FPWM
TAILORED FINANCIAL SOLUTIONS

QUARTER 1 2019

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 to strong overweight as we continue to look to insulate portfolios in uncertainty. Market dynamics and liquidity conditions favour US Treasuries and selected non-EUR government issues. USD may be softer in Q1 for seasonal liquidity reasons
Investment Grade Bond	N	We stay neutral Investment Grade bonds as we value diversification and Corporates appear healthy despite signs of global growth slowing. Credit spreads are still tight on a historic basis and while trade concerns are still around profit growth is under threat everywhere
High Yield Bond	-	We reduce exposure here to underweight. Whilst we can see no significant signs of increasing default risk the asset class is more equity like in volatile times due to higher credit risk. We are concerned that re-financing becomes more challenging as credit conditions tighten
Emerging Market Bonds	-	Despite the small rebound we stay underweight as we remain concerned that USD headwind is negative for this asset class. We believe tightening credit environment is a challenge for Emerging Markets as beneficiaries of cheap USD liquidity. We are wary of a credit event
UK Equity	N	The continuing Brexit uncertainty and consequent lack of business investment has damaged UK plc. The market's relative valuation still a positive but unlikely to show until Brexit is sorted one way or another. We stay Neutral in a circumstance where there is a binary outcome
Developed Market Equity	+	Global growth is slowing, but still looks likely to continue. Trade wars are making all markets jumpy and creating volatility which we need to get used to. We stay overweight US amid stronger growth and value USD exposure vs GBP as potential volatility hedge
Emerging Market Equity	N	The market has rerated and despite some headwinds, it offers better long-term value than developed markets at this point, so we move to increase exposure due to compelling long-term market valuation. We still stay watchful as EM is very volatile and China a concern
Commodities	N	We stay neutral here as a conclusion to trade wars may lead to a subsequent potential uptick in industrial sentiment and global growth. The potential for a binary outcome in trade situation leads us to stay neutral in this basket which is closely correlated to demand
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 and diversified portfolios to protect against Brexit issues
Absolute Return	+ +	The current market dynamics place even greater focus on this basket to provide diversification, reduce portfolio volatility and provide downside protection. We use a combination of short biased, market neutral and macro strategies to diversify risk exposure here
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 clear buying opportunity. Market volatility has returned and cash provides a balance if not an uncorrelated return

LOOKING BACK…

The fourth quarter of 2018 was a painful one for equity markets, with a background of rising geopolitical concerns - Brexit, Italian politics and the ongoing US/China trade conflict. At the same time investors had to digest the implications of rising US interest rates, a sharp slowdown in eurozone business confidence and weaker Chinese growth, which together proved too much for them to stomach in one go and the FTSE World Index fell -13.16% (-11.34% in GBP). Conversely, government bonds lived up to their traditional defensive role (BofAML US Treasury +1.96%)

The quarter's volatility started with the Federal Reserve (Fed) chairman Powell's comment that the US policy rate was still "a long way" from neutral, and equity markets started to worry about faster-than- expected rate rises selling off through October. November saw a brief bounce, but when US 10-year yields rose above 3.2% for a second time, again equity markets took fright. Equities fell with US government bond prices rising in a classic risk-off trade. In November, Powell moderated his comments saying rates were "just below" the range of estimates for neutral – a more dovish announcement – leading markets to price in a more than 50% probability US interest rates peak at 2.5% in 2019. While the Fed lowered guidance from three to two rate hikes next year this was not what markets had been hoped for given Powell's insistence that the plan to reduce the central bank's balance sheet was essentially on autopilot increasing the tightening bias.

In the UK the FTSE All Share index fell -10.97%. Despite accelerating wage growth rising at the fastest pace since the GFC and 0.6% GDP growth in Q3, the ongoing uncertainty surrounding the Brexit negotiations has weighed on business and consumer confidence, retail sales, house prices, and also the number of house purchases. PM May's Withdrawal Agreement sparked resignations and a vote of confidence in her leadership, leading to concerns about the stability of the government. The vote on the agreement was deferred and will take place in mid-January. Against this background the Bank of England kept rates at 0.75%. Sterling fell again amid the uncertainty, which reduced losses on foreign holdings for UK investors.

Europe also fell with the FTSE World Europe ex UK index returning -11.99%. Worries over rising US interest rates, trade tariffs, slower Chinese growth and Brexit proved a difficult environment for equities. The defensive communication services and utilities sectors were the only sectors to register a positive return. The third quarter earnings season was characterised by sharp share price swings, even in cases where earnings met expectations. Data evidenced slowing momentum in the eurozone economy with the December composite purchasing managers' index showing business activity at the weakest level in over four years. The "gilets jaunes" protests in France and new car demand were significant factors. As expected, the ECB ended its bond-buying programme in December stating that interest rates would remain on hold "at least through the summer of 2019". December also saw the end of Italy's 2019 budget dispute, reducing the deficit but this failed to quell concerns about the health of the country's banks weakening financial stocks.

