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, as our central case is for a raise in US rates in December, but the Fed to stay relatively dovish with gradual rises from then onwards. US will need to issue $600bn of treasuries to fund budget deficit adding to upward pressure.
Investment Grade Bond	+	Despite low yields and narrow spreads, we still favour investment grade over government bonds to provide yield, diversification and lower portfolio risk. Investment Grade bond investors are still being paid to take risk relative to historically low interest rates
High Yield Bond	+	We stay overweight for yield and diversification, mindful that default risk will increase as the economic cycle matures and interest rate rises will make refinancing more difficult than at present. A Dovish Fed means we stay with our exposure at this point in time
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 and the effect of any Brexit deal on the UK economy. Balanced exposure in terms of investment style, company size and source of earnings is important to reduce the effect of political risks undermining returns
Developed Market Equity	+ +	Global growth picked up due to China's spending spree and US investment banks massive liquidity increase providing support to markets. We expect this to slow a little over time but growth should remain We stay light US, overweight Europe, Japan and Asia.
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	-	Geopolitical and weather factors along with supply restrictions drove the oil price upwards last quarter so a continuation of the trend seems unlikely. China tightening may be a negative in the coming months. Gold may benefit if N Korean bluster continues
UK Commercial Property	+	Low interest rates along with pressure on bond prices and dividend yields mean we keep our Property exposure despite the reducing demand for trophy assets. Our manager mix accents industrial and logistical over retail, along with more liquid and active strategies
Absolute Return	+ +	As interest rate rises become more certain, the search for portfolio diversification beyond equity risk becomes more difficult. Our manager mix should provide diversification, reduce correlation and provide portfolios with downside protection in uncertain times.
Cash	+ +	Cash allocations stay overweight the benchmark both as a balancing or risk reducing option and also to provide funds to allocate in the event that markets provide a buying opportunity. Market volatility remains very low and cannot stay that way forever

LOOKING BACK……..

The traditionally quieter summer period was rudely interrupted by an upsurge of political risk—led by mounting US-North Korea tensions, boosting volatility and pushing some market returns into negative territory during the quarter. However, macroeconomic data was positive, with stronger-than-expected growth registered in many countries so that developed market equities finished up strongly. Foreign asset returns were affected by the Pound's strength against other major currencies other than the Euro.

Central banks have highlighted their desire to reduce the level of monetary policy stimulus in place, albeit gradually. The US Federal Reserve (the Fed) announced that it will start the process of "quantitative tightening" - reversing some of the quantitative easing (QE) that has been so supportive of asset prices in recent years. The European Central Bank (ECB) looks set to reduce its own QE programme increasing the monetary tightening bias. The Fed and the Bank of England (BoE) have both intimated that they will raise interest rates before year end.

The US stock market rose (S&P 500 +3.96% in USD terms) with continuing low volatility, driven by decent earnings growth. Consumer confidence remains buoyant and business investment intentions are rising according to leading indicators. There has been talk of tax reform from the Trump administration, but market expectations for delivery of stimulus remain quite muted with earnings expectations for the end of 2018 lower today than before the US election. Markets have risen as a result of better US and global growth this year, not in expectation of fiscal stimulus. This has weakened the USD and reduced returns for UK investors (S&P 500 +0.65% in GBP terms).

In the UK, the news continues to be dominated by Brexit negotiations - the political outlook remains highly uncertain; and the economic outlook is not much clearer. Very low unemployment is positive, but productivity is still poor compared to other developed economies. Whilst inflation may be close to peaking, consumer confidence remains subdued and there are signs of weakness in the London housing market. Mark Carney, the Governor of the Bank of England, has been clear that an interest rate rise is warranted in the near future, with possibly more to come next year. The future path for interest rates will be determined by factors such as inflation, wage increases and the pace of economic growth. Expectations of a rate rise supported the pound, damaging the returns from large UK companies compared to other equity markets (FTSE All Share +1.19%) as the majority of FTSE 100 revenues come from outside the UK.

In Europe, growth has continued its upward path, providing a positive backdrop for strong corporate profit growth. There has been a rebound in consumption with an improving labour market supporting consumer confidence: In response, ECB President Mario Draghi has led markets to expect a further reduction in the pace of QE purchases, reducing liquidity in an attempt to control the pace of growth. This rosier picture was reflected by European markets (FTSE Europe Ex UK + 4.21% in EUR) and despite the Euro gaining as much as 6% vs GBP at one point over the quarter, it ended flat preserving the return of the market for the sterling investor.

Japanese equities had a strong quarter (TOPIX +3.90% in JPY) as global growth helped exports to 18% year-on-year growth even without a weak yen, which was flat against the dollar over the quarter. Prime Minister Abe's decision to call an election is a risk to Japan's supportive monetary policy backdrop, but this risk has not yet affected local equity markets. JPY fell 3.12% vs GBP over the quarter reducing returns for the UK investor.

The weaker dollar, improving emerging market growth and rebounding earnings have helped emerging market equities to deliver very strong returns since the start of the year and especially this quarter (FTSE Emerging +6.4% in local currency terms) but were affected for sterling investors by GBP strength (+3.31%). Continued momentum in the Chinese economy and a pickup in commodity prices were also positive for EM equities.

The Bloomberg Commodities index rose in Q3 (+2.52% in local terms). Energy led, with Brent crude up 20.1% driven by the fall in US crude inventories, increased expectation for production cuts, and rising global demand. Industrial metals also rose as economic momentum in China remained firm with Iron ore rising +14.9%. In contrast, agricultural commodities suffered with wheat and corn prices falling sharply amid record global supplies. Gold rose 3.2%, amid geopolitical concerns.

