Peter Elston: Investment Letter

Issue 50: July 2019

This document is intended for professional investors only

A Confusing Time for Economists

The very rapid decline in safe haven bond yields in recent months has taken me somewhat by surprise. Although we at Seneca have been preparing for a downturn in 2020 for some time, I had been expecting economies and thus bond yields to remain firm for a little while longer, and therefore to be able to buy safe haven bonds on what I had hoped would be decent valuations ahead of the end of the cycle. As it is, the bond rally started in November when real yields globally were at -0.4%, which hardly represented good value; they are now at -1.0%.

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Multi-Asset Value Investing

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The decline in yields can be attributed to changing expectations for future monetary policy. Equity markets across the globe fell sharply in the fourth quarter, sending the clear message that monetary policy was too tight and thus threatening growth. In January, the Fed and other central banks began to reverse their collectively hawkish stance and have not looked back since. This has resulted not only in plummeting bond yields – an indicator of expectations of looser monetary policy ahead – but also rampant equity markets.

The question is, will a bit of loosening prolong the cycle further, or is economic growth now in an unstoppable downward spiral as usually happens when a cycle ends?

Equity markets certainly seem to believe that a dose of central bank tonic will do the trick. But then equities often respond well to prospects of looser monetary policy. It is only when it becomes clearer that the looser monetary policy is simply 'pushing on a string' that they wake up to the reality of an inevitable recession. So, which is it? Will the cycle be extended or have we entered the end game?

There are I think four factors that complicate investigation of this question more than might otherwise be the case.

First, we live in a world that is experiencing strong deflationary forces, so expecting policy rates during this cycle to peak where they did in previous cycles may be wrong. The term 'secular stagnation' has been making a comeback of late, and so-called 'stagnationists', to support their thesis, point to the natural rate of interest – the rate that supports the economy at full employment and maximum output while keeping inflation constant[1] – having fallen over the last ten years as well as the last four decades[2].

Second, quantitative easing has clouded measurement of the extent to which monetary policy was loosened during the years following the Great Financial Crisis, and therefore the extent to which it has since been tightened. Leo Krippner at the Reserve Bank of New Zealand has sought to address this problem[3] by using some clever maths to represent a certain amount of quantitative easing at a particular time in terms of an effective policy rate – the greater the amount of quantitative easing, the more negative the effective rate (see charts).

Third, major developed economies are out of sync with respect to their economic cycles, evident from differences in prevailing monetary policy. The US is most advanced and has been able to increase its policy rate nine times this cycle. The UK is second, but a distant second, having increased rates only twice. As for the Euro Area and Japan, they are fighting over last place, with neither having been able to push through a rate hike this cycle.

Fourth, China is no longer supporting global growth in the way it has been doing for most of the last three or so decades. It is only to be expected that growth slows as an economy matures, but China may be particularly vulnerable given that it has grown so quickly and that its growth has been both credit driven and somewhat one dimensional, based as it has been around fixed capital investment.

On balance, I think these four factors have the scope to cause global growth to be weaker than expected, not stronger. The problem for central banks, however, is that core inflation across the developed world is not showing the signs of softness that would warrant some loosening of monetary policy. If anything, accelerating wages and rising trade tariffs argue for the opposite.

