Heartwood
Investment Management

May 2017

Market Update

Monthly Strategy Review

Summary

- The global growth outlook remains constructive, despite a weaker than expected first quarter GDP outcome in the US.
- As economic conditions improve, central banks are shifting the tone of their official communications to a more balanced tone.
- The fundamental backdrop remains supportive to financial markets in the shorter term, but we are mindful of potential challenges further out.

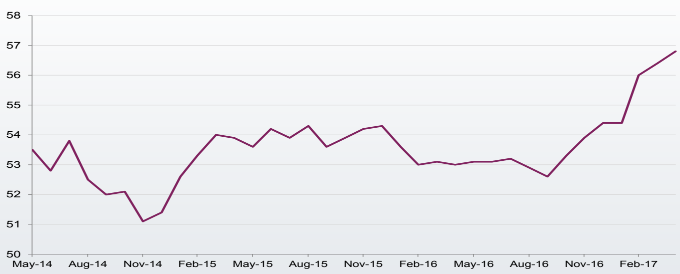
Evidence of a tighter US labour market

NFIB hard-to-fill vacancy rate series at highest level since 2000

Source: Bloomberg

Ongoing survey strength in the eurozone

Composite PMI at a multi-year high



Source: Bloomberg

Past performance is not a reliable indicator of future performance.

Economic review and outlook

Despite a weaker than expected first quarter GDP outcome in the US, the overall outlook for global growth remains constructive. We are currently seeing a synchronised picture of both developed and emerging economies contributing to global growth. Manufacturing and services surveys are maintaining a firm trend across regions, with the eurozone a notable outperformer. As economic conditions improve, global central banks are shifting their communications to a more balanced tone, increasing the probability of interest rate hikes, albeit from very low levels. The US Federal Reserve has indicated that it will raise interest rates in June, but the market remains sceptical as to whether further rate rises will be seen later this year. Meanwhile, the European Central Bank appears to be in no hurry to adjust policy, despite questions around tapering its asset purchase programme in the light of economic improvements. Headline inflation measures across developed economies have cooled over recent weeks on softer energy prices. We expect this trend to relieve the pressure on real incomes, which should be supportive to consumption. 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 in the near term.

US

First quarter US GDP underwhelmed expectations at 0.7% quarter-on-quarter, due to weaker real consumer spending, a slower rate of inventory build and lower government spending. However, business investment rose more strongly than expected, helped by equipment spending. Seasonality issues, such as the weather, tend to weigh on growth at the start of the year and most economists expect a stronger outcome in the second quarter. Although consumers appear to be more cautious on spending – real consumer spending rose just 0.3% in March, which was largely driven by utilities, while the savings rate edged up to 5.9% - labour market conditions remain solid and there is further evidence of firming wage pressures. The US employment cost index, which measures changes in labour costs, bounced 0.8% in the first quarter, with private sector wages and salaries seeing its strongest increase in a decade. Furthermore, unit labour costs accelerated 3.0% in the first quarter, as productivity growth declined 0.6%. While wage pressures remain moderate, it is worth noting that the hard-to-fill vacancy series in the National Federation of Independent Business (a small business survey) rose in April to its highest level since 2000. Inflation pressures have cooled of late – with core (excluding food and energy) – falling to 2.0% year-on-year in March. However, the impact of a tightening labour market will be something to monitor.

Expectations of a gradual tightening cycle remain on course, although the US treasury market appears to have more dovish expectations for this year than US Federal Reserve (Fed) policymakers. While the market is fully priced for a rate rise in June, it is not yet pricing in an additional rate increase later this year. This remains at odds with Fed policymakers' forecasts. Fed commentary has perhaps been slightly more hawkish of late. At April's policy meeting, the Fed appeared willing to overlook the disappointment of the first quarter GDP report, believing this weakness to be "transitory". Policymakers noted that fundamentals "remained solid" and the consumer remained underpinned by a firm labour market, notwithstanding the disappointment of March's payrolls report. The Fed will no doubt be reassured by April's payrolls report, as the US economy added 211,000 jobs and the unemployment rate fell to 4.4% - its lowest level since 2007.

Europe

With political risks subsiding in the eurozone in the wake of the French election result, the economic outlook remains constructive for the region. Survey data across the eurozone continue to strengthen to multi-year highs. The PMI manufacturing survey rose to a six-year high in April, as output, new orders and employment all remained on an upward trend. The European Commission's economic sentiment indicator also rose to a near-10-year high, with optimism rising among both industry and consumers. This trend was further reinforced by the German IFO Business Survey, which showed ongoing improvement. While surveys are at elevated levels, there is some concern as to whether these improvements are translating into actual activity data. The initial estimate of first quarter GDP came in at 1.8% quarter-on-quarter (annualised), which continues the above-trend rate of growth seen since mid-2013 but is below what the PMI surveys are indicating. Nonetheless, credit conditions remain supportive to economic activity going forward. The European Central Bank's (ECB) Bank Lending Survey showed that the outlook for the demand and supply of loans remains firm. Indeed, bank loans to households and corporates rose by €34 billion in March, which was the largest monthly gain in the post-crisis years.

