FPWM
TAILORED FINANCIAL SOLUTIONS

QUARTER 4 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	+	We move the dial here again as we move to insulate portfolios in a mature market. We expect European savers to continue to buy US Treasuries, Gilts providing some support. Repatriation of USD due to tightening credit conditions is likely to support the dollar
Investment Grade Bond	N	We reduce Investment Grade bonds in favour of government bonds. Corporates are still healthy despite signs of growth slowing but feel that government bonds will provide better insulation to portfolios in stressed markets when credit spreads are so tight
High Yield Bond	N	We maintain Neutral exposure. Whilst we can see no signs of increasing default risk the asset class is more equity like in adverse scenarios, so we remain neutral on the asset class, farming yield. USD issues again preferred due to currency hedge and USD strength
Emerging Market Bonds	- -	We move to underweight partly in recognition of 2018 falls, but we are concerned that USD headwind is negative for this asset class. We believe tightening credit environment is a challenge for Emerging Markets which have benefitted from cheap USD liquidity
UK Equity	N	We maintain neutral exposure as, despite small signs of life, estimates of UK economic growth lag other developed markets. The continuing Brexit uncertainty and consequent lack of business investment has damaged UK plc. Relative valuation a small positive
Developed Market Equity	+ +	Global growth seems to be slowing, but the US is the outlier seeming better placed than other developed markets. We maintain our US overweight due to US economy's stronger growth and the comfort that USD exposure vs GBP can hedge against market volatility
Emerging Market Equity	-	Slowing global growth, dollar strength, tightening credit conditions and sentiment led us to move underweight here. The market has rerated but still has some headwinds, so we stay with our current underweight exposure expecting that we will increase in 2019
Commodities	N	We stay neutral here as structural issues in oil market suggest that the energy dominated sector might sustain the basket despite slowing global growth. Lack of infrastructure investment means supply stays constrained supporting the oil price in the short term
UK Commercial Property	+	We maintain Property exposure despite slowdown in UK economy. Property is a valued income source and we hold the asset class over the long term. Managers have reduced exposure to vulnerable London offices as more space becomes available + Brexit fears
Absolute Return	+ +	The mature equity market places greater focus on this basket to reduce correlation, provide diversification and downside protection where fixed interest exposure is more challenging. We expect short, market neutral and macro strategies to diversify risk exposure
Cash	+ +	Cash stays overweight the benchmark as a balancing or risk reducing allocation and also to provide funds to allocate in the event that markets provide a buying opportunity. Market volatility has returned and cash provides a balance if not an uncorrelated return

LOOKING BACK…

Global equities made gains in Q3, primarily due to US market strength as political uncertainty and US/China trade war concerns weighed on other regions. Quality growth strategies outperformed Value over the period. Core government bond yields rose over the quarter despite a bout of safe haven demand in August.

US equities (S&P 500 +7.2%) advanced in Q3 significantly outperforming other major markets and on 22 August the US equity bull market became the longest in history. Strong growth and earnings data overshadowed concerns around the escalating US-China trade war as the US targeted a total of $250 bn of tariffs on Chinese products over the quarter. Growth and employment figures led the Federal Reserve (Fed) to enact its widely anticipated rates increase by 0.25%, reiterating its outlook for further gradual hikes into 2019. September data showed wages to be growing at the fastest rate 2009 and industrial activity indicators show little impact yet from the trade wars.

The FTSE All-Share fell 0.8% amid Brexit uncertainty, a slowing global growth outlook, and trade war escalation. Fears of a "no deal" Brexit weighed on the share prices of many UK domestic companies, driving a poor relative performance from the mid-caps, with the FTSE 250 index (excluding Investment companies) falling by 2.7%. By contrast the near-term economic outlook actually improved, with growth recovering from the Q1 slowdown leading the Bank of England (BoE) to raise rates by 25 basis points to 0.75%. Despite the rate rise, sterling resumed its downward trajectory.

Eurozone gains were modest (FTSE Europe ex UK +1.8) lagging developed market equities as a whole. Banks saw sharp declines amid concerns over exposure to emerging markets (notably Turkey) and worries over the Italian budget deficit proposal, at 2.4% within the EU's 3% threshold but higher than anticipated. Trade worries reduced after Trump and EU President Juncker agreed to work towards zero tariffs on non-auto industrial goods, leaving new car tariffs on hold. Q2 growth was revised up to 0.4%, as leading indicators suggested slower expansion than Q1. September's 2.1% inflation estimate was up from 2.0% in August. The ECB reiterated that rates would remain on hold "at least through the summer of 2019".

