



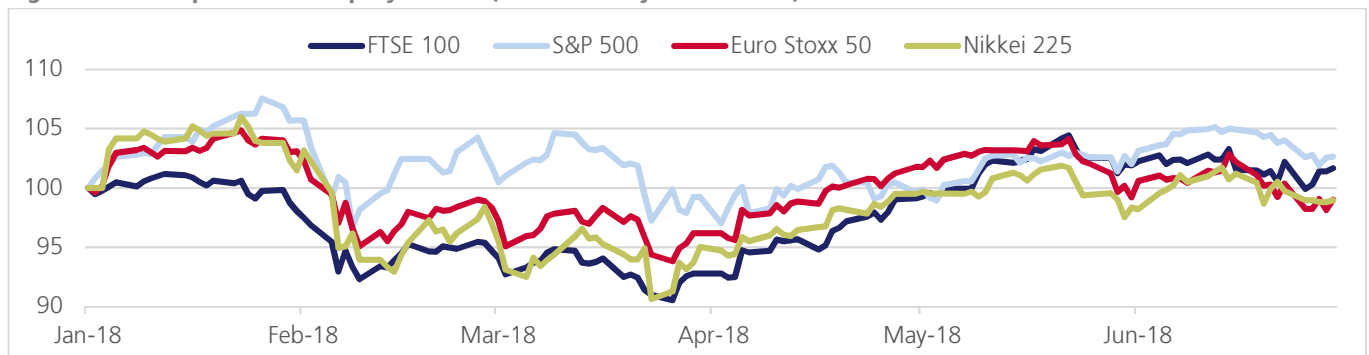
Macro summary

The first half of 2018 has seen a rise in volatility, with sharp moves in both directions for equity markets. However, towards the end of the period we have witnessed a relatively moderate shift (Fig. 1). Having fallen in the first quarter, by May the FTSE 100 Index had risen sharply. From the Q1 lows to the peak in May, the Index saw a 15% increase with the total return for the half year being just 1.6%. Most recently, the volatility in markets comes from fears over a trade war, the outlook for interest rates, moves in the oil market and political developments in Europe and elsewhere. None of these factors are likely to go away in the near term so we may expect continued fluctuations in markets as the year goes on. While volatility continues, it is important to remember that the global economy is broadly in good health and there are many reasons to be positive.

The fear of a trade war has caused more concerns in markets than anything else. The outcome is hard to predict, not least because of President Trump's habit of announcing policy by tweet based on his gut feeling. He also tends to take an extreme position and the outcome after negotiations are watered down. The tariffs he has placed on imports have been met by tariffs on goods sold into China and the European Union. When other countries respond, he raises the prospects of further tariffs on their goods sold in the US. US companies and the US consumer have been beneficiaries of globalisation of trade at the expense of some jobs moving overseas. Companies and trade organisations have complained about the policies and when the US consumer has to pay more for goods subject to tariffs, Trump's popularity may wain. Trump's team continue to talk of ongoing negotiations and in the end, it is in the interests of all concerned that the differences are resolved.

The US Federal Reserve ("Fed") continued to raise rates this quarter and indicated that rates may rise four times this year, which is one more than was previously talked about. The US economy is growing strongly and with additional stimulus from Trump's tax changes, they see room to raise rates faster. However, the impact of rate rises takes time to feed through and in the long run, we expect US interest rates to peak at a lower level than in previous cycles. In contrast, the Bank of England had been expected to raise rates in May but with weaker economic data for the first quarter, it has so far held off. There is a possibility that this weakness may have been linked to turbulent weather and, as such, there remains a possibility of another move in August. The European Central Bank (ECB) has announced that it will start to reduce bond buying later this year but does not expect to be raising rates until late next year at the earliest.

Figure 1: Developed market equity indices (local currency/total return)



Source: London Stock Exchange/Standard & Poor's/ Stoxx/Tokyo Stock Exchange

The oil price has risen substantially from the lows of last year. Trump is pulling the US out of the Iran nuclear deal and, as a result, sanctions may be re-imposed which could result in a reduction of supply. The Organization of the Petroleum Exporting Countries (OPEC) increased production but less than was hoped for or demanded by the US president. The US could increase production in response to the price rise but this takes time to come on line. With strong global growth, demand continues to grow despite the switch to alternative energy sources.

