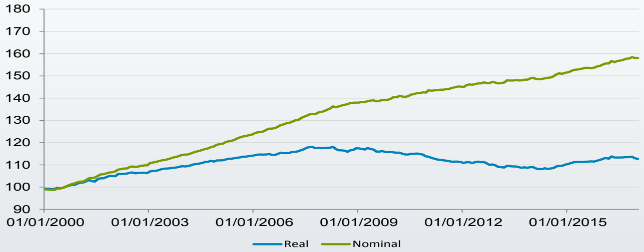
Monthly Strategy Review

Summary

- Global growth continues to improve and is being supported by a meaningful recovery in manufacturing.
- Central banks are likely to remain accommodative and overlook the transitory impact of higher energy prices on headline inflation, given that core inflation rates remain stable.
- Recognising that we are in an unusually extended market cycle, we believe that the improvement in financial conditions can continue in the near term, driven by excess liquidity, low interest rates and an improving global backdrop.

UK real income growth: constrained by higher prices

UK average weekly earnings regular pay real (inflation-adjusted) and nominal, seasonally adjusted 2000=100

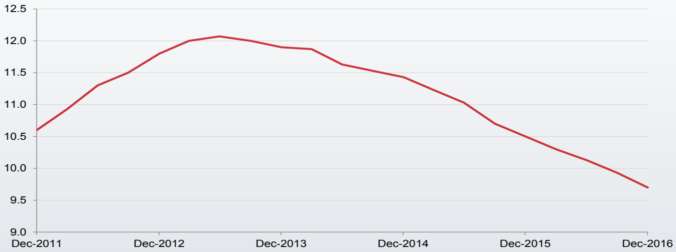


Source: Office for National Statistics, Monthly Wages & Salaries

Past performance is not a reliable indicator of future performance.

Unemployment in Europe has fallen substantially

Eurozone unemployment rate (%)



Source: Bloomberg

Economic review and outlook

The global economic environment continues to improve, supported by a meaningful recovery in manufacturing. The JP Morgan Global manufacturing PMI survey rose to its highest level since May 2011, with some of the strongest improvements seen in Europe. Japan's economy is also benefitting from strengthening global demand, which is being driven by rising confidence in the US outlook and a stabilising growth course in China. To a certain extent, the UK economy counters this more optimistic trend, where data reports have softened at the margin, albeit from relatively elevated levels. Central banks globally are expected to remain accommodative and are likely to look through the transitory effects of higher energy prices lifting headline inflation measures; core inflation in most developed economies remains broadly stable. The Bank of England probably has the most challenging mandate, given it is contending with inflation on two fronts – energy costs and import prices – balanced against downside risks to growth amid Brexit uncertainty.

US

US economic indicators continue to show rising confidence, with regional and national manufacturing surveys reporting improving operating conditions. Some of these elevated survey readings have yet to fully translate into actual activity data, such as factory orders and industrial production. However, forward-looking indicators are upbeat and the regional US Federal Reserve ('the Fed') survey of capital expenditure plans stood at its highest level of the expansion in February.

As US data continues to improve, the inflation path is now a key focus. The US economy is reaching full employment: initial jobless claims have fallen to a 44-year low and payroll growth has averaged above 200,000 in the last three months to February. Wage growth continues to maintain a steady pace at 2.8% year-on-year, but expectations are rising that tighter labour market conditions will exert upward pressure on nominal wage growth. At the same time, there is also concern that rising price pressures could have a dampening effect on real incomes. It is worth noting that real consumer spending had its weakest monthly reading in seven years in January. Inflation measures remain relatively well contained – in February consumer prices recorded their smallest monthly gain since last July - but are moving closer to the Fed's target of 2%.The headline personal consumption expenditures index, an inflation gauge closely monitored by the Fed, rose to 1.9% year-on-year in February from 1.6% year-on-year in the previous month and is moving closer to the Fed's target of 2%.

That said, Fed policymakers appear willing to overlook headline inflation potentially exceeding the central bank's target, due to the transitory impact of energy price rises. After delivering a much anticipated 25-basis-point rate hike this month, which followed a period of hawkish Fed commentary in recent weeks, the Fed's policy statement noted that core inflation – which excludes food and energy prices – has been stable in recent months. The Fed is maintaining its view of a gradual pace to its interest rate tightening programme. No changes were made to the Fed's 'dot plot' – policymakers' interest rate forecasts for this year and further out – with the median expectation in 2017 remaining at three interest rate hikes.

