FPWM
TAILORED FINANCIAL SOLUTIONS

QUARTER 4 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	+ +	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 and some non-EUR government issues. USD direction vs Sterling is less certain now No-Deal very unlikely
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 still slightly favour US and UK exposure where possible. We remain wary of liquidity concerns and the index is at a historic high of BBB rated issues adding risk
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 if 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…

After a difficult summer for risk assets, investors returned from their holidays in a bullish mood driving equity markets higher in September, leaving global equities broadly flat for a quarter marked by a continued global economic slowdown data, offset by easing from the US and Europe.

US equities made modest gains in Q3, (S&P 500 + 1.19%) despite ongoing growth concerns and uncertainty surrounding US-China trade. Growth concerns were most pronounced in August, when the Federal Reserve's (Fed) communications about its policy response underwhelmed investors. The Fed cut rates by 25 basis points in July and again in September but has not confirmed a more extended easing cycle. Despite some periods of optimism, there are no concrete solutions to the ongoing US-China dispute and to increase nervousness there was increasing speculation over possible impeachment proceedings for President Trump. US economic data continued to moderate without any big surprises. Unemployment remains at 3.7%, August wage growth was stronger than anticipated, non-farm hires were lower than expectations and consumer confidence weakened (August Conference Board consumer confidence index fell to 125.1 from 134.2). The slowing bias in the data led to the Fed's rate cuts in an attempt to prolong the economic expansion.

Eurozone shares made gains in the quarter (FTSE Europe ex UK + 2.16%), with utilities, real estate and consumer staples leading. September's market rotation saw previously out of favour financials leading the gains. Economic data stayed muted as the eurozone economy expanded just 0.2% in Q2. Inflation was 1.0% pa in August, vs 2.1% in August 2018.In September the (ECB) took steps to boost the flagging economy - cutting interest rates further into negative territory, restarting quantitative easing and committing to buying assets until its inflation target is reached. Christine Lagarde, head of the IMF, will replace Mario Draghi as president of the ECB on 31 October.

UK equities recorded modest gains (FTSE All Share +0.12%) in a mixed quarter for the UK market. Mid cap stocks outperformed and investors favoured defensive assets including "quality growth" companies. M&A activity was supportive as trade and private equity buyers took advantage of UK equity valuations, Sterling weakness and cheap debt financing. Brexit drama continued. Parliament forcing the government to ask for an extension if it can't agree a deal with the EU, sending Sterling higher. PM Johnson made a "do or die" pledge to achieve Brexit saying he'd rather be "dead in a ditch" than ask for an extension. His attempt to suspend parliament was ruled unlawful and a highly unpredictable election seems inevitable. The Bank of England remained on hold as Brexit uncertainty affects the outlook for the UK economy with Q2 GDP growth confirmed at -0.2 amid a global slowdown in activity, PM Johnson promised fiscal measures to stimulate economic activity.

Japanese equities gained (TOPIX +2.36%) and after a strong September ended the strongest developed market. Consumer confidence continued to decline but the Bank of Japan didn't join the easing game, saying it would review the outlook at its next meeting - hinting at further easing to come. PM Abe's Party won the Upper House elections falling just short of the 2/3 majority, which would have allowed for his constitutional reforms, but the result confirmed continuity of policy for the foreseeable future. The trade war played a prominent role, with further tariffs due to come into place by the end of the year unless renewed talks between the US and China make sufficient progress. This should be more straightforward for Japan, as much of what the US is seeking was already on offer within the negotiations, from which the US withdrew.

Asian markets were hit by intensifying US-China trade tensions (FTSE Asia Pacific ex Japan -3.33%) and concerns over global growth. Hong Kong was the weakest of the regions, as demonstrations continued despite the authority's efforts to resolve social unrest started by the proposed extradition bill which HK leader Carrie Lam has promised to withdraw. China is wary of a repeat of Tiananmen Square. Malaysia, Singapore and Thailand all posted negative returns and underperformed. China and South Korea lagged the index by a more modest margin. Chinese authorities responded to domestic weakness with fresh policy support as industrial production grew at 4.4%, down from around 7% at the start of 2018. Retail sales slowed to 7.5% from close to 10% in early 2018. Meanwhile the US announced new tariffs on $300 billion of goods imported from China. In South Korea, a trade dispute with Japan also weighed on sentiment