On the political front, we have seen the formation of a populist Eurosceptic government in Italy and Merkel having difficulties with her coalition partners over immigration. The yield on Italian bonds rose relative to other Euro government bonds. At the last European leaders' summit, Brexit was not the main concern and progress in the main sticking points, such as the Irish border, appears to be limited. Theresa May is having as much difficulty with her own party as she does with her European counterparties. These political moves and the prospect of more rate rises across the Atlantic have given rise to some weakness in the euro and pound relative to the US dollar.

Emerging markets suffered from the impact of trade restrictions and a rise in the dollar. In Brazil, the currency and stock market fell sharply on the back of a truckers' strike and uncertainty surrounding elections due for later in the year. Mexico has elected a populist left-wing leader and we will have to watch closely how this affects relations with the US leadership, particularly in light of renegotiating the North America Free Trade Agreement.

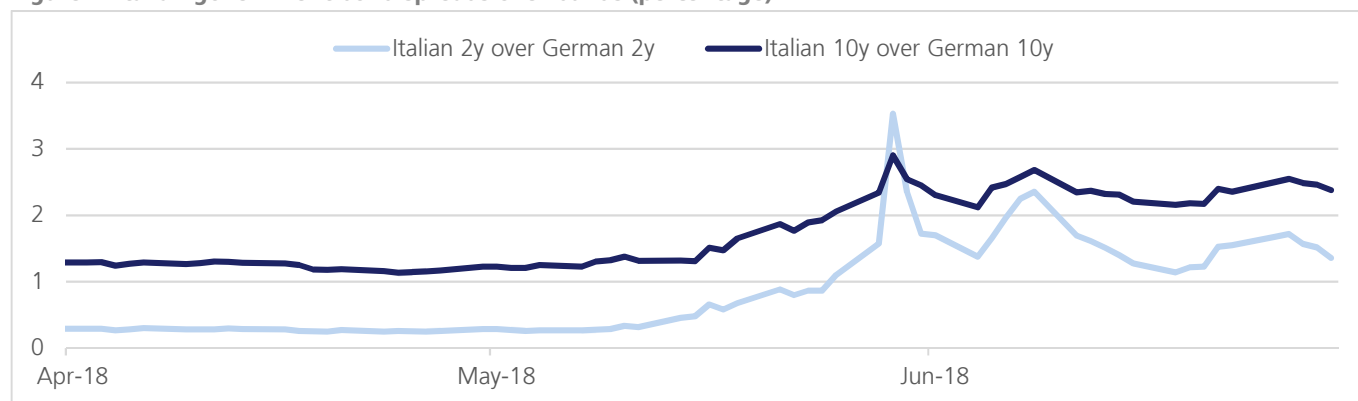
On a more positive note, the meeting between the US and North Korean leaders appears to have defused one source of political risk. However, it is early days and denuclearisation of the Korean peninsula is still a long way off. Chinese cooperation on this may give the US an additional incentive to avoid a prolonged trade dispute. As all these events swing in and out of focus, it is not surprising that we have seen a rise in market volatility. With all this noise we need to remember that developed market economies are doing well, particularly in the US. The full impact of Trump's tax cuts and the repatriation of overseas earnings has yet to be felt. Rate rises are in response to this strength and should not necessarily be feared. Individual companies may not be impacted by these events and those with strong compounding earnings will continue to do well. Investors may have to become accustomed to greater fluctuations in equity markets and will need to look through to longer term returns. We continue to stress a selective approach to investment and remain wary of getting caught out chasing short term moves.

Fixed Income

Last year, the global economy achieved its best synchronised growth momentum since the financial crisis. Investors were therefore able to look through political developments and focus on the underlying fundamental picture. This shifted in the second quarter of this year as politics became more erratic and hence, once again, took centre stage.