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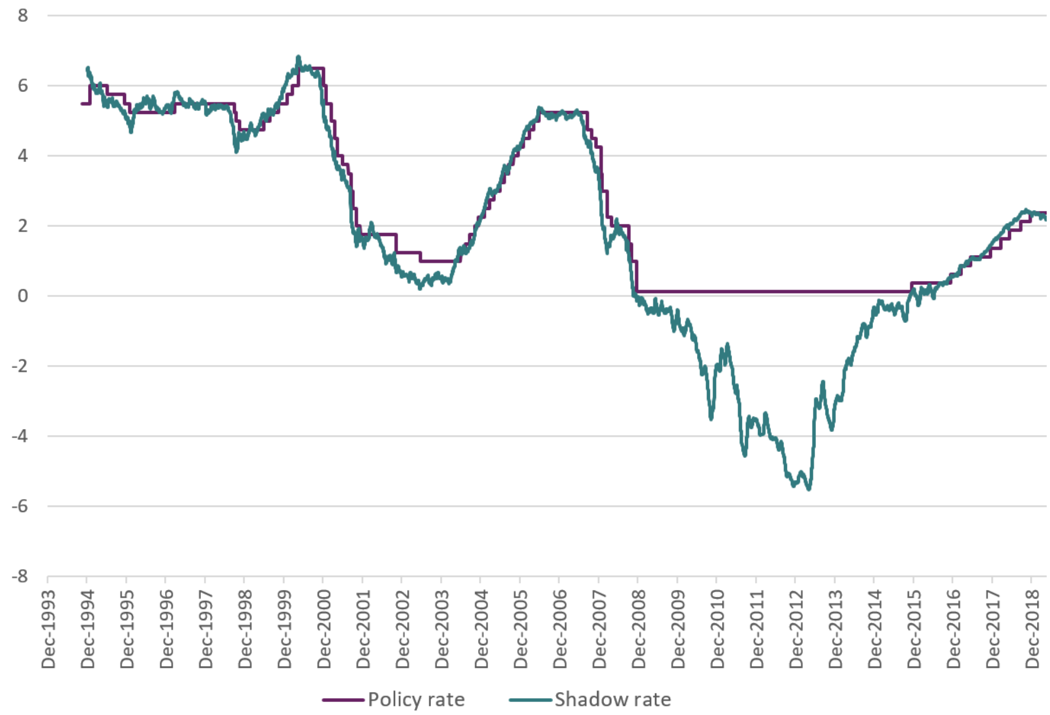
[1] https://en.wikipedia.org/wiki/Natural_rate_of_interest
[2] https://www.economicshelp.org/blog/14955/interest-rates/the-natural-rate-of-interest/
[3] https://www.rbnz.govt.nz/research-and-publications/research-programme/additional-research/measures-of-the-stance-of-united-states-monetary-policy/comparison-of-international-monetary-policy-measures

Actual central bank policy rates versus Krippner's shadow rates

United States (%)

