Quarter 1 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	-	In the current Goldilocks scenario with a dovish Fed and the market seemingly comfortable with the forward guidance on rates, we maintain the underweight position. This basket balances risk positions and gives safe-haven protection against stock market falls
Investment Grade Bond	+	Investment Grade bond investors are still being paid to take risk relative to historically low interest rates and government yields. Corporates are still healthy and global growth supports this asset class despite low yields and spreads over government bonds
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 interest rate rises likely to be muted for some time. The dovish Fed policy means we stay with our exposure at this point in time
Emerging Market Bonds	N	We increase our exposure to neutral as EM economic growth strengthens in concert with global growth. Some EM countries have better debt levels and growth prospects than developed markets and the yield provided by this asset class provides valuable income
UK Equity	N	We reduce exposure amid concerns regarding UK economic growth despite the better performance in 2017. We maintain a balanced exposure in terms of style, company size and source of earnings to reduce the negative effect of political risks or GBP weakness
Developed Market Equity	+ +	Synchronised global growth is supportive of developed markets even at current valuations, if the Goldilocks scenario is maintained. We remain wary of how this scenario may be derailed. Within this basket, we stay light US, overweight Europe, Japan and Asia.
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	-	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	+	We maintain Property exposure wary of softening UK economy, but valuing yield and diversification which is scarce. Our manager mix accents industrial and logistical over retail, has sensibly reduced asset size and accented more liquid and active strategies
Absolute Return	+ +	This basket provides portfolio diversification to balance equity risk. Our manager mix should continue to provide diversification, reduce correlation and provide portfolios with downside protection in uncertain times. Skilful short biased strategies are key here
Cash	+	Cash is reduced but 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 remains very low and cannot stay that way forever

LOOKING BACK……..

The final quarter of 2017 was a good one for stock markets, putting the cherry on the cake of what was a good year for equity investment. Credit markets also rose over Q4 to finish the year on a positive note having outperformed government bonds in 2017. A positive earnings season, continued healthy economic growth and US tax cuts have helped equity markets this quarter. Over 2017, global growth improved and unemployment rates continued to decline, leading some central banks to slowly tighten monetary policy. Downside political risks were more muted than expected and movement on the US tax reform has set the scene for a more positive US corporate environment, driving risk assets higher. Sterling's continued resurgence reduced foreign asset returns other than against the Euro, a continuance of one of the themes of 2017, with GBP finishing nearly 9% up vs USD over the 12-month period.

In the US, the S&P 500 ended a strong 2017 with a Q4 gain of +6.6% (in USD terms). Two Republican defeats in Senate contests forced agreement on the long-awaited tax reform bill, with cuts for corporations as the centrepiece. Markets rallied on the news. US equities benefitted from positive data – Q3 GDP growth of 3.0% (annualised) beat expectations, corporate earnings were robust, employment numbers were good, wage growth stayed subdued and the US Federal Reserve (Fed) raised 2018 growth forecasts to 2.5% from 2.1%. As a result, the Fed increased interest rates by 0.25% in December in line with expectations.

The UK's FTSE All-Share index saw positive returns (+5.0%), supported by gains for resource stocks and progress on Brexit negotiations with an agreement struck to allow talks to proceed to discussion of trade arrangements. Ignoring the sluggish economy, the Bank of England (BoE) raised interest rates for the first time since November 2007, from a record low of 0.25% back to 0.50%. Consumer price index inflation reached 3.1% in November, breaching the BoE's upper target. A lacklustre Autumn Budget did little to help dampen fears for the UK economy and the Office for Budget Responsibility downgraded 2018 UK GDP growth forecasts (1.6% to 1,.4%) due to poor productivity growth. The movement in Brexit negotiations raised hopes driving the index into positive territory in December.