The ECB left monetary policy unchanged, as expected and did not alter its forward guidance. However, the monetary policy statement acknowledged that growth risks had "further diminished", perhaps leaving the door open to shifting towards a balanced assessment of economic conditions in June. There was, though, unanimous agreement between policymakers that underlying inflation remains subdued. That being said, eurozone core inflation (flash) surprised to the upside in April at 1.2% year-on-year, although this was mainly due to distortions around the timing of the Easter holiday.

UK

First quarter GDP growth came in below consensus expectations at 0.3% quarter-on-quarter, which also falls short of the Bank of England's 0.5% forecast. However, some of the slowdown in activity has been attributed to payback in construction and manufacturing following a strong fourth quarter. It is worth noting, though, that private sector services growth weakened to levels not seen since the final quarter of 2012. That being said, the latest survey data suggests that the UK has begun the second quarter on a solid footing. The manufacturing, services and construction PMIs were all better than expected. The manufacturing survey rose to its highest level in three years, supported by stronger external demand and faster rates of growth in output and new orders. Services activity also rose back to its December 2016 level on the strength of both domestic (driven by business versus the consumer) and external demand. While the consumer outlook remains opaque, given the pressures on real income growth, April's CBI retail sales survey rose to its highest level since September, 2015 and the GFK consumer confidence survey remained stable. The recent bounce in sterling versus the US dollar and fall in the oil price may go some way to help alleviate rising cost pressures. 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

The strength and sustainability of China's economic recovery in the last 18 months has surprised many investors. The latest quarterly GDP report came in at 6.9% year-on-year, which was above our expectations and that of the consensus. March activity data also showed broad-based strength, with industrial production, fixed asset investment and retail sales improving over the month. We have also seen capital outflow presssures ease, as Chinese foreign exchange reserves rose for a third straight month in April to $3.03 trillion. The likelihood is that we may see growth slow marginally in the second half of 2017, as the effects of previous policy measures begin to wane. Indeed, the moderation in manufacturing surveys in April may already be initial indicators of this trend. Moreover, in light of recent cyclical improvements and with greater confidence in the economic outlook, the authorities are likely to focus their efforts on addressing leverage in some parts of the corporate sector and maintaining financial stability. China's central bank has been increasing interbank lending rates this year and we are likely to see further measures to tighten policy in specific areas of the economy, such as property. The authorities will need to

Political concerns in France ease

CAC (French domestic equity market)

Source: Bloomberg

Past performance is not a reliable indicator of future performance.

Oil falls below $50 for the first time since November 2016

Brent crude oil price

Source: FactSet

support the economy if needed, particularly as this remains an important political year with Communist Party leadership changes taking effect this autumn. However, the risk is that investors may underestimate the impact of financial tightening on the overall economy and we remain vigilant.

The Bank of Japan kept monetary policy on hold and made no changes to its growth and inflaton forecasts at its April policy meeting. Inflation remains weak in Japan and significantly away from the Bank's target of 2%, but the overall macro environment continues to improve, reflected in the solid trend in business surveys as external demand has strengthened.

Market Outlook

Benign economic conditions, strong corporate earnings results in aggregate across regions and reduced political risks remain supportive of our pro-cyclical stance in the near term. While the so-called 'reflation trade' has suffered a modest setback over recent weeks, mainly arising from frustration around President Trump's ability to deliver tax cuts, we expect markets to take a somewhat more positive view of growth-friendly US policy changes, further supported by growth that is durable, liquidity stimulated by ongoing central bank accommodation, and corporate earnings improvements. US policy outcomes are uncertain, but it is our view that if the Trump administration can at least make some headway on its proposals, such as tax relief on overseas cash repatriation, then this cannot be ignored for its potentially positive impact on US capital expenditure and broader economic activity. Furthermore, headline inflation measures have started to peak, due to energy price effects, which should in time help to relieve the pressure on real incomes, adding support to consumption.

While our view remains constructive in the shorter term, we can envisage being more cautious further out. We remain modestly overweight in risk assets and have not made any meaningful changes to portfolios. Our risk exposures are tilted towards more specific and targeted areas of the market, whether by sector or market-cap, to reflect our degree of confidence in the near-term fundamental outlook. However, we also recognise that we are in the later stage of the market cycle and investor sentiment could be more vulnerable to potential pressure points as we move through the year. In particular, we would highlight the potential headwinds of higher US interest rates and tighter financial conditions in China. Furthermore, one of the key elements to a stable financial environment over the last few years has been central bank support, which has been reflected in rising valuations across asset classes. We expect this comfort blanket to be tested more by investors in the second half of the year, particularly as we pass through the electoral cycle in Europe. Overall, we are maintaining our positive view in the shorter term but expect to be more cautious as the year progresses.

