

AJ Bell Income Funds – Q2 2019 review

Introduction

We are delighted to bring you the quarterly report from AJ Bell Investments covering the Income funds since launch on 8 April.

This report is designed to keep you up-to-date on what is happening with your AJ Bell managed investments. It covers the major macro-economic events of the past three months, looks at how these have impacted the portfolios, and highlights any changes made in the period.

Summary

After a strong start to the year in Q1, Q2 broadly continued the theme, particularly for sterling investors who were helped by a strong tailwind from the weakening currency. Investors across the world were of the view that ‘bad news was good news’ as the chances of interest-rate cuts or further monetary stimulus seemed to increase as the quarter progressed.

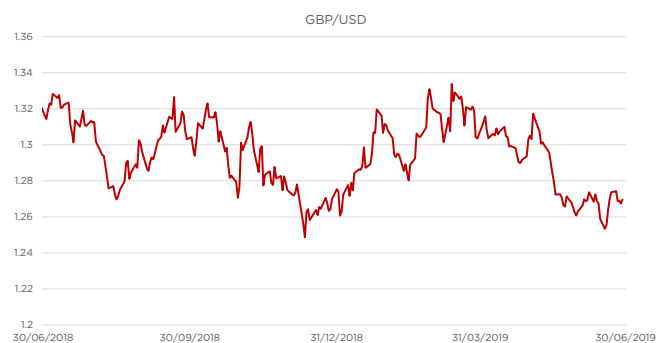
In the UK, Brexit was once again in the spotlight with the date for leaving the EU pushed back again, this time until the end of October. However, this resulted in Theresa May resigning as Prime Minister, finally admitting defeat in getting her deal approved by parliament. Trade wars and tariffs were a feature of the quarter as the US/Chinese spat continued, while bond yields fell sharply as the bond market perceived increasing risk to the global economy.

Economic and market review

The second quarter of 2019 saw a continuation of the first with broadly positive performance from both equities and bonds, although Asian and emerging markets equities struggled to progress. The positive performance was based upon indications from central banks in the major economies that they were ready to provide further support and stimulus to economies should they judge that the world was at risk of an economic slowdown. The positive feeling behind this seemed to outweigh increasing tensions towards the US/Chinese trade war and increased tensions in the Middle East that pushed both the oil and gold prices higher.

In a serious case of *déjà vu*, Brexit dominated the UK agenda over the past quarter as the original date for leaving the EU was extended, perhaps aptly, to 31 October, or Halloween! However, following disastrous European election results for the Conservative Party and a failure for parliament to pass the Withdrawal Agreement, Theresa May took the decision to resign, triggering a leadership contest and a market expectation that the risk of a no-deal Brexit had increased. With Boris Johnson the hot favourite, all eyes will be on the run up to the October deadline. During the period, UK economic performance was solid with continued low unemployment and GDP growth in line with expectations. The Brexit uncertainty saw sterling fall in value vs the US dollar, which helped the performance of larger stocks given their focus on overseas earnings while overall the FTSE All-Share Index was up 3.3%. With the weakening of sterling, overseas exposure in both equities and bonds was boosted in GBP terms.

The bond market predictably reacted to the increased risk of a no-deal Brexit with the yield on the 10-year gilt falling sharply, ending the period at just 0.82%. This helped the FTSE Actuaries UK Conventional Gilts All Stocks Index increase by 1.3% over the quarter. With the risk on environment, credit risk was rewarded, helping corporate bonds to perform well, with the iBoxx UK Sterling All Maturities Index increasing by 2.3% over the quarter, while high-yield bonds also performed well with the Bloomberg Barclays Global High Yield Bond Index increasing by 2.1% over the period.



Source: Bloomberg LP, AJ Bell Investments, July 2019

In the US, two major issues dominated the quarter: firstly, the ongoing trade war with China; and secondly, the shift in narrative from the Federal Reserve surrounding interest rates. The trade war escalated during the quarter as negotiations broke down and in May, the US increased the tariffs on \$200bn of Chinese goods from 10% to 25% and threatened to extend this to another \$300bn of goods. Naturally, the Chinese didn't take this lying down and responded by increasing the tariff on \$60bn of US goods. This tit-for-tat battle has yet to truly be seen in economic data, but the risk is that a pick-up in inflation and a slowdown in growth could be seen in the second half of 2019. Turning to the Federal Reserve, during the quarter it became apparent that investors sense that the Fed may have to cut interest rates at some point this year. While initially the Fed appeared adamant that it was comfortable with the economic position, as the quarter progressed the narrative shifted with an indication that rate cuts could come if data deteriorated. With inflation remaining low and the boost from the Trump tax cuts about to leave the economy, there is a sense that a slowdown is occurring that will force the Fed's hand. As a result, market behaviour has become somewhat strange, with equities and bonds rallying on weaker data in the expectation that the Fed will be more likely to act sooner rather than later. This backdrop saw equities perform strongly with the S&P 500 Index increasing by 6.6% over the period. The more accommodative language from the Federal Reserve saw interest rate expectations change markedly, and as a result the US 10-year Treasury yield fell from 2.4% at the start of the year to 2.0% at the end of the quarter, resulting in a strong rally for US bonds.

