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AJ Bell Passive funds – Q4 2017 report

Introduction

We are delighted to bring you the latest quarterly report for the AJ Bell Passive funds that were launched in April 2017.

This report is designed to keep you up-to-date on what is happening with your investments that are managed by AJ Bell. We take a look forward at planned changes to the service that will come into effect in Q1 2018, cover the major macro-economic events of the past three months and look at how these have impacted the funds.

The fourth quarter of 2017 was another positive one for equity markets, bringing a strong finish to 2017. The global economy continued to expand amid a relatively calm corporate environment and while politics was once again at the forefront of the news with Brexit challenges dominating the headlines, this failed to have an impact on stock markets, with all major markets in positive territory.

With interest rates being increased in both the UK and the US, there was a shift in monetary policy as central banks responded to improving global conditions. With equity markets at or close to record highs, it will be interesting to see whether this can be sustained through 2018 or whether markets may see a pick-up in volatility from record low levels.

Asset allocation update

We regularly review our products and services to ensure that they continue to deliver low-cost solutions that consistently deliver the right outcomes for our customers. As a result of this, we have decided to adopt a new strategic asset allocation approach for the AJ Bell Passive funds. In the first quarter of 2018 the AJ Bell Passive funds will move to an in-house process rather than using the services of Moody's.

The AJ Bell Passive funds will in turn become more diversified, adding a number of asset classes including global bonds, emerging market debt, global technology. In addition, an increased allocation to UK equities is also made on a long term basis, reducing some of the currency risk that was in the funds. Despite these changes, the risk profile of each of the funds remains the same.

Economic and market review

The final quarter of 2017 followed a similar pattern to the rest of the year with positive performance coming from equities to leave global stock markets close to record levels after a very strong year. Japan led the way over the quarter, closely followed by the US and Asia as the global economy continued its advance.

In the US, economic data continued to be robust, with third quarter GDP growth coming in at a healthy 3.2% which in turn helped drive down unemployment to just above 4% which was the lowest level since early 2001. With both manufacturing and services industries growing strongly and with inflation relatively stable at 2%, the Federal Reserve saw fit to increase the interest rate for the third time this year. The Fed pointed to a strong labour market and solid industrial activity to support the rise and also indicated that it expected three further rate rises in 2018. It was announced during the quarter that Janet Yellen would not be granted a second term as governor of the Federal Reserve, with President Trump instead nominating Jerome Powell to take over. Powell is seen as a safe pair of hands and business- and market-friendly, meaning the announcement was welcomed. President Trump also managed to pass his major tax reforms during the period, significantly cutting Corporation Tax. During the quarter, US companies reported strong earnings growth which helped push the S&P 500 Index to record levels. It ended the quarter up 6.5%.

In the UK, the deadlock on Brexit negotiations was finally broken with the EU agreeing to move to the next phase of discussions which will look at drafting the all-important trade agreement. The economy continued to defy expectations with GDP growth for the third quarter coming in at 0.4% which was ahead of expectations, helped by the resilient consumer. In addition, a buoyant jobs market saw unemployment hit a 42-year low. With an increasing oil price and higher prices in other areas including transport, leisure and food, inflation was pushed higher, hitting 3.1% in November which represented a five-year high. Against this backdrop, the Bank of England took the opportunity to increase interest rates by 0.25% to 0.5%, its first increase in a decade, with a view to bringing inflation back in line with the 2% target. With sterling weakening against the US dollar, after a strong rally in the third quarter, UK equities performed well, with the FTSE All Share Index advancing by 5.0% over the period.

From an economic perspective, Europe had an excellent quarter with strong data at almost every turn. Unemployment fell to a nine-year low while consumer confidence hit a 16-year high which helped propel GDP growth to 2.5%. This growth was led by Germany, however France and Italy were also strong with signs also that the recovery was widening to a number of other countries. The strength of the economy gave the ECB confidence that it was able to reduce the support it was giving to the economy through its Quantitative Easing programme,

however, the option was retained to extend this again should circumstances require it. While the economics of the region were strong, the politics of Europe was once again dominant. While progress was made on the Brexit talks, the failure of Angela Merkel to form a coalition government saw concerns increase that Europe's largest economy was about to enter a period of prolonged political uncertainty. The prospect of a grand coalition eased these concerns into December, however with talks not beginning until the New Year, this risk remained. Away from Germany, a major constitutional crisis in Spain was the dominant headline over the quarter. An unofficial referendum on the independence of Catalonia saw the regional government declare independence, however, this was immediately overruled by the Spanish government, which assumed direct control and called fresh elections. While tensions eased as the end of the year approached, new elections saw the independence parties win another majority, leaving a major period of uncertainty ahead of the country. As a result of this uncertainty, European equities lagged other major markets but still managed a small increase of 0.1%.