Despite trade tensions, Japan ended up (TOPIX +5.0%). The yen weakened vs US$ improving equity market sentiment and quarterly results were broadly in line with expectations. Trade concerns dampened sentiment until the US agreed to defer any decision on auto tariffs until after trade negotiations. Economic growth rebounded strongly from Q1 weakness and inflation strengthened. PM Abe's re-election as leader improved policy visibility for the next 3 years - positive for foreign investors. Abe also made reference to "exit" from the current accommodative monetary policy within his next term in office.

Asia ex Japan equities fell (FTSE Asia ex Japan -1.3%) primarily due to weakness in China and underperformed the World index. China underperformed as the US implemented tariffs and China responded tit for tat on $110 billion of US goods. Meanwhile, Chinese macroeconomic data disappointed and authorities announced a range of targeted economic support measures, including fiscal stimulus, credit easing and the Peoples Bank of China moving to stabilise the renminbi. The Indian market suffered from rupee weakness, rising inflation and concerns over the trade deficit given oil price strength. In Taiwan, semiconductor stocks supported performance, and Malaysia also generated solid gains and outperformed. Elsewhere, Australian equities posted a gain over the quarter in local currency terms, with communications and technology stocks driving returns.

Emerging markets equities lost value in what was a volatile third quarter, with US dollar strength and the trade dispute weighing on risk appetite. The MSCI Emerging Markets index decreased in value and underperformed the MSCI World. Turkey was the weakest index market amid a sharp sell-off in the lira. Conversely, in Thailand financials and energy stocks performed well leading to index outperformance. Despite ongoing risk of new US sanctions, Russian equities also finished ahead of the benchmark, benefiting from crude oil price strength.

Core government bond yields rose over the quarter due to positive economic data, particularly from the US, outweighing August's safe haven demand related to emerging market instability, trade tensions and political issues in Europe. The Fed hiked rates for the third time this year, removing references to "accommodative" policy and striking an optimistic tone. US 10-year yields rose from 2.86% to 3.06%, with Bund and UK gilt 10-year yields rising from 0.30% to 0.47% and 1.42% to 1.57% respectively. Italian 10-year government bond yields rose from 2.68% to 3.15% amid political concerns and the budget deficit proposal.

Corporate bonds saw positive total returns in local currency terms. Global high yield (HY) returned 2.1%, led by a 2.4% return from the US dollar market. Global investment grade (IG) returned 0.6% as US dollar IG rose 1.0%, while the sterling market declined 0.2% and euro IG was flat. Emerging markets debt experienced a tumultuous quarter, largely centred on idiosyncratic factors. Effects were felt most in currency markets, hard currency sovereign and corporate EM bonds made positive returns, but local currency was down. Some of the countries most affected started to take steps to address their problems.

The S&P GSCI Spot Index posted a marginally negative return in Q3 with US dollar strength weighing on prices. Industrial metals were weaker on global trade uncertainty. Copper (-5.5%), nickel (-15.6%) and lead (-15.9%) registered steeper declines. Precious metals weakened with silver and gold down 8.9% and 4.8% respectively. By contrast, the energy segment posted a positive return as Brent crude gained 5.5% and natural gas was up 2.9%. Prices rose amid supply concerns linked to the re-imposition of US sanctions on Iran, the first phase of which took place during the month.

Please Note: All quoted returns are on a price basis in local currency terms.

LOOKING FORWARD…

"We have two kinds of forecasters: those who don't know, and those who don't know they don't know." **- J.K. Galbraith**

On August 22nd we passed the previous record for the longest duration bull market in history as measured by the S&P 500. It is true that records are there to be broken and we still have some way to go before we surpass the return record set by the market ending in March 2000 that was characterised by the The Dot com bubble (that ended well….). But it doesn't take a genius to opine that we are much closer to the end than we are to the beginning.

