Quarter 1 2015

Tactical Asset Allocation Views & Commentary

Tactical positions are relative to the long term strategic allocations for our five proprietary risk rated portfolio benchmarks which are at the core of our investment process. Please contact us if you require further information.

- -	-	N	+	+ +
Strong Underweight	Underweight	Neutral	Overweight	Strong Overweight

Developed Equity neutral positions are: **US** 55%, **Europe Ex UK** 20%, **Asia Pacific Ex Japan** 15%, **Japan** 10%.

Asset Class	Tactical Position	Commentary
Global Government Bond	N	An increasingly deflationary environment and continuation of low interest rates longer than the market believes drive our continued neutral position. We do not expect UK/US rate rises for 2015 and value protection qualities and real returns
Investment Grade Bond	- -	Potential illiquidity is not reflected in yield spread compared to government bonds and limited ultimate safe haven characteristics mean we stay strong underweight this quarter even though corporates still look fairly strong
High Yield Bond	+	Yield pick-up over other fixed interest justifies overweight position whilst we stay wary of high issuance and valuations in this area. No increase in defaults at present, but we remain alert to any complacency especially in US HY market
Emerging Market Sovereign Bonds	-	The long term structural story still attractive, but we stay underweight due to some concerns over potential for EM currency devaluations. Still value over the long term at present yields while we move towards a more blended approach
UK Equity	+	A combination of political uncertainty, deflationary fears and potential for disappointment in the UK economy drive a reduction on a tactical basis. We reduce FTSE 100 and commodity exposure to protect value and diversify income
Developed Market Equity	+ +	Our US exposure offers a potential $ safe haven hedge for the equity market risk despite the market's higher relative valuation. We increase Europe in expectation of QE providing momentum and a lower relative valuation. We reduce Asia
Emerging Market Equity	-	Move to underweight here to reduce risk at this point where we see a number of threats to markets. The high Beta of EM equity allows us to take risk off the table more efficiently. A tactical move reflecting our house style to preserve capital
Commodities	- -	Go strong underweight as deflationary environment and overstocking is a real negative for the resource sector. Long term mean reversion from current valuations will happen, but this is some way down the line from this point
UK Commercial Property	+ +	We stay strongly overweight despite strong returns and assets rotating into this sector during 2014. Managers still confident of good returns from yield and growth over the next few years. Diversification and yield are key elements here
Absolute Return	+ +	We maintain strong overweight position for diversification and volatility reduction. We expect this basket to provide downside protection and allow for continued equity exposure. An alternative to fixed income at historic low yields
Cash	+ +	Uncertainty on many fronts: political risk in UK, deflation risk and prospect of currency devaluations; drives a strong overweight here. In deflationary environments cash is king, but we stay alert and prepared to allocate to risk assets

Minster Chambers, 35 High Street, Wimborne, Dorset, BH21 1HR • 01202 881538 • info@fpwm.co.uk

Looking Back

Concerns over global growth came to the fore at the beginning of Q4 with both equity markets and bond yields falling sharply. Again, central banks came to the rescue as policymakers in the US and Eurozone indicated that they were prepared to increase liquidity should activity drop away as many seemed to fear.

In Asia, we saw both the Bank of Japan and People's Bank of China ease monetary policy. Equity markets and risk assets rebounded whilst bond yields came down further in response to expectations of interest rates staying low for longer.

The oil price fall, which had begun during the summer, gathered momentum as Saudi Arabia refused to cut production in response to the glut in the market. No longer willing to play the swing producer, the Saudi strategy is to drive higher cost producers out of business with the focus on US shale. Markets took this negatively with risk assets selling off once again. Energy stocks and credits have been hit, but this needs to be balanced against the benefit consumers and many corporates may receive from lower energy costs. Conversely, this also adds to deflationary pressure which we feel is troubling.

Economic data for the US at the end of 2014 showed solid growth but stubbornly low inflation. The economy expanded by a revised 5% in the third quarter on an annualised basis, reflecting stronger consumer spending thanks in part to falling fuel prices. This also means falling levels of inflation which could concern the US Federal Reserve and led to speculation surrounding the timing of the first interest rate hike. However, the decline in inflation was largely perceived as temporary and less of a concern if economic growth remains above trend and the labour market continues to tighten. Consensus expectations that the US economy will continue to be robust in 2015 helped push markets higher with the S&P 500 ending the year up 13.7% in USD terms.

On the other hand, despite the strength of the UK economy, the returns from the FTSE 100 were barely positive over 2014 with a 0.7% rise over the year. Japan, Asia, Europe and EM all produced positive numbers, leaving the UK in the shade.

Bond market returns over the year surprised as interest rates stayed low. European Government bonds led the way along with EM debt and European High Yield.

UK Property returns were strong, with the IPD Total Return Index up 19.3% over the 12 months to 31st Dec.

Looking Forward

"Turning Japanese, I think I am turning Japanese I really think so" – *The Vapors*

The first meeting of the Investment Strategy Committee for 2015 was a challenging one for all involved. Our independent economist Andrew Hunt painted a dark picture for the future if Governments and Central Bankers are idle. We believe that they will do what is required, but only after all other options have been exhausted. We also feel that there is a changing of the guard in central banks away from the last 10 years' predictable policy that has spawned a $6.5 trillion carry trade. Risks to economic growth and markets remain at the forefront of our allocation decisions.

The 2008 GFC and the failure of western growth to revive since has caused a once in a lifetime shift in global trade patterns. Asia is producing a surplus in traded goods that the west doesn't want any more and has turned to competitive easing/devaluations to sustain their old models, which is importing further deflation to the west.

While the spotlight is on the oil price, there are broader effects on commodity producers as a result of the Asian supply issues. Many commodities are well below cost of production with high stock levels driving prices down. However, world trade price deflation extends beyond commodity prices with many Asian countries export prices dipping below the danger zone. We would not be surprised to see a negative CPI number in the UK and/or US in 2015 which is dangerous for markets.

Policymakers have little in the way of ammunition and the west is struggling with weak income trends despite good employment numbers as many jobs are lower paid or part time which does not increase spending power.

We expect US GDP growth to surprise on the downside this year - closer to 2% than the predicted 3% mitigating an increase to interest rates. Hopefully, this will halt the rise of USD as we feel that the trade weighted value of USD needs to come down if any control is to be gained on the gathering deflationary forces. At the same time the failure to fire the "third arrow of Abenomics" in Japan and their reduction in the acceleration of QE may halt the weak Yen and help markets muddle through by reducing the deflation that is being exported from Japan.

Although our central case is that in 2015 markets will muddle through and avoid a full blown Japanese style deflationary spiral; we are still concerned about the risks that we see – political, currency et al - and that leads us to hold cash as the ultimate hedge, if only for a short period.