Emerging market equities were down (FTSE Emerging -2.89%), again over the escalation of US-China trade tensions and mounting concerns over global growth. Argentina was the weakest as surprise primary election results triggered a major sell-off in equities and the currency. Those markets more sensitive to a stronger US dollar also came under pressure, notably South Africa but also Indonesia. Saudi Arabia and Colombia underperformed with crude oil price weakness a headwind. China underperformed by a more modest margin. Following the announcement of further US trade tariffs, the renminbi weakened beyond the symbolic seven-per-dollar threshold, leading to the US Treasury calling China a currency manipulator. By contrast, Turkey registered a robust return, as the central bank cut interest rates by a total of 7.5% over the quarter; more than expected. Taiwan also outperformed, driven by strong performance from technology stocks.

The Bloomberg Commodity Index fell -1.84%, impacted by US dollar strength. Crude oil prices fell as demand concerns outweighed ongoing supply risks, despite a sharp price spike in mid-September following an attack on oil infrastructure in Saudi Arabia. Soft commodities were also weaker, and the industrial metals component fell slightly amid demand concerns. Precious metals delivered rose strongly, (gold +4.5% and silver 4.5% +11%) amid safe haven buying.

Central bank easing and rising concerns about the global growth outlook supported government bonds, albeit with a temporary sell-off in early September (FTSE WorldBIG Domestic Sovereign +2.70%). The US 10-year Treasury yield was over 30 basis points (bps) lower, finishing the quarter at 1.67%. In Europe, the 10-year German Bund yield fell 24bps to finish even deeper in negative territory at -0.57%. The Italian 10-year yield fell 126bps to 0.82% expecting new stimulus and a calmer political backdrop. Brexit uncertainty drove 10-yr UK Gilt yields down 34bps, mostly in July.

Corporate bonds rose (Barclays Global Aggregate Corporates +1.21%) in line with global yields and improved sentiment. Investment grade corporate bonds outperformed High Yield (Barclays Global High Yield -0.67%.). Emerging market bonds were positive, while currencies weakened vs USD meaning negative returns for the USD denominated index (JPM GBI-EM Global Composite -0.98%).

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

LOOKING FORWARD…

"So the dollar is money, money is value, value is trust, trust is a contract, and the contract is debt."— ***James Rickards***

This quarter we will look at the different roles of the US and China in the global economy, the power wielded by the issuer of the global reserve currency, how that affects the trade war and how a power vacuum has appeared in the Federal Reserve System. We will also set out our core views of what happens next in the global economy and how that affects our approach to asset allocation.

In simple terms, China is responsible for the direction of global growth, and the US as the provider of the world's reserve currency is responsible for the provision of sufficient liquidity to permit that growth to flourish. So, what happens to this dynamic when they are in conflict as in the US-China trade wars? We believe that in an effort to slow the growth of China and maintain the US as the dominant global economic power, the US is "weaponising" their Capital Account to increase pressure on China where it really hurts - slowing the flow of money into China and choking their economy. In this trade Cold War, the Capital Account is the US's the most effective weapon in their financial arsenal as they try to halt China's ascent to world economic dominance.

A country's capital account flow reflects factors such as commercial borrowings, banking, investments, loans, and capital. Last quarter we mentioned the Triffin Paradox - that 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. Currently, we believe global growth should read "China growth" ……….. this is where the conflict lies.

China's surging imports lay behind the 2017 Global Recovery and conversely their slumping imports in 2018 caused the global slowdown. As a result, in 2019, we have been watching events in the PRC very closely as they have significant effect of the pace and direction of global economic growth.

China has used a great deal of credit in order to finance its post 2000 growth, but we believe that few realize just how much is required to sustain growth as so much of the credit growth occurred through China's Local Government, SOE and Private Non Finco's. Our economist estimates that on average they need to borrow around 16% of national GDP in order to cover their combined financial deficit. Since 2012, China's banks have witnessed loan growth far above their rates of deposit growth which means that they have become dependent on wholesale funding to finance this deficit. Since 2016, the primary source of funding came from abroad meaning that China's banks possess an estimated $2.5 trillion of Foreign Liabilities. Through 2018 a lack of foreign funding led credit growth rates to slow and by October 2018 there was insufficient credit to finance the private sector's funding gap choking off growth as Local Governments were obliged to save increasing financial reserves and leading to a slump in fixed asset investment of GFC-like proportions which resulted in the Global Trade Slump.

