SENECA
INVESTMENT MANAGERS

Peter Elston: Investment Letter

Issue 41: October 2018

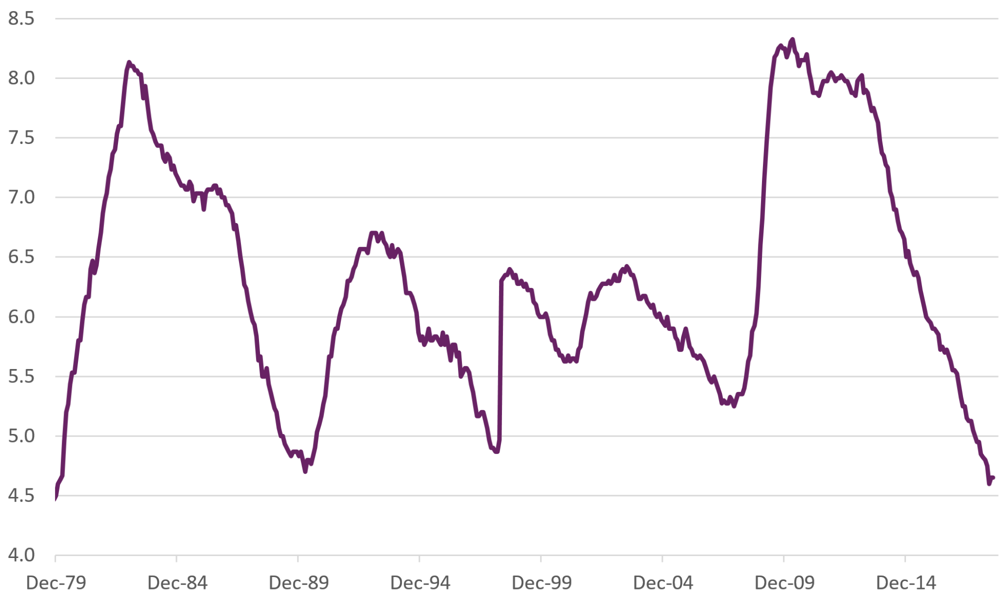
This document is intended for professional investors only

- We have reduced equity targets further for all our funds
- Macro and markets monthly
- Current fund targets

We have reduced equity targets further for all our funds

Last year we laid out a road map for a gradual reduction in our funds' equity exposure, firstly from overweight – in relation to strategic asset allocation (SAA) – towards neutral, then from neutral to underweight. In our latest reduction at the beginning of October, we reduced equity targets for our three public funds – LF Seneca Diversified Income Fund, LF Seneca Diversified Growth Fund, and Seneca Global Income and Growth Trust – to 32.5%, 47.5%, and 52.5% respectively. These positions represent underweights in relation to SAA of 7.5%, 12.5% and 7.5% respectively – the reason the growth fund's underweight is greater than those of the other two is that it has no requirement to distribute income so can be higher conviction with respect to its tactical asset allocation.

Chart 1: Unemployment rate % (avg US, Eur, Japan and UK)



Source: Bloomberg

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Multi-Asset Value Investing

It would be nice to think that we could know precisely when the next global equity bear market will start and move portfolios from being very overweight to very underweight the day before. Unfortunately, that is not the way markets work. Instead, one has to estimate, based on analysis, when it might start, then shift portfolio positioning gradually ahead of time. This allows for the virtual certainty that one's estimate will be wrong – one will either be too late or too early. Too late and one will already have reduced. Too early and one can continue to reduce. But bear markets are like death and taxes – they are certain to happen. Thus, with asset allocation it is about the 'what' not the 'when'.

In recent weeks and months, we have started to see comments from respected economists that appear to fall into the 'this time it's different' bucket. Former US Fed Governor Ben Bernanke has warned against reading the wrong thing into the yield curve – in the past it has been a reliable predictor of recessions. Former US Treasury Secretary Larry Summers has argued that the relationship between employment and inflation – known as the Phillips Curve – appears to have broken down. More recently, Jerome Powell, current Fed Governor, has suggested that the expansion now underway in the United States can continue "effectively indefinitely".