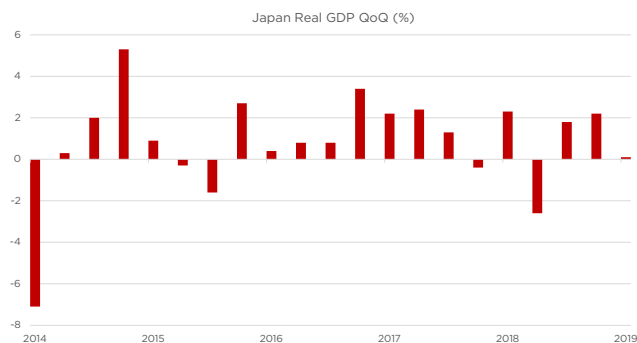


Source: Bloomberg LP, AJ Bell Investments, July 2019

With a myriad of economic and social problems in Europe, investors have been nervous of the region for some time. However, after solid performance from the equity market during the quarter, European equities have actually had their best first half of a year for 21 years, providing a healthy reminder that investing in companies is not always representative of the underlying economies. At an economic level, data has been mixed with a very poor performance of the manufacturing side of the economy as the global economy – notably China – slows down, but a stronger performance from the services element of the economy, which is less reliant on overseas consumption. The ECB has been alive to the risks and Mario Draghi has talked of the possibility of restarting quantitative easing in some form should the economy need it. These comments saw bond yields fall sharply, with the 10-year German Bond turning negative again and actually reaching a lower level than it saw even in the eye of the Euro crisis storm back in 2014. In Italy, the government remained at loggerheads with the EU, with talk of the potential introduction of a parallel ‘currency’ called mini-BOTs to stimulate their economy. Over the period, the MSCI Europe ex UK Index increased by 8.3%.

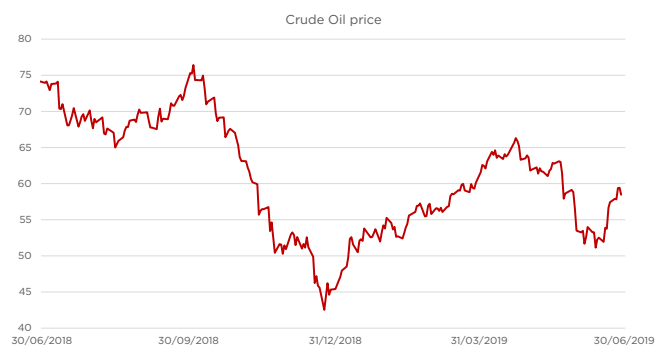
In Asia, China was the dominant factor as the previously mentioned trade war was prevalent. As Trump’s trade tariffs kicked in, investors began to digest how much this could impact on Chinese growth and the Chinese central bank acted quickly, providing a cut to the amount capital banks have to hold in a hope of stimulating lending. They also cut both personal and corporate tax rates in a sign that they were prepared to act decisively. Away from China, India had a general election in what is said to be the largest democratic election in the world, with nearly 1 billion voters. Prime Minister Modi was re-elected with a majority, which should enable him to continue his reform agenda. Over the period, the MSCI AC Asia ex Japan Index fell in local currency terms, but increased by 1.7% in sterling.

In Japan, economic data showed strong growth in the first quarter, catching experts, who had expected the economy to contract, off guard. However, as ever, the devil is in the detail and analysis of the data showed that the GDP was pulled up by a sharp fall in imports rather than any strong underlying demand. In fact, a fall in exports and private demand pointed to a continued challenging outlook, particularly given the slowdown in neighbouring China. Over the quarter, the Topix Index was the worst performing major market, but for UK investors, the weakness in sterling actually meant that the Topix Index increased by 2.7% over the period.