The result of the decline in credit growth detailed above meant that China's imports imploded, but it seems that this passed many by and therefore global inventories continued to rise whilst global growth was declining sharply. These rising inventories boosted Q1 reported GDP growth but have become negative factors in Q3 and the high inventory build-up has meant an excess of supply over demand and a consequent return of deflation.

Global GDP growth in late 2017 suggested that the World might finally have escaped the damage of 2008's GFC. However, China's recent weakness has caused a global slowdown that is bordering on a nominal recession. A result of this is that bond markets are reaching bubble like territory, with many European bond investors paying for the privilege of lending their money to governments. Probably the most dramatic indicator is Greek 10 year yields (not long ago the sick man of Europe) which ended Q3 at 1.75%. Bond yields are a concern, especially at the long end of the yield curve and at some point we are concerned that, absent central bank support, there are no Greater Fools left.

We have discussed previously the importance of liquidity in financial markets and how that has affected stock markets over the past few years. This has largely been driven by the actions of the US Federal Reserve as they have sought to influence the economy through their open market policy, set by the Federal Open Market Committee (FOMC). This action is done through the New York Federal Reserve Bank, one of the 12 banks in the Federal Reserve system and until recently was the responsibility of Simon Potter a very bright but very academic and analytical character who lacks the broader market understanding that was a feature of many of the top people in the Fed system post the GFC, such as his erstwhile boss Bill Dudley who was ex Goldman Sachs. Under Janet Yellen there was a move away from the more market aware but perhaps overly pally staff to a more academic approach that lacked the connections in the large banks such as JPM or Goldman Sachs. As an example, Dudley's successor, John Williams doesn't even have a Bloomberg screen on his office desk, suggesting he is not quite in tune with the day to day market flow. Yellen's changes may have gone too far and laid the seeds for the two recent notable liquidity issues that have spooked markets first in December 2018 and again in mid-September 2019, both of which caught the Fed by surprise. Indeed, in December 2018 the Head of JP Morgan phoned the Chairman of the Fed, Jerome Powell to let him know what was happening to credit conditions which drove the stock market's sharp falls. This lack of market awareness has led to a number of senior departures and a resulting power/knowledge vacuum at senior levels in the Fed that is contributing to the volatility. Simon Potter has been replaced by Lorie Logan, who appears to be his polar opposite with much more EQ to go with her IQ. She has had a baptism of fire and was front and centre when the US Repo rate spiked sharply in mid-September to levels not seen since the financial crisis.

The repo market underpins the U.S. financial system, helping to ensure banks have the liquidity to meet their daily operational needs and maintain sufficient reserves. In a repo trade, one party will offer U.S. Treasuries and other high-quality securities as collateral to raise cash, often overnight, to finance their trading and lending activities. The next day, borrowers repay their loans plus a nominal rate of interest and get their bonds back – i.e. they repurchase, or repo, the bonds. The system usually works smoothly with the interest rate charged on repo deals hovering close to the Fed's benchmark overnight rate, which last quarter was 2.00% to 2.25%. But when investors get fearful of lending, as seen during the global credit crisis, or when there are just not enough reserves

or cash in the system to lend out, it sends the repo rate soaring above the Fed Funds rate. Consequently, trading in stocks and bonds can become difficult., it can also pinch lending to businesses and consumers and a prolonged disruption would be a drag on a U.S. economy heavily reliant on the flow of credit. Coming out of the financial crisis, after the Fed cut interest rates to near zero and bought more than $3.5 trillion of bonds, banks built up massive reserves held at the Fed. But that level of bank reserves, which peaked at nearly $2.8 trillion, began falling when the Fed started raising interest rates in late 2015. They fell even faster when the Fed started to cut the size of its bond portfolio in 2018. There was an equity market shock at the end of 2018 as the market ran scared of the tightening bias and as a result the Fed stopped raising interest rates and has cut them twice this year as well as no longer allowing bonds to roll off its balance sheet. The Fed was dramatically behind the curve at the end of last year and again failed to anticipate liquidity restrictions in September as the delicate liquidity situation shocked markets as the repo rate spiked.