Given that business cycles – in which business and consumer confidence gradually improve from depressed levels following a downturn, then peak at a level from which the only way is down – are very real phenomena; it is always very dangerous to suggest that 'this time is different'.

However, the temptation is to seek reasons why the party can last longer. That is, after all, human nature.

In the pessimists' corner – the 'this time is the same as last time, which is the same as the time before that, etc…' camp – sits renowned economist Nouriel Roubini who is suggesting that a 'perfect storm' will hit the US economy in 2020, exacerbated by the first late cycle fiscal stimulus in history during peace time.

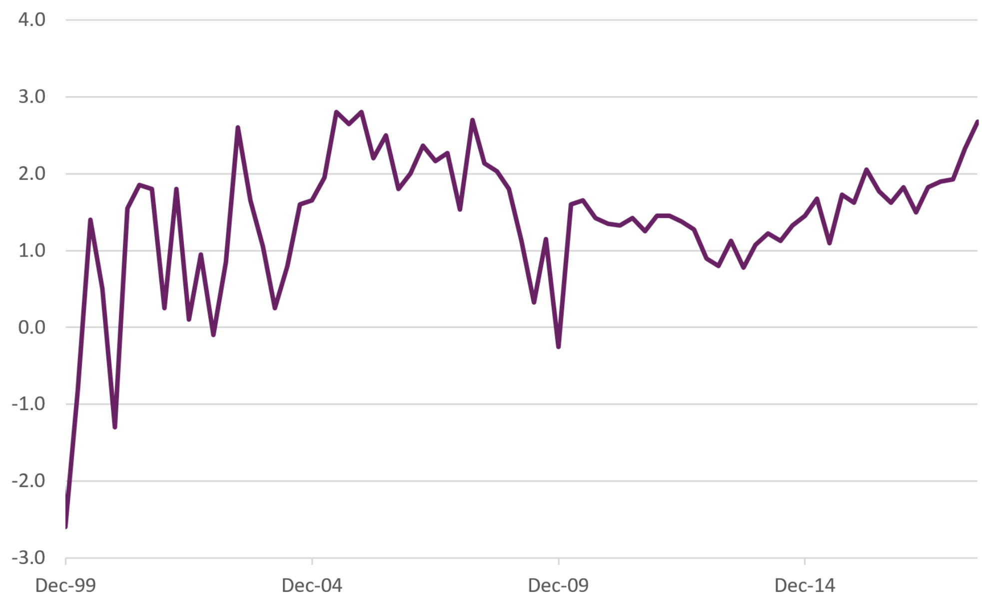
We share Roubini's view that the US, and the world, economy will hit trouble in or around 2020, and are positioning our portfolios accordingly ahead of time.

Our approach is based on business cycle analysis that relates employment levels to wages to inflation to monetary policy to the performance of financial assets. There are logical links between each of these.

The three charts in this letter indicate that unemployment rates across the developed world have fallen to levels which are now causing wages to accelerate which in turn, in combination with the rising oil price, is putting upward pressure on inflation. It seems clear that inflation will continue to rise which, via tighter monetary policy and a higher price of money, will put further pressure on financial asset prices. It is also possible that the rise in inflation could turn out to be much more rapid than even the most pessimistic currently expect.

The great Sir John Templeton once said that the four most dangerous words in the English language are, 'this time is different'. These are certainly words worth remembering in the current climate.

Chart 2: Wages YoY% (avg of US, Eur, Japan and UK)



Source: Bloomberg

Chart 3: Consumer price index %YoY (avg of US, Eur, Japan and UK)

Source: Bloomberg

Review and Outlook

Despite the volatile backdrop of the Brexit negotiations, the UK has grown at its fastest pace for a year. In figures released in September, the economy grew 0.3% in July and 0.6% over the 3 months prior to July. This growth is being attributed to the warm weather and the World Cup.

The trade war between the US and China continued with a further $200 billion of tariffs on Chinese imports taking effect this month. China responded by adding 5% to 10% on a range of US imports. These tariffs were again focussed on the agricultural industries which are located in Republican strongholds.