In Japan the TOPIX fell -17.78% with big falls in October and late December, coinciding with periods of yen strength as the currency was again viewed as a safe-haven at times of increased uncertainty. The Bank of Japan left monetary policy unchanged as expected and economic news was somewhat mixed, strongly influenced by a succession of natural disasters in Japan which caused some slowdown in activity followed by a relatively strong rebound. Away from the spotlight, there have been record levels of share buybacks, as the trend towards better shareholder returns continues.

Asia ex Japan continued its fall (FTSE Asia Pacific ex Japan -10.04%) as trade conflict and the pace of US interest rate hikes dominated sentiment. China's economy recorded its weakest quarterly growth since the GFC as industrial production and retail sales slowed more than expected, heightening growth concerns. Policymakers responded with measures to support the economy, including cutting banks' reserve requirement ratios and boosting credit for small and private companies. Export-oriented markets Taiwan, South Korea and China posted sharp declines.

Similar themes meant Emerging markets lost value (FTSE Emerging -6.72%). Mexico was among the weakest markets as rising concern over the incoming government's policies, drove a sell-off in equities and the peso. Taiwan, South Korea and China all underperformed amid trade uncertainty, disappointing corporate earnings and technology cycle concerns. A sharp fall in crude oil prices was an issue for several oil producing EM, notably Colombia but also Russia. Brazil rose strongly as equities and the real rallied expecting a market-friendly election outcome, confirmed with Bolsonaro's victory in late October. Several markets sensitive to external pressures also posted gains, including Indonesia and India, which benefited from the decline in crude oil prices.

Bond yields fell reflecting increased risk aversion and volatility amid continued uncertainty. Comments from Fed Chair Jerome Powell indicated a slightly dovish shift though the Fed implemented the fourth rate rise of the year in December. US 10-year Treasury yields fell from 3.06% to 2.68%. In Europe, the ECB confirmed it would end its bond purchase programme but downgraded its growth and inflation forecasts for the year. Italian 10-year yields were volatile, but overall fell from 3.15% to 2.74% as the government reached an agreement with the EU on the budget, having reduced its fiscal deficit target to 2.04% from 2.40%. Heightened Brexit uncertainty in the UK meant than Ten-year gilt yields fell from 1.57% to 1.28%.

Corporate bonds struggled underperforming government bonds (Barclays Global Aggregate Corporates -0.81%). Deteriorating risk sentiment led to poor returns across investment grade credit sectors relative to government bonds. High yield was weak (Barclays Glob. High Yield -3.49%), led down by the energy sector, particularly in the US. Emerging markets bonds saw performance improve as the quarter progressed with US dollar strength waning and currencies of oil exporters benefiting from weaker energy prices (JPM GBI Global Composite +2.48%).

Commodities fell sharply (Bloomberg Commodities -9.41%), driven by a large decline in energy as crude oil prices sold off heavily due to a weakening outlook for global demand. Industrial metals were also weaker as Chinese macroeconomic data weighed on demand expectations. Wheat and cotton prices fell but cocoa and sugar recorded positive returns. Precious metals prices posted solid gains as global growth concerns spurred demand for traditionally safe-haven assets.

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

LOOKING FORWARD…

"Money makes the world go around, it makes the world go 'round. A mark, a yen, a buck or a pound is all that makes the world go around." - **Liza Minelli**

The violent market sell-off in the final months of 2018 has cast a shadow over the investment outlook for 2019 and the big question now facing investors is whether the correction has created an attractive entry point for putting money to work, whether we are at the start of a sustained downtrend in risk assets or something in between. Further, as long-term investors and asset allocators we must consider asset valuations not just in terms of the considerable short term noise but also over the long term. To do this we need to look at what is happening in the global economy both above and below the surface. Like an iceberg it may be that what is below the water is more important than what is easily seen above.

We feel that the Global Economy has weakened quite significantly over recent months and while world trade volume trends have softened, they are not yet in full recession territory. Global industrial trends are also weaker, but we doubt that conditions are quite as bad as these subjective confidence indices are suggesting, as there is a clear relationship between equity markets and confidence indices, which tend to take their cue from the recent market performance. This unhealthy relationship, along with a weaker global monetary environment, is likely to continue to restrain risk asset prices in the near term.