On both sides of the Atlantic, political rhetoric moved up another gear. On this side, we saw an unlikely coalition in Italy between the right-wing Lega and the populist Five Star Movement in March, after nearly three months of negotiations. The initial policy discussions led to leaks indicating that the new Italian government wanted the ECB to write-off the Italian debt that it held. The subsequent proposal of a Eurosceptic Finance Minister and its rejection by the Italian president led to shockwaves across the Eurozone. Italian sovereign bond yields (Fig. 2) rose in spectacular fashion with 2-year debt moving from -0.31% at the end of March to as high as 2.77%, before stabilising to 0.69% at the end of quarter.

Figure 2: Italian government bond spreads over bunds (percentage)



Source: Bloomberg

The speed of repricing was unprecedented; the one day move in short dated Italian debt was the largest ever for a G7 government. Tensions quickly subsided with a more market friendly stance taken. However, given the make-up of the coalition government, Italian debt still trades at elevated levels compared to their German peers. The Euro also weakened versus its peers in light of heightened break-up concerns. This episode brought back some echoes of the Eurozone crisis but, taking into consideration the ongoing ECB asset purchase program, the contagion was limited.

In terms of fundamentals, surveys showed the Eurozone slowing down, albeit from high levels, but unemployment continued to decline. Given this outlook and heightened political risks, the ECB had a tough line to balance given its desire to normalise policy. President Draghi managed to walk this tightrope by indicating a final extension of the asset purchase program, the monthly rate will decline from €30bn to €15bn beginning in October up to the end of the year. Whilst this move could be seen as hawkish in isolation, the ECB countered this by stating that it expects interest rates to remain unchanged through the summer of 2019. Investors had previously been pricing in the first hike in June of 2019, so the combined policy action was taken as a dovish step.

On the other side of the Atlantic, President Trump's stance on trade became more hard line. He has doubled down on his aggressive stance towards China, where the US trade deficit is the largest. He also removed the exemption on EU steel and aluminium. Both of these led to reciprocal tariffs and raised fears of a larger scale trade war. Needless to say, this year's G7 summit was highly contentious and could in many ways be seen as G6+1.

Domestically, the US economy continues to push on strongly given the boost from the fiscal stimulus passed at the end of year. Economic data surprises have been more positive here than the rest of the world, resulting in significant dollar strength over the quarter. Unemployment continued to decline to multi-decade lows with some signs of a further pickup in wages. This backdrop gave the Fed the confidence to raise interest rates by 0.25% in June, signalling a more hawkish path with two further rate hikes expected this year. US Treasury yields are little changed over the quarter as several Fed members indicated their concern of escalating trade tensions that could significantly weigh on sentiment; this echoed a prior warning from the IMF over the global economy.

Caught between these two dominating events is the lacklustre Brexit progress. In-party fighting has continued over the quarter, thus compromising the negotiation position resulting in businesses ramping up their contingency plans. The mixed data in the UK over the quarter has put the Bank of England in a difficult position. They still seem keen to hike rates later this year given the strong employment data but, beyond that, the growth outlook remains mired in uncertainty and could significantly dip if businesses do not get their much needed clarity.

Credit spreads continued to drift wider this quarter as the equity volatility has remained elevated, compared to the historically low levels seen in 2017. Euro denominated debt faced the most amount of pressure given the ongoing situation in Italy. The prospect of bond purchases coming to an end, resulting in less liquidity, paired with elevated level of US government debt supply has weighed on existing debt. Supply concerns have also come to forefront as AT&T's acquisition of Time Warner was approved by the high court which could result in more M&A activity.

