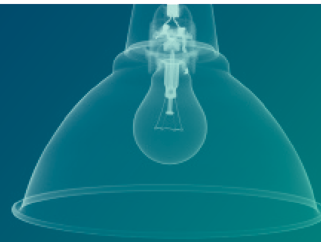
Heartwood
Investment Management



April 2017

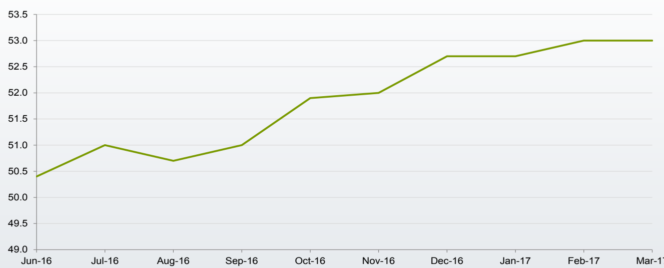
Market Update

# Monthly Strategy Review

## Summary


- Global growth data once again paints a positive picture of synchronised global growth, with both developed and emerging economies contributing.
- Central banks remain accommodative, although with a more balanced rather than dovish tone.
- While the so-called "reflation trade" has lost some momentum, we believe the fundamental backdrop remains supportive for financial markets.


**Surveys are moderating, but from relatively elevated levels**
JP Morgan Global Composite PMI




Source: Bloomberg

**Discussions around unwinding the Fed's balance sheet begin**
US Federal Reserve Balance Sheet ($bn)

Source: Bloomberg

Past performance is not a reliable indicator of future performance.

### Economic review and outlook

Global growth once again paints a positive picture of synchronised global growth, with both developed and emerging economies contributing. While survey data has moderated slightly from relatively elevated levels, it remains comfortably within expansionary territory. Moreover, activity data remains broadly intact and points to global growth being on a solid footing. In recognition of the improvement in economic conditions, global central banks are shifting their communications to a more balanced tone. Headline inflation measures have been drifting higher due to rising energy costs, but these price pressures are likely to ease over coming months. Any slowing in inflation, we believe, would be positive for consumption and relieve the pressure on real income growth. While the reflation trade that started last summer has lost momentum in certain parts of the market, our view remains that the fundamental backdrop remains constructive for financial markets.

### US

National business surveys in the US have cooled slightly over the past month, but this moderation comes off relatively elevated levels and is, in our view, to be expected, particularly in the case of manufacturing. While business and consumer confidence levels have remained buoyant, a message which was reinforced by the sharp jump of the Conference Board's Consumer Confidence Index in March to its highest level since December 2000, actual activity data has been softer in the first quarter. This moderation can be explained by seasonal factors. The slowing in industrial production growth is mainly due to the utilities sector, as unseasonably warm weather reduced demand for heating. However, manufacturing output has risen for six consecutive months, which has been helped by a recovery in the mining sector and business equipment spending. Real consumer spending (inflation-adjusted) has also slowed over the past two months, again due to the drag from lower spending on heating. Higher headline inflation, due to higher energy prices, may have also had an impact on slowing consumption.

We continue to believe that US economic growth remains on a sustainable trajectory. The US Federal Reserve minutes of March's policy meeting showed a higher level of conviction among US policymakers about the economic outlook such that they discussed not just interest rate policy normalisation, but also balance sheet normalisation. This optimism was based on their view of an economy at or near full employment, supportive financial conditions and expectations, though delayed, of expansionary US fiscal policy. While March's employment report was disappointing in terms of job gains, the weaker number was attributed to bad weather during the month. More

Clear Thinking

significantly, the unemployment rate fell to 4.5% and wage growth remained firm at 2.7% year-on-year. In addition, initial jobless claims also resumed their downward trend following rises in previous weeks. Overall, therefore, labour market conditions remain supportive to the US consumer and we expect price pressures to remain relatively contained. Consumer prices in February moderated slightly from the previous month, indicating that the effect from higher energy prices is starting to roll over. We expect Fed policymakers' forecasts of three interest rate hikes this year to be realised, unlike in recent years where Fed forecasts have not been met.

## Europe

Business and consumer confidence in Europe continues at strong levels and this increasing sense of optimism is broadening across countries. The final PMI composite survey was confirmed at a near six-year high in March and improvements have been evident across new orders, employment and input prices. Stronger momentum is particularly notable in France, which had lagged other countries up until this year and also when considered against the backdrop of upcoming electoral uncertainty. In Germany, where the country is also facing a general election in September, activity data rebounded in February. Export volumes, factory orders and industrial production saw solid increases over the month. In particular, both construction and manufacturing output showed large increases. Consumption also appears to be well supported by ongoing labour market improvements. Euro-area retail sales climbed 0.7% month-on-month in February, despite an energy-related increase in headline inflation. The effects of higher prices have been countered by the continuing trend of job creation, highlighted by the region's unemployment rate falling to 9.5% in February.