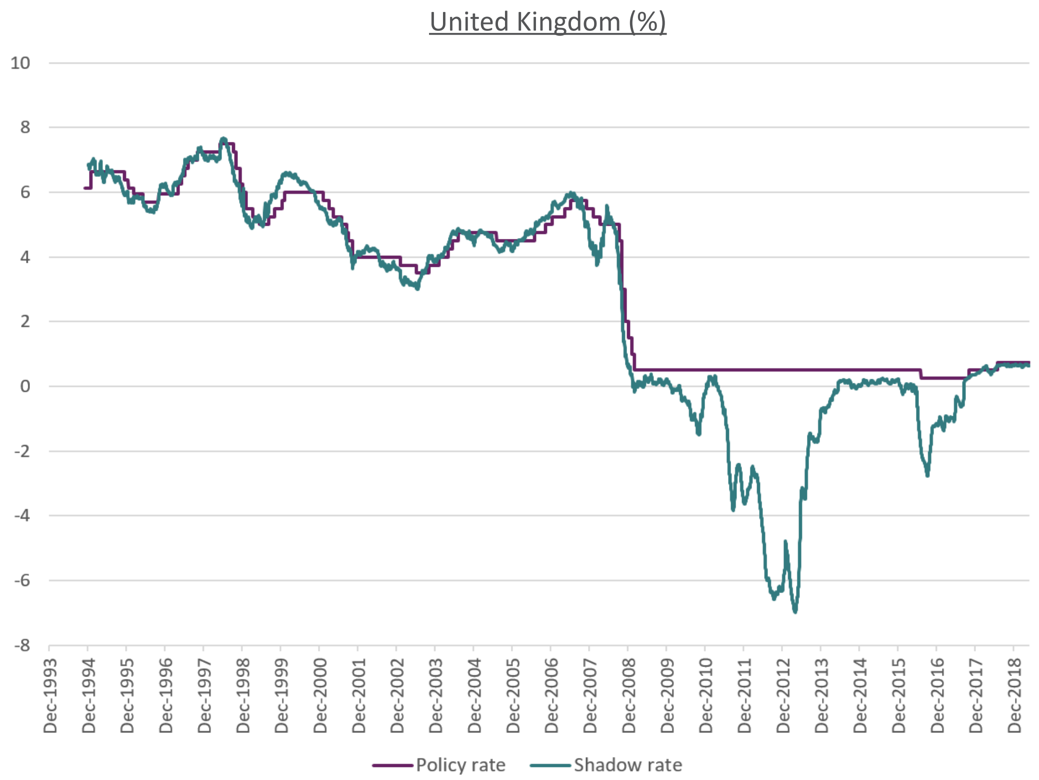


Source: Reserve Bank of New Zealand

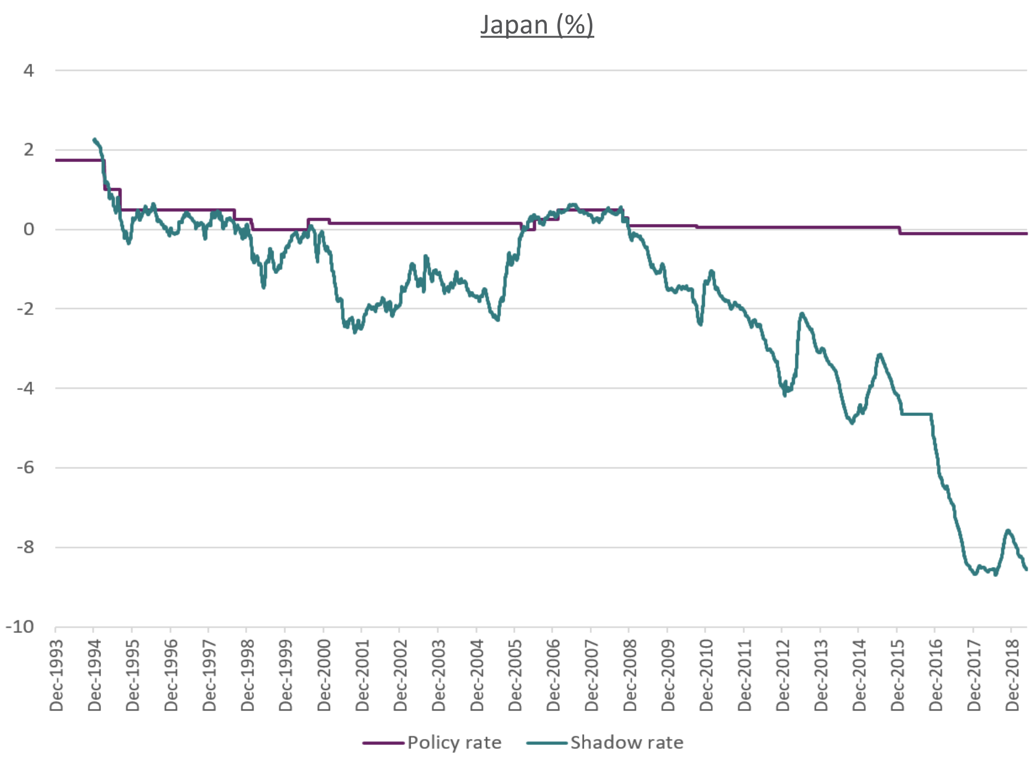
Euro Area (%)

Source: Reserve Bank of New Zealand

Actual central bank policy rates versus Krippner's shadow rates



Source: Reserve Bank of New Zealand



Source: Reserve Bank of New Zealand

Review and Outlook

Economic data was weak in June. The global manufacturing slump deepened as poor data highlighted the impact of the US-China trade conflict. IHS Markit global manufacturing index fell to its lowest level since 2012. In the UK the same index hit a six-year low. The US is the only region in which manufacturing is still expanding, but US manufacturers reported business conditions have remained tough.

Central banks reacted to the worsening economic data with both the Fed and the ECB indicating further economic stimulus. This resulted in most asset classes appreciating including risk assets such as equities and credit. Safe-haven assets such as government bonds and gold also performed well. The MSCI World equity index was up 6.1% in Sterling terms for the month. This was led by Europe Ex UK +6.4% and the US +6.41%.

As the Conservatives whittled down the potential leadership candidates to two, the lack of clarity over Brexit continues. The Confederation of British Industry’s reported retail sales measure was the weakest since the financial crisis. Overall, negative news has led to central bank reassurance and positive stock markets this month.