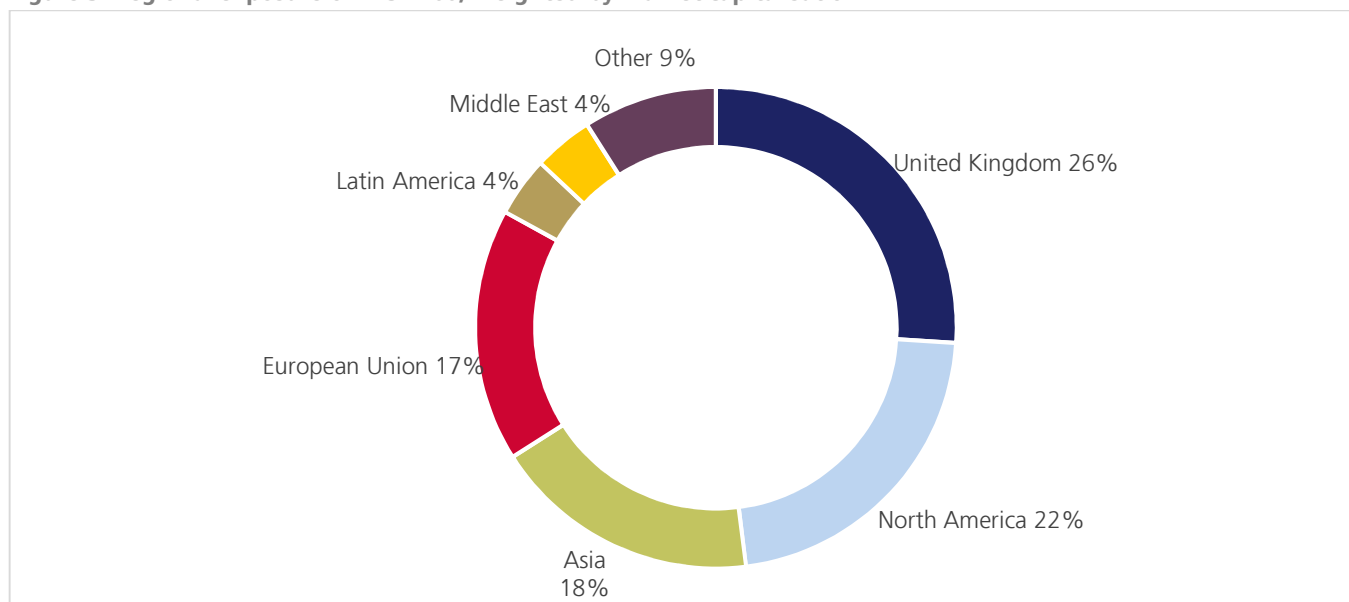
Equities

UK Equities

In the first quarter of the year, the UK was one of the worst performing equity markets with a fall of roughly 9%. There were two main reasons for the sell-off seen in the period. The first was the upwards move in the pound against the dollar since around 75% of earnings for the top 100 companies are generated outside of the UK (Fig. 3). This weighed on the earnings potential of the market, and the dividend outlook for large dividend payers like Shell and HSBC that actually report in dollars. The second reason was politics and more specifically, widespread concerns that infighting within the Tory party could usher in a vote of no confidence, a new General Election, a Labour victory, and a 'hard' Brexit.

We highlighted in our last quarterly update that the sell-off in the UK market in the first three months of the year presented an opportunity. To illustrate the point, we drew attention to the fact that the dividend yield for the wider UK market had only been higher at one point in the last 20 years.

Figure 3: Regional exposure of FTSE 100, weighted by market capitalisation



Source: ASR Ltd, Factset GeoRev, Thomson Reuters Datastream

Over the course of the second quarter, the UK stock market subsequently managed to bounce back by c. 9%. This was sufficient to wipe out the losses seen in the first quarter. Enthusiasm for higher yielding names was undoubtedly a factor in the market's rally and a bounce in the oil price provided investors with an additional reason to buy big dividend payers like Shell and BP.

Fresh weakness in the pound (good for all the overseas earners) provided further justification for bargain hunting, but investors were also galvanised into action by a spate of takeovers, and the declaration by US based value funds that they had taken major stakes in groups such as Whitbread and Micro Focus. Corporate activity is likely to continue, and the UK market should receive additional support from yield hungry investors. However, there is no getting away from the fact that Brexit negotiations and the value of the pound will be key influences from here to the end of the year.

At the time of writing, despite some opposition, Theresa May appears to have secured support for a 'Third Way' plan that paves the way for a soft Brexit. This would come via a close regulatory alignment with the EU and a 'mobility framework', which should enable UK and EU citizens to "continue to travel to each other's territories, and apply for study and work". This raises hope that the UK can avoid tariffs and customs checks, and any resultant supply chain disruption.

