Quarter 3 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 Brexit has severely restricted the chance of any rate rises in UK or US and uncertainty is one of the knowns. Despite recent performance there is still a case for UK index-linked as sterling weakness will drive inflation
Investment Grade Bond	N	Spreads over government bonds are still attractive and underpinned by the dovish interest rate environment. Credit risk is still subdued at these low interest rates as there remains appetite within credit markets to refinance companies
High Yield Bond	+	Absent the US Energy sector, there is historically low default risk so we stay overweight. HY provides lower interest rate sensitivity, but we are more interested in the good yield spread which still compensates for default risk
Emerging Market Sovereign Bonds	- -	We stay defensively positioned despite strong rally in 2016 and currency gains. We are still wary of China's issues and potential for RMB devaluation. Continuation of a strong USD is likely to be challenging for this asset class
UK Equity	+ +	The fall in Sterling post Brexit has focussed investors on the composition of the UK market which favours foreign earners. A slowdown in GDP is probably priced in at this point and we look to tilt in favour of the winners from GBP devaluation
Developed Market Equity	+ +	We remain positive on the US as outlook and positive momentum offset valuations. We reduce Europe post Brexit favouring US and Asia where Brexit is less an issue. We are wary of Japan where strong Yen reduces competitiveness
Emerging Market Equity	-	Valuations are attractive with price-to-book ratios for EM equities below the 15-year average. However, the outlook for a broad turnaround in EM earnings in the near term remains challenging given the many headwinds facing EM economies
Commodities	- -	Gold is a bright spot as uncertainty prevails and lack of interest rate pressure reduces opportunity cost. The 4th strongest El Nino since 1950 could impact crop yields and Farmers are under pressure from low prices, impacting supply
UK Commercial Property	+	The Brexit result has impacted the markets view of commercial property which we feel is probably overplayed. Our managers are diversified outside of London and we are long term holders of the asset class for yield and long term growth
Absolute Return	+ +	We stay strong overweight expecting managers to provide value and diversification in increasingly volatile conditions. Low correlation to other assets provides balance for equity and bond exposure whilst maintaining liquidity
Cash	+ +	We maintain high cash allocations to protect against further heightened market volatility. Political uncertainty is likely to create opportunities but we must be patient. Nevertheless, we are mindful that time in the market is the key to returns

Looking Back

Markets made a confident start to Q2, with much of the momentum from March's recovery carrying into April and May, driven by positive economic data and continuing policy support from most central banks. However, the UK's EU referendum in late June ultimately overshadowed other market drivers by the end of Q2. The "Leave" vote surprised markets, and positions built in anticipation of a "Remain" vote increased market volatility immediately after the result. Sterling fell by over 11% on 24 June and government bond yields reacted by falling lower.

Despite the Brexit shock and the subsequent extreme volatility, both UK and US equities ended the quarter higher, with the S&P 500 up 2.5% and the FTSE All-Share advancing by 4.7%. The UK equity market recouped all of its post-Brexit losses as the Bank of England governor Mark Carney moved swiftly to assure investors that the Bank of England could provide additional monetary policy stimulus to counter the impact on the domestic economy and investors factored in the beneficial impact of a weakened currency to the index's foreign earners. Equally significant was the realisation that additional rises in US interest rates were further deferred. Comments by Federal Reserve officials, led by chair Janet Yellen, both before and after the referendum saw expectations for additional rises in US interest rates significantly pushed back.

Eurozone equities declined in the second quarter with the MSCI EMU index returning -2.2%. The timescale for UK departure and the economic implications remain unclear, which has weighed on stock markets across Europe. Indeed, some commentators believe the risks of Brexit may be greater for Europe than the UK.

Elsewhere, Japanese equities posted considerable declines as a sharp appreciation in the yen (up 9.1% against the dollar) had a particularly negative impact on the stock market, but gave protection to GBP investors. Asia finished the quarter marginally positive on expectations of low US interest rates. Emerging markets slightly lagged developed markets with Brazilian equities up sharply due to easing political risk.

In Q2 the UK 10-year gilt yield fell from 1.42% to 0.87% mostly in the final days of June. 10-year US Treasury yield moved from 1.77% to 1.47%; and German 10-year Bund yields declined from 0.15% to -0.13%. In the eurozone periphery the more uncertain economic backdrop was balanced by the likelihood of policy accommodation from the ECB. Italian 10 year yields rose 0.02%.

The BofA Merrill Lynch Global Corporate index generated a positive total return in Q2 of 3.0% and excess returns over government bonds of 0.7%. Across investment grade US dollar, euro and sterling credit markets, only sterling credits generated negative returns in Q2 (-0.2%). The BofA Merrill Lynch Global High Yield index generated positive total returns of 5.1% (in local currency).

Looking Forward

"As politicians we have to react to the fact that many people do not feel that they can relate to the EU". - **Angela Merkel**

Much has been written too hastily about the pros and cons of the UK's impending exit from the EU, yet the scale and immediacy of certain reactions has been a harsh wake up call. There will be winners and losers; and no comparison possible in years to come. So we should keep calm and carry on.

Mark Carney's response has calmed markets for now but it is difficult to see a lasting effect from a small cut in rates and more QE. What is sure is that uncertainty will linger for some time and it is important that the Conservative Party unite to provide leadership to a worryingly rudderless government.

It is too early to fully understand how the Brexit decision will affect the long term cost of imported goods as so much depends on trade agreements reached between UK, the EU, and other countries. A falling pound could import inflationary pressures which if accompanied by slowing growth and slowing wage increases would be uncomfortable for the average UK consumer. The most likely outcome near term is modest "stagflation". Growth weakens moderately (the economy had already been losing some confidence and momentum pre-referendum) and inflation picks up.

It is easy to become inward looking and overly negative so for perspective it is worth noting that the Brexit shock is a blip in terms of the global economy - an estimated 0.2% reduction in global growth. The diversified nature of modern investment portfolios and access to foreign markets provides ample opportunity for investors.

So what next for the EU? The stresses within the Eurozone have only been increased by the UK's rejection and it remains to be seen whether there is a domino effect set off by Brexit.

Italian Prime Minister Matteo Renzi has called a referendum on constitutional reform to streamline their political system, which may turn into a vote on Italy's membership of the EU. Italy's banking system is in crisis with nearly 20% of non-performing loans and poorly capitalised banks, restricting their ability to lend and help an ailing economy. EU rules dictate that before the state can help the banks they would have to wipe out many shareholders and depositors who own €173bn of subordinated bank debt. Renzi might decide to ignore the EU rules and establish a "bad bank" supported by the state, or pressure the EU to fudge the rules. However, Italians, along with the Greeks, view the EU most negatively and a lost referendum may leave the door open to Beppe Grillo and the populist Five Star Movement who recently called for a referendum on Italy's EU membership.

The UK left the ERM in 1992 and Italy followed, achieving economic growth in 1993 in splendid isolation. Brexit could yet beget a period of creative destruction in Europe……….