Europe

Positive economic momentum continues to unfold in Europe, as the pick-up in global demand, a weaker currency and European Central Bank (ECB) stimulus measures are all helping the cyclical recovery. Improvements in the PMI surveys (manufacturing and services) continue to be broad-based across countries and this trend is also supported by domestic surveys. In particular, the German IFO survey saw a strong bounce in February. The European Commission's consumer confidence survey fell marginally in February but remains above the long-term average. These reports have been welcome news in a climate of increasing political risk, given this year's electoral cycle. Bank lending continues to see steady increases - January saw the largest monthly rise in eight years - and this must reassure ECB policymakers that stimulus is working. Going forward, consumption is expected to remain supported by improving labour market conditions. The euro-area unemployment rate has come down meaningfully over the last year and business surveys also suggest that hiring is picking up.

Headline inflation has seen a sharp rise to 2.0% year-on-year, all of which has been attributed to energy and food costs; core inflation remains stable at 0.9% year-on-year. While the ECB has upgraded its growth and inflation forecasts for 2017, policymakers expect that core inflation will remain low and may thus rely on ongoing monetary stimulus to lift the longer-term trend towards the ECB's target. That said, with US interest rates rising, there is more focus in the market on the ECB's exit strategy from extraordinary stimulus. While monetary policy was left unchanged in March and there were few hints about tapering the purchase programme, President Draghi expressed more comfort with the economic environment, believing that downside risks were "less pronounced." We expect that the ECB will take a measured approach when it comes to scaling back its quantitative easing programme.

UK

UK growth has been resilient since the referendum result and fourth quarter GDP was nudged higher to 0.7% quarter-on-quarter. However, there have been signs of softer momentum across various data reports and concerns are growing that UK consumption, which was the principal driver of growth in the second half of 2016, will slow in coming months as real income growth (inflation-adjusted) is curbed by rising price pressures. Monthly retail sales data and the GFK's consumer confidence indicator both declined in February, as did the PMI manufacturing and services surveys. It is noteworthy that the fall in services to a five-month low, albeit from a relatively high level, was due to consumer-related sectors, suggesting that UK households are starting to feel the pinch of higher import prices and energy costs. Consumer prices rose by 1.8% year-on-year in January, which was the highest rate since June 2014. That said, employment trends remain supportive to the consumer, as the UK unemployment rate fell to 4.7% in the three months to January – the lowest level since 1975.

The Bank of England kept monetary policy on hold in March, although there was one dissenter who voted for a rate hike. Clearly, there is more concern around the inflation outlook and the Bank reiterated its view regarding its tolerance levels for above-target inflation. However, policymakers are also concerned about the impact of higher prices on household consumption, acknowledging that real income growth is likely to decline over the course of this year. Monetary policy is being kept very accommodative to support overall economic activity, but the Bank is maintaining a neutral stance to allow for a policy response in either direction, depending on how growth and inflation trends evolve.

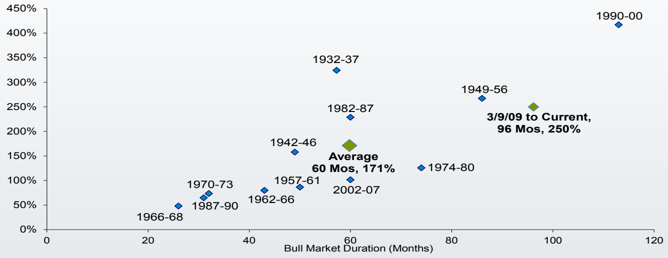
Asia

Japan's economy is continuing to show improvement. Since late 2016, growth has been driven by a recovery in both exports and manufacturing output, helped by a weaker yen and rising global demand. In turn, these factors are helping to boost corporate profits. Japan's manufacturing PMI survey, which rose to a 35-month high in February, reported improvements in output, new orders and job growth. Moreover, bank lending increased 2.9% year-on-year in February - its highest growth rate since May 2009 – which supports the view that capital expenditure is picking up. It is noteworthy that corporate bond issuance in Japan reached a historical high in 2016. These trends may reassure the Bank of Japan that its yield curve control policy is taking effect in the real economy.

While the corporate sector has shown signs of recovery, household consumption has disappointed expectations in recent months, despite the unemployment rate remaining at a 22-year low and robust labour market conditions. There is, though, a glimmer of hope that the trend might be turning. Japan's Cabinet Office reported that its monthly real consumption index rose 0.9% month-on-month in January.

