Quarter 2 2017

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	-	This asset still hedges any "risk-off" scenarios and some managers have increased duration as yields have risen. Expect the pace of interest rate increases to be slower than the market consensus, but rises are inevitable. Stay underweight.
Investment Grade Bond	N	Stronger growth favours credit over government bonds. We believe fixed income investors are being paid to take some risk. Credit markets have a larger safety cushion than government bonds vs the risk of further rises in interest rates.
High Yield Bond	+ +	Improving growth, higher commodity prices and an expected decline in default rates through 2017 is positive. Carry and spreads should absorb much of any rate increase and we expect investors to rotate out of interest rate-sensitive sectors.
Emerging Market Sovereign Bonds	-	With USD issues less compelling, we prefer EMD local currency bonds due to more attractive valuations. We move to underweight position in recognition of the strong compression in spreads over government bonds in recent months.
UK Equity	+	Despite resilient UK growth, we expect a slowdown. Weaker business investment and inflation will hit consumer spending because of Brexit. To balance this, the BoE will ignore rising inflation and keep rates unchanged. We trim to overweight
Developed Market Equity	+ +	Global growth has improved but we remain suspicious of the difference between sentiment and hard economic data. We are more positive towards Europe as growth is emerging and the market valuation is cheap compared to the US
Emerging Market Equity	-	EM economies benefit from faster growth but might suffer due to higher bond yields and a strong dollar. There is a broad upswing in EM economic activity, but China concerns and our defensive mindset mean we stay underweight here
Commodities	-	Our perceived tightening bias (especially in China) is negative for the commodity sector despite sentiment. China has provided a third of recent global liquidity so we need to be realistic about oil, copper and industrial materials such as iron ore
UK Commercial Property	+	We remain long term holders of the asset class for yield, diversification and long term growth. We are moving exposure away from potentially vulnerable trophy assets to smaller and more liquid lots to diversify and drive a higher yield
Absolute Return	+ +	Increased interest in non-correlated assets is typical late-cycle behaviour, but we are structural holders of these funds. We are adding a short selling fund to the basket, increasing diversification, downside protection but reducing correlation
Cash	+ +	We maintain high cash allocations in the absence of a glut of other balancing or risk reducing asset options. Trump, geopolitical risks and Brexit negotiations suggest continued equity market volatility and chances to add to risk exposures

Looking Back

Equity markets had a good start to the year, extending last year's strong performance. The US election, associated hopes for tax cuts, increased public spending and regulatory reform, have undoubtedly played a part in the rally since November, but US business and consumer confidence surveys led the global economy in 2015. Sharp improvements in these surveys has been notable but they are leading indicators, reflecting how businesses and consumers feel about the economy. How secure the foundations of the post-election rally are will depend on whether this improvement in confidence translates into stronger economic growth and higher corporate profits.

US markets have paused for breath questioning Trump's ability to deliver his policy agenda - failure to repeal and replace the Affordable Care Act highlighting the disunity of the Republican majority in Congress. Nevertheless, the breathless advance before the "Trump Slump" means the S&P 500 ends the quarter up 6.1% in USD terms - reduced for Sterling investors as GBP gained 1.6% against the USD.

The start of 2017 has seen a deterioration in business confidence in the UK. Inflation has picked up sharply and wage growth slowing, putting pressure on real wages. Against this backdrop the FTSE All Share improved over the quarter slipstreaming global equity markets, ending +3.0%

In Europe, business surveys rose to five year highs and consumer confidence close to pre-crisis highs. Improving business confidence is widespread across the eurozone and European companies are finally starting to show broad-based earnings growth. This helped European equities to keep up with the US in Q1, in marked contrast to 2016, with FTSE Europe ex UK +6.7% in GBP terms.

Japanese data was reasonably positive, with surveys indicating expansion and falling unemployment - down to only 2.8%. However, the strength in the Yen weighed on the performance of Japanese equities as the TOPIX only rose 0.6% (+3.0% for a Sterling investor).

Signs of improvement in emerging market growth and more stable US Dollar and bond yields, provided a good backdrop for EM and Asian equity performance. Asia led global markets (MSCI Asia ex Japan+10.2%) and Emerging Markets were next on the podium (MSCI Emerging Markets +7.8%).

The quarter saw a pause in the upward movement of US government bond yields and therefore in yield differentials. Markets had already moved to price in two rate rises from the US Federal Reserve for 2017 which allowed US Treasuries to tread water in the first quarter despite the March rate rise. UK Gilts prices had fallen 3% by late January but recovered, ending the quarter +0.67%.

Against the backdrop of improving growth and low defaults, credit outperformed government bonds as US High Yield rose 2.7% in USD, Global Investment Grade +1.6% and Emerging Market Debt up 3.8% in local terms

Looking Forward

"To travel hopefully is a better thing than to arrive" **Robert Louis Stevenson -** El Dorado

At the risk of sounding like a stuck record, we are still surprised by the marked difference between the hard and soft economic data coming from the US, which we believe has the greatest dispersion since a hiatus after 9/11. Then the hard data won out, showing the optimism to be overplayed and we feel that it is likely to be the case again that this almost euphoric rise in markets will ultimately disappoint.

We expect the next six months to be dominated by two main themes – tightening in economic policy and fluctuations in inflation which will be largely driven by China.

Tightening can already be seen in many major economies. With interest rate rises in the US along with reductions in liquidity - an estimated $80bn was taken from the US economy in the last 2 months. The Bank of Japan has started tightening and significant action has been seen as recently as 6 weeks ago to stop China's credit boom in its tracks. China's command economy can take swift action by Xi Jinping forcing the PBoC to reduce or stop lending, but it risks a corporate recession caused by the severity of its actions. Chinese companies starved of credit to feed their businesses may then have no option but to increase prices, or fail.

The other side of the Chinese coin is that there has been a drop in the savings rate and a consequential increase in private spending. These factors suggest an inflationary bias that will leak out into the global economy feeding inflation. Our economist estimates that US core inflation could be as high as 2.5% by year end.

The reins of the global economy have passed from central banks to governments as fiscal policy succeeds the monetary policy that has sustained markets since the GFC.

Our reading of the hard economic data suggests that US growth is not coming through as needed to sustain market prices, but that does not mean that we expect a recession any time soon or indeed that optimism (although fading) might sustain levels for some time yet. The feeling is that a combination of tightening, increasing interest rates and high expectations means the tide may be going out for equity markets. We will be happier if a more realistic and sustainable atmosphere is resumed as we feel that markets can grind higher over time, but need a pause and possibly a little reboot before that can be the case. The current geopolitical issues are contributing to the uncertainty and causing markets to pause and draw breath. In the UK the triggering of Article 50 heralds a period where the reality of Brexit will come into focus and the ebb and flow of news will add to volatility.

Nothing is simple or certain - maybe more so than ever in our experience – but we remain confident in our core principles of investing. We are confident that diversification through talented active managers will serve our clients well.