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 continue with our strong overweight in this asset class as we look to insulate portfolios in uncertainty. Market dynamics and liquidity conditions favour US Treasuries and selected non-EUR government issues. USD should stay steady in Q2 as liquidity tightens
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 stay underweight as global growth slows. 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	-	We stay underweight here as we are concerned that slowing global growth and strong USD is negative for this asset class. We believe a tightening credit environment is a challenge for Emerging Markets that benefitted from USD liquidity. We remain wary of a credit event
UK Equity	N	The continuing Brexit uncertainty and consequent lack of business investment has damaged UK plc. The UK's relative valuation is at a 30 year low, but unlikely to narrow until Brexit is sorted one way or another. We prefer to stay Neutral as we still view this as binary outcome
Developed Market Equity	+	Global growth is slowing, but dovish central banks are supportive of sentiment. Trade wars fears and the knock-on effect on sentiment seems to be reducing. We stay overweight US amid stronger growth and value USD exposure vs GBP as potential volatility hedge
Emerging Market Equity	N	The market has some headwinds but offers better long-term value than developed markets at this point, so on balance we stay with Neutral exposure despite compelling long-term market valuation. We still stay watchful as EM is very volatile and China still a concern
Commodities	N	We stay neutral here as a reduction in trade wars and dovish moves may lead to a 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 which gives valuable income. Property is a long term asset allocation in our portfolios. Our Managers have reduced exposure to vulnerable London offices and diversified portfolios to protect against adverse Brexit scenarios as much as possible
Absolute Return	+ +	The current market dynamics continue to place focus on this basket to provide diversification, reduce portfolio volatility and provide downside protection. We stay with 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 new year has brought with it a new wave of optimism, with equities and credit rallying strongly across the world. The Fed reacted to the markets Q4 malaise and weaker global growth by a more dovish tenor. Market consensus is that the Fed has ended rate rises for the immediate future, indeed, the bond market is now expecting a cut, with 10-year Treasury yields down to 2.4%. The sharp market falls may have also influenced the decision not increase tariffs on China over the quarter thereby reducing two of the drivers that had caused it in the first place.

US equities rose (S&P 500 +13.07%) with January particularly strong with increasingly dovish Fed commentary, the end of the government shutdown and signs of progress in US-China trade war. The Fed softened through the quarter as economic indicators reflected slower economic growth - Q4 GDP adjusted downwards to 2.2% from 2.6%. By March end markets advanced more cautiously as investors considered what the Fed's stance implied for economic growth, lowering its projections for US growth and inflation, and reducing expectations for interest rates hikes. The "dot plot" showing no rate hikes this year and only one in 2020. The adjusted outlook caused the Treasury yield curve to invert with short term rates higher than longer term rates - historically associated with a coming recession.

Eurozone equities also recovered well as central banks moved away from tighter monetary policy, despite lingering worries about economic growth in the region (FTSE Europe ex UK +11.75%). There was also optimism over global trade as the US suspended planned tariffs hikes on Chinese goods. The European Central Bank (ECB) said rates would remain at current levels at least until the end of the year, having previously indicated no move until the end of summer. The eurozone economy grew by just 0.2% in Q4 2018. Germany saw zero growth and Italy slipped into recession. Forward-looking data points to weakness as manufacturing Purchasing Managers Index (PMI) dipped to 47.6 in March - a reading below 50 indicating contraction.

UK equities rallied over the period in line with global equities (FTSE All Share +8.25%). Defensive sectors initially did well and later in the quarter domestically-focused areas bounced back strongly following the delay to Brexit beyond March 2019, increasing hopes that a disorderly exit from the EU could be avoided. UK employment growth remained robust and nominal wages continued to pick bucking a wider slowdown in the economy and inflation was muted. The UK economy slowed Q4 2018 as Brexit uncertainty weighed on business investment. GDP growth decelerated to 0.2% in Q4 as the UK economy grew at 1.4% in 2018, the lowest rate for several years. The OECD predicted UK economic growth would decelerate to 0.8% in 2019 (assuming an orderly Brexit) while the Bank of England cut its 2019 GDP growth projection from 1.7% to 1.2%.

Japanese shares gained but lagged other developed markets (TOPIX +6.53%). Bouts of volatility after the inversion of the US yield curve and the likelihood of a lower global interest rate environment sparked a renewed preference for stable equities. The corporate results season ended with real earnings surprises marginally skewed to the downside driven by the sharper-than-expected global slowdown, especially in China. Share price reactions were muted, suggesting this was discounted in stock prices. Headline inflation was slightly ahead of forecasts with a range of categories seeing some increase in prices. The Bank of Japan's quarterly Tankan survey showed that conditions for large manufacturers have deteriorated - largely due to the global backdrop.

