Quarter 2 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. They are expressed as seen in the key below.

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

Please contact us if you require further information.

Asset Class	Tactical Position	Commentary
Global Government Bond	N	A continuing deflationary environment and likelihood 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 real yields may lead to surprises over 2015
Investment Grade Bond	- -	We are not being adequately rewarded for liquidity risk by yield spread over government bonds and limited ultimate safe haven characteristics mean we continue strong underweight. Corporates still look strong but richly priced
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	- -	Despite long term structural story we go strong underweight due to increasing concerns over EM currency devaluations. EMD would suffer from unwinding of carry trade. We expect yield to provide worthwhile returns over the long term
UK Equity	+	The UK election is likely to create short term volatility whatever the eventual outcome which is very much in the balance. Post May 7th markets would like a Tory/LibDem coalition and doubtless panic if Labour/SNP formed an alliance
Developed Market Equity	+ +	US exposure offers a potential $ safe haven hedge for equity market risk despite historically high valuation. We favour Europe's lower relative valuation and in expectation of QE providing momentum. Japan may benefit for similar reasons
Emerging Market Equity	-	We stay underweight here to balance risk as we still see a number of threats to markets. The high Beta of EM equity allows us to reduce risk more efficiently than reducing other equity markets as we continue to try to preserve capital
Commodities	- -	We stay strong underweight as deflationary environment and overstocking is a real negative for the resource sector. Mean reversion from current valuations will surely happen, but current economic and market dynamics suggest not just yet
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 stay strong overweight for diversification and volatility reduction. At this stage of the cycle the basket is valued as a balancing factor while we are light fixed income driven by historic low yields; this allows for continued equity exposure
Cash	+ +	Political risk in UK, global deflation risk, the spectre of currency devaluations; geopolitical uncertainty and some rich market valuations drives a strong overweight. Despite uncertainty, we remain prepared to allocate to risk assets

Looking Back

It was a volatile quarter, with UK and global markets driven by top-down factors as investors attempted to guess when the US Fed would raise interest rates. The FTSE All-Share index rose 4.7% in the period, outperforming US equities but underperforming the eurozone. After a poor start to the year with earnings downgrades dominating sentiment, expectations in results season were generally met or even bettered.

Global equities registered positive returns over the first quarter with central banks in the eurozone and China easing monetary policy. Crude oil prices stabilised after their previous sharp drop. The S&P 500 delivered a modest positive return with concern over the impact of the strong dollar limiting the market's progress.

Eurozone equities enjoyed strong returns after the European Central Bank's (ECB) announcement that it would buy sovereign bonds, with the size of the package surpassing market expectations with a total of €60 billion of bond purchases a month until at least September 2016. The news sent the euro lower versus the dollar, suppressed bond yields, and supported equity markets.

Japan gained amid some positive corporate earnings and was further supported by hopes that additional QE would be forthcoming. There were signs that the correlation between the stock market and the Yen were reducing, a potential benefit for foreign investors.

Emerging markets posted positive returns. Chinese equities were supported by the authorities' moves to boost growth with looser monetary policy. Russia gained amid the stabilising oil price and hopes of a peace deal with Ukraine. In LatAm, Brazilian equities were the biggest loser amid anaemic economic growth.

Q1 saw further yield compression in global bond markets. Speculation on the timing of first Fed rate hike continued, but the Fed was restrained regarding US economic progress. Global monetary policy was accommodative - 21 central banks have cut policy rates so far this year. Gilt, Treasury and Bund yields broadly fell, particularly with reference to bonds at the longer end of the yield curve.

In corporate bond markets, investment grade bonds were marginally outperformed by high yield. In both cases, bond prices responded positively to a firmer macroeconomic environment. The investment grade BofA M L Global Corporate Bond index rose by 2.13% but the high yield equivalent rose by 2.66%. GBP corporate bonds outperformed USD and EUR equivalents.

Looking Forward

"Dance, but dance by the fire door and listen for the bell."- *Andrew Hunt*

Our primary concern at present is deflation. We see evidence all around us which shows that it has arrived as a force to be reckoned with. We have felt lonely in the past when set against those that shouted that QE must create inflation as a logical consequence of the increase in liquidity. That has not arisen; as that liquidity has not transmitted into the broad money supply and into the hands of the man in the street. It has instead stayed at an institutional level funding a massive global carry trade. If this reverses, what effect might it have on the global economy and therefore markets?

One of the 'problems' associated with being a reserve currency is that the economy in question must export its currency to the rest of the world in order to "accommodate" global growth. As world trade increases, so does the need for reserve currency. This creates a conflict of economic interests that arises between short-term domestic and long-term international objectives for those countries whose currencies serve as global reserve currencies.

As the world's primary reserve currency the US has exported dollars to the rest of the world, fuelling global growth. As trade increases, so does the need for US dollars. The credit boom leading to the Great Financial Crisis and the response that followed created many more dollars than the world needed. Now that deflation has arrived in global goods markets, it carries with it the threat of a disorderly unwind of the Global Dollar Carry Trade that could become a serious threat to markets and provide an immense deflationary shock to the system.

The ISC's economist, Andrew Hunt, calculates that the so far controlled unwind of the dollar carry trade, the BoJ's bond buying, and the ECB's actions are together propelling $500 billion of liquidity per calendar month into risk assets. This is currently supportive of markets.

As we tend toward the fundamental in our investment style we are a little nervy at this point as markets are driven by momentum keeping the funds flow chasers happy.

Interest rate rises still seem a distant concern as the US has very weak income trends holding back spending and reducing the need for a rate rise. We feel 2015's performance will be determined by monitoring risks in deflation trends, EM financial systems, US profits and the shiny new Eurozone QE experiment.

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