

## 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
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Please contact us if you require further information.

ASSET CLASS	TACTICAL POSITION	COMMENTARY
Global Government Bond	+ +	Remain strong overweight in this asset class despite strong rallies as we look to insulate portfolios in uncertainty. Market dynamics and liquidity conditions favour US Treasuries and some non-EUR government issues. USD should stay strong in H2 2019 as liquidity tightens
Investment Grade Bond	N	We take a neutral view on IG bonds. This is a nuanced view, however, and we remain focused on high-quality and keep our US dollar denominated exposure where possible. We remain wary of liquidity concerns and the indexes historically large percentage of BBB ratings.
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	Brexit headwinds remain and with the next Prime Minister likely to pursue a hard-line Brexit strategy, the outlook remains precariously unclear. Valuations are attractive, but we do not believe in taking a strong view given this backdrop. Sterling may weaken further yet
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 reduced but Trump is difficult to predict. We favour the dynamic US economy 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. USD and China are key factors here
Commodities	N	We stay neutral here as any real reduction in trade wars and dovish moves may lead to a potential uptick in sentiment on stimulus. The still uncertain outcome in trade situation and slowing growth 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 whilst diversifying 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 expected to year end and cash provides a balance if not an uncorrelated return

**Please Note:** The views expressed are those of the Investment Strategy Committee. They should not be taken as a personal recommendation to invest or refrain from investing.

Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and can fall as well as rise due to stock market and currency movements.

## LOOKING BACK...

Developed equity markets gained in Q2 despite a steep fall in May due to concerns over the US-China trade war. Stock markets were supported by an expectation of increasingly accommodative central banks and, by the end of the quarter, hopes of progress in trade tensions. Whilst the Federal Reserve (Fed) didn't cut interest rates in June, it indicated that there may be rate cuts ahead. Government, corporate, high yield and emerging market bond markets were also positive.

US shares gained in Q2 with the S&P 500 (+3.79%) setting a new record high despite a mid-quarter market wobble due to trade war worries. Investors were buoyed by Fed dovishness and hopes of progress in trade tensions in June on signs of progress in talks with China. Economic data was mixed: Q1 US GDP, grew, unemployment remained stable at 3.6% (a 49-year low) and average hourly earnings climbed 3.1% from a year earlier. However, consumer and business confidence indices weakened, suggesting that business activity is slowing. The Fed "dot plot" - showing where policymakers think rates will be in the future - signals easier policy ahead. More cyclical areas of the market generally performed strongly with Financials, materials and IT all strong. More defensive (less cyclical) areas made modest gains. Energy stocks largely declined.

Eurozone shares rose (FTSE World Europe ex UK +2.54%) despite its own mid-quarter wobble. IT, consumer discretionary and industrials led the way, whilst more trade-exposed areas of the market such as semiconductors and car makers were affected by trade tensions, which eased in June. Economic signs were muted with Q1 GDP growth confirmed at 0.4% quarter-on-quarter and June inflation stable. The forward-looking purchasing managers' index (PMI) reached a seven-month high of 52.1 in June (indicating improving conditions), however, the manufacturing portion of the index remained at a level that indicates it is shrinking. European Central Bank President Mario Draghi hinted that further monetary policy easing, such as new bond purchases, could be on the way if the eurozone inflation outlook fails to improve.

UK shares rose (FTSE All Share +1.98%), despite ongoing Brexit-related uncertainty increased by PM Theresa May's resignation. Her successor will be either Boris Johnson and Jeremy Hunt, both banging the Brexit drum loudly to garner support from the Leave leaning Conservative party membership. Stocks perceived to offer superior and defensible earnings growth extended their YTD outperformance. Conversely, domestically-focused sectors underperformed amid renewed Brexit and political uncertainty. The negative impact of the original 31 March Article 50 deadline became clearer, as, the Office for National Statistics (ONS) revealed that the economy shrank by a higher than forecast 0.4% in April driven by a sharp fall in car production related to Brexit uncertainty. The ONS also reported widespread weakness across manufacturing, as the boost from the early completion of orders ahead of March 31<sup>st</sup> faded in April. The UK manufacturing PMI for May slipped below 50 (indicating contraction) for the first time since July 2016.

Japanese shares (TOPIX -2.54%) underperformed other major developed markets. The yen strengthened, partly as a result of its reputation as a safe haven at times of geopolitical risk, and also due to changing interest rate expectations for the US. The market was dominated by the continued escalation of trade issues, and the repercussions throughout global supply chains.