We believe that China is at the centre of the global economic slowdown and the Eurozone and UK are now contributing to the malaise. The US picture remains mixed and more challenging to call but even here we can expect slower growth in the first half of 2019. China's authorities remain constrained in terms of their ability to enact any meaningful stimulus by their weak balance of payments position, which probably makes China a weak contributor to global growth in the first half of the year. Whilst the outlook for global growth in 2019 is far from stellar, the real surprise is the extent which deflation seems to have returned to the global goods markets. It may be that due to deflationary pressures, 2019 will not only see weaker global economic growth but also lower nominal growth, which poses a risk to the heavily indebted parts of the world. This scenario seems not to be lost in bond markets and we wonder whether we are moving towards yet another deflationary end to a post-1990s Credit Cycle.

As responsible investors in a mature equity bull market, we are always on the look out for threats to equity market direction and as regular readers will know, for some time we have been commenting on the potential for a large-scale credit event, which we feel has largely been ignored while markets have been in thrall to Trump's stimulative tax policies. This all stems from global corporate and private debt higher than in 2007, prior to the Great Financial Crisis (GFC). This was made greater by a largely unnoticed event in early 2017 when an estimated $300bn was injected into the financial system by clearing the Treasury's coffers into the hands of a few US banks that then lent it out into the global market place. From there it has likely been leveraged many times. This event was QE like in proportion and we believe was the primary reason for the "Trump Trade", which put another shot in the arm of global markets that have been running off easy liquidity since 2009. This has led to a global credit pyramid which is vulnerable to any significant tightening of liquidity that drives the US banks to demand their money back.

As a result of the significant effect that liquidity (in effect, the amount of money available in the global financial system) has on markets, both positively and (more recently) negatively, it is worth looking in some detail at current liquidity trends in the US which as the largest economy, tends to drive trends. We can see that money really does make the world go around……….

In recent weeks some rather strange events occurring within the US system, in that bank asset growth appears to have surged despite an unchanged official policy stance and Quantitative Tightening (QT) operations remaining more or less unchanged. However, the data suggests something is happening that is a little out of the ordinary. We can only engage in informed speculation, but it is possible that, as a result of the Mid-Terms, Government shutdown, and speculation over Trump's impeachment, that large offshore branches of US companies accelerated their repatriation of funds as 2018 ended. We may have seen another +/- $100 billion surge in the repatriation of foreign earnings driving the increase of deposits within the US banking system, which the US banks in turn have then parked money in the US T bill and T bond markets. boosting liquidity in the US system. We are concerned that this movement of money back into dollar deposits in the US has affected the availability of funds to the Euro Dollar Markets, tightening credit conditions in a market that has come to rely on these offshore dollars for funding. Many institutions rely on the flow of funding for their daily operations and any interrupting of this flow has negative consequences. As a result, we are monitoring for signs of stress in French & Italian banks as well as their respective economies.

Another factor that may help to explain the recent strength in US liquidity data is the impact of the government shutdown and the holiday season. In early December, the Fed saw a sharp reduction in its own holdings of bonds, but the data then flattened towards the end of the month – in effect QT was front-loaded in December and absent in late December. Meanwhile, the government shutdown and perhaps seasonal considerations resulted in reduced T bond issuance, so the government had to draw on its General Account' (i.e. its "savings account" at the NY Fed) to fund expenditure. This may have released around $50 billion into the US financial system and whilst clearly a very short term phenomenon, in aggregate the combined effects of the Federal Reserve's QT actions and the pre-shutdown increase in the Treasury's General Account resulted in a >$80 billion decrease in the level of reserves in the US banking system in early December which then reversed and have witnessed close to a 5% annualized rate of expansion in the effective monetary base. Even if the banks only partially reacted to these events, there will still have been some significant swings in the availability of credit within the system – particularly at the very short end of the curve increasing the availability of intra-financial system credit.

Finally, there have been suggestions that savers are moving away from the more esoteric savings vehicles such as crowd-funding, Business Development Corporations and even private equity-like instruments and the share prices of many of these providers have been suffering.

Even the US banks appear to be shunning private sector debt securities at present. It may therefore be that the banks are witnessing portfolio shifts by savers into vanilla FDIC-insured instruments, such as bank deposits.

This view relies to a degree on circumstantial evidence but nevertheless it does seem that the core parts of the US domestic credit and financial system is gaining funds (i.e. banks gaining deposits and investing into the Treasury markets and perhaps loans to blue-chip financial sector borrowers) at the expense of shadow banks, peripheral borrowers and international borrowers of dollars creating a reduction in the availability of credit. Other things being equal, in the very short term this could prove positive for US bonds /US blue chips but less supportive of credit spreads, small companies, illiquid assets and of course dollar-hungry international borrowers.