In the past couple of weeks, European Central Bank (ECB) commentary has pushed back any speculation of tapering the quantitative easing programme towards the end of this year. Various ECB policy members have reaffirmed their view of needing to be patient, highlighting that the underlying inflation rate continues to remain low. Indeed, this trend was evident in the surprise fall in both headline and core inflation in March to 1.5% year-on-year and 0.7% year-on-year, respectively (albeit somewhat distorted by the timing of the Easter holiday). The ECB policy minutes of the March meeting also reiterated the view that while policymakers have more confidence in the economic outlook, they continue to believe that monetary accommodation would still be needed if the recovery in inflation is to be self-sustaining. We are not expecting any changes to monetary policy this year, but recognise that there are more ambiguities around the forward guidance as the region's economic and financing conditions improve.

## UK

The UK economy appears to be wrestling between the conflicting forces of a weaker consumer outlook as real income growth slows and the positive impact of stronger global demand. Business surveys have remained fairly resilient in the face of domestic headwinds. The PMI manufacturing survey reported a moderate decline in March, due to a fall in the consumer goods sector, but the overall level remains above its long-term average. Meanwhile, the services PMI saw unexpected strength last month, rising to a three-month high, which mainly resulted from the improvement in external conditions. While this rebound is encouraging, the services survey also flagged concerns around the potential impact of higher prices on consumption. Prices charged rose to their highest level since September 2008, which was due to the pass-through from a weaker exchange rate. The impact of sterling's depreciation has also been noted in the higher than expected jump in headline and core inflation in February to 2.3% year-on-year and 2.0% year-on-year, respectively. The Bank of England is likely to keep monetary policy accommodative to support overall economic activity, but has also expressly stated its limited tolerance for above-target inflation.

## Asia

Japan's economy continues to benefit from the overall pick up in global demand and a weaker currency. The Bank of Japan's Tankan survey reported improving business sentiment over the first quarter, although manufacturers remain cautious about the outlook. The PMI manufacturing survey moderated in March, but this decline was offset by stronger services activity, which rose to its highest level since August 2015. There are a few signs that consumption is improving, albeit very slowly, with core real household spending rising in both January and February. Furthermore, the Cabinet Office's consumer sentiment index rose to its highest level in the last three years. As we have previously stated, labour market conditions remain very supportive, with the unemployment rate at a 22-year low and the ratio of job openings to applicants standing a multi-year high. While energy prices have had a moderate impact on inflation, both headline and core remain very low and unlikely to reach the Bank of Japan's target of 2% anytime soon.

The stable growth trend in China remains intact, with survey data in manufacturing and services continuing to see improvements. Encouragingly, foreign exchange reserves rose in March to just over $3 trillion, which was helped by a

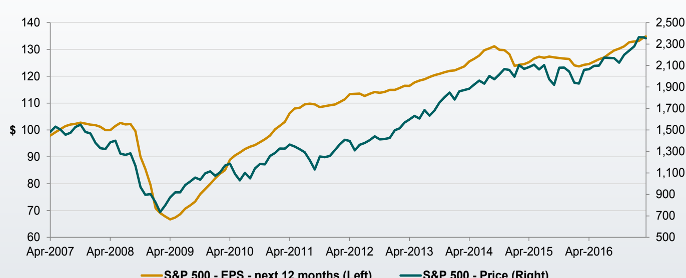
### 'Trump/reflation' trade loses some momentum

Dow Jones Industrial Average

Source: Bloomberg

Past performance is not a reliable indicator of future performance.

### S&P 500 corporate earnings growth is improving




Source: FactSet

depreciated), but this suggests that some capital is returning to China. Survey data (official and PMI) has seen improvements in March, alongside rising industrial profits, solid housing activity and increased infrastructure investment. While the People's Bank of China has tightened inter-banking lending rates this year, we expect monetary policy to remain broadly unchanged and any support to the economy is likely to come from the government. A stable growth trend is likely to be maintained, given leadership changes at the highest level of the Communist Party due to be announced in the autumn.

## Market Outlook

Notwithstanding that there has been a recent fading of momentum in the reflation trade, signalled by lower bond yields and the underperformance of certain more cyclical parts of the equity market, we believe the fundamental backdrop remains supportive to financial markets. Markets have come through a quieter period of late, but we view this pause as constructive. Investors' expectations had moved too quickly and are now being scaled back to more realistic levels. Economic survey data had reached lofty levels which were unlikely to be sustained due to the trailing gap with real activity data. Furthermore, the rolling over of inflation expectations should in time help to relieve the pressure on real incomes and add support to consumption. Overall, global growth continues to present a positive picture. The fundamentals remain supportive to corporate earnings growth, which is already seeing improvement. According to FactSet, companies in the S&P 500 reported their first two quarters of back-to-back profits growth in two years. In addition, plentiful liquidity continues to remain a key driver of financial markets, aided by very accommodative central bank policies.

Although our level of conviction in the economic outlook remains, we have made no changes to portfolios, remaining modestly overweight risk assets. That being said, our risk exposures are tilted towards more specific and targeted areas of the market, whether by sector or market-cap, which reflect our degree of confidence in the fundamental outlook. We are not inclined to increase risk levels further, as we are mindful of upcoming event risk in Europe, especially the French election, as well as broader geopolitical risks. Furthermore, while markets have paused, there has been no major setback and therefore few compelling broad valuation opportunities.