Table 1: Current fund tactical asset allocation (TAA) target weights as of 30.06.2019 (prior month's targets in brackets)

TAA target Weights (%) (prior month's targets in brackets)		OEICs		Investment Trust
		VT Seneca Diversified Income Fund	VT Seneca Diversified Growth Fund	Seneca Global Income & Growth Trust plc
Equities	UK	18.7 (18.7)	17.9 (18.9)	29.5 (29.5)
	North America	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)
	Europe ex UK	2.7 (3.2)	6.2 (6.2)	4.7 (5.2)
	Japan	1.0 (1.0)	7.5 (7.5)	2.5 (2.5)
	Asia Pacific ex Japan	4.8 (5.3)	10.3 (10.3)	8.8 (9.3)
	Emerging Markets	1.0 (1.0)	4.5 (4.5)	3.0 (3.0)
	Global Funds	3.0 (3.0)	3.0 (3.0)	3.0 (3.0)
	Equities Subtotal	31.2 (32.2)	49.4 (50.4)	51.5 (52.5)
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	29.7 (29.7)	12.5 (12.5)	10.8 (10.8)
	Fixed income Subtotal	34.7 (34.7)	14.5 (14.5)	12.7 (12.7)
Specialist assets*	Property	6.8 (6.8)	6.9 (6.9)	7.3 (7.3)
	Private equity	2.7 (2.9)	3.2 (3.4)	3.2 (3.4)
	Specialist financial	6.8 (6.8)	6.7 (6.7)	7.4 (7.4)
	Infrastructure	9.6 (9.6)	9.7 (9.7)	10.1 (10.1)
	Specialist Subtotal	25.9 (26.1)	26.5 (26.7)	28.0 (28.2)
Liquidity	Cash	2.0 (2.0)	2.0 (2.0)	2.0 (2.0)
	Managed Liquidity**	4.2 (4.0)	5.6 (5.4)	3.8 (3.6)
	Gold***	2.0 (1.0)	2.0 (1.0)	2.0 (1.0)
	Liquidity Subtotal	8.2 (7.0)	9.6 (8.4)	7.8 (6.6)
Total		**100.0**	**100.0**	**100.0**

On 24 of May 2019 the ACD of the funds changed to Valu-Trac Investment Management Limited. On that date the name of the funds changed from LF Seneca Diversified Income Fund to VT Seneca Diversified Income Fund and also LF Seneca Diversified Growth Fund to VT Seneca Diversified Growth Fund.

Source: Seneca Investment Managers, 30th June 2019

Increased ***Decreased***

* 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.

**Managed Liquidity is a term used to describe assets that can be quickly converted into cash. This category includes investments in open ended funds which invest in short dated corporate bonds and covered bonds (these will have a minimum credit rating of AA-) and money market instruments (these will have a minimum credit rating of A). These funds offer very low risk exposure to interest rate, credit spread and currency risks.

***Exposure to physical gold is achieved through investments in exchange traded certificates (ETC). These are certificates secured by gold bullion, held within the vaults of a nominated custodian and aim to provide the performance of gold, as measured by the LBMA Gold Price (PM), a recognised benchmark for gold.

Fund Commentary

SIGT

- The equities target was reduced by a further 1%pt, to 51.5%, as per our equity reduction roadmap in the lead up to the end of the investment cycle that we expect sometime towards the end of next year.
- The reduction was split between Europe ex UK and Asia Pacific ex Japan equities.
- Both global bond and equity markets rose during the month, driven by expectations of some central bank stimulus in the face of weakening economic growth.
- The target weight to Kier Group was halved. Fundamentally, there is material upside to the shares, however, we are cognisant that customer and supplier confidence is now more fragile.
- The new CEO of Kier Group brought forward his Strategic Review. Asset disposals should materially reduce debt levels and also dampen working capital volatility.
- Marks & Spencer completed its rights issue to fund its joint venture with Ocado. The fund participated in the rights issue and rump placing.
- We had positive meetings with several of the fund managers in our Asian allocation over the month, which highlighted the attractive valuations that can be found in the region.
- It was a quiet month for fixed income, with no trades during the period.
- We participated in the further equity fund raises of Greencoat UK Wind plc and Sequoia Economic Infrastructure, having previously moved the holdings underweight when the shares were trading at a wide premium to NAV.
- Hipgnosis Songs Fund announced its inaugural annual results for 2019 which demonstrated a good start in building up a widely diversified music catalogue by genre.

