Quarter 4 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 although we are nervous at current yields the chance of any significant rate rises in UK or US is still low and nervy investors are still buyers at almost any level. UK index-linked are priced for above BoE target 3% inflation
Investment Grade Bond	N	Spreads over government bonds are still attractive in selective areas and there is room for some yield compression with so many sovereigns at negative yields. Central banks bond buying programs are also supportive of this asset class
High Yield Bond	+	Still wary of the US Energy sector, but elsewhere continuing low default risk and a strong positive carry over other fixed interest means we stay overweight. Lower interest rate sensitivity and yield spread compensates for any 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 post Brexit run has focussed more on FTSE 100 foreign earners and continued sterling weakness will ensure currency earnings are healthy for good companies. We favour sustainable dividend plays in a market that is pausing for breath
Developed Market Equity	+ +	We remain positive on the US despite a strong run as Hilary Clinton seems favourite to triumph in an election of the least ugly candidate. Markets should be calmed by greater certainty but may not make great strides for a little while yet
Emerging Market Equity	-	Headwinds for emerging markets are reducing, but still remain. USD appreciation is slowing, EM growth improving and commodity outlook is more positive. Strong returns have naturally increased allocations in portfolios
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 markets' view of commercial property is becoming less extreme and funds are opening again as investors realise that the knee jerk negative reaction was overplayed. We sit tight in the asset class for yield and some growth over time
Absolute Return	+ +	We stay strong overweight having faith in this basket to provide a balancing mechanism, diversification and low correlation to other assets, which allows us to continue to take equity risk and farm dividends as part of total portfolio return
Cash	+ +	We maintain high cash allocations as we have as much bond exposure as we are comfortable with. We expect further opportunities to add to current exposures as markets have travelled far and fast, but we are prepared to watch and wait

Looking Back

In the first quarter of the Brexit era UK equities performed well as markets digested the effect of sterling depreciation and the Bank of England (BoE) launched a series of monetary easing measures in the wake of the post referendum economic uncertainty. Forecast UK GDP growth for 2017 was cut from 2.3% to 0.8% and the MPC halved base rates to 0.25%. The £170 billion stimulus package surprised investors, as they restarted quantitative easing sooner than expected, with an additional £70 billion of planned asset purchases and a £100 billion Term Funding Scheme to support the banking sectors as it passes on base rate cuts to customers. The FTSE All-Share index rose +6.8% over the period.

The US lagged other developed markets, as investors digested economic news and its impact on the FOMC's interest rate decision. No change was made so we move on to the December meeting with forecasters (yet again) favouring a rate rise. USD strength provided a tail wind for sterling investors with the S&P 500 up +6.3% in GBP.

European markets recovered from their UK referendum wobble with FTSE World Europe Ex-UK up +8.6%, half of which was currency related. Investors were reassured by some good corporate results and macroeconomic data as well as the expectation of further economic stimulus.

Japan recovered from its June sell-off, rising +10.7% (in GBP terms) over the quarter. In August, the Abe administration released details of a fiscal spending package on top of their existing aggressive monetary policy. These measures are expected to add up to 1.5% to GDP over the next two years; supporting their aim to increase the long-term growth rate.

Asian equities were strongly positive as hopes of looser global monetary policy and better-than-expected company earnings supported markets. Chinese equities performed well as investors expected more easing from the People's Bank of China (PBoC) to arrest a continued slowdown in China. FTSE- World Asia Pacific Ex Japan rose 10.9% in GBP.

Emerging markets led in both local and sterling returns amid expectations of a more supportive liquidity environment. Investors focussed on high yielding assets supporting that section of the market. FTSE All World Emerging Markets Index ended the quarter up +11.5% in GBP terms.

Global benchmark bond yields have fallen uniformly across the board post referendum. Expectations of higher borrowing costs have been delayed, despite the Federal Reserve's first rate rise in seven years back in December 2015. Predictions of a September rate rise receded over the quarter and forecasters have reset predictions to December. Sterling's fall raised inflation fears as UK Index Linked stocks rose +9.9%, a significant outperformance over Conventional Gilts which were up +1.4%. US High Yield (+6.8%) and UK Corporates (+5.9%) had great runs on the back of reduced interest rate expectations and supportive corporate conditions. EM bonds continued their recovery achieving a +5.2% increase.

Looking Forward

"The intelligent investor shouldn't ignore Mr. Market entirely. Instead, you should do business with him- but only to the extent that it serves your interests." - **Benjamin Graham**

It is now eight years since the failure of Lehman Brothers and the economic recovery is clearly maturing, especially in the US. As a consequence of the slow pace of the recovery and continuing loose monetary policy, we think it is too early to call the end of the cycle. However, returns for many asset classes are likely to be constrained, not just by the stage of the cycle, but also the strong performance already seen in 2016.

The Brexit vote and the rise of Donald Trump highlight the fact that the tepid global growth rates experienced since the global financial crisis are not good enough for many people. The world economy has experienced growth of 2.5% since 2012 compared with 5% pre-crisis. Although the growth rate was fuelled by irresponsible bank lending and led to the crisis, the collective memory can be selective.

QE was like "Welfare for the Wealthy" producing an uneven distribution of those gains and the outcome for the man in the street is worse than headline macro growth figures imply.

We expect the 2.5% muddle-through can continue at least into 2017, but the wider question is whether this growth rate is sustainable from a political rather than an economic perspective, as voters respond to populist/nationalistic solutions. The rhetoric identifies globalisation and the free movement of goods and people as the threat to living standards. Reversing such trends are likely to weaken rather than accelerate economic growth, inviting protectionism.

With no recession imminent, we think investors are likely to continue to own risk assets as a source of income, even if they don't expect significant capital appreciation. Equities are an important source of income with historically low bond yields and we continue to search for and value attractive, sustainable yields. The headwinds for emerging markets are reduced, as dollar appreciation slows, growth improves and commodity prices start to find a bottom.

We continue to believe that the carry available on high-yield debt remains attractive given that default rates outside of the energy sector remain low. But it pays to be active in this sector, with security selection key.

We are in a time where continuing to own risk assets and seek income is increasingly becoming the only game in town. As a result, we continue to place faith in the value of our long term portfolio construction thesis in which we balance risk assets with absolute return strategies to provide some downside protection and, potentially, broader diversification.

We remain mindful of the risks to the outlook from politics, high corporate debt levels in China, over-extended property markets in some parts of the world and the rising medium-term risk of a recession which is a natural consequence of a maturing economic cycle. Returns are never risk free.

to make a *difference*