AJ Bell Passive funds – Q2 2018 review

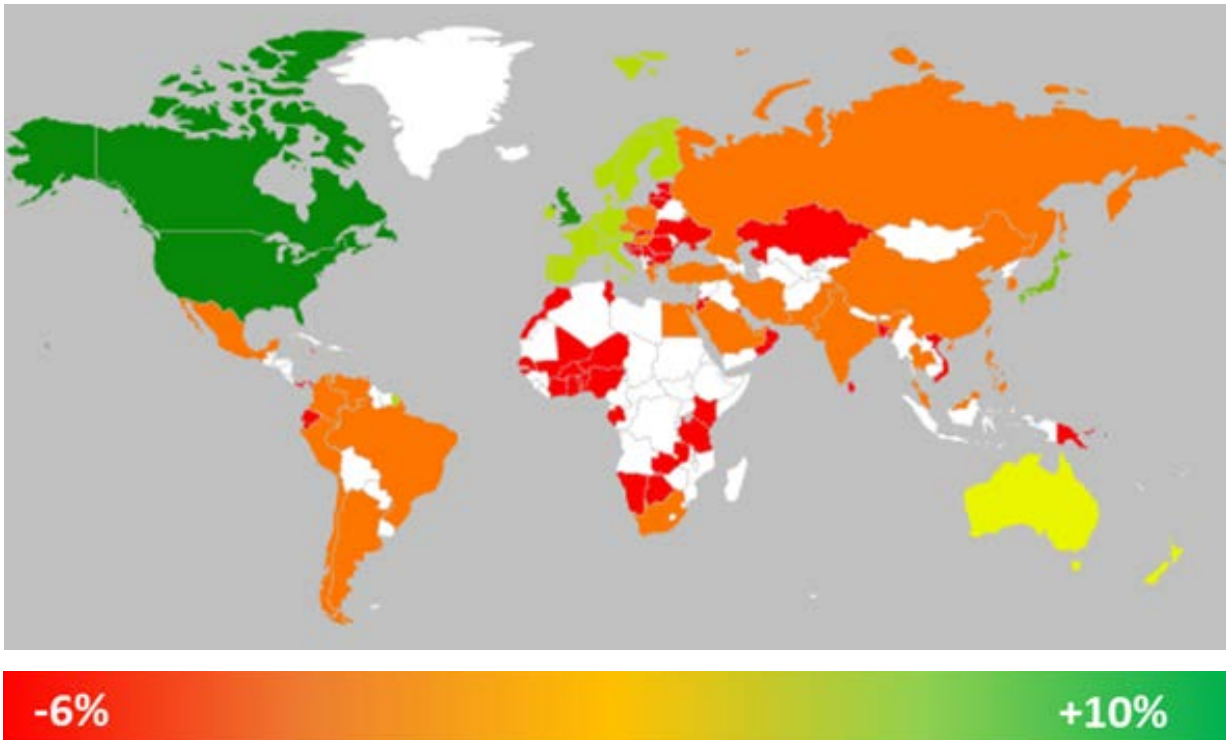
Introduction

We are delighted to bring you the latest quarterly report from AJ Bell Investments.

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

Market Performance & Outlook

Share returns were a mixed bag in the second quarter of the year. Developed regions such as the US, Europe and the UK performed well, whereas emerging regions such as Africa, South America and parts of Asia saw negative returns. Bond markets were fairly flat and alternative areas of investment such as property performed reasonably well.



Heat map of global equity returns by region, Source: Bloomberg, AJ Bell

The market moves across the quarter can be summarised in our view by three factors:

- Bumpy currency markets across the globe
- A potential trade war
- The continued momentum in technology shares

We will look at each cause in more depth and provide our outlook for the funds based on different scenarios.

Currency Moves

Over the last quarter, currency moves have played a significant part of returns for a UK based investor, as the US Dollar went up strongly. The US central bank has repeatedly increased interest rates recently and the prospect of a trade war between the two biggest economies in the world; the USA and China makes the Dollar a safe haven in these more turbulent times.

Should the Dollar continue to strengthen, US bonds and shares will be worth more when converted back to Sterling. This effect would also be seen in the FTSE 100, where a large portion of companies in the Index make a significant proportion of profits in the US.

Whilst good for some markets, a rising Dollar is not a welcome development in emerging markets and their performance in Q2 reflects this. Since emerging economies are competing with developed economies for investors' money, rising interest rates in the US tempt investors away from the riskier emerging areas, leading to an exodus of investment and a falling local currency. Compounding matters, a lot of emerging economies rely on commodity exports to drive their economies and with these priced in US Dollars, a rising Dollar, generally means a lower price is received on these goods. Perhaps the straw that breaks the camel's back is the high level of borrowing undertaken by emerging markets in US Dollars. This allows them to access loans with lower interest rates than they would be able to achieve in their own currencies, however as the Dollar rises, so does the amount of interest they owe, putting pressure on the financial health of indebted emerging economies.

