 500 Index

Source: Bloomberg, 29 March 1929 – 29 September 2017

About RWC

RWC is an independent investment firm founded in 2000, providing high-alpha asset management to institutions, professional investors and intermediaries.

The firm provides an intense focus on investment performance and extracting maximum 'alpha' (manager skill). Each of our select range of strategies is based around the proven skills of talented investment professionals.

The firm only launches strategies where it can secure top-performing managers to run them. The firm provides an environment in which talented managers, supported by dedicated analysts, can focus on delivering performance using their preferred process and philosophy.

This focus on performance sits within a culture of strong risk management. At all times, the firm's results are based on delivering returns within known and acceptable levels of risk. In each strategy, protecting clients' assets is as important as capturing return.

RWC is independently managed and controlled. The long-term stability of RWC is under-pinned by a shareholder structure based on employee ownership. We believe that employee ownership generates a level of stability and professionalism essential to the on-going strength of a fund management business. Most RWC staff have chosen to invest directly in equity and or funds managed by the business.

About the portfolio manager

John Innes

- Founding member of RWC in 2000; major shareholder within business; significant personal investment in own and RWC managed funds
- Focus on flexible UK equity mandates: awarded first Institutional equity long only mandate in 2002; UK Focus Fund established in 2010
- 30 years experience
- M&G (1998-2000 – Head of Institutional Business)
- Robert Fleming (1993-1998 – Charities Investment Director)
- Lazards (1986-1993 – Head of International Institutions and UK Equities)
- Qualified as Chartered Accountant with Peat Marwick Mitchell (KPMG)
- Graduated from Bristol University with a BA (Hons) in Economics

Previous achievements

- Micropal Award Winner (1991)
- Independent Newspaper Pension Team of the Year (1991)
- S&P Fund Research AAA Rated in (1992 and 1993)
- Top performing UK Equity Common Investment Fund (1994-1997)
- Top quartile Balanced Pension Fund (1999)
- Top decile Professional Pensions DC league table (1999)
- Eurohedge UK Equity Fund of the year (2005)

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The Alternative Fund Managers Directive (Directive 2011/61/EU) ("AIFMD") is a regulatory regime which came into full effect in the EEA on 22 July 2014. RWC Asset Management LLP is an Alternative Investment Fund Manager (an "AIFM") to certain funds managed by it and by RWC Focus Asset Management Limited (each an "AIF"). The AIFM is required to make available to investors certain prescribed information prior to their investment in an AIF. The majority of the prescribed information is contained in the latest Offering Document of the AIF. The remainder of the prescribed information is contained in the relevant AIF's annual report and accounts. All of the information is provided in accordance with the AIFMD.

In relation to each member state of the EEA (each a "Member State"), this document may only be distributed and shares in a RWC fund ("Shares") may only be offered and placed to the extent that (a) the relevant RWC fund is permitted to be marketed to professional investors in accordance with the AIFMD (as implemented into the local law/regulation of the relevant Member State); or (b) this document may otherwise be lawfully distributed and the Shares may lawfully offered or placed in that Member State (including at the initiative of the investor).

Information Required for Distribution of Foreign Collective Investment Schemes to Qualified Investors in Switzerland

The representative and paying agent of the RWC-managed funds in Switzerland (the "Representative in Switzerland") is Société Générale, Paris, Zurich Branch, Talacker 50, P.O. Box 5070, CH-8021 Zurich. In respect of the units of the RWC-managed funds distributed in Switzerland, the place of performance and jurisdiction is at the registered office of the Representative in Switzerland.