The US campaign against Huawei is impacting Japanese electronic component suppliers exacerbating the reaction to a slowdown in corporate earnings growth, seen in fiscal year final quarter results. While Japan's GDP grew 2.1% annualised (consensus was for a decline), the detailed breakdown was not particularly encouraging. In the short-term Japan is likely to avoid a technical recession allowing the Bank of Japan to leave monetary policy unchanged.

In Asia (FTSE Asia Pacific ex Japan +0.06%), markets performance was mixed as trade tensions and economic risks played on the minds of investors especially relating to China. As a result, ASEAN (Association of Southeast Asian Nations) stocks outperformed with Thailand and Singapore notching the biggest gains. Hong Kong benefited from the rally in financials stocks, while investors also cheered the suspension of a contentious extradition bill. Indian stocks rose slightly as Prime Minister Modi's Party was re-elected with a stronger mandate. Separately, the central bank cut its benchmark interest rate twice to spur growth.

Emerging markets (FTSE Emerging -0.46%) lagged their developed market counterparts as trade uncertainty weighed on Chinese and South Korean stocks. Those markets most sensitive to changes in global liquidity performed well. In Argentina, the leading presidential candidates appeared to adopt a more centrist stance boosting sentiment. In South Africa, the re-election of the African National Congress Party was positive, despite a decrease in the size of its majority. Russia also performed better than the average as state-controlled oil company Gazprom rallied strongly and the Russian central bank cut interest rates by 25 basis points (bps) and signalled potential for further easing this year. China and South Korea fell, impacted by global trade uncertainty, further tariffs and the attack on Huawei. The pause in the trade war and relaxation of export controls against Huawei agreed at the G20 Osaka summit were a relief but failed to lift these markets into positive territory before the end of the quarter.

In commodities, the Bloomberg Commodity Index fell 2.57%, amid increased concerns over the outlook for global growth. Industrial metals recorded the steepest falls, with zinc down 14.5% and copper losing 7.8%. Energy was also down, (Brent crude -4.5%) despite rising geopolitical tensions in the Gulf. Soft commodities fell but precious metals recorded gains, led by gold (+9.1%).

In government bond markets expectations continuing loose monetary policy and US rate cuts was a positive, with yields falling (FTSE WorldBIG Domestic Sovereign +2.66%). Comments from the Fed and ECB confirmed the growing dovishness among policymakers, with both clearing the way for further policy measures if needed. The 10-year US Treasury yield fell 40 bps, 10-year German Bund fell 25bps to -0.33%. The Spanish 10-year yield fell 65bps post the April general election which removed political uncertainty. The UK 10-year yield underperformed, as the yield rose in April following the extended Brexit deadline and March (later reversed in April).

Corporate bond markets were strong (Barclays Global Aggregate Corporates +3.93%) outperforming government bonds and High Yield (Barclays Global High Yield +2.97%). Emerging market bonds had a positive quarter (JPM GBI-EM Global Composite +5.82%) with EM debt denominated in local currencies performing particularly well as the US dollar weakened in June.

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

## LOOKING FORWARD...

*“Uncertainty is an uncomfortable position, but certainty is an absurd one.” – Voltaire*

This quote is on the wall in our office as a reminder that our job is to make good decisions in a climate of uncertainty. Investment markets are always uncertain, indeed if the consensus seems to be in only one direction then we get very nervous and wonder whether we just aren't looking hard enough. We are helped greatly in our decision making by the analysis of our economist on the ISC, Andrew Hunt, whose forensic analysis of economic statistics helps us see beneath the bonnet of metrics that others can paint as one dimensional. By trying to understand the underlying drivers of key economic data Andrew is invaluable in helping us to position to protect portfolios.

Andrew's detailed analysis has meant that we hold a non-consensus view of US growth, believing it to be weaker than other commentators and recent data suggests that the global slowdown now includes the USA. Global airfreight volumes fell by 3.4% in the year to May led by weakness amongst the Asian & Middle East carriers, but US air-freight data has lost virtually all of its previous momentum, suggesting that the global trade recession has started to impact the US.

Despite our non-consensus view we have been surprised by the weakness that has been emerging within much of the US shipments and transport sector data over the last quarter. This is seen in port and road freight micro data. The Port of Long Beach reported a 14% decline in inbound container traffic and a similarly weak rate of outbound traffic and the number of empty containers in the Port has hit an all-time high. The volume of freight being carried by trucks in the USA since the first quarter has fallen dramatically with some of the trucking sector commentary describing a 'bloodbath' in the industry, particularly in the NE of the country. The volume of spare capacity is higher and a number of companies within the sector have reported poor figures. In addition, the volume of heavy truck inventories has increased as sales growth in the sector has evaporated.