We believe that the changes in Fed staff and the seeming lack of market awareness is contributing to recent volatility. It is further exacerbated by the significant volatility in the US Treasury balance which is flooding the market with liquidity and then taking it back again with increasing regularity. The Treasury's General Account (effectively the US governments current account) has been erratic but generally expansionary for the monetary system this year, and since late September the Treasury has been issuing large quantities of debt to finance the activities of government, which has the effect of sucking liquidity out of the financial system. To balance this and keep liquidity in the repo market, the 'Acting Head' at the NY Fed, Lorie Logan, is now reacting to the liquidity shortages through Repo's on demand. In effect, the Fed is now accommodating the Trump budget deficits by maintaining high liquidity despite the economy still being at full employment, when traditional economic theory would suggest a tightening bias. What is not clear is whether the Fed open market policy is expansionary or merely neutral for the system at present. This liquidity is key for the whole financial system that has feasted on low rates and a free flow of readily available financing since the GFC. Increasingly, China is amongst those that need that financing to fuel its growth and by association, global growth.

To complicate matters further, we believe that there is a fundamental mismatch between China's assets and liabilities. We have mentioned the amount of wholesale borrowing that has been done to fuel growth. On the flip side, China owns $1.4 trillion of US bonds, $380 billion of Bunds, and $280 billion of UK bonds. Clearly, selling these to ease their problems or strike back at the US would have implications for the debt and currency markets.

In addition, China (inc Hong Kong) has provided significant amounts of bank financing in Australia, Canada and elsewhere. There would be significant implications for the banks in these countries if these funds were withdrawn. China has also amassed significant credit claims on EM and Frontier markets that range between 10-50% of these countries' levels of GDP (average = 17% of recipients' GDP). Many if not most of the assets are illiquid long duration assets (such as mining, oil and ports) that in practice represent a claim on their future (commodity market) export earnings. Liquidating these funds may not be possible and would be catastrophic for the former recipients creating an Economic / Humanitarian Crisis in many of the World's lowest income economies.

Clearly, the authorities in China know the true situation and this has caused them to tighten their stance which is reflected in the slowing of the Global economy. The inability to call on its assets and the short-term demands created by the use of now unpredictable wholesale funding to fuel growth means that China's economy is effectively limited by its Balance of Payments – it now can only rely on spending what it earns. Recently, the combination of the current account surplus, some inflows of Portfolio Capital, and the some PBoC FOREX interventions to prop up the Renminbi have together allowed China to service its debts avoiding a default/currency crisis. If there was insufficient money coming into the economy, then the picture might be very different and put even more focus on their need for external funding handing greater power to the US as global provider of liquidity.

As you can see, the world needs growth and China is the engine of that growth. China needs wholesale financing to fund their growth and that wholesale financing in turn relies on consistent liquidity in the financial system. The US as provider of the global reserve currency in turn is responsible for the provision of sufficient liquidity to fuel that growth. The US and China are in conflict in a trade war that is a reflection of a battle for global economic leadership and they are as a result in an odd position in that they are mutually dependant but in conflict. So where does that leave us in terms of our tactical views and positioning?

Our core view remains that China works within its growth constraints, import growth remains weak, and that the RMB only weakens slowly as the country takes 3 – 5 years to recycle its current account surpluses into debt repayments. This would mean a relatively long period of global stagnation and attendant 'deflation risks' but markets would be spared any immediate China Crisis and likely to be fuelled as required by G3 policy responses. In effect, "lower for even longer" in terms of rates and sufficient financial liquidity to keep things chugging along at sub-par growth for a while yet.

Conversely, it is also possible (but less probable we feel) that further easing by US could reduce the need to prop up the RMB and provide China with a reprieve in the near term, creating a new leg to the boom rather than a crisis.

Finally, there is also a scenario under which China does not gain sufficient funding and is forced into a currency devaluation/foreign-asset-fire-sale that triggers a major global deflation scare.

Overall, the global economy presents asset allocators with some binary and unpredictable risks. Will the trade war escalate? How will the US/China dysfunctional financial dependency play out? Will a UK election lead to a no-deal Brexit? Will the tension in the Middle East cause another spike in the oil price? And will companies respond to slowing growth and profits by cutting jobs?

Until we have more clarity on the answers to these questions, we continue to believe that it makes sense to avoid overweight positions in equities and credit and to look for quality within both asset classes. In our equity fund selection, we accent managers likely to prove most resilient if the downside risks materialise. Alternatives continue to be key in balancing portfolio risks and we feel that US Treasuries should also provide a hedge if growth rolls over or an adverse scenario plays out. Holding a bit more cash gives optionality in the event that markets become attractively priced.