Quarter 2 2016

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	We remain neutral as data and growth worries are likely to restrict significant further interest rate rises in 2016. We value the flight to safety effect if sentiment turns negative, favouring index-linked as inflation might return off a low base
Investment Grade Bond	N	We stay neutral as spreads are reasonably attractive, especially with more dovish interest rate moves. Liquidity is still a tail risk, but with our long term view and yield requirements we have to live with this whilst credit risk is still subdued
High Yield Bond	+	No change. Search for yield and continued low default risk (non-US Energy sector) means we stay overweight. HY should help limit damage if the Fed hikes faster than we (or now the market) thinks due to lower interest rate sensitivity
Emerging Market Sovereign Bonds	- -	We stay defensively positioned despite recent strong rally and currency gains. We are wary of China's issues and expect an RMB devaluation at some point. Likely wider EM currency devaluations would be negative in the short term for investors
UK Equity	+ +	Strong overweight reflects comparative strength of UK economy despite short term Brexit uncertainties probably leading to heightened volatility. We take a long term view through short term noise created by Brexit fears – probably unfounded
Developed Market Equity	+ +	No change to our views of comparative US strength, better valuations in Europe and ECB/QE support. Asia and Japan are struggling as evidence appears to suggest that the BoJ has abandoned Abenomics preparing for a zero growth world
Emerging Market Equity	- -	Remain very defensively positioned. China dominates EM sentiment with growth concerns, crazy credit growth and structural issues. An RMB devaluation would increase stress but might provide long term opportunity – just not quite yet……
Commodities	- -	We remain with a strong underweight as deflation, anaemic global growth and China concerns dominate the sector. We seek a catalyst to a meaningful rebound. Gold is a possible bright spot still valued by Central Banks who continue to buy
UK Commercial Property	+ +	We maintain our strong overweight here. We expect marginal capital growth with a healthy yield. But the sector's relative certainty and long term lower volatility return profile provides valuable balance and diversification to portfolios
Absolute Return	+ +	We stay strong overweight expecting managers to prove their mettle in these more volatile conditions. Low beta to other assets provides scope for portfolios to maintain equity exposure as their characteristics should limit downside risk
Cash	+ +	We maintain high cash allocations to protect against further heightened market volatility. This is not a comfortable position and we are staying alert to opportunity as over the long term, time in the market is the key to real returns

LOOKING BACK

Last year's volatile market ride has continued into the first quarter of this year. Equity markets in the US and UK are now close to where they started the year, with Europe slightly down. But that comes after much fretting over global growth, China and the fall in the oil price in January and February. These fears started to ebb in the latter part of the quarter, when we also saw more stimulus from the ECB and dovish noises from Federal Reserve (Fed) chair Janet Yellen. This has all helped to restore some composure to markets.

The US equity market responded positively as forecasts for additional increases in US interest rates were deferred following the dovish comments from Janet Yellen suggesting the rate of interest rises would be slower than first thought. The S&P 500 rose 3.75% over the period measured in GBP.

Eurozone equities had a turbulent quarter with banks under particular pressure. The European Central Bank announced fresh monetary policy easing in early March to support the recovery and try to get inflation back to target. The ECB will purchase a further EUR 20 billion per month and will also buy non-financial investment grade corporate bonds. The FTSE World Europe Ex UK index rose 0.58% in sterling terms.

In the UK, sterling and equities fell as part of the general malaise, but also affected by the possibility of "Brexit" after the June Referendum. Nevertheless, by the end of the quarter the FTSE All Share had recovered (-0.41%) despite being down more than 10% in early February.

Japanese equities declined amid unusual volatility, falling 12% over the quarter as the Bank of Japan surprised investors with a move to a negative interest rate policy. This was balanced by Yen strength providing some protection for an unhedged UK investor.

Emerging market equities rose and outperformed developed market equities in local currency terms. An easing in US dollar strength supported emerging markets while Brazil was the strongest market amid heightened expectations for a political change. (FTSE World Emerging +1.71%).

In fixed interest markets, both government and corporate indices were positive. The 10-year Treasury yield fell from 2.27% at the end of December to 1.77% at the end of March. In credit markets, the investment grade Bank of America (BoA) Global Corporate Index generated a total return in Q1 of 3.3% in local currency. Euro, sterling and US dollar credit markets all generated positive total returns with the sterling corporate market the only one to underperform its equivalent government bond index.

For sterling investors GBP weakness was a positive for returns from foreign holdings with the highlights being the Japanese Yen gaining 9.6% and Euro 7.39% over the quarter.

LOOKING FORWARD

"Should I stay or should I go now? If I go there will be trouble and if I stay it will be double" **The Clash**

Recent polling (Daily Telegraph April 5th) shows the stay campaign marginally ahead, but the gap is paper thin even if we believe in the reliability of polling after recent experience. Betting odds suggest a 56/44 split in favour of BrexIn and these have a better recent track record. That said, bad news of terror attacks, migration or even England failing in the European Championships may sway undecided voters.

What are the key facts? 45% of our trade is with the EU making it our largest trading partner as well as a key source of foreign direct investment. It is also a major source of migrants, but in reality for every year for at least the last decade non-EU migration has been higher. Since 2005 there have been a net 2.1m non-EU immigrants compared to 1.2m from the EU. So EU migration is not the problem many would have us believe and migration is needed to deal with our long term demographic problems. Germany has recognised this as reflected by Angela Merkel's recent stance which is more practical than humanitarian. Although the UK was the third largest contributor to the EU from 2010-14, proportionally it ranks seventh suggesting our deal is not a bad one without much wriggle room. Sovereignty and EU legislation is much talked about, but will it change much post-Brexit if we want unfettered access to EU markets? Let's ask Norway……

In the near-term, we feel a vote to leave the EU in June would create lasting uncertainty and negatively impact market sentiment. This uncertainty would likely affect both foreign and domestic investment, whilst causing UK consumers to cut spending as confidence is dented. We would expect a weakening of sterling which may be a positive for net trade, but the overall impact would be lower growth and higher inflation compared to the current predicted economic path. We are also concerned about the impact on the Financial Services industry which is the largest contributor to UK GDP.

It is impossible to accurately predict the effect that Brexit would have on the UK economy but numerous studies have been done which seem to suggest a negative short term effect on GDP which is risky in a low growth cycle such as this.

In the long-term, the key factors would be how much access to the single market the UK retains, how migration flows are impacted, and how much the UK government manages to save in EU subscription costs vs the likely higher costs of trade. Most "independent" studies offer a range of scenarios suggesting that the most likely outcome would probably be lower long-term growth compared to remaining in the EU.

So, will we or won't we? Our view is the UK will vote for the status quo – but it is close and could go either way, so if you have a view and want it heard - vote!

to make a *difference*