Looking ahead, and assuming that the Federal Reserve does not abandon its QT and that the government shutdown is resolved at some point this quarter, we can suggest that mainstream as well as peripheral dollar conditions will tighten sharply over the second quarter. This could coincide with further goods price deflation from Asia, the onset of a China 'recession', and problems in the EU caused by slowing economic growth, problems within the banks, auto companies, and of course BREXIT. In that environment, the second quarter would be an interesting one but, until then onshore USD monetary conditions may actually be quite supportive of the US main markets. So, what might happen to balance or reverse the current liquidity squeeze?

Chinese stimulus is one option as seen in 2008-09 and again in 2016, when China eased monetary, fiscal and regulatory policies, helping re-ignite global growth and spark a market rebound. However, a repeat exercise is more difficult now because China is now far more indebted than before, and it may be that China feels less willing to rescue other big economies when its relationship with the world in general, and the US in particular, is so uncertain.

Another possibility is the effective Peace Dividend created by a continued US retreat from its foreign military commitments. Trump ran, and was elected, on a promise to bring troops home, and with the 2020 election looming, he may feel that one path to re-election is to pursue this plan, hence the recently announced US pull-out of Syria and talk of withdrawal from Afghanistan, which led to the resignation of some generals in Trump's cabinet. If Trump's foreign policy moves in this direction, then the cost savings could be significant giving room for more stimulus.

The simplest way out of the liquidity squeeze would be if the Fed relaunched quantitative easing, or at least backs off quantitative tightening. There is even a scenario where it could keep raising interest rates and still allow the government to roll-over its growing debt and even buy new issues, boosting liquidity and growing its balance sheet. The Fed might then not appear to have caved in to political pressure. This is a delicate balancing act which until recently seemed unlikely, but Fed Chairman Powell's latest comments have revived hopes that the "Fed put" still exists, and that action might be closer than we had previously thought possible.

This is a pretty gloomy analysis to this point, but we are trying to identify threats to our client's portfolio returns - looking beneath the surface of the iceberg to try to navigate our way around it.

At the start of 2018, investor complacency made us wary and as contrarians the gloomy consensus prevailing at the start of this year is a more comfortable position. It means that financial markets have adjusted to more fully price in many of the key risks that we have been aware of for some time and this is reflected in asset valuations. Risk assets are now more attractive than they were at the start of 2018, but not outstandingly cheap. We start 2019 at levels where history suggests reasonable medium to long terms returns are likely.

Despite the uncertainties overshadowing the investment outlook for 2019 global macroeconomic fundamentals are by no means disastrous. We expect that growth in the world economy will slow in 2019 with most of the adjustment being due to a deceleration in the US, as the effects of the 2017/18 fiscal stimulus recede and the effects are felt of recent increases in interest rates, bond yields and the US dollar. The subdued inflation outlook in the major economies will keep interest rates low for the foreseeable future and we are broadly in agreement with what is currently indicated by financial markets which indicate policy interest rates in two years' time to be close to zero in the Eurozone and Japan, 1% to 1.25% in the UK and somewhere between 2.5% and 2.75% in the US.

Of course, the timing of the next US recession has become a major debate among investors in recent months, understandably, given the unusual duration of the current US recovery and the tight link between recessions and bear markets. There is as yet no evidence to suggest that a US recession is imminent, and a US soft landing is still a potential scenario for 2019. Looking at key lead indicators of recession, we are particularly interested in labour market data, which have been a reliable warning bell in the past. This data tells us that recessions usually occur about a year after unemployment claims or the unemployment rate turns up. Both are still trending lower.

Another big policy question overshadowing the market outlook is whether international trade tensions will escalate again, threatening global economic confidence and growth. While this topic dominated market sentiment at different times in 2018, it may be that these concerns have already peaked, given that a lot of bad news is now factored in and progress has been made to de-escalate trade tensions in a number of important areas recently, most notably on the US-China front.

If both policy and political uncertainty remain high in 2019, we will all need to learn to cope with the oscillations in investor sentiment that could well be a defining feature of the market environment in 2019. The days of QE-becalmed financial markets are over, volatility is back, and we need to become reacquainted with what has normally been a feature of equity investment. History tells us that double-digit equity market pullbacks have been experienced in the US in roughly two out of every three years since 1928 and pullbacks of 15% or more have been seen about one year in three.

In the UK despite the raging political battles in Parliament and the possibility of real changes to the political system, a No-Deal Brexit now seems the only thing that MPs can agree about, which has calmed UK markets a little. Otherwise, all bets are off and we are left with a version of May's fudge, some Canada/Norway style arrangement or even a 2nd Vote. The Brexit iceberg may not be quite as big as was previously thought and March 29th may not quite hole the UK below the water line.