The US continues to see low unemployment (3.9% in September). Wage growth hit a nine year high at 2.9%. The economy also added another 201,000 jobs. As a result, inflationary pressures persist. The Fed's preferred measure, the core personal consumption expenditures price index (PCE), rose 2 per cent last month from a year earlier (this measure excludes the volatile food and energy components). This measure hit the Fed's target of 2% in May and has remained there ever since.

Table 1: Current fund tactical asset allocation (TAA) target weights as of 30.09.2018 (prior month's targets in brackets)

TAA target Weights (%) (prior month's targets in brackets)		OEICs		Investment Trust
		LF Seneca Diversified Income Fund	LF Seneca Diversified Growth Fund	Seneca Global Income & Growth Trust plc
Equities	UK	**19.0 (19.0)**	**15.5 (15.5)**	**29.5 (29.5)**
	North America	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)
	Europe ex UK	5.0 (5.0)	8.0 (8.0)	7.0 (7.0)
	Japan	1.0 (1.0)	8.0 (8.0)	3.0 (3.0)
	Asia Pacific ex Japan	5.5 (5.5)	10.5 (10.5)	9.5 (9.5)
	Emerging Markets	1.0 (1.0)	4.5 (4.5)	3.0 (3.0)
	Global Funds	2.0 (2.0)	2.0 (2.0)	1.5 (1.5)
	Equities Subtotal	**33.5 (33.5)**	**48.5 (48.5)**	**53.5 (53.5)**
Fixed income	DM Government	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)
	EM Debt	5.0 (5.0)	2.0 (2.0)	1.9 (1.9)
	Corporate	27.7 (27.7)	10.5 (10.5)	7.8 (7.8)
	Fixed income Subtotal	**32.7 (32.7)**	**12.5 (12.5)**	**9.7 (9.7)**
Specialist assets*	Property	6.5 (6.5)	6.6 (6.6)	7.0 (7.0)
	Private equity	3.8 (3.8)	4.0 (4.0)	3.4 (3.4)
	Specialist financial	8.9 (8.9)	8.2 (8.2)	9.5 (9.5)
	Infrastructure	10.5 (10.5)	10.7 (10.7)	11.3 (11.3)
	Specialist Subtotal	**29.7 (29.7)**	**29.5 (29.5)**	**31.2 (31.2)**
Cash		**4.1 (4.1)**	**9.5 (9.5)**	**5.6 (5.6)**
Total		**100.0**	**100.0**	**100.0**

Increased *Decreased*

Source: Seneca Investment Managers, 30 September 2018
* Target weights for the specialist assets subsectors are the aggregate of holding level targets as top down driven asset allocation targets are not applied to this sector.

Fund Commentary

SIGT, SDIF and SDGF

- The US Federal Reserve raised the Fed Funds rate as expected by 25bps to a target range of 2-2.5%, and stated that monetary policy was no longer “accommodative”.
- Unemployment rates in key developed economies either fell or stayed flat, stoking inflation pressures.
- Long-term global inflation pressures, as implied by bond yields, rose sharply in September.
- There were no asset allocation changes in September.
- RPC confirmed that it was in discussions with Apollo Global Management and Bain Capital which may result in an offer for the company. Shares closed up 18% on the day.
- Halfords held a Capital Markets Day in which the company set a target of generating more free cash flow between 2019 and 2021 than it did between 2016 and 2018.
- Templeton Emerging Markets Bond Fund was brought to target weight. The Fund now has a distribution yield of 10.5%.
- The strength of share price in Greencoat UK Wind has put the shares on a 14% premium to NAV therefore we have trimmed the position to move underweight.
- After meeting with INPP’s management team following recent results we feel the underlying valuations of infrastructure assets are very conservative, therefore we increased the overweight position.

SDIF

- Added to BlackRock World Mining Trust which is trading at a double digit discount to net asset value.

SDGF

- Following weakness across emerging market equities, we had the opportunity to make an additional investment in the HMG Global Emerging Markets Equity Fund.