SDIF

- The equities target was reduced by a further 1%pt, to 31.2%, as per our equity reduction roadmap in the lead up to the end of the investment cycle that we expect sometime towards the end of next year.
- The reduction was split between Europe ex UK and Asia Pacific ex Japan equities.
- Both global bond and equity markets rose during the month, driven by expectations of some central bank stimulus in the face of weakening economic growth.
- The target weight to Kier Group was halved. Fundamentally, there is material upside to the shares, however, we are cognisant that customer and supplier confidence is now more fragile.
- The new CEO of Kier Group brought forward his Strategic Review. Asset disposals should materially reduce debt levels and also dampen working capital volatility.
- Marks & Spencer completed its rights issue to fund its joint venture with Ocado. The fund participated in the rights issue and rump placing.
- We had positive meetings with several of the fund managers in our Asian allocation over the month, which highlighted the attractive valuations that can be found in the region.
- We added to the CIM Dividend Income Fund, which aims to pay a distribution yield of 6% per annum.
- Within fixed income, we added to the holdings in the Muzinich, Templeton and Royal London funds.
- We participated in the further equity fund raises of Greencoat UK Wind plc and Sequoia Economic Infrastructure, having previously moved the holdings underweight when the shares were trading at a wide premium to NAV.
- Hipgnosis Songs Fund announced its inaugural annual results for 2019 which demonstrated a good start in building up a widely diversified music catalogue by genre.

Fund Commentary

SDGF

- The equities target was reduced by a further 1%pt, to 49.4%, as per our equity reduction roadmap in the lead up to the end of the investment cycle that we expect sometime towards the end of next year.
- The reduction came out of UK equities, specifically the UK equities ETF we have been holding for efficient portfolio management purposes.
- Both global bond and equity markets rose during the month, driven by expectations of some central bank stimulus in the face of weakening economic growth.
- The target weight to Kier Group was halved. Fundamentally, there is material upside to the shares, however, we are cognisant that customer and supplier confidence is now more fragile.
- The new CEO of Kier Group brought forward his Strategic Review. Asset disposals should materially reduce debt levels and also dampen working capital volatility.
- Marks & Spencer completed its rights issue to fund its joint venture with Ocado. The fund participated in the rights issue and rump placing.
- We had positive meetings with several of the fund managers in our Asian allocation over the month, which highlighted the attractive valuations that can be found in the region.
- We added to the iShares MSCI Japan ETF which is a temporary position whilst we continue to conduct due diligence on a new fund.
- Within fixed income, we added to the holdings in the Royal London funds.
- We participated in the further equity fund raises of Greencoat UK Wind plc and Sequoia Economic Infrastructure, having previously moved the holdings underweight when the shares were trading at a wide premium to NAV.
- Hipgnosis Songs Fund announced its inaugural annual results for 2019 which demonstrated a good start in building up a widely diversified music catalogue by genre.

Important Information

Past performance is not a guide to future returns. The value of investments and any income may fluctuate and investors may not get back the full amount invested. This document is provided for the purpose of information only and if you are unsure of the suitability of these investments you should take independent advice.

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VT Seneca Funds
This document is provided for the purpose of information only and if you are unsure of the suitability of this investment you should take independent advice. Before investing you must read the key investor information document (KIID) as it contains important information regarding the fund, including charges, tax and fund specific risk warnings and will form the basis of any investment. The prospectus, KIID and application forms are available in English from Valu-Trac Administration Services (01343 880344).

Seneca Global Income & Growth Trust plc
Before investing you should refer to the Key Information Document (KID) for details of the principle risks and information on the trust's fees and expenses. Net Asset Value (NAV) performance may not be linked to share price performance, and shareholders could realise returns that are lower or higher in performance. The annual investment management charge and other charges are deducted from income and capital. The KID, Investor Disclosure Document and latest Annual Report are available at senecaim.com

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