Eurozone equities disappointed (FTSE World Europe Ex-UK +0.18%) amid profit-taking and simmering political risk. Economic data remained positive as GDP grew by 0.6% in the third quarter. Inflation was 1.5% in November 2017, up from 0.6% in 2016 and unemployment fell to 8.8%, the lowest rate since January 2009. In October, the European Central Bank announced that quantitative easing would be extended to September 2018 but that the pace of purchases would be reduced from €60 billion per month currently to €30 billion. Euro gained marginally vs Sterling ending 2017 +4% vs GBP in contrast to other major currencies.

Japanese equities posted strong gains (TOPIX +8.7%) amidst strong corporate earnings and a win for the incumbent LDP in the October general election. Mr Abe's win led to more stable sentiment driving increased purchases of Japanese equities by foreign investors, maintaining upward market momentum. December economic data was positive as unemployment fell to a new low for this cycle of 2.7%, inflation data improved, and industrial production and retail sales were comfortably ahead of forecast. The Bank of Japan's quarterly Tankan survey recorded the strongest sentiment among large manufacturing companies for over 11 years.

The MSCI Asia ex Japan index was up 8.2% in Q4. India and Korea led the region. India announced plans for a recapitalisation for state-controlled banks, whilst Korea benefited from improved relations with China's after South Korea's THAAD missile deployment. Hong Kong and China recorded strong gains with China, Q3 GDP growth stable at 6.8%. The 19th Communist Party Congress in October focussed on the quality of growth and addressing structural risk. Following the Fed's hike, the Chinese central bank raised some rates by 5 bps. and warned of a targeted cut to the required reserve ratio, wef January 2018.

Emerging market equities recorded a strong gain in Q4 (FTSE Emerging +6.11%) and outperformed developed markets with political developments supporting gains. In South Africa, the election of Cyril Ramaphosa as leader of the African National Congress increased the prospect for a return to more orthodox policy after elections in 2019 and the stock market led Q4 EM equity index returns. The FTSE Emerging Index ended 2017 +27.42% over the year.

The Bloomberg Commodities index posted a Q4 return of +4.7%, driven by industrial metals and energy. Nickel (+22%), copper (+12%) and iron ore (+12%) posted the strongest gains as Chinese demand remained firm. Brent crude surged +18.2%, primarily driven by an agreement among OPEC, and a number of non-member countries such as Russia, to extend production cuts to the end of 2018. In contrast, agricultural commodities lost value, notably wheat and palm oil. In precious metals, gold gained +1.8% while silver was up +1.7%.

US Treasury yields rose over the quarter, and the yield curve flattened, amid growing momentum behind a tax reform bill which is expected to stimulate growth and inflation. For Q4 10-year yields rose from 2.33% to 2.41%. In Europe the ECB announced the reduction of asset purchases, but extended the programme, boosting bond yields. In the UK, ten-year gilt yields were down from 1.36% to 1.19% with less pronounced decreases for five and two-year maturities. A November rate hike by the BoE was well anticipated and was accompanied by dovish guidance. Economic activity remains subdued and political uncertainty continues.

Corporate bonds capped a good year with positive total returns, outperforming government bonds. Investment grade bonds saw stronger returns than high yield, aside from in Europe, as the latter experienced challenging conditions in November having reached elevated valuations. The BofA Merrill Lynch Global investment grade index total return was +1.0%, and for high yield +0.5% (in local currency). Sterling IG credit was the strongest. Euro and sterling high yield made good returns.

LOOKING FORWARD………

"Two super-contagious diseases, fear and greed, will forever occur in the investment community. The timing of these epidemics will be unpredictable" – ***Warren Buffett***

We have commented previously on both the length and extended returns in this bull market cycle which started in March 2009 - second only to the Dot-Com bubble of the late 90s - as we value the lessons of history and what it teaches us about recurring themes in the investment world. However, it is said that history never repeats but it always echoes and we are wondering whether this current extended cycle is a fainter echo due to the effects of the unprecedented and experimental economic policy of Quantitative Easing.