On a final note, we should acknowledge that over the past month the UK government has triggered Article 50, an event that largely went unnoticed by the markets. While Brexit remains a significant event risk in the UK, we believe any fallout will be relatively contained to our domestic market. We reiterate our caution on the UK economy and maintain a defensive home bias positioning.

- Equities: Our view remains that a modest overweight in equity is appropriate. The reflation trade has lost some momentum around fears of Trump's ability to implement his reform plans post the unsuccessful attempt to repeal the Affordable Care Act. We wish to remain fully invested in the US (and no more given valuations), with more targeted exposure – healthcare being one theme we have recently added. We remain positive on Europe, despite the upcoming event risk of the French election, and are encouraged by continuing economic improvements. Japanese equities have delivered lacklustre returns, but we continue to believe that developments in the corporate sector are supportive. We have taken some exposure to small- and mid-cap Japanese equities. Our less preferred market is the UK amid signs of slowing consumption, meaningful structural imbalances and Brexit uncertainty. In emerging markets, we maintain our overweight position but would not add at this point, given recent resilience and possible risk of a trade policy shock out of the US.

- Bonds: The loss of momentum in the reflation trade has benefited bond markets through lower inflation expectations, a fall in longer-dated bond yields and support to emerging market debt given a softer tone to the US dollar. A supportive fundamental backdrop has also helped corporate credit markets. Given the hawkish tone of the Fed minutes as well as more focus on an ECB exit strategy, we continue to believe that being short duration remains appropriate. Moreover, headline inflation trends in the UK continue to rise. We hold select exposures to shorter-dated investment grade corporate bonds, specialist lenders and emerging market sovereign debt.

- Property: UK property developers and listed vehicles have been solid performers this year, 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 the shorter term, given supply concerns and uncertainty around Brexit, and we retain our underweight position. On a regional basis, we are primarily invested in cities outside of London, which are less exposed to '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: The lack of volatility in the oil market came to an abrupt end in the last few weeks, but having fallen sharply prices are now recovering. We continue to expect that an improving global economic environment and a tighter supply/demand balance will ultimately be supportive to commodity prices 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 willo invest as and when we see specific opportunities. Market volatility remains low, a situation unlikely to persist throughout 2017.

# Asset class returns as at 31 March 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 | 1.2% | 3.8% | 8.2% | 23.6% | 16.4% | 23.6% | 31.5% | 51.9% |
| Equity - US | MSCI North America | -0.3% | 4.8% | 14.0% | 34.9% | 39.7% | 75.0% | 92.7% | 129.3% |
| Equity - Japan | MSCI Japan | -0.7% | 3.4% | 8.5% | 32.0% | 27.1% | 60.4% | 57.5% | 80.1% |
| Equity - Europe ex UK | MSCI Europe ex UK | 4.6% | 7.4% | 12.7% | 28.4% | 22.5% | 32.1% | 55.8% | 83.9% |
| Equity - Pacific ex Japan | MSCI Pacific ex JP | 2.1% | 10.5% | 13.0% | 36.3% | 27.3% | 42.7% | 32.1% | 66.8% |
| Equity - Emerging Markets | MSCI EM | 2.1% | 10.2% | 11.1% | 35.2% | 23.3% | 39.6% | 25.8% | 35.4% |
| Bonds - Conventional Government | Merrill Lynch UK Gilts | 0.3% | 1.6% | -2.0% | 6.9% | 10.4% | 26.6% | 23.3% | 30.0% |
| Bonds - Inflation Linked Government | Merrill Lynch UK Gilts, Inflation-Linked | 0.6% | 1.9% | -0.8% | 20.4% | 22.6% | 45.3% | 39.5% | 54.4% |
| Bonds - Corporate Credit | Merrill Lynch Sterling Corporate Master | 0.3% | 2.0% | -0.9% | 10.6% | 10.8% | 26.0% | 28.7% | 45.9% |
| Commercial Property | IPD All Property & FactSet UK Real Estate Invest Trust Index | 0.2% | 2.1% | 0.8% | -3.5% | -1.8% | 14.5% | 42.0% | 52.5% |
| Commodities | GSCI Index | -4.4% | -6.2% | 4.3% | 24.7% | -8.2% | -38.4% | -43.3% | -43.3% |
| Hedge Funds - Equity Long/Short | CSFB/Tremont Hd Fd Long/Short Eq | -0.1% | 2.4% | 2.1% | 2.7% | 0.6% | 6.9% | 22.0% | 29.8% |
| Hedge Funds - Global Macro | CSFB/Tremont Hd Fd Global Macro | -0.1% | -0.1% | 4.4% | 5.7% | -0.6% | 8.1% | 10.0% | 16.1% |
| Hedge Funds - Multi-Strategy | CSFB/Tremont Hd Fd Multi-Strategy | -0.1% | 1.6% | 2.7% | 6.6% | 7.1% | 15.2% | 27.1% | 39.6% |
| Cash | 1 Month LIBOR | 0.0% | 0.1% | 0.1% | 0.3% | 0.9% | 1.4% | 1.8% | 2.4% |

## Source: FactSet

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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