FPWM
TAILORED FINANCIAL SOLUTIONS

QUARTER 1 2020

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	+	Move to overweight in this asset class due to strong rallies and extended pricing. But we still want to insulate portfolios in uncertainty. Market dynamics and liquidity conditions favour US and TIPS. USD direction vs Sterling is less certain now post-election, so we are neutral GBP /USD now
Investment Grade Bond	N	We maintain neutral view on IG bonds and we remain focused on high-quality and still slightly favour US and UK exposure where possible. We are cognisant of liquidity concerns and index weighting of BBB rated issues adding risk, but recession risk is low and issuance strong for corporates
High Yield Bond	-	We stay underweight as global growth is subpar. 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. If US inflation increases, then re-financing becomes more challenging if credit conditions tighten
Emerging Market Bonds	-	We maintain our underweight here as we are concerned that subpar global growth, inventory overhang and strong USD is a headwind for this asset class. We look for signs that the credit environment and USD liquidity are reaching the EM reducing the chance of a credit event/currency volatility
UK Equity	+	A strong Conservative majority has cleared the uncertainty and mad Brexit a certainty, for now at least. We expect the UK market to play catch up and feel that domestically focussed and small and mid-cap stocks are the sweet spot in the short term as GBP starts to look a stronger currency
Developed Market Equity	+	Global growth is subpar, but dovish central banks are supportive of sentiment and “Powell Put” guarantees market liquidity. Trade war fears and the knock-on effect on sentiment reduced. We favour the dynamic US economy as Trump positions himself for a strong S&P 500 and re-election
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 remain key factors here
Commodities	N	We stay neutral here as any real reduction in trade wars may lead to a potential uptick in sentiment added to bank stimulus. The Phase One trade agreement stabilises the situation for now continuing subpar 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 liquidity issues which are still apparent but improving
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 market neutral and macro strategies to diversify risk exposure here, despite challenging dynamics
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

LOOKING BACK…

In Q4 fading geopolitical risk and easy monetary conditions helped global equity markets rise capping a stellar 2019. Corporate bonds performed well amid the improved investor sentiment, and government bond yields moved lower on weaker economic data.

US equities made robust gains (S&P 500 +8.53%) aided by the US and China's "phase one" trade deal announcement. The deal (due to be signed in mid-January) stops new tariffs and those imposed in September will be halved. The 25% tariffs on $250 billion of Chinese goods will remain and China will increase purchases of US goods, especially agricultural produce. US GDP rose 2.1% (annualised) in Q3; beating expectations and an increase on Q2. December unemployment fell to 3.5% - the lowest since 1969 – along with increasing wage inflation. The forward-looking purchasing managers' indices continue to indicate modest expansion. The Federal Reserve cut interest rates and indicated that "the current stance of monetary policy is appropriate", suggesting rates will stay lower for longer and supporting markets. Tech benefitted from easing trade tensions and Energy stocks, which had lagged the S&P 500 rallied as the oil price rose on lower-than-expected supply.

Eurozone shares advanced (+5.04%) amid better economic data from Germany and optimism surrounding US and China. Economically sensitive sectors led with information technology, consumer discretionary and materials outperforming, while communication services and consumer staples sectors registered a negative return, and utilities weak. Unilever warned of weaker 2019 sales growth, Fiat Chrysler and PSA Peugeot will merge in a €40 billion deal and LVMH bought US jeweller Tiffany & Co for $16.6 billion. The eurozone composite purchasing managers' index was unchanged at 50.6 in December indicating weak growth. Annualised inflation was 1.0% in November, up from 0.7% in October but still well below the ECB target of close to 2%. Christine Lagarde took over as president of the European Central Bank on 1 November. In her first major speech she urged governments to boost public investment in order to increase domestic demand in Europe.

UK shares gained (FTSE All Share +3.32%). Domestically focused areas of the market performed well amid reduced near-term political uncertainty, following the landslide general election victory for the Conservative Party who will use their large majority to take the UK out of the EU by 31 January 2020, entering a transition period when the next stage of negotiations will begin. The reduction in uncertainty was reflected in a very strong performance by small and mid-cap shares and a sharp recovery in sterling. Latest GDP figures confirmed the UK economy had avoided entering a technical recession in the third quarter after contracting in the previous quarter. GDP growth was 0.4% quarter-on-quarter in Q3 compared to -0.2% in Q2. Economically sensitive areas of the market outperformed, in line with global markets amid a return of risk appetite.

