Quarter 2 2018

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	-	Slight softening in growth and inflation means we feel the Fed will raise slower than the current market consensus, so we are happy to maintain current exposure. This basket balances risk positions and gives safe-haven protection against stock market falls
Investment Grade Bond	+	Investment Grade bonds generally perform well in this stage of the cycle, which balances the narrow spread over government bonds. Investors are still being paid to take risk relative to historically low interest. Corporates are still healthy and growth supportive
High Yield Bond	+	We stay overweight for yield and diversification. We can see no increase in default risk yet as economic growth is supportive and we feel rate of interest rate rises will be slower. Our view of likely Fed moves means we stay with our exposure at this point in time
Emerging Market Bonds	N	We maintain our neutral exposure with EM economic growth supportive fed by developed market growth. Certain EM issuers have better debt levels and growth prospects than developed markets and the yield provided by this basket provides valuable yield
UK Equity	N	We maintain neutral exposure amid concerns regarding UK economic growth, despite beating forecasts in 2017. We don't believe GBP strength can continue. UK set to be slowest growing developed economy in 2018. Asset managers are heavily underweight UK
Developed Market Equity	+ +	Synchronised global growth is supportive of developed markets. Q1 correction has refreshed the market and we welcome the return of normal levels of volatility which should be a positive. Trump trade bluster is overplayed and not yet a real threat to global trade
Emerging Market Equity	N	EM economies have faster trend growth and cheaper valuations compared to developed markets so should outperform in the current period of synchronised global growth, so we prefer to take risk here than in the UK at this point in time. Currency can provide hedge
Commodities	-	China has been stockpiling oil, iron ore and coal. Oil purchases have been 3 ½ times rate of industrial growth sustaining price. We feel oil stays at current levels for now. Demand for resources should remain in current environment but best returns are behind us
UK Commercial Property	+	We maintain Property exposure despite our concerns for UK economy. We need yield and diversification and our managers moved overweight industrial and logistical over retail and have sensibly reduced asset size and accented more liquid and active strategies
Absolute Return	+ +	Our manager mix should continue to provide diversification, reduce correlation and provide portfolios with downside protection in uncertain times where fixed interest is challenged. Skilled short biased strategies are key along with more market neutral plays
Cash	+	Cash stays 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 has returned and we have reduced cash where heavily overweight

Looking Back……..

Q1 has not been short of headlines or volatility, but equity markets started well after a great finish to 2017. We moved into February with a sharp selloff as fears of the implications of accelerating US wage growth spooked investors worried that US interest rates would have to rise faster than the economy could withstand. A brief recovery was "Trumped" in March by a potential trade war between the US and China, as the US imposed tariffs on steel and aluminium imports and China in return imposed increased tariffs on $3 billion worth of US imports. This protectionist stance drove markets down again despite the proposed tariffs representing around 0.1% of Chinese GDP and even less for the US - not very significant for global growth. Risks to trade are real but should be kept in context. Market volatility, absent for so long, is returning to what history shows is a more normal pattern. Sterling strength again dampened portfolio returns ending +3.8% vs USD and +1.2% vs Euro.

In the US the S&P 500 index finished down -1.2% and in February volatility (measured by the VIX index) hit readings not seen since 2015. The index went into correction territory (-10%) less than a fortnight after record highs in January, all coming after a 2017 where the S&P 500 closed down over 1% on only four days and made money for 15 months in a row until falling in January. The dominant fears were higher inflation and higher interest rates and then in March the potential effects of trade wars. On the plus side, growth remains healthy and recession risk seems low as economic indicators remain positive.

The UK was the worst performing developed market (-7.76%) - its worst first quarter performance since 2009. Brexit dominated sentiment and underlying economic uncertainty means the UK is predicted to be the slowest growing developed economy. Sterling strength contributed to the malaise hitting foreign earners that dominate the FTSE 100. Market falls hit all sectors with Technology the worst performer and Basic Materials the best. Healthcare, industrials and consumer services outperformed, but were still negative. To balance this, between 11th February 2016 and 12th January 2018 the FTSE All Share had risen over 40%.