Asia ex Japan equities rebounded strongly (FTSE Asia Pacific ex Japan +10.59%) though lagging the FTSE World index. All markets in the region closed higher, helped by progress in US-China trade negotiations and the dovish tone of major central banks, but global growth concerns remained a drag. China's economy grew at its weakest pace since 1990 and January-February data pointed to a continued slowdown leading the Chinese government to lower its growth target to 6-6.5%, outline higher public spending and tax cuts, while the central bank eased financial conditions by cutting the reserve requirement ratios for banks. China and Hong Kong fared best with Chinese stocks buoyed by index provider MSCI's move to increase the weighting of China-listed shares in its benchmark indices and the expectation that Chinese authorities would continue to introduce supportive policies to counter the economic slowdown.

Emerging markets equities posted a strong return in Q1 (FTSE Emerging +9.81%) led by China but underperformed the FTSE World. Optimism over a trade agreement with the US and ongoing government support for the Chinese domestic economy were beneficial. A rally in the price of crude oil was beneficial for net exporter countries such as Russia and Colombia. Turkish equities declined, and the lira lost value as the government's unorthodox policy response to the country's economic problems continued.

The Bloomberg commodity Index rose +6.32% in Q1 with Energy leading the way as crude oil prices rebounded from a sell-off in Q4. Production cuts from OPEC and other oil producers, together with the implementation of US sanctions on Venezuela, served to tighten supply. The industrial metals component also moved higher amid positive signs emanating from US-China trade talks. By contrast, precious metals recorded a modest gain, supported by a small rise in gold prices.

In bond markets, the dovish moves from major central banks proved particularly significant (FTSE WorldBIG Domestic Sovereign +2.33%) with the heads of both the Fed and the ECB indicating rates would not rise in 2019. Growth and inflation forecasts were also lowered. US 10-year Treasury yields fell reaching their lowest level since late 2017. The 3-month Treasury bill yield rose higher than that of 10-year bonds in March, in a sign of growing caution among investors over economic growth. In Europe, 10-year German Bund yields moved more than 30bps lower, falling below zero toward the end of March for the first time since October 2016. 10-year UK Gilt yields fell to 1.06 having started 2019 at 1.31 reflecting stable interest rate expectations from the BoE.

Corporate bonds had a strong quarter, retracing the weakness experienced in Q4 2018 (Barclays Global Aggregate Corporates +4.15%). High yield credit outperformed investment grade (Barclays Global High Yield +6.33%), with both outperforming government bond markets over Q1. Emerging market (EM) bonds had a positive quarter with US dollar-denominated debt outperforming local currency bonds as certain EM currencies weakened.

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

LOOKING FORWARD…

"Risk means more things can happen than will happen." – **Howard Marks**

Regular readers will be familiar with our monitoring of financial liquidity trends and their strong correlation with markets in the post Global Financial Crisis Quantitative Easing/Tightening (QE/QT) world that we live and invest in. As expected, the US Treasury has continued to run down its General Account at the Federal Reserve and this has provided a very significant boost to liquidity. Indeed, driven by the law surrounding the maximum allowable level of cash balances, the Treasury released some $150bn into the financial system over a 10-day period, which was recycled and leveraged, providing a tailwind for markets in early Q1. However, at the same time, the Fed upped the pace of its QT and the December–January boom in corporate repatriation, seemingly driven by fears of Trump's impeachment, appears to be winding down. Hence, the liquidity data is not quite as strong as we might have expected given the extent of the release of funds by the Treasury.

In April we expect that the US Treasury will reverse the funds flow and, given the Fed's more aggressive QT over recent weeks, we could well find that the monetary base becomes quite small at that time, with a predictable impact on overall liquidity trends. Q2 may yet see tight liquidity, upward pressure on bond yields and the USD; and headwinds for the EM markets. We may also witness pressure on credit spreads. Those countries that rely on cheap dollar funding – the EM, Australasia and even parts of Europe - can expect to see downward pressure on their currencies in Q2, particularly as their own central banks look to ease in response to the global slowdown.