Japanese shares ended higher and the yen weakened slightly against the US dollar. Economic data continued to show a significant divergence between the strength in service sectors and the weakness in manufacturing. Sentiment towards Japanese equities fluctuated in line with geopolitical tensions but was ultimately helped by signs of easing in relations between the US and China and expectations for the signing of a phase one trade agreement. The quarterly reporting season ended in November and was largely in line with expectations. The downturn has been greater than consensus expectations, even if allowance is made for the devastating typhoon which hit central Japan. In response, the government has announced a significant supplementary budget, with a particular focus on reconstruction. Investors have generally responded positively to this planned fiscal stimulus, while the Bank of Japan governor, Mr Kuroda, has welcomed the change in emphasis away from monetary policy alone while. making no change in policy this quarter.

Asia ex Japan equities delivered a strong return in Q4, supported by easing geopolitical risk with the phase one trade deal. US dollar weakness also provided support to returns. In Taiwan there was strong performance from the technology sector following solid Q3 sales figures. In South Korea, the central bank cut interest rates by 25bps to 1.25%. Pakistan was the best-performing index market, led higher by banking stocks. Thailand was the weakest index market as Q3 GDP growth remained subdued at 2.4% year-on-year. The Philippines and Malaysia finished in positive territory but lagged the index. India also underperformed, negatively impacted by higher crude oil prices, rising fiscal pressure and concerns over slowing growth. Hong Kong posted a solid gain but lagged the wider index.

Emerging market equities posted a strong gain in Q4 (FTSE Emerging +9.49%), benefiting from easing geopolitical concerns. And outperformed developed markets. China posted a strong gain despite underperforming other Ems benefitting from the relief of the outline phase one trade agreement with the US. Russia and Colombia generated strong returns, benefiting from crude oil price strength as oil producing nations announced further production cuts for the first quarter of 2020. A number of EM markets sensitive to US dollar strength outperformed, including South Africa. Brazil also finished ahead of the index, aided by currency strength while Q3 GDP growth rose to 1.2% year-on-year - ahead of expectations. Chile fell amid mass protests and concerns over inequality, while Turkey's, military incursions into Northern Syria led to tensions with the US and negative performance. Oil price strength was a headwind for Indian equities, in addition to concerns over slowing growth.

The phase one US-China trade deal and moderately better economic data supported robust risk sentiment over the quarter. Government bond yields rose (meaning prices fell) and corporate bonds outperformed. The US 10-year yield rose from 1.66% to 1.92%, while the two-year yield dropped from 1.62% to 1.57%, steepening the yield curve as investors took a more optimistic view on the economy. European 10-year yields increased with German Bunds rising -0.57% to -0.19%, French from -0.27% to 0.12% and Italian from 0.82% to 1.41%, as political risk resurfaced. The UK 10-year yield rose from 0.49% to 0.82% amid a decisive election victory for the incumbent Conservative party and optimism around Brexit.

Corporate bonds performed well to cap a strong year. High yield outperformed, but US investment grade was also notably buoyant relative to government bonds, across various sectors.
Emerging market bonds saw good returns. Local currency bonds did particularly well as EM currencies performed strongly in December. Lower rated issuers led in hard currency sovereigns and corporates, partly reflecting a rebound in Argentina.

In Commodities the Bloomberg Commodity Index rose 1.42% in Q4, led by energy. Crude oil prices rallied as OPEC+ announced further production cuts to ease oversupply concerns. News of the US-China trade deal also supported the demand outlook for oil. In agriculture, coffee (24.8%) and wheat (12.2%) were notably strong. In precious metals, both gold (3.3%) and silver (5.0%) advanced. Industrial metals posted a more modest gain. Copper gained 7.9% but nickel (-17.8%) was firmly down. Spot nickel prices fell as the world's largest producer, Indonesia, lifted export restrictions for some companies.

UK Commercial Property was largely flat as the IA UK Direct Property Index was down -0.50%

All major currencies fell against Sterling with USD -7.34%, EUR-4.56% and JPY -7.70% leading to a significant effect on foreign asset returns for the Sterling investor.

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

LOOKING FORWARD…

***"We're gonna party like its 1999"* - The Artist formerly known as Prince**

The global economy is again basking in a goldilocks scenario with growth not too cold, inflation not too hot and most importantly, central banks committed to defending against slowdowns. The chance of recession is low, and we might even see some stabilisation or improvement in Chinese growth numbers. The Phase One agreement between the US and China lifted trade optimism, and Trump needs to keep the US economy stable, trade optimism high and a rising S&P 500 in an election year. At the time of writing, the extreme Election risks have reduced as Trump's re-election chances seem set fair and the Democratic candidate seems likely to be the more mainstream Joe Biden. Despite a strong rally, investor positioning doesn't appear stretched, with little movement over year end. What makes us more sanguine over 2020 is the return of what became known as the "Greenspan put" – the Fed underpinning market liquidity.