The decline in the US domestic freight data is clearly a worrying sign when combined with the recent increase in inventories that has been seen. In short, if the US is not transporting or selling as much as it has been then it suggests that the US economy has joined the global slowdown. The data is particularly significant given that the Federal Reserve Bank is known to pay close attention to this type of input, supporting the case for rate cuts and maybe even cutting faster than expected.

Outside the USA Global Industrial Production (ex-China) deteriorated further in May. and has been in negative territory since October last year, thereby confirming the existence of a 'production recession' in the ex-China global data. If we add China to the data, then the picture changes and there is no global industrial production recession. At the risk of sounding like a conspiracy theorist, can we trust the official Chinese data? Andrew produces his own proprietary bottom-up data series for Chinese production which is somewhat different to the official line and when this data is added it suggests that there is indeed a global industrial production recession. His bottom up analysis is more consistent with the various global confidence / PMI / trade surveys and suggests that China's data may be creating a forecasting error within the global system which has contributed to the recent chronic build-up of inventories within the global economy.

Industrial production is only part of the elements that make up the global economy and other areas such as the consumer and service sectors are significant contributors, especially so in western developed countries. Nevertheless, we believe that Global nominal GDP growth (measured in US\$ not allowing for Purchasing Power Parity) is close to zero year on year while the global wage bill has increased by 2%, illustrating that the weakness in global economy has been concentrated in investment and manufacturing rather than consumption and services. If this is correct, then global profits in USD have declined by 4-5% over the last 12 months, not that the equity markets seem to have noticed or indeed cared.....

If as we believe, nominal wage data is beginning to weaken, it is reasonable to expect companies will be acting to reduce their wage costs further, putting labour markets and wage incomes under pressure over the coming quarters. This could lead the global consumer and service sectors to join the economic slowdown.

This lack of nominal income growth in the global system has potential implications for debt sustainability in both the public and private sectors. The sensitivity of government finances to weak growth is seen in Japan and countries with high debt burdens will feel pressure to act, either through austerity or further QE like experiments. Nevertheless, we feel that it is the private sector that is the more likely to be a concern for financial markets in the months ahead.

In the world of economics, the Triffin Paradox is a well-known theory that suggests that the supplier of the World's Reserve currency has to grow its external liabilities at a reasonable rate in order to facilitate global trade and economic growth. In short, it suggests that to allow the global system to function efficiently, the US as provider of the Global Reserve Currency (the US dollar) needs to supply enough USD liquidity to the World so that the global economy can expand.

However, this international "duty" may not sit well with the Trump administration and its America First policy. There are whispers of the US regulators showing a less than accommodating stance to lending by US institutions to certain parts of the World, and there is also an increasing amount of supporting evidence from the monetary, balance of payments, banking system data, and the Flow of Funds data that the supply of dollars to the world from the US is starting to become tighter. When we add in the seeming lower appetite amongst US investors to buy foreign assets, it does seem that the US may now be keeping hold of more of its own currency and running an underlying basic balance surplus. The result of these factors is that we can certainly see that the supply of dollars to the World from the combination of the US current account deficit and US resident purchases of assets abroad has begun to reduce, which has wider implications than just in the US, which we will attempt to illustrate in the remainder of this commentary.

During the 2017 credit boom, we estimate that the global private sector incurred a further \$8 trillion in new bank credit and at least \$2-3 trillion in capital market debt. A large proportion was either directly dollar denominated or ultimately funded from USD wholesale funding (banks borrowing from other financial institutions or government). One unusual feature of this credit boom was the extent to which it was led by banks in the EM and EZ borrowing USD through the wholesale money markets to finance loan growth in their domestic currencies.

In particular, the French, German, Japanese and many EM banking systems incurred a very significant increase in their dollar liabilities; and the latest data suggests that the French banks are still mining dollars to fund their asset growth. Our conclusion is that much of the world is short of USD and in some countries (most notably China), this has already become a significant constraint on their financial systems.

Despite the hard work done by the Bank of International Settlement (BIS) it is still not clear just how much new debt was created in 2017-18 and how much of it was essentially dollar denominated, but we estimate that total credit growth was around 15% of global GDP in 2017 and that a larger proportion than usual of this debt was ultimately funded from dollars. Setting aside the thought that these numbers suggest an incremental debt to output ratio of about 1.5 times which is not an impressive use of the debt raised, a combination of the factors discussed earlier suggests that the world as a whole may now be short of dollars. If we are correct, then we can assume that the recent slowdown/contraction in dollar-denominated income growth will have been uncomfortable for those debtors that have incurred larger dollar liabilities. Consequently, we are prepared for the fact that credit spreads amongst the more vulnerable companies and countries may widen over the remainder of the year, even in the context of a world that still seems intent on chasing yield wherever possible.