After a strong early rally, government bonds sold off in September as markets started to take central bank tightening more seriously. This left government bonds broadly flat over the quarter. US 10-year yields began the period at 2.31% and finished at 2.33% with Bund 10-year yields virtually unchanged from 0.47% to 0.46%. 10-year UK gilt yields rose 10 basis points (bps) to 1.36%. As the Fed, the Bank of England speak of rate rises and ECB President Mario Draghi talks of a further reduction in the pace of QE purchases, the likelihood of further upward pressure on bond yields has increased. The timing and quantum of rises will be dependent on the pace of economic growth.

The risk-on sentiment also helped fixed income markets, as corporate bonds made positive returns, outperforming government bonds. The Barclays Global Aggregate Corporate Bond index rose +2.25% and Barclays Global High Yield by 2.52% (in local currency terms). Sterling strength affected these index returns over the period (-1.01% and -0.74% respectively). Default rates remain low, even in high yield bonds.

Money flowed into emerging market bonds as investors seek higher real yields than available from developed markets - JPM GBI EM Global Composite +4.37% in local currency terms.

LOOKING FORWARD………

"Interest rates are to asset prices what gravity is to the apple. When there are low interest rates, there is a very low gravitational pull on asset prices" – **Warren Buffett**

The long road to recovery from the great financial crisis passed another milestone in September when the US Federal Reserve (Fed) announced that it would start to reduce the $4.5 trillion on its balance sheet from October. Quantitative Easing (QE), is finally being unwound, albeit slowly at first by $10 billion per month and increasing to $50 bn per month by the end of 2018. This is a meaningful change in liquidity - quantitative tightening (QT) has begun. QE played a significant role in boosting asset markets by driving down government bond yields and forcing investors to take more risk, which drove up prices of credit, equities and property The question now is whether turning the process around and withdrawing liquidity at the same time as increasing interest rates, will send asset prices into reverse.

The Fed has been transparent in signalling its intentions, having learnt from 2013's "taper tantrum" when bond and stock markets reacted badly to then Fed Chairman Ben Bernanke's comments about reducing QE. US bond yields are undoubtedly under upward pressure but a continuation of steady but unspectacular growth and low inflation could maintain a "Goldilocks" environment where activity is neither too hot nor too cold to drive up rates and tighten conditions faster than the markets can bear. This what the Fed is hoping to achieve.

However, we have been looking at the factors which might derail this attempt to exit QE in a calm, unhurried and structured manner. Despite the Fed's plans we feel that ultimately policy error seems to pose the biggest threat to the current market levels. Misjudging the withdrawal of liquidity or the pace of interest rates could be the catalyst that ends this long bull market run, so how might the Fed get it wrong? We discussed threats to the Goldilocks scenario with our economist Andrew Hunt and we need to look both inside and outside the US to see where potentially the most significant economic events are unfolding.

Post Trump's surprise election victory markets have been on something of a tear and whilst initially talks of fiscal stimulus were a factor, if we look under the bonnet something else was in play. Probably anticipating a Clinton Victory, Barack Obama left office with more than $400 billion in Treasury reserves – effectively the Government's cash to pay its bills. The new administration rapidly spent this money funding the expanding budget deficit whilst at the same time reducing Treasury issuance. The US investment banks who are recipients of these funds have bought assets and lent into global financial markets, creating a massive surge of liquidity which was a big factor in market performance this year.

As Congress has agreed to suspend debt ceiling legislation and the US Treasury needs to pay its bills, it seems likely to issue up to $600 bn of bonds in a very short space of time. This will add to upward pressure on bond yields at the same time as the Fed is reducing market liquidity through QT. This is a challenging and possibly dangerous combination.

China represents 13% of the global economy but holds over 30% of global bank deposits so its spending and investment habits have a real effect of the global economy. In the last quarter of 2017 China acted to slow the flow of the purchase of foreign assets which was putting pressure on its currency reserves and as a result Chinese consumers have binged on high end consumer goods. We estimate that China's import volumes have increased by 15% over the last year - a major event in world's second largest economy leading us to believe that the global recovery is largely driven by Chinese domestic demand that has itself been created by a sharp fall in the domestic savings rate in China. We believe more than a third of the revival in world trade volumes this year can be traced to China's resurgent demand for imports.

This combination of large amounts of money, an increase in demand for goods and surging property prices is a recipe for inflation. Ultimately, it is inflation not growth that brings single party regimes down and we can look to Latin America, the demise of the Eastern Bloc as well as China's own history for examples. The events in Tiananmen Square in 1989 were a reaction to a massive squeeze on urban living standards created by China's dash for growth and the Party leadership are sensitive to the potential for rising unrest if food prices accelerate. Post the Party Meetings, we expect China to look at tightening monetary conditions and as a consequence we expect global growth to slow. That said, it will take some time for this to flow through and it may be that markets confidence in the global recovery theme can remain in place for a further 3-6 months before this scenario plays out.

Inflation pressures have receded in the western economies but as huge consumers of imported goods, we need to pay attention to what is happening in the Asian manufacturing base where we sense a change in the economic model. The economies of Asia have long relied on heavy injections of credit to sustain their corporate model and underwrite full employment, but with the Regional banking systems now under pressure companies are becoming more profit-focussed with implications for the global economy. Regional export prices are rising so that Asia is starting to export inflation. When this is added to the potential for China to do the same if they fail to cool their domestic spending boom, we think this represents the biggest threat to the Goldilocks Fed exit from QE. If inflation is exported and is higher and more aggressive than expected this may leave Central bankers behind the curve driving interest rates up faster than expected or desired by business and stock markets.

If Chinese inflation does not moderate early in 2018 it represents a real threat to markets, but with effective monetary tightening controlling excess demand, it is possible that global growth can sustain at a reasonable pace for a while longer, which may support markets.