Honda's car plant near Swindon, the global centre for production of the 5-door Civic, provides a good illustration of the risks. The plant uses 2m components a day but only 25% of the Civic is now "true UK content". Parts from EU suppliers arrive within 5 and 24 hours. If Britain were to leave the Customs Union, Honda estimates that it will need to handle 60,000 additional customs declarations. More pertinently, it also estimates that parts from the EU will take a minimum of 2/3 days to arrive and possibly as long as 9 days. The problem is that a warehouse capable of holding 9 days of stock would be the equivalent of 42 football pitches and almost 3x the size of Amazon's main distribution centre.

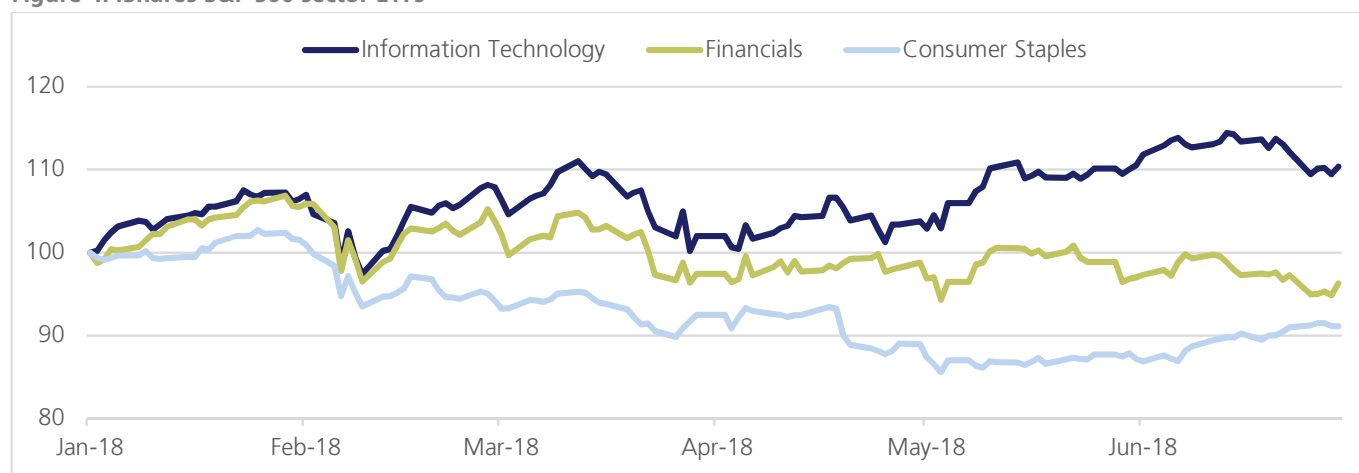
It is too early to tell if the Third Way plan will hold, but UK stocks with mainly domestic revenues will benefit from a move towards a soft Brexit. Conversely, the large cap stocks with overseas revenues will suffer if the pound strengthens. Further comment on this whole subject can be expected in future quarterly updates.

International Equities

The normal service of recent years resumed with equity markets positive after a brief pause in Q1 2018, with the MSCI World Index eking out a 1% gain in Q2. The S&P 500 in the US rose +3.4%, with the technology sector once more leading the way (+6.8%) as the quarterly earnings reporting season demonstrated accelerating growth at many of the most ubiquitous names. Alphabet, the parent company of search engine behemoth Google, rose 8% and the world's largest company by market capitalisation, Apple, rose another 10%. Microsoft rose 8% and MasterCard 12%, not to mention Amazon rising 17% during the quarter.

The contrast with previous market darlings – consumer staples – could not be more marked as -8% performance in Q1 (the worst performance in eight years) was followed by a further 2% fall in Q2. Tobacco stocks were the prime losers as the lower health risk heat-not-burn cigarettes saw formerly sharply rising sales plateau in early adopting Japan. US financials fell 3.6% despite the vast majority of US banks sailing through the Fed's latest stress tests and using the windfall from much lower US tax rates to sharply increase (once more) their payouts to shareholders in the form of dividends and share buybacks. For example, both JP Morgan and Bank of America intend to return 9% of market capitalisation to shareholders in 2018 and scandal-hit Wells Fargo a startling 12%.