Dollar move against Sterling, Q2 2018, Source: Bloomberg

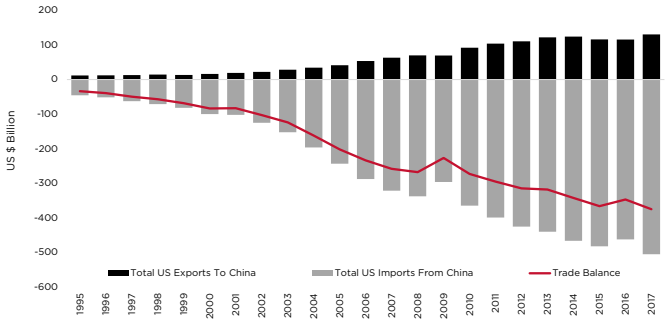
Our view

Whilst the team are always cognisant of the impact of currencies on our portfolios, we don't actively position the funds to benefit from or avoid specific currency themes. Experience tells us that over our investment horizon of 5 years upwards, currency flows will generally even themselves out and as such, we feel time is better spent building a diversified portfolio on both an asset class and geographic basis. This should enable the portfolio to keep an even keel in what are sometimes turbulent currency waters.

Trade Wars

A building story has been the fermenting "Trade War" between the USA and China. The weapons in a trade war are all the international imports around us; foods we consume, transport we use, even the screen (for the tech savvy) that this article is being read on. How do they start? When one country feels another is using unfair practices, they look to impose tariffs on their competition to level the playing field, making imports from the other country more expensive. Tariffs may also be used to keep a competitor's products out of its markets and give their own producers a chance to fill the gap; this is called "protectionism".

The standoff between the US and China has arisen due to President Trump's perception that China has benefitted from anti-competitive practices such as stealing of intellectual property and discouraging US investment into China. This has meant China has been able to undercut the US and allowed a significant trade surplus to build up (effectively China sends more goods to US than it buys from them). The scale of this situation is illustrated when we look at the numbers; the US bought $500 billion of goods from China but only exported $125 billion in 2017, leaving a trade deficit at $375 billion. President Trump is attempting to clawback $100bn of this deficit through tariffs on Chinese goods, with around 1,300 items in the firing line. China responded by revealing it would levy tariffs on items such as cars, corn, whiskey and tobacco.



Net trade between the US and China, Source: Bloomberg

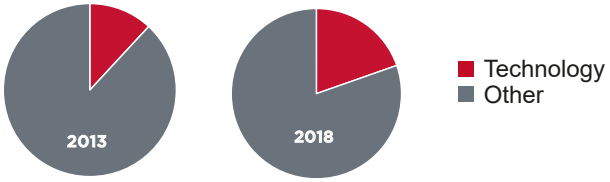
Our view

On 6 July 2018, the US imposed $34bn worth of tariffs on China, to which China has responded with tariffs to a similar level on the US. The prospect of a full blown trade war between the world's two largest economies and superpowers is an unnerving one, especially with the use of "Twitter diplomacy", whereby unexpected tweets from President Trump can change the narrative without warning. However, at the moment, we feel the standoff is relatively contained and being disadvantageous to both parties, it is just as likely to fizzle out as it is to escalate. For now, we believe a lot of the current hot air are tactical in nature to strengthen each countries hand in negotiations and as such, we haven't made any specific changes to positioning at our recent asset allocation meetings. We will, however, continue to monitor developments on the story, whilst remaining vigilant of the impact to the funds from any further escalation or contagion from the trade standoff.

Technology

In Q2, the MSCI World Technology Index increased by almost 13% in Sterling terms, bringing its total return over a 1 year period to an impressive 29%. Only a small part of the UK stock market is made up of technology companies, whereas in the US over a quarter of large public companies are technology companies. This has been a driver of strong performance of stock market performance as the world embraces the benefits new technology delivers, both for consumers and companies. Over the last year earnings of US technology companies have grown by 19%, the second fastest growing sector after Oil & Gas, meaning that unlike in the technology bubble of 2002 strong market returns are not just based on future expectations.

MSCI AC World Index Breakdown



Sector breakdown of the iShares MSCI ACWI ETF, Source: Bloomberg

Our view

The world continues to embrace technology, as highlighted by its growing share of world equity indices. We believe that as an investment it has a place in portfolios for those investors who can accept higher risk. We use it in the Balanced, Moderately Adventurous, Adventurous and Global Growth funds. This position has boosted returns over the quarter, however we are aware that if we move into a recession or the markets become nervous of political risks, the technology sector is likely to be hit hard, and this is why we do not use it in the Cautious and Moderately Cautious funds. Despite the strong performance over the last year we do not feel the market is overly expensive, as share price growth has mainly been fuelled by growth in company earnings.

AJ Bell Passive Global Growth fund

Performance

The Global Growth fund launched on the 11th June 2018, it is therefore too early to comment on performance of the fund, however since early June equity markets have fallen, as such the main reason the fund is showing a negative return so far.

Activity

The fund is now invested across different equity regions and sectors, with a small allocation to UK property and cash. Over 40% of the fund is exposed to higher risk, higher expected return equities across Emerging Markets, Asia and Technology. We have also invested into a thematic ETF which is set to benefit from the growth of automation and robotics across the globe.

Outlook

Since the end of the financial crisis in 2009 global stock markets have risen by over 300% - this is one of the longest and largest rallies since the end of the Second World War. Despite strong performance market valuations do not appear overly stretched and we continue to invest in equity markets. However we believe in the current political landscape it is important to remain alert to developments and ready to change our asset allocation if necessary. We expect to see bumpier times ahead, and therefore feel it is important to be diversified across equity regions and sectors when choosing a higher risk fund.

This report provides general information about the AJ Bell Passive funds. It should not be read or construed 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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