It is clear that the global economy is suffering an increase in savings over investment, which is usually a deflationary event leading to negligible global GDP growth mid-year. We expect to see negative earnings surprises as global corporate earnings contract. In response to this Global Recession / Near Recession we expect the FOMC to halt its Quantitative Tightening mid-year, and to reduce interest rates in the second half of 2019. However, in the near term, the risk is that they may be slow to act having been surprised by the suddenness of the global slowdown that it clearly was not expecting. We feel that this is clearly the impact of the excessive speed of QT, which was driven by inter-personal factors within the Bank.

In Europe, the reduction in stimulus from trade is reducing income growth at the same time that a combination of demographics (ageing population) and politics (Brexit) are forcing savings rates higher. Years of lending to the peripheral European states to prop up their economies has left the core Europe nations carrying massive peripheral risk. The TARGET2 (non!) settlement system has held the EUR together as no one will willingly risk a settlement date lest the house of cards comes tumbling down. This uneasy position gives Italy freedom to ease fiscal policy as deflation reasserts itself despite serious friction from its European partners at Italy's projected budget deficit. France embarked on a massive credit boom in 2017-18 – basically being responsible for nearly all of the European credit growth in that period - and was able to hide its deficit problems last year by borrowing USD. However, in a tightening liquidity environment will that be able to continue? We are wondering how long Germany will continue to support the poor fiscal habits of others.

We believe that the driving force behind the ECB's long-term refinancing operations has been to prop up the French banks who used USD to fund the credit growth. Increasingly, the reality seems to be that Germany and the Netherlands are financing the rest of Europe and we wonder when Germany could become a more reluctant lender given its own demographics & needs? Germany needs higher rates as its ageing population of savers needs to generate a positive return on their deposits, but can the ECB & Europe's indebted states afford to pay interest on those higher rates?

We have seen a sharp change in Germany's Savings – Investment balance which historically have destabilized the EMS (1990s) / EUR (2010-11). This is driven by uncertainty but more importantly the increase in the dependency ratio (ratio of workers to the retired). This is only going to get worse as 15% of Germans are retiring in the next ten years and they need a return on their savings if they are going to be able to live comfortably in retirement. Clearly negative interest rates are unacceptable to Germany in the long term, but the ECB can be expected to provide more EUR-weakening loans to the European banks, while keeping interest rates at current levels, increasing the parallels to the Japanese and their lost generation.

Meanwhile, the UK economy has neither imploded nor soared in the post referendum period. Since the vote, the UK's real GDP has increased by 4.3%, a relatively modest and uninspiring amount that is slightly less than the 5% growth witnessed in the EZ as a whole (although the UK's performance is comfortably ahead of Italy, a fraction better than Germany, and only just behind France despite the latter's 2017-18 credit boom).

Post the Referendum, foreign investors have acquired around £10 billion in sterling bank deposits, £295 billion of assorted sterling-denominated bonds, £6 billion of UK equities and £253 billion of direct investments (likely heavily weighted to the property market) suggesting that either foreign investors don't believe that Brexit will occur, or that if it does the UK will retain its credit rating.

We are concerned about the UK's low productivity growth trends and high debt levels, but in the near term our focus is on the low savings rate and persistent current account deficit. At the moment the UK's current account deficit is running at around £80 billion per annum – effectively spending more than it earns. If the UK had not attracted the necessary level of (net) capital inflows to cover a still large current account deficit, then we expect that sterling would have declined to a point where it achieved an equilibrium that would encourage exports and make imports prohibitively expensive to a population experiencing a decline in its real incomes. Movements in sterling's exchange rate materially affect the rate of inflation in the UK and declines in sterling tend to result in pressure on the level of household real incomes.

At the time of writing, PM May has been provided with an exit day of the 31st October by EU leaders, placing further pressure on her tenure from within the Conservative Party. The potential outcomes of any agreement are myriad and predicting the effect on the UK economy is impossible, ranging from a balance of payment crisis as the capital flow reverses, to a softer Brexit in name only, where the current account deficit remains funded by capital inflows and very little actually changes from an economic perspective.

As we are witnessing every day in the media, Brexit has created the potential for a possibly quite violent shift away from the type of centre-ground PR- and sound-bite-driven politics and policies that has been the landscape since mid-1990s. As in the USA, politics and policy look set to shift either right or left, but it seems that change is coming, one way or another and Brexit is at its heart simply one manifestation of this new era.

The Bank of Japan is unlikely to move policy and seems happy as it is having been here before. Japan's economy is cooling along with global trade but the BoJ is accepting of the situation. Sources in the bank say that staff 'never wanted' inflation and are happy to let QE 'run off'. Their only regret is not raising rates last year. As a result, Japan may enter a technical recession and still struggles to break out of its demographic straitjacket.