Figure 4: iShares S&P 500 sector ETFs



Source: iShares/Bloomberg

The MSCI Europe ex-UK followed the US lead in rising +2.7%. This was remarkable given European financials were very weak with many European banks down near double digits or more. While there was no smoking gun for such performance, flatter yield curves and fears over weaker capital bases (and required equity raises) once more came to the fore.

In the Far East, the Topix Index in Japan rose 1% with banks, electricals and autos down and consumer staples defying the global malaise to end the quarter up. The exceptions to the positive bias on equities were emerging markets where the push-me-pull-you of Trump's tariffs on China (and other countries) looks to be heading towards an actual trade war, rather than the hoped-for threat of one followed by healthy compromise. The Shanghai composite fell 10% for its third consecutive quarterly fall. A focus on the very large current account deficits in Turkey and Argentina meant their currencies and, consequently, equity markets were very weak. India defied the doom and gloom as robust growth and little direct involvement in the trade war led the Sensex Index to rise 7%.

Alternative Investments

Hedge Funds/Targeted Absolute Return

Absolute Return Funds continued to perform well during the second quarter and have, on average, performed better than bonds and some of the equity markets. This clearly demonstrates the benefit of diversification offered by these strategies in a portfolio context. The strongest performance came from event driven strategies during the quarter, which benefitted from lower regulatory uncertainty. The approval of the AT&T and Time Warner merger has reduced some of the regulatory risk and we should see an increase in number of deals on the back of this. However, the 'America First' policy of the current US administration and trade skirmishes means that the threat to cross-border deals remain.

Global macro strategies were another strong performer during the quarter. The moves in emerging markets and uncertainty related to the formation of the Italian government provided attractive opportunities for these managers. This year has been a much better environment for macro managers than the last two years, which were characterised by high asset class correlation and low volatility. The increase in inter and intra-sector stock dispersion provided a good opportunity for long/short equity funds. The multi-asset funds recovered negative performance in the first quarter, mainly due to moves in government bonds. Similarly, systematic strategies recovered some of the losses from February, mainly from the commodity exposure and rates.

We continue to recommend an allocation for absolute return strategies as balancing allocation within portfolios. Clearly, the strategy and manager selection remains critical and therefore diligence needs to be paramount in allocating to these strategies. The opportunity set for the sub-strategies remains good and there is not one particular strategy which remains a stand out and therefore we recommend a well-diversified allocation among sub-strategies and managers. Our view is that market volatility will remain high on back of the uncertainty surrounding monetary policy, trade wars and political uncertainty. This is a good environment for macro funds. The tax reforms implemented by the US at end of 2017 encourages capital expenditure, however given the current growth outlook, we believe companies may need to engage in corporate action to meet growth expectations, which is positive for event driven strategies.

Property/Infrastructure

The rally in bonds and fall in yields saw a recovery in property related investments during the second quarter. Infrastructure recovered losses from earlier in the year. However, given the valuation and the sensitivity to rates, we remain cautious on this sector and we find opportunities in niche, tangible parts of the real estate universe.

A report from the International Monetary Fund ("IMF") on housing is a potential point of concern, namely global housing cycles are becoming more synchronised. The sustained global economic recovery, coupled with historic low borrowing costs, has provided a major boost to house prices across many countries. The IMF research states that a possible explanation for this trend is continued integration of global financial markets and greater cross-border capital flows by global investors (particularly Chinese investors) in search of yield or safe assets. This has accelerated foreign demand for housing in many major cities, suggesting that residential markets are starting to behave more like other financial assets. As a result, housing markets in one country are now more sensitive to potential swings in another. A more synchronised global housing cycle has clear implications for investors diversification strategies and suggests that there is greater downside risk from any sudden slowdown in global economic growth, as local housing market dynamics are now more vulnerable to unexpected foreign shocks.

In summary, given a continued global growth and manageable leverage levels, the real estate asset class is unlikely to be the source for financial stress as in the Great Financial Crisis of 2008. The asset class will remain supported for its yield opportunity compared to government bonds, however there is limited scope for capital growth. In this return environment, it is preferential to be very selective on the investments.

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