Source: Bloomberg LP, AJ Bell Investments, July 2019

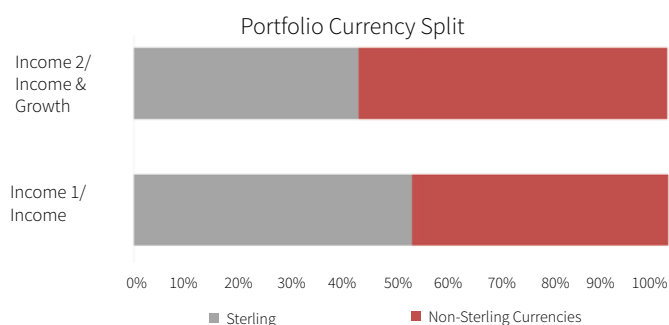
In the emerging markets, Russia was a very strong performer, as the country benefited from the rise in the oil price this year. With Gazprom and Lukoil making up a third of the Russian index, the rally in the price of ‘black gold’ this year has seen their share prices rally sharply, with Gazprom announcing a significant increase in its dividend. In Brazil, the stock market hit an all-time high despite the economy showing a contraction as confidence in President Bolsonaro fell and the growth rate for 2019 was slashed. During the period, MSCI announced changes to its emerging markets index which will see Saudi Arabia and Argentina added to the index while the weight of domestic Chinese equities continues to be increased. Over the period, this index was up by 3.0% while emerging markets fixed interest was the best performing asset class, with the JPMorgan GBI Emerging Market Global Composite Bond Index increasing by 8.3% over the period.



Source: Bloomberg LP, AJ Bell Investments, July 2019

Asset allocation positioning

As highlighted in the previous section, sterling fell against all major currencies. As sterling falls, the value of international assets increases when converted back into sterling, providing a boost to UK based investors. Currency fluctuations provide extra volatility to the returns of a portfolio, therefore our Income Fund has a balance between sterling and international assets, whereas our Income & Growth Fund has a slightly greater focus on international holdings. Sterling falling up to 6% against major currencies provided a boost to returns to both funds



Source: AJ Bell Investments, July 2019

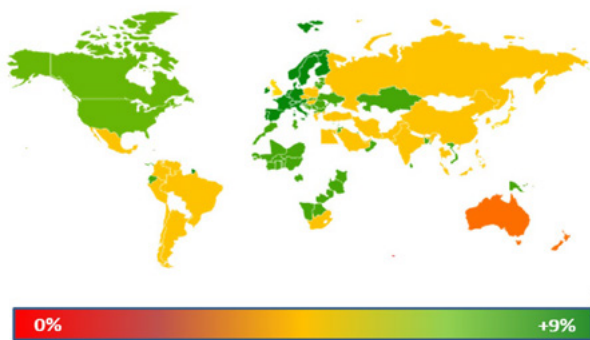
AJ Bell Income funds review – Q2 2019

Although the funds' equity holdings are allocated by region, income-focused equities tend to be slightly tilted towards certain sectors. Mature industries tend to pay out a greater proportion of profits as dividends, and this leads to a bias towards financials, industrials and materials stocks. Given the risk on environment, financials were one of the best performing sectors since the funds' launch. Materials and industrials also outperformed the markets in general, helped by the bounce in commodities such as oil and iron ore.

Financials, materials and industrials are large sectors within the European equity markets, and so it was this region that performed the best since the funds launched.

The one sector we specifically allocate to is infrastructure. This performed well (up 8%) as it tends to be focused toward utilities and industrials, with the former performing well when bond yields fall.

Q2 equity market returns



Source: AJ Bell Investments, Bloomberg LP, July 2019

The Income Fund aims to generate a proportion of its income target through an allocation to fixed income. Given the low level of yields in the UK, a significant part of the fixed-income portion of the portfolio is in international bonds, and given the desire to maximise yield, only global high-yield bonds are sterling hedged, as the hedging cost negates the yield advantage in lower risk overseas bonds. Therefore our holdings in US treasuries, US investment grade and US high yield bonds (all unhedged) benefitted from three factors: falling treasury yields, tightening spreads and the fall in sterling. Alongside the strong performance of emerging market bonds, fixed income was a major driver of returns in the lower risk portfolio.

The Income & Growth fund, on the other hand, eschews fixed income, achieving diversification through listed UK and global property holdings. UK property returns crept into positive territory over the period, with returns held back by Brexit uncertainty and its effects on UK property prices. International property, however, performed well on weakening sterling and falling bond yields.

Given strong markets since the launch, all elements of the portfolios helped deliver positive returns.

Fund performance

The funds launched during the quarter; as such, it is perhaps too early to discuss the performance of individual securities. It is, however, pleasing to see that since launch to quarter end, all securities in the Income Fund delivered positive absolute returns, and in the Income & Growth Fund 12 out of 13 positions delivered a positive return. The funds blend both passive and active holdings together, with a view taken on an asset-class-by-asset-class basis to ensure the funds' income and return objectives are met, whilst minimising risk.

As the funds grow, the OCF will fall below the 1% cap, as fixed costs become a smaller percentage of the assets under management.

Fund changes

The funds launched on 8 April, and since then no changes have been made. The funds have been fully invested throughout the period.

Fund holdings are continually reviewed and changes, where appropriate, will be made on an ongoing basis and communicated in timely fashion.



This report provides general information about the AJ Bell Income funds. It should not be read or construed as investment advice. It is your responsibility to assess your client's circumstances and make a personal recommendation that is suitable for their needs.

The value of investments can go down as well as up and your client may not get back their original investment. Past performance is not a guide to future performance and some investments need to be held for the long term.