The US S&P 500: History of bull markets

An extended bull market cycle



Source: Stategas

Past performance is not a reliable indicator of future performance.

Oil prices: A tight trading range was disrupted in mid-March

West Texas Intermediate ($ / barrel)

Source: Bloomberg

Wage growth remains subdued, although momentum is picking up for part-time workers. Inflation trends remain low and some distance from the Bank of Japan's target of 2%, despite Japan's core inflation rate entering into positive territory for the first time since December 2015, mainly due to a weaker yen and higher energy costs.

Data releases in China over the past month have been distorted by the Lunar Holiday effect – most notably February's trade report, which fell into a modest deficit due to a fall in exports and a surge in imports. Nonetheless, China's economy is depicting a stable growth trend, evidenced by steady growth in credit, industrial production and fixed asset investment. Retail sales growth disappointed expectations in February, rising 9.5% year-on-year, but this has been blamed on falling auto sales where tax incentives have ended. The People's Bank of China, which has recently tightened interbank lending rates, is unlikely to change monetary policy anytime soon. Targeted tightening measures have been implemented in areas of the economy which are vulnerable to overheating, such as property. These measures appear to be working as house price rises are moderating in larger Tier 1 cities, while smaller Tier 2 and Tier 3 cities are outperforming. Stability is the key policy mantra this year, with leadership changes at the highest level of the Communist Party expected to be announced in the autumn. In keeping a stable growth trend, we expect any policy support to be fiscal rather than monetary.

Market Outlook

The global economy is presenting a positive picture with both developed and emerging markets contributing to growth. The improvement in global conditions has coincided with rising financial market confidence. We appear to be in a steady state of equity markets grinding higher, gently rising bond yields and low volatility. Recognising that we are in an unusually extended market cycle, with markets now eight years on from their Global Financial Crisis lows, we believe that the improvement in financial conditions can continue in the near term, driven by excess liquidity, still dovish central banks and an improving global backdrop, with inflation not expected to run into the danger zone. That said, we acknowledge that valuations across developed market equity indices are looking more expensive and credit spreads are at historic lows (the yield difference versus the equivalent maturity sovereign bond). We are therefore comfortable with the current moderate risk overweight, but have little inclination to add further to risk levels.

- Equities: Notwithstanding the positive and improving growth outlook, our view remains that a modest overweight in equity is appropriate. The 'reflation trade' continues to dominate the market narrative, despite the bond market showing some scepticism that the growth momentum can be maintained. Valuations and performance prevent a more positive stance toward equity overall, particularly with event risk in Europe and some uncertainty around the pace of US policy moves. We retain our positive view on US equities beyond the immediate future, maintaining our slant to cyclical stocks. We have also added to positions in healthcare, where we see long-term opportunities to benefit from ageing demographics and new therapeutic discoveries. Our overweight in European equities remains a contrarian trade, but we believe this region will benefit from a corporate earnings recovery as fundamentals improve. Similarly, we expect these trends to also support Japanese equities. We remain underweight in UK equity and believe it is too early to repatriate assets. In emerging markets, we maintain our overweight position but would not add to it at this point, given its recent resilience and possible risk of a trade policy shock out of the US.
- Bonds: Interest rate policy divergence is emerging as a stronger theme in developed sovereign bond markets. Over the last month, US treasury yields have drifted higher on the re-pricing of interest rate expectations, while UK gilts, in particular, have outperformed despite a backdrop of increasing inflation. We believe that being short duration remains appropriate in the current environment of improving global growth and reflation. Credit markets should continue to be supported by improving economic fundamentals, although supply has weighed on some parts of the market more recently. In a Fed tightening environment, leveraged loans have seen notable outperformance. We continue to have select exposure to shorter-dated investment grade corporate bonds, specialist lenders and emerging market sovereign debt.
- Property: UK property developers and listed vehicles have performed well of late, supported by better than expected fourth quarter results and the rally in UK gilt yields. Nonetheless, there are few catalysts that we can see in favour of this market over the medium term, given uncertainty around Brexit, and we believe it would be too soon to add. Our underweight in UK commercial property remains intact based on the supply outlook, especially in the South East. Across sectors, we continue to seek income opportunities in the industrials and offices. On a regional basis, we are invested in cities outside of London, which are less exposed to the 'Brexit' fallout. Outside of the UK, we are also looking at opportunities in the US REIT (real estate investment trust) market, although we remain wary of the impact of the Fed's more hawkish stance.
- Commodities: Until mid-March, the low volatility and tight trading range of the oil price have been noteworthy this year and we did not expect this situation to last. Concerns around inventory levels and the discipline of OPEC producers keeping to agreed limits are now testing the market's resolve, leading to the oil price sliding to a three-month low. Despite the sell-off, we continue to expect that an improving global economic environment, reflation and a tighter supply/demand balance will ultimately be supportive to commodities this year. Direct access to this market is through owning futures contracts rather than the physical assets and while the risk/return profiles are looking more attractive across some parts of the complex, they are not yet at levels where we are ready to invest. We have, though, a position gold in some strategies for diversification.
- Hedge funds: While we have held a limited allocation to hedge funds in recent years on concerns around performance, we believe that increasing interest rate divergence should create more opportunities going forward. Our preference remains for macro/CTA strategies, but we are also taking a more positive view on equity hedge strategies, given the greater likelihood of increased stock dispersion (i.e. between winners and losers), as well as credit long/short strategies.
- Cash: We have reasonable levels of liquidity across our portfolios both in cash and short-dated bonds, which we are ready to invest as and when we see specific opportunities. Market volatility remains low, a situation unlikely to persist throughout 2017.