In mid-2019 we saw a re-run of the dramatic surge in global credit growth that was a feature of 2017 but this time it was dominated by the French banks who are refugees from zero rates and have re-invented themselves as dollar "miners" & lenders. The French are in a peculiar position in that for regulatory reasons they seem able to ignore the capital rules in the first two months of each quarter as long as they adhere to them in months 3, 6, 9 and in particular December – perhaps central to quarter end pressure on USD funding markets. Fresh from the repo rate spike in September (see Q4 commentary) the Fed responded to the potential for a December Crisis by creating an unprecedented boom in liquidity and their actions in 2019 tell us that the Fed cares more about 401Ks rather than resource allocation and productivity. Their actions do not seem to filter down into the real economy, only really affecting the primary dealers (JP Morgan, Bank of America and to a lesser extent Citi and Goldman Sachs) who recognise the dynamic and have been leveraging it as seen by JP Morgan's recent record profit announcement.

What is truly remarkable is that the Fed (and Treasury) have eased against the backdrop of a fully employed economy with wage growth hinting at an underlying domestic inflation problem. This is not obvious as headline CPI data shows the weighted average of (imported) goods prices and domestic non-traded goods & services. Goods prices are one third of the index and have shown little growth for many years as a result of globalisation. More recently the rise in inventory has continued the trend but it is worth remembering that inflation surprises come from import prices not the domestic economy. Imported goods prices are likely to remain low as long as global growth is muted, but we should be wary of a global recovery and the return of pricing power which could cause an inflation spike in the US. Further, equity bubbles occur when service prices inflate but goods prices deflate (see Asia 1993-4, the World 1999 & 2004-6) as people have more money in their pockets while the prices of the things that they buy are falling sometimes leading to irrational exuberance.

If imported goods prices inflate, bonds tend to sell off and we should expect a reaction from the central banks. The US domestic economy is indeed showing signs of a possible return of inflation. The question is how long will goods prices continue to deflate and obscure Powell's inflation? The US inventory overhang will depress growth in the near term, but we are unsure how long it can last as we expect the domestic US to be strong in much of 2020. Conversely, outside the US global GDP growth in dollar terms is negligible –almost recession-like. This should help to obscure the US's inflation problem for much of 2020 – or perhaps even longer?

In a world of falling world trade prices, we suspect that most real economies would 'quite like' a stronger USD. But a strong dollar raises the servicing costs of the now large stock of USD denominated debt incurred by the banks and others. Trump would like a weaker dollar to help the US sell to other countries. The world cannot afford a strong or weak dollar – hence we are almost back on a de facto dollar standard. Like a new Bretton Woods with all currencies effectively pegged to the USD, a concept that has been in the background since the early 2000s. The world economy's dependence on both the level of the USD and the provision of liquidity is such that if it fails to get it right, currency and market volatility will spike. The US Federal Reserve Chairman Jerome Powell did not know this in September 2019, but now he certainly does and has reacted by providing massive support in Q4 2019. Powell knows that he is the World's central banker and, like his predecessor Arthur Burns fifty years ago, he will be under pressure to provide conditions that allow the world economy to inflate. The Bretton Woods system was successful for the US as it maintained their financial hegemony post WWII, but it ended with hyperinflation and while we don't expect that extreme, we are wary of an inflation spike which could shock markets further up the line. If Geopolitics allow, US and other asset prices should inflate until World Trade Prices turn higher.

Has the FOMC effectively engaged in a further bout of Quantitative Easing (QE) over recent weeks? We feel that effective monetary policy should result in a change in the volume of credit available to the non-bank private sector and/or the amount of money that the private sector owns. QE1(in practice) resulted in the Fed giving the government large amounts of money, that the government then gave to the private real sectors when it increased its deficit and spent money in the private sector.

During QEs 2 & 3the FOMC purchased large quantities of bonds from investors, giving people (in the investment community) the money that it had created. We also feel that the Trump Administration's aggressive run down of its own deposits at the Federal Reserve (the Treasury General Account) in Q1 2017 resulted in a situation in which the government gave funds to the private real economy sector and (by redeeming $110 billion of bonds) the investment industry. Both resulted in their being more money in the private sector and also increase in bank reserves during 2017 that was the catalyst for a globalized dollar lending boom – effectively QE4.