If we consider the trade war in the context of the inexorable rise of China over the last 30 years, we should not be surprised that Americans (and their President) are worried about their place in the world. The US emerged from the Great Financial Crisis better than most but has endured a tepid recovery, two decades of no wage growth, and at the same time is aware of a constant stream of news coming from rising China, a nation of 1.3 billion people with seemingly limitless potential. By any measure, America's relative power is in decline and in the context of the broad sweep of world history, we are reverting to an established pattern.

Historically, economic power, has been driven by demographics. Up until about 300 years ago, economies across the world were mainly agricultural, with most of the value produced from the land. Therefore, the leading economies had the largest populations and controlled the most land. This is evidenced by the Song Dynasty in China and the Mughal Empire in India. Industrialization is a very recent phenomenon and it was the British Empire that subverted the long-term trend because of the industrial revolution, which enabled it to smash through the growth ceiling that agricultural economies faced. Economic dominance was at its most extreme post World War II when at its peak the US was responsible for as much as 50% of global output, partly due to the devastation of industrial production in Europe and Asia. Since that time, America's relative power has been on the decline, not because of slow growth at home, but because the rest of the world is catching up. This follows a broad historical pattern, linked to demographics – if you have a population vastly higher than others you have an economic advantage even though your workers might be less productive. Increased globalisation has exacerbated this trend as economic and technological revolutions occur in one part of the world, and then spread quickly elsewhere.

The main limiting factor to China's reclaiming world economic dominance was technological knowhow and years of being a global manufacturing hub have allowed them to examine technology first-hand and now they are the equal of the west. We suspect that this is the background to the US attack on Huawei – an attempt to maintain some sort of technological advantage – but in reality, that horse has probably bolted. Nevertheless, the US as the provider of the world's reserve currency has other tools in its armoury with which it can conduct its economic war.

Whilst post G20 noise from the Trump and Xi camps seems more conciliatory and positive, we suspect that the Trump Administration may be moving the 'Trade War' into the Capital Account where the US has more power and hence more chance of achieving its geopolitical aims. Our data suggests that by restricting the flow of USD which is so essential for global growth, the World's supplier of the Reserve Currency is beginning to become less generous at a time when the rest of the world (especially China) may already be quite short dollars and requiring dollar liquidity.

We are therefore moving towards a more medium-term positive outlook on the US dollar, even as we expect the FOMC to reduce interest rates. In fact, in a continuation of the liquidity theme that we have touched on many times in these commentaries, we suspect that the 'dollar shortage' may become more pressing later in the year as the Treasury again has to replenish its reserves and play 'catch up' with regard to its bond issuance.

The US Treasury issues bonds to raise the money to run the US government and for much of this year, the Treasury has systematically under-issued bonds relative to the deficit and used its 'cash reserves' (held in the Treasury General Account at the NY Federal Reserve Bank) instead of more debt. As we saw in 2017, this activity tends to inflate the monetary base, increasing the amount of liquidity in the financial system (and the amount of USD available) and it is clear that so far this year the US monetary base has enjoyed periods of growth and that the US commercial banking system has been able to provide significantly more credit to the financial markets. We believe that it has been this 'flow of funds factor' that has allowed the equity market to perform well despite the weak earnings environment that we noted earlier.

If as we believe the US Debt Ceiling and Budget Processes can be resolved over the coming weeks, we would anticipate that the Treasury Department will start playing catch up regarding its debt issuance and start rebuilding its own cash reserves in the fourth quarter. We expect that this may well lead to a sharp contraction in liquidity growth of the type that was witnessed in April 2018 and early December 2018. Clearly, such an event will also make any dollar shortage within the global system even more acute and the knock-on effect of this might be that global markets and even the Teflon US equity market may be obliged to take notice of the weakening liquidity situation.

The bond market is gloomy about the economy, US equities are banking on Fed easing and positive news in US-China trade. We are concerned this may be too optimistic on both counts and that restrictions in dollar liquidity might be a stronger influence on market direction in the second half of 2019. Whether action from governments and Central Bankers provides sufficient support for markets to grind on remains to be seen. We stay relatively neutral overall – always wary of binary outcomes at times such as these.