Asian equities continued their upward march during the final quarter of the year, propelled higher by positive growth in China where GDP came in at nearly 7% year-on-year as retail sales grew strongly. The Chinese held their 19th National Party Congress and the output of this saw investors reassured with a focus on financial stability and economic reform. Across the region, the dominant driver was the performance of technology-related stocks which have performed very strongly, despite a wobble during the end of November, particularly internet-related companies in Hong Kong as the growth of online retail continues. This performance pushed the Hang Seng Index to a 10-year high during November. Australian equities also performed well as mining stocks rallied throughout the period on the back of strong commodity prices. As the period progressed, tensions looked to ease between South Korea and North Korea giving investors renewed confidence in the country. This was enough to push the Korean market to a record high. The Indian economy progressed well during the quarter and this was sufficient for ratings agency Moody's to upgrade the credit rating for the country. This helped push the market higher early in the quarter, however, investors saw this as an opportunity to take some profits after some strong performance through 2017. Overall, Asian equities performed well with the MSCI AC Asia ex Japan Index increasing by 6.2%.

In Japan, Prime Minister Abe was re-elected having called a snap general election. This was viewed positively by domestic and foreign investors with continuing reform being at the heart of Abe's election campaign. The labour market continued to be relatively tight with likely wage pressure coming in 2018 which should push up inflation. This positivity was reflected in updates from companies during the quarter who continued to report positive earnings growth. This was sufficient to push the Japanese market to a 26-year high and saw Japan as the best-performing region over the fourth quarter, with the Topix Index increasing by 8.7%.

In the emerging markets, performance was positive, helping the region finish the year as the best-performing equity region. Emerging Asian countries were the main drivers over the quarter with China and India previously mentioned. Away from Asia, South Africa finished the year strongly following the election of Cyril Ramaphosa as the leader of the ruling African National Congress (ANC) with investors hoping that this gives the country a firmer footing. In Latin American, Mexico struggled as worries that the North American Free Trade Agreement (NAFTA) would collapse and evidence that the earthquakes and hurricanes had damaged the economy led investors to move away from the country. With an advancing oil price, Russia continued to prosper as it agreed to extend production cuts until the end of 2018. Overall, the MSCI Emerging Markets Index increased by 5.7% over the quarter.

In fixed interest markets, major central bank action dominated the key moments over the quarter. The widely anticipated rise in interest rates in the UK by the Bank of England in November was already priced into markets and therefore didn't impact the gilt market during the quarter. Uncertainty surrounding the UK's future trading arrangement with Europe kept gilt yields low as investors remained cautious and saw it as unlikely that interest rates would rise much further in the foreseeable future. As a result, the FTSE Actuaries UK Conventional Gilts All Stocks Index increased by 2.0% over the quarter. With inflation hitting a five-year high, index-linked bonds had a very good quarter, regaining some of the ground that was lost during the third quarter. The Bloomberg Barclays UK Government Inflation-Linked Bond Index rallied 3.9% over the quarter.

UK corporate bonds were also positive over the period, however they lagged government bonds as investors took a more cautious approach to fixed interest given the uncertainties that exist into 2018. However, the Merrill Lynch Sterling Corporate Bond Index was still positive, gaining 2.1% over the quarter and ending 2017 comfortably positive. Typically, strong equity markets would signify a positive environment for high-yield bonds, however, with the increase in yield available over lower-risk bonds now having compressed significantly, performance was more muted during the final quarter of the year. As a result, the Bloomberg Barclays Global High Yield Index was only marginally in positive territory, increasing by 0.9%, and ending the year slightly higher.

The commercial property market finished the year strongly, with UK property having a particularly strong finish to the year, boosted by the news that the UK and the EU were moving to the next phase of negotiations. The FTSE EPRA/NAREIT UK Index ended the quarter up 8.3%. Global property was not as strong but still managed positive returns with the FTSE EPRA/NAREIT Global Index increasing by 2.5%.

Portfolio review

As the funds have only recently been launched, we are unfortunately not able to comment on their early performance. We look forward to providing this information once the funds have been in existence for one year.

Over the quarter, currency moves were again a major factor in global markets as the performance of sterling was volatile given the uncertainty surrounding the Brexit negotiations. Having seen some significant moves in the third quarter, for much of the period, sterling was weaker. However, as the end of the year approached, it rallied against both the US dollar and Japanese yen to reduce returns for UK investors.

As each of these funds follows a long-term investment approach, there have again not been any changes to the underlying holdings, matching the third quarter. We do however remain focused on ensuring that each of these portfolios is exposed to the most appropriate investments to gain exposure to our asset classes. Should the need arise to make changes to the underlying holdings, either to lower overall costs or to improve the quality of the investments, we will not hesitate to make them.

This report provides general information about the AJ Bell Passive funds. It should not be read or constructed as investment advice. It is your responsibility to assess your circumstances and make sure it is suitable for your needs.

The value of investments can go down as well as up and you may not get back your original investment.

Past performance is not a guide to future performance and some investments need to be held for the long term.

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