Eurozone equities were negative, the bulk of the declines coming in March (FTSE Europe Ex UK -5.2% in Sterling). Worst hit were healthcare and telecoms, often seen as "bond proxies", affected by fears of rising interest rates and bond yields. The European economic backdrop remained encouraging with Q4 2017 GDP growth 0.6% and stable unemployment, but the PMI hit a 14-month low in March. With inflation below target, ECB chairman Mario Draghi confirmed interest rates would not rise until after the end of QE. Italy's election produced no overall winner, but the anti-establishment Five Star Movement emerged as the largest single party, continuing the recent populist theme in politics. Angela Merkel remains as Germany's Chancellor after her centre-right CDU/CSU agreed another coalition with the centre-left SPD.

Japanese equities followed a similar pattern to other markets ending the quarter -4.7% in JPY. Heightened uncertainty resulted in a stronger yen against major currencies. The most pervasive influence came from the US move towards increased protectionism. The decision to recommend the reappointment of Mr Kuroda for a second term as Governor of the Bank of Japan has eliminated one area of potential uncertainty and should ensure a stable policy environment. The longer-term trend of economic improvement appears intact.

Asia ex Japan equities saw a rise in volatility amid global trade concerns, and FTSE Asia ex Japan Index finished down -1.1% (-4.8% in Sterling) outperforming the FTSE World and FTSE World Ex UK. Thailand was among the best-performing markets, with strong performance from energy and utilities. Taiwan's technology stocks led their market higher, and Malaysia also recorded strong returns. China made solid gains finishing ahead of the index as macroeconomic data was better than expected and 2017 GDP growth rose to 6.9%.

Emerging markets equities registered a positive return, despite rising volatility. The FTSE Emerging Index was +0.3% (in local currency), but sterling strength meant the index was down -2.5% for the GBP investor. Brazil generated the strongest return as former president da Silva's criminal conviction was upheld, increasing the chances that he will not participate in October's presidential elections. Russia was a highlight as the central bank cut interest rates and the country's debt was upgraded to investment grade by ratings agency S&P.

The Bloomberg Commodities index was slightly down in Q1 due to weakness from industrial metals affected by the global trade tensions which might impact demand (-0.4% local and -3.95% in Sterling), with Copper down -8.3%. On the plus side energy and agricultural components recorded solid gains with corn (+10.6%) and soy bean (+9.8%) notably strong. Brent crude (+5.1%) rallied with rising confidence that OPEC would maintain its production cuts through 2018. Safe haven buying of gold (+1%) was a positive but silver (-5.1%) fell.

In government bonds, US Treasury yields rose markedly across all maturities over the quarter as expectations of growth, inflation and interest rates shifted higher. The US yield curve continued to flatten modestly (short term rates rising to closer to longer term rates) with shorter-dated maturities impacted by a rate hike and substantial issuance in March. Ten-year yields increased from 2.41% to 2.74%, reaching a high of 2.95% in February before falling again as fear hit markets in March. UK gilts saw more pronounced curve flattening as 10-year yields rose from 1.19% to 1.35%, while five and two-year yields rose by 0.39% and 0.38% respectively. German Bund yields rose and French, Spanish and Italian bonds moved lower.

Corporate bonds made negative total returns, underperforming government bonds. Investment grade (IG) credit saw larger negative returns than high yield (HY), notably in US dollar, while sterling HY performed well. In emerging markets, local currency sovereign bonds made strong total returns as the US dollar declined, but hard currency sovereign and corporate bonds saw negative total returns.

LOOKING FORWARD………

"Power tends to corrupt and absolute power corrupts absolutely" – ***Lord Acton***

The world's dominant economies are the US and China and they are very different in terms of their political structure. The US is the epitome of Capitalism and China a command economy rooted to its Communist past. What they do have in common is the concentration of executive power in their leaders. President Xi Jinping is the most powerful Chinese leader since Mao Zedong and like all leaders of his type throughout history he has surrounded himself with people unswervingly loyal to him. While this ensures that he can implement his policies efficiently and act swiftly to make any changes to the economy that are needed to keep China moving forward, we are concerned that this concentrates power and ideology to an extent that makes us wonder whether China will be too slow to react to bad news or changes in the economy. Xi seems to be very pro-growth and needs to be so to support his legitimacy as leader. Our concern is that he may be too slow to react to rapidly strengthening inflation, which is a theme that we have previously highlighted as being a threat to the current buoyant market.