China's growth into the second largest economy in the world has seen it drive global GDP growth until relatively recently. Despite rumours to the contrary, there is little evidence that there has been a shock and awe policy response from China to its slowdown. Whilst the inclusion of Chinese bonds in indices created inflows which seem to have been used to increase funding in the domestic banking system, we find that policy conditions are still tight and that the boom in the equity market is likely to have been part of the population's ongoing search for an alternative store of value to RMB deposits. Ultimately, China will ease, but at present its balance of payments is too weak to allow it the necessary freedom of movement. It can move after the US does, but not before, for fear of a currency devaluation. The easing which we expect from the major central banks should be core fixed income friendly in the first half of 2019, although the growth slowdown may pressure credit spreads in the USA & Eurozone.

Investors have spent years looking for the 'end of the cycle' and the global expansion is now the longest in modern history, set to break records in the United States and running even longer in China, India and Australia. So what signals are out there to help us?

The persistent flattening in the US yield curve (a measure of the bond market's interest rate expectations) has been weighing on investors' minds, with the curve inverting (fleetingly) at the end of March. US yield curve inversion (short term rates being higher than long term rates) is usually followed by recession, typically within two years. Meanwhile, a range of other macro indicators is also causing varying degrees of anxiety. Global industrial demand has slumped, capex has slowed, unemployment in some countries has hit previous cyclical lows and there are signs of fatigue in the credit cycle, with wider spreads and stricter lending standards. Yet the problem with calling the 'end of the cycle' is that none of these warning signs is particularly definitive.

So why does the bond market appear to suggest that the probability of a US recession is significant and rising? One possibility is that there are distortions in bond markets that are influencing the yield curve signal (in this instance the effect of QE?). But history argues against this interpretation being exactly what the authorities have always argued in the past – usually erroneously. Perhaps the more important point is that the US curve only inverted for a few days and it is persistent inversion that provides the more reliable signal.

The one time the yield curve previously provided a false recession signal, after the collapse of LTCM in 1998, the inversion only lasted three days. But the other thing to remember about yield inversion is that it can tell us nothing about what is likely to happen to asset returns over the next two years. The lag between inversion and recession is long and variable and stock markets can either plunge, rise significantly or move broadly sideways. If you are an investor with a 1-2 year investment horizon, it is not clear the yield curve tells you anything particularly valuable.

The best we can say about the recent inversion of the yield curve is that it suggests there is a chance of US recession in the next couple of years and most economists agree. A Wall Street Journal survey showed 90% of economists thought there would be a major US downturn by the end of 2021 and the average forecast was 2020. But how useful are these recession warnings? A cynic might suggest that Economists always predict a downturn is at least 18 months away and they have a nasty habit of pushing back these warnings rather than rethinking their analysis. Including a recession warning in your forecast might be a way to hedge your bets. What is not clear is whether such projections are useful for making investment decisions.

Right now, markets are reminding us of the 1998 'false' US yield inversion, when Central bank stimulus helped prevent recession in 1998, triggering a two year 'melt-up' in risk assets. Ultimately, disappointing earnings meant the resulting stock-market bubble was unsustainable and here in 2019 we feel that the direction of markets after the strong bounce back in Q1 is similarly tied into corporate profits. It is difficult to see significant progress from current market levels without profit growth - again likely to play a decisive role in determining how long the current cycle lasts.

Equity markets seem likely to oscillate between risk on and risk off but ultimately their trend performance will be hampered by the global economy's apparent failure to sustain even moderate rates of nominal GDP growth. Japan's lost generation may yet become a template for us all.

If the US avoids recession in 2019 through Fed action, what does that mean for markets? The economic cycle may well grind on slowly as a result, pushing out the next recession to 2020 or 2021. However, if recent experience repeats and as a result of the "Powell Put" we see a 1998-2000 style bubble in asset prices, this could be dangerous as current macro fundamentals wouldn't justify it. However, with a more cautious response in markets and no 'melt-up', perhaps the longest economic expansion in history could continue to defy the pessimists' expectations and grind on for a while longer yet.

Our response to the current scenario is to stay true to our investing principles and continue to try to insulate portfolios through a combination of different factors. We see no compelling reason to make big bets anywhere within the asset allocation framework as many of the outcomes are quite binary and therefore remaining largely neutral is the sensible option. That said, we are looking to gain some protection for worst case outcomes through a combination of those assets that benefit in times of real market stress – Government bonds and the USD. We take comfort from the defensive nature of our asset allocation framework and the historically superior risk return profiles of our favoured active managers.