Quarter 3 2017

Investment Strategy Committee Tactical Asset Allocation Views & Commentary

Tactical positions relate to the strategic allocations for our five risk rated portfolio benchmarks which power our investment process. They are expressed as in the key below.

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

Please contact us if you require further information.

Asset Class	Tactical Position	Commentary
Global Government Bond	-	We maintain our positioning in this asset basket, as we expect the pace of interest rate increases to be slower than the market consensus due to over optimism on growth, but rises are inevitable. US will need to issue $600bn of treasuries to fund budget deficit.
Investment Grade Bond	+	Despite low yields and narrow spreads, we favour investment grade over government bonds in our search for yield and lower risk assets. We feel Investment Grade bond investors are being paid to take risk, but value and yield is increasingly difficult to find.
High Yield Bond	+	We trim as recent data on income trends and the global tightening bias suggest a more difficult environment for HY especially, as issuance will need to increase to refinance in the period to come. We value yield but wonder whether default rates might increase
Emerging Market Bonds	-	We prefer EMD local currency bonds due to more attractive valuations. The only element of this basket providing yields above the 10-year average. We stay underweight in recognition of the strong compression in spreads over government bonds in recent months.
UK Equity	+	We have concerns regarding UK economic growth but there are good UK companies not solely reliant on domestic demand. Skilful stock selection is key to maintaining exposure and we feel our favoured managers are positioned to prosper despite political risks
Developed Market Equity	+ +	Global growth picked up due to China's $4 trn credit growth driving the global economy and then further by the Fed's using cash reserves to maintain liquidity. We are light US, overweight Europe and Asia mostly on valuation grounds compared to the US.
Emerging Market Equity	-	EM economies have faster trend growth and valuations are cheaper than developed markets, but might suffer due to higher bond yields and a strong dollar. A reduction in Chinese growth might be a headwind for this basket as China halts rampant credit growth
Commodities	-	Our perceived tightening bias (especially in China) is negative for the commodity sector as shown in Q2 performance. China has been the driver of the global growth upswing, so we are careful of the effect that tightening will have on the commodity sector
UK Commercial Property	+	Low interest rates and pressure on dividend yields mean we stay committed to Property, but recognise the dangers of reducing global liquidity on trophy assets. As a result we continue to favour smaller lots and move to more liquid and active strategies
Absolute Return	+ +	This area is attracting much interest. As structural holders of these funds over time, we feel we are well placed to select funds that provide diversification, reduce correlation and provide portfolios with downside protection in uncertain times. A key allocation
Cash	+ +	We keep high cash allocations absent many other compelling balancing or risk reducing options. Market volatility is very low at present and as contrarians we are concerned that it will not last forever and an increase may provide welcome entry opportunities

Looking Back

Global equity markets advanced in Q2 (FTSE World +2.33% in local currency), but the general resurgence of the Pound against major currencies other than the Euro reduced those returns for the sterling investor. A theme of tightening monetary policy undermined progress.

US equities gained (S&P 500 +2.57% in USD) despite mixed economic data and continued political uncertainty over Trump's ability to push through his fiscally expansive policies. With US unemployment now lower than 96% of the time since 1970, the Federal Reserve raised rates again in June and is likely to start reducing the size of its balance sheet "relatively soon", further increasing the tightening bias.

UK equities were positive (FTSE All Share +0.31%) amid robust corporate earnings in a volatile quarter plagued by post hung parliament political uncertainty and the future path of monetary policy. The more hawkish 5-3 MPC vote and comments from BOE Governor Mark Carney were taken as signalling a shift towards tighter monetary policy.

Eurozone equities gained (FTSE Europe Ex-UK +1.08%) despite giving up much of their returns in June. Political risk reduced with Emmanuel Macron's strong showing in the French elections. Positive economic data and improved corporate earnings supported shares, but gains were capped after remarks by ECB President Mario Draghi hinted at the withdrawal of QE and tightening monetary policy in Europe.

In Asia, Japan's TOPIX gained +6.56% with encouraging corporate earnings and an upbeat economic assessment from the Bank of Japan. The Yen was volatile throughout the period, reflecting global uncertainty, but ended on a softer note against most major currencies. Asia ex Japan (+4.4%) continued 2017's strong run on the back of improving data for the Chinese economy and a risk-on approach from global investors. Korea's newly elected President promised corporate reforms and to reinvigorate the economy, leading to healthy returns.

Emerging market equities (FTSE Emerging +2.72%) mostly benefited from the supportive global backdrop, in particular USD weakness. Russia was the exception due to the decline in oil prices and the Rouble. Qatar was the weakest market due to the economic and political blockade from its neighbour countries.

In fixed income, government bond yields were well-supported for much of the period, though a sell-off in the last week of June due to Central banker's comments resulted in losses for Bunds and gilts for the quarter overall. The US 10-year yield fell from 2.39% to 2.30%,the 10-year Bund yield rose from 0.33% to 0.46%, 10-year gilt rose from 1.14% to 1.26%. Corporate bonds performed strongly, well ahead of government bonds, with global investment grade credit rising (Barclays Global Aggregate Corporates +3.53%) and high yield also very strong (Barclays Global High Yield +3.19%) (all bond returns in local currency).

Looking Forward

"Bull markets are born on pessimism, grown on scepticism, mature on optimism and die on euphoria"
- Sir John Templeton

I think that it is fair to say that we live in interesting times. As we move towards the end of the Alice in Wonderland period of endless liquidity and the loosest of monetary policy, which characterised the QE period since 2008's Great Financial Crisis; it is probably sensible to consider how far we have come and draw some comparisons from history.

In my 30+ years in markets there have been countless examples of people or institutions calling the end of bull markets, but they have no greater accuracy than a man with a doomsday sandwich board. A few have had the same precision as a stopped clock and been lauded for their prophetic genius. We have no greater insight, but after a strong market run, we have been looking at some numbers for perspective. As the US is the largest and most expensive market; we have used the S&P 500 as a proxy and see some interesting information:

- The current US bull market is the second-longest ever at 3,034 days (9/3/09-30/6/17)
- The longest bull market lasted 4,494 days (4/12/87-24/3/00), or 1,460 days (4 yrs.) longer
- The price return on the S&P 500 in the current bull market was 258.21% as of 30/6/17
- The price return on the S&P 500 was 189.81% on day 3,034 of the longest bull market ever
- The price return on the S&P 500 was 582.15% in the longest bull market that included the "TMT Bubble"
- The S&P 500 cyclically adjusted price-to earnings (Shiller P/E) ratio was 43.53 in 3/2000
- The S&P 500 Index's cyclically adjusted P/E ratio was 30.1x on 30/6/17, above the average since 1980 of 21.7x
- The S&P 500 Index's forward P/E ratio stood at 17.5x at 30/6/2017 above the average of 15.8x and below its peak in 31/7/1999 of 24.5x
- The annual earnings posted by the S&P 500 Index doubled between 2008 and 2016

Since 1945, on average, the S&P 500 Index has experienced a pullback (5.0%-9.9% decline) once a year and a correction (10%-19.9% decline) every 2.8 years. No one knows exactly where markets go from here and the relative value of the S&P 500 (and all markets) is always best judged in hindsight, as sell side analysts have a poor forecasting record. Is it optimism or euphoria? Will the current bull trend set new records? Our view is that the most reliable indicators say the US market is expensive and as long term returns are directly related to the price which you pay for assets, we are becoming more cautious in our risk allocations. We are using diversification and an even greater focus on manager selection and style to try to maximise returns, while (as always) being mindful of limiting the downside risk inherent in portfolios. ***"Round and round we go, and where it stops nobody knows".***