In the US President Trump does not have the unswerving support that Xi enjoys, but that is not really an issue for a man that seems only to trust his own counsel. The Presidency has so far been notable for a hire and fire strategy which reflects that it is clearly "my way or the highway" in the Trump administration as numerous changes have shown. This has also created a concentration of executive power that only the checks and balances in the US constitution seem to be able to check. However, markets feed on rumour and Trump's Twitter habit provides plenty to feed on, helping to drive 2018's return of volatility as he threatens trade wars, protectionist policies and military action. With the world's dominant economic powers driven by two men who seem to lack balancing views, the potential for policy error seems to us to be heightened. Our central view is still positive with the global economy in good health and inflation not yet a major problem, but we are watching economic data closely for signs of change which might drive a policy change derailing markets.

As we move further into yet another stage of the unknown in economic terms as the developed world continues with Quantitative Tightening or QT, markets are very sensitive to any news which may cause the Fed to raise interest rates faster than the market expects. This was shown in Q1 when accelerating US wage growth triggered the first sell off.

Whilst it would be easy to glibly explain the current market levels on wage growth, inflation fears and protectionism, we feel that there is a story behind the story that needs to be understood as it may be the real driver and remains in the background. When Barack Obama was in the final stage of his Presidency he expected that he would be succeeded by another Democrat, Hilary Clinton, which at the time, was the most likely outcome.

Rather than leave a note like the departing Labour Chancellor saying they had spent all the money, Obama left a healthy balance at the US Treasury so that Hilary would be able to pay the Government's bills for some time before going back to the House for more money.

After Trump took occupancy of the White House, he took a different view of this money and cleared out the Treasury coffers with indecent haste in the first few months of 2017, fuelling the "Trump rally". $300 bn or more went to a small number of US investment banks, who in turn lent it out to the market making a turn on the deal which swelled their own coffers. This lending leveraged the banks own balance sheets and was likely again levered by those that received it both domestically and internationally, delivering a liquidity boost to global markets which was QE like in its magnitude at a time when markets were braced for tightening. This weakened the dollar and fuelled the "Trump Trade".

Post this massive injection we see that liquidity in the financial sector is drying up, with the US monetary base shrinking at a rate that we haven't seen since the 1930s. We feel this has removed the markets Teflon coating and the almost volatility free returns of 2017. We are comforted by the fact that the selloff has been relatively orderly, but also feel the nature and magnitude of last year's Treasury fuelled credit boom allied to the extraordinary nature of the post GFC economic cycle has created increased the risk for a more significant and more disorderly decline in markets, such as that seen in 1998 in the LTCM crisis. The concentration of liquidity funding in such a small number of hands and the leveraging up of that lending has created an inverted pyramid with 1-2 institutions at the bottom that believe that they have liquid 'safe claims' on their debtors but at the top of the debt structure many of the funds have ultimately been lent to less liquid entities. As a result, we are sensitive to movements within the share prices of a number of key US, Japanese, Asian and European mega-banks.

The balance to this reduction in liquidity and the volatility in markets is that we suspect that we will see a softening in data and a reduction in the pace of global growth. We would expect this to reduce fears of overheating and subsequent inflation becoming a problem that forces central banks (especially in the US) into raising interest rates faster than expected in order to confront the inflation problem.

In the wider market context, investor concerns about the price of Treasuries, inflation and interest rate rises mean that markets are likely to stay choppy, but our central view is that Q1's market falls have refreshed equity markets and we see the return of volatility and better appreciation of risk as a positive. There is still appetite for equity with buying on weakness and companies are profitable, reporting good earnings. Bull markets in late cycle "climb a wall of worry" so it is normal to navigate conflicting data and monitor risks that are out there to catch the unwary. That is why we diversify.

As Voltaire said -"*uncertainty is an uncomfortable position, but certainty is absurd one*".