Quarter 3 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	Stay neutral as we value some safe haven in the event of market disruption. We look to shorten duration where possible to guard against rate rises. We still doubt UK/US rate rises 2015 but market may force yields higher in anticipation
Investment Grade Bond	- -	We remain concerned about liquidity risk which is not compensated by extra yield over government bonds which give ultimate safe haven characteristics therefore we continue strong underweight preferring other fixed interest classes
High Yield Bond	+	No change here as yield vs other fixed interest justifies overweight position. If government bond yields increase the effect on HY is lower. No real increase in defaults at present, so we prefer taking credit risk rather than interest rate risk
Emerging Market Sovereign Bonds	- -	We stay strong underweight and are very concerned about potential for EM currency devaluations as EMD will suffer from disorderly unwinding of carry trade. We are moving to $ bond issues over local currency as a result of this view
UK Equity	+ +	The UK election result was market friendly and we move to strong overweight here reflecting comparative strength of UK vs many other developed markets. We retain our quality/value bias despite short term lag vs more cyclical strategies
Developed Market Equity	+ +	Dynamic US companies offer a potential $ safe haven hedge for equity market risk despite richer valuations. We increase bias to Europe due to lower valuations and QE providing momentum. Whispers suggest Bank of Japan may be cooling on QE
Emerging Market Equity	-	Although India is emerging as a bright spot we see many issues in EM. Currency devaluations, slowing in China, potential regime change in LatAm and withdrawal of foreign investment in many areas. We stay defensively positioned
Commodities	- -	We stay strong underweight as deflationary environment, insipid global growth and China's slowdown are real negatives for the resource sector. History supports our belief that mean reversion of prices will happen, but not at this juncture
UK Commercial Property	+ +	We stay strongly overweight despite strong returns and assets rotating into this sector in recent years Managers are still confident of good returns from yield and growth over 2015. Expect an eventual reversion to lower growth and good yield
Absolute Return	+ +	We stay strong overweight to add diversification, reduce correlation and volatility. At this stage of the cycle the basket provides balance while we are light fixed income driven by historic low yields. This allows us to keep equity exposure
Cash	+	Conservative win reduces immediate political risk in UK, leads to reduction in cash and a reallocation to UK equity. Increase in risk is supported by attractive relative valuation of equities over bonds in UK and other developed markets

Looking Back

Global equities registered a small positive return in US dollar terms over Q2. Regional performances were mixed; strong gains in Japan contrasting with weakness in the eurozone and UK.

US Equities were a rare highlight as the S&P 500 reached fresh highs although returns were modest; up +0.3% for the quarter. Economic data was mixed but improved towards the end of the period. M & A activity continued to be a positive driver.

Eurozone (-4.5%) and UK (-1.6%) equities suffered as the Greek debt crisis escalated, leading to concerns over the impact if Greece were to leave the eurozone. UK data was mixed as the BoE revised down growth forecasts, while Q1 GDP, increasing retail sales and wage growth suggested an improving economic picture which was enhanced by a market pleasing election result.

The Japanese stockmarket recorded a strong second quarter, with the TOPIX Index registering a rise of 5.8%, in Yen terms as market optimism was driven by a broadly positive corporate results season.

Emerging markets surprisingly outperformed, with Latin America the strongest performing region. Brazil led the way, largely owing to political news flow as the government vetoed measures that would have increased spending on pensions. Chinese equities saw gains after the authorities loosened monetary policy.

Bond yields rose across most major markets amid expectations that interest rates could rise in the US and UK this year. Stronger economic data in the eurozone also send Bund yields higher over the quarter.

In the US, statements from the Federal Reserve warning that investors should expect rate hikes to begin in 2015 pushed Treasury yields higher, the 10 year rising from 1.92% to 2.35%. In the UK the BoE's central view remains that the UK is strengthening, and GDP growth for Q1 was revised upwards. Consequently, 10 year Gilt yields rose from 1.58% to 2.02%.

In the eurozone, the 10-year Bund yield rose from 0.18% to 0.76%. The Italian and Spanish 10-year yields rose 109 bps apiece in the quarter, to 2.33% and 2.30% respectively.

Corporate bonds struggled given softer returns in sovereign bonds and a continued high level of supply in the US. The investment grade BofA Merrill Lynch Global Corporate index fell -2.58%. The equivalent high yield Index was stronger, with a positive return of 0.58% in Q2.

Looking Forward

Greece is the word in all the headlines as commentators ponder the implications of "Grexit". But with the Greek economy about 1.5% of EU GDP, why the fuss? The furore highlights the inherent weakness of the European Union, laying bare where the real power lies in the EU.

Currency Union works if the richer members practice fiscal transfer to the poorer ones to even out the differences in economic performance. With a common currency, weaker members lack the ability to depreciate their currency to improve competitiveness.

It is clear that Germany is not committed to full Currency Union as in order for that to work, they would have to commit to fiscal transfer through the TARGET2 mechanism which allocates capital to where it is needed in the European monetary system –richer to poorer. As the EU's richest nation Germany is on the hook for the largest amount of any country in the EU and they are hugely resistant to providing Greece the kind of help that is essential if the Eurozone experiment is to succeed.

It is interesting to look at history for perspective and use as comparison two established currency unions: the UK and the US. Germany contributes 0.2% of its GDP to other countries in the EU. By contrast, in the 1920s in order to keep a struggling Wales in the Union the UK government made more than 50 times that contribution to the Welsh economy. In the US Federal system, Georgia has run a fiscal deficit to New York every year since the Civil War without being asked to repay. Fiscal transfer in practice.

Problems in the periphery keep the Euro weak, making German manufacturing more competitive, dominating export markets with their quality products. Before monetary union this competitiveness would have been tempered by a strong Deutschmark and less efficient countries could have benefitted from currency weakness; levelling the playing field. Greece does not have that luxury within the Euro and is being forced to destroy its economy piece by piece whilst Germany prospers. No wonder Greece reminded Angela Merkel about the post WW II German debt write offs.

Ironically, German fiscal austerity stems from the hyperinflation of the Weimar Republic which led to Nazism. Greece now has a Marxist government. Extreme hardship can lead to extreme politics.

Greece is not an innocent in this game but also not the only sinner. The result? Who knows but do not underestimate political will within the Eurozone.