Were last year's injections by the Fed effectively QE5? They bought some securities outright and also lent considerable sums of money to some banks via the primary dealer facility to allow them to buy bonds. In addition, the Fed also implicitly gave assurances to the banks that funding costs would not rise and that it would supply settlement cash to them elastically at the prevailing interest rate, something which should have given the confidence for those banks to boost the potential supply of credit available. What happened in 2019 Q4 was multifaceted and the Fed threw everything including the kitchen sink at the perceived problems in the money markets.

Clearly, there are many strands to the analysis of what happened in Q4 2019 and if we return to our maxim that "effective monetary policy should result in a change in the volume of credit available to the non-bank private sector and/or the amount of money that the private sector owns", then we can say that the Fed's various actions last year clearly resulted in a sharp change in the amount of money being created by the banking system as a whole in the debt markets, and that as a result there was a sharp increase in reported monetary growth.

Equally clearly, over recent weeks, the Fed and the banking system has started to reduce (but not reverse) its level of net buying of Treasuries and there has been a moderation in monetary growth as a result. Conditions are not as expansionary as they were before the Holiday Season but are far from being contractionary. More pertinently, we also know that many of the foreign banks that were previously constrained by their regulatory issues in December are back in the game. We believe the credit creation process has probably moved from being US centric to where the foreign banks are again mining dollars in the US and lending them outside the US to investment vehicles and the Emerging Markets. In fact, it seems that some foreign banks and many non-bank lenders have become quite gung-ho with regard to their activities.

Whilst the level of credit demand from the US commercial and industrial sector may be falling while they reduce their inventories, there does seem to be credit growth in mortgage markets and within the financial markets themselves. So as monetary trends in the US itself are weaker than they were three or four weeks ago, we believe that relatively more of the funds that were created through the Fed's various actions in Q4 are probably leaking from the US and thereby causing a revival in the offshore credit markets and global capital flows. While this occurs, there may be some downward pressure on the USD, at least until the next regulatory cycle looms and the quarter end effect starts to re-assert itself again. This effect has a shelf life as French bank regulation is set to change in 2021, ending this particular party.

High Inventory levels and their ratio to freight movements around the world, along with the need to reduce that inventory overhang through production cuts and price discounting, leads us to believe that in the near to medium term, it will be difficult for the global Industrial production cycle to revive meaningfully. At the same time, we don't feel that nominal export growth – particularly in Asia – are likely to move the needle very much even if shipment volumes begin to increase as companies attempt to shed inventory. As at the end of Q4, global export volumes are all negative on a 3month rolling year on year basis. As a result of this dynamic we feel that most important implication for financial markets is that the rate of World Trade Price inflation will likely remain negative over the next six months or perhaps even longer, a situation that will serve to virtually guarantee that headline inflation rates in most countries (i.e. those with reasonably stable FX rates) will remain benign and market friendly. The Fed's recent action may be inflating the global financial system, but we suspect that we will have to wait several quarters – and perhaps even a year or two – before the Fed's actions finally begin to manifest themselves in the type of inflation surprises that might destabilise markets.

If geopolitical risk stays in the background, we feel that the dynamic of the global economy hints at a modest pickup but continuing subpar growth. The pressure on profit margins that affected corporate profits over 2019 is still apparent and the rise in markets has pushed valuations higher. Looking at market valuations on a forward P/E basis only the US looks a little high, but Global earnings estimates have turned round significantly from 2019 and if earnings fail to meet expectations, prices might look a little stretched.

Despite the fundamentals, we must remember that equity markets have grown fat on a steady diet of low rates and liquidity. Both the Federal Reserve and the European Central Bank have announced significant stimulus packages over 2019 and while they may be pausing, the existence of a "Powell put" means markets will not go hungry. Economic activity would have to surprise well on the upside for rates to increase and on the flip side, any further deterioration would trigger a new wave of support and policy easing. Only if governments take up the baton and provide significant and concerted fiscal stimulus leading to accelerated growth and inflation is that likely to change and therefore it seems that rates are likely to stay lower for even longer……

With the benefit of 20/20 hindsight and following significant market rallies, we have been over cautious on risk assets and our concerns regarding market liquidity, whilst correct turned out to be like annoying speed bumps that only slowed the advance for a short period of time. We were always less concerned about geopolitical risk, whereas now that seems the outlier that might challenge this new Goldilocks scenario. The risks we have discussed in previous commentaries are still there, but we won't look to fight the Fed at this juncture.

We have not made big changes in our asset allocations and believe that despite the relatively benign economic scenario, chasing returns in what is still a mature market environment is not prudent. The selection of skilled and consistent managers whose approach enhances our portfolio characteristics is still our modus operandi – if it ain't broke don't fix it.