Central banks were granted freedom of action to cope with the consequences of the financial crisis and their bail-out of stricken banks was then followed by an unprecedented monetary stimulus in China, the US, Japan, the UK and even Germany. Unfortunately, this stimulus failed to transmit through into the broad economy and into the hands of the average "man in the street". Instead it became a form of welfare for the wealthy providing liquidity and encouraging almost risk-free speculation that made the rich richer and laid the foundations for the surge of populism which spawned Brexit and the rise of Donald Trump.

The various iterations of QE represent the biggest Public intervention in the financial world since World War II and might almost be described as nationalisation of asset markets, such is the marginalisation of the Private investor in certain markets. As an example, in Japan the government owns half of the issuance of JGBs and when you add in the amount forced into the hands of banks and other financial institutions for regulatory compliance, it is estimated that the free float available to private investors represents 8% of the government bonds in issue. The situation is similar in Germany. As the European Central Bank attempts to stimulate the economy it has been buying lower down the credit scale in a predictable manner that supported speculation by investors who knew there was always a buyer with deep pockets willing to take the asset off their hands. Public interference and the removal of risk and moral hazard distorts markets and might explain the low levels of stock market volatility represented by historically low levels in the VIX – the often quoted volatility measure.

Central Banks, the world's largest and most powerful financial organisations, have long been targeting higher asset prices and have gone to extraordinary lengths through their asset purchase programmes. As markets have become dominated by the public sectors – they seem to have undermined the effectiveness of private sector valuation measures by distorting asset prices. This policy seems likely to continue as the world's governments have come to fear the "balance sheet recession", where high levels of private sector debt cause individuals or companies to collectively focus on saving or paying down debt rather than spending or investing, causing economic growth to slow or decline. As a result, they have become hooked on providing rising asset prices and are reticent with regard to exiting this policy.

Monetary policy remains stimulative, potentially far into 2018. In effect, even the Fed, and certainly the ECB and BoJ, are simply making policy less loose and not actually tightening in any normal sense. Whilst this continues and if synchronised global economic growth continues, it seems reasonable to presume that asset prices will be supported, even at such high valuations in a historical context. Whilst we would not expect another stellar year such as experienced on the S&P 500 last year, positive gains should still be possible.

However, could higher CPI inflation undermine the central banks plans? Clearly, the central banks have gone to extraordinary lengths to support asset prices through their asset purchase programs. Whilst this is the focus of their policy they will be committed to a very slow increase or "normalisation" of interest rates in step with economic growth in a manner which they believe will not derail the economy. To date this has meant that the Fed has preferred to risk being slightly behind the curve rather than raise rates or tighten too fast and choke off the recovery. If they get too far behind the curve and inflation rises faster than expected, they might increase rates faster than the market has priced in, which is dangerous for markets.

To date, low energy prices and the "Amazonisation" of retail has suppressed US inflation much to the consternation of many economists. Whilst Amazon remains committed to an ongoing battle for market share, price rises are likely to remain muted. Oil prices are rising, but we do not believe that to be a long-term trend. While we don't put too much faith in the soft sentiment indicators which seem to echo rises in markets, the US is nonetheless a fully employed economy and the potential for wage increases fuelling inflation is a consideration.

We believe the threats lie elsewhere. Japan may actually be succeeding in creating inflation and Asian GDP growth has accelerated, but China is at the centre of the inflation story. We believe their GDP inflation has moved towards 6% and they are in the midst of a conventional (inflationary) monetary boom. The key call for 2018 is "Does China tighten?" If not, then we are concerned that its growth will drive global nominal GDP growth to a level that is not in line with current interest rates forcing the Fed into regime change, returning to targeting inflation rather than asset prices, and raising interest rates faster than the market expects.

As the global growth acceleration is largely a China story, if they do tighten (the PBoC meeting after the Lunar New Year is the likely time) then the effect might weaken earnings and create a market wobble, but probably not a crash. This might actually represent a buying opportunity. But if the current rate of Chinese growth continues to accelerate, exporting inflation to developed nations, then the current "Goldilocks" economic scenario is seriously at threat. Then like Goldilocks we might want to flee in haste from the wrath of the Bears.