Our Investment Strategy Committee meeting coincided with the first day of the current market weakness, which as I write sees the S&P 500 having been down as much as 5.5% this week and 7% from its peak on 17th September. In the UK the FTSE 100 is down 4% on the week and 10% from its peak on May 13th. 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. Given how 2017 so clearly bucked that trend it is both unsurprising and to some of the the old soaks in the ISC, quite reassuring that 2018 is reverting more to trend.

Is this the beginning of the end? At the moment we don't think so, rather that this is a correction in a bull market, which is driven by escalating trade tensions and the reduction of monetary policy support. Looking at markets as a whole, we are not seeing a widespread panic and behaviour looks more like position squaring at this juncture. Experience and history suggest that corrections take time to complete and we would favour a scenario where we see further equity weakness over the next few weeks and then some consolidation before the bull market resumes. Seasonal trends suggest this is likely to carry on into year-end as is often the case. Trump's continuing argument with China supports the argument for some further weakness and the Fed's tightening policy will continue unless things get much worse. Rate rise expectations limit the scope for bond yields to rally much if equities fall further.

Of course, we may be wrong and are actually witnessing the beginning of a bear market, but the usual triggers - imminent recession, inverted yield curve, earnings downgrades etc.- are not in evidence and given the recent numbers from the US, even valuation and sentiment can't be said to be unreasonably extended. Declining support from the Fed is a relatively new factor, as QE turns into QT (Quantitative Tightening). The bull market is also very mature by any historical standard which means that we are late in the cycle and the balance of risk versus reward has been deteriorating for some time. We have been advocating an increasingly more cautious stance for a while now, while still trying to keep some skin in the game as we feel it is still too soon to move to a full blown defensive stance.

So, if not now, then when? We feel the biggest threats to the current markets lie a little below the surface and are entwined in politics and the darker reaches of the banking and credit system.

These threats have been in the background for some time, but we feel that they may come to a head in the near future and how they play out may well be determined by the US mid-term election results, at which point we will know what type of government we are dealing with.

At present with Trump in the White House and Brett Kavanaugh about to take up his seat on the Supreme Court, the Republican Party has control of all branches of the Federal government – executive, legislative and judicial. Whilst not unknown it is a relatively rare occurrence in US politics, which if it continues after the mid-terms will give considerable freedom in terms of policy direction. Our concern is that if this continues then politics will have a greater influence on Fed monetary policy than otherwise might be the case.

The problem lies in the management of the balance sheet of the Federal Reserve (Fed). As interest rates rise so does the cost of paying interest on the excess reserves that banks hold with the Fed, this is both a financial and a political issue because more than a third of these reserves are from foreign banks and many Republican politicians don't want to see the US paying money to make foreign banks richer. Fed Chairman Powell is under political pressure to shrink the Fed balance sheet by up to a third. Powell seems to be a more straight line economic thinker than his predecessor and seems to put great faith in output gap analysis which tells him the economy risks overheating. All things being equal this could lead to a further 100 bps of rate rises in the next 12 months. These rises on their own would represent significant tightening but if done in tandem with a dramatic reduction in the Fed balance sheet, would be a dramatic swing from what is still a fairly loose and supportive monetary policy, to full on QT.

We think a move this aggressive is a real risk to the US market and by association the direction of world stock markets. Much of the support to the US stocks has come from buy backs financed from easily available capital which in the scenario detailed above would likely disappear. Further, money spread with largesse around the world following the $300 bn released from the US Treasury's coffers in early 2017 which fuelled the "Trump Trade", would need to be reversed in what is likely to be a disorderly fashion, damaging to EM markets in both debt and equity. Making a market fuelled on liquidity and easy monetary conditions go Cold Turkey might have serious implications for world markets.

Our hope is that the Democrats can ride the wave of disdain following the Kavanaugh nomination and gain a majority in the House of Representatives and this seems to be the consensus. We feel that this is likely to lead to QT through interest rate tightening and a more natural behaviour relating to the Fed balance sheet, which the market could cope with. We remain vigilant and cognisant of the worst-case scenario, which would put more bonds into the market putting upward pressure on yields across both bond and credit markets. Turning off the tap of liquidity that has sustained equity markets for so long, places strain on the continuing performance of companies without the comfort of stock buy backs. We hope for the best, but still make plans for the worst - plus ça change, plus c'est la même chose.