Asset class returns as at 28 February 2017 (in GBP)

Asset Class	Index	Historic Returns							
		1 Mth	3 Mths	6 Mths	1 Yr	2 Yrs	3 Yrs	4 Yrs	5 Yrs
Equity - UK	MSCI UK	3.1%	8.0%	8.9%	24.2%	12.8%	18.9%	31.5%	48.3%
Equity - US	MSCI North America	4.8%	8.3%	15.6%	40.4%	43.6%	77.8%	100.0%	136.1%
Equity - Japan	MSCI Japan	2.2%	6.4%	12.1%	35.2%	35.5%	60.5%	66.4%	83.9%
Equity - Europe ex UK	MSCI Europe ex UK	2.0%	9.7%	9.5%	27.3%	20.6%	27.0%	47.7%	75.4%
Equity - Pacific ex Japan	MSCI Pacific ex JP	4.2%	8.8%	14.6%	44.7%	28.1%	43.9%	28.7%	58.7%
Equity - Emerging Markets	MSCI EM	4.2%	9.5%	11.2%	45.5%	24.0%	41.8%	21.1%	28.3%
Bonds - Conventional Government	Merrill Lynch UK Gilts	3.2%	3.2%	-4.7%	6.4%	12.4%	26.2%	25.1%	28.5%
Bonds - Inflation Linked Government	Merrill Lynch UK Gilts, Inflation-Linked	1.1%	4.8%	-2.2%	20.8%	26.3%	46.6%	44.3%	53.3%
Bonds - Corporate Credit	Merrill Lynch Sterling Corporate Master	2.7%	3.9%	-2.5%	13.4%	12.0%	25.4%	30.6%	45.5%
Commercial Property	IPD All Property & FactSet UK Real Estate Invest Trust Index	2.3%	4.7%	-0.9%	0.6%	-3.1%	12.5%	41.6%	55.2%
Commodities	GSCI Index	1.3%	3.9%	14.6%	32.6%	-6.8%	-35.2%	-40.3%	-42.1%
Hedge Funds - Equity Long/Short	CSFB/Tremont Hd Fd Long/Short Eq	1.3%	3.3%	2.2%	3.4%	0.3%	5.7%	23.8%	30.6%
Hedge Funds - Global Macro	CSFB/Tremont Hd Fd Global Macro	0.3%	1.0%	4.6%	5.7%	0.8%	7.9%	11.2%	15.7%
Hedge Funds - Multi-Strategy	CSFB/Tremont Hd Fd Multi-Strategy	0.9%	3.2%	3.3%	7.4%	8.3%	15.0%	28.0%	40.3%
Cash	1 Month LIBOR	0.0%	0.1%	0.1%	0.4%	0.9%	1.4%	1.9%	2.4%

Source:

Please note that the returns given for the hedge fund and property indices are estimates, because of the delayed release of the monthly index values. The value of any investment and the income from it is not guaranteed and can fall as well as rise, so that you may not get back the amount originally invested. Past performance is not a reliable indicator of future performance.

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