- **Equities:** Notwithstanding the generally supportive backdrop, our view remains that a modest overweight in equity is appropriate. Valuations and performance prevent a more positive stance towards equity overall, as we are mindful of potential event risk and the later stage of the market cycle. We wish to remain fully invested in the US (and no more given valuations), with more targeted exposure to specific sectors. We are maintaining our overweight positions in European and Japan, which favour our pro-cyclical stance. In Japan, we have taken some exposure to small- and mid-cap Japanese equities in our higher risk strategies. UK equity remains an underweight position and we believe it is still too soon to repatriate assets. However, to mitigate the risk of a further bounce in sterling, we are slight re-orientating our UK equity position towards more exposure to mid-caps. The resilience of emerging market equities has been impressive and suggests a more positive outlook in the absence of a trade shock out of the US. However, we do not want to chase performance from here, already having a reasonable exposure to this asset class.
- **Bonds:** Over the last month, bonds have benefitted from elevated geopolitical tensions and softer inflation expectations. We do not believe the downward trend in yields is being driven by a deteriorating growth backdrop and therefore do not see durability in this trend. Furthermore, investor positioning is less of a headwind to higher yields than it was six months ago. Given the Fed's more hawkish tone, albeit at the margin, as well as more focus on an ECB exit strategy, we continue to believe that being short duration remains appropriate. Credit spreads - both US corporate credit and emerging market sovereign debt (hard and local currency) - continue to tighten given the solid growth backdrop.
- **Property:** UK property developers and listed vehicles continue to perform well, supported by better than expected fourth quarter results and the fall 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:** Notwithstanding the recent slide in the oil price, we continue to expect that an improving global economic environment and a tighter supply/demand balance will ultimately be supportive to commodity prices later 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. Despite its recent pullback, we maintain our position in gold as we continue to see it as a vital diversifier. Industrial/base metals have been weak, despite positive data surprises from China. Any further weakness may provide an opportunity to add.
- **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 will invest as and when we see specific opportunities. Market volatility remains low – a situation that we believe is unlikely to persist as we move into the second half of the year.

Asset class returns as at 30 April 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	-1.3%	3.0%	5.8%	20.1%	11.2%	18.1%	29.0%	50.4%
Equity - US	MSCI North America	-2.5%	1.8%	6.5%	32.9%	39.3%	71.6%	89.4%	128.4%
Equity - Japan	MSCI Japan	-2.3%	-0.9%	-1.7%	25.5%	24.1%	62.9%	44.9%	84.7%
Equity - Europe ex UK	MSCI Europe ex UK	0.8%	7.6%	9.4%	28.9%	23.6%	32.5%	52.9%	96.0%
Equity - Pacific ex Japan	MSCI Pacific ex JP	-2.9%	3.3%	5.4%	32.1%	23.1%	37.2%	26.4%	62.1%
Equity - Emerging Markets	MSCI EM	-1.2%	5.1%	2.9%	35.4%	17.1%	39.2%	26.4%	37.6%
Bonds - Conventional Government	Merrill Lynch UK Gilts	0.2%	3.8%	2.4%	8.5%	13.2%	26.0%	22.2%	29.6%
Bonds - Inflation Linked Government	Merrill Lynch UK Gilts, Inflation-Linked	2.5%	4.3%	2.2%	26.3%	26.4%	47.5%	41.4%	58.3%
Bonds - Corporate Credit	Merrill Lynch Sterling Corporate Master	0.6%	3.5%	3.5%	10.7%	13.7%	25.1%	25.6%	47.0%
Commercial Property	IPD All Property & FactSet UK Real Estate Invest Trust Index	3.9%	7.3%	10.9%	-1.4%	0.1%	15.6%	41.5%	57.5%
Commodities	GSCI Index	-5.4%	-8.3%	-5.8%	9.1%	-19.0%	-41.4%	-42.3%	-45.2%
Hedge Funds - Equity Long/Short	CSFB/Tremont Hd Fd Long/Short Eq	-0.1%	2.1%	3.9%	4.3%	1.5%	8.9%	21.5%	31.5%
Hedge Funds - Global Macro	CSFB/Tremont Hd Fd Global Macro	-0.1%	0.4%	3.0%	5.6%	0.2%	8.2%	8.2%	16.5%
Hedge Funds - Multi-Strategy	CSFB/Tremont Hd Fd Multi-Strategy	-0.1%	1.8%	3.6%	7.2%	8.1%	16.7%	26.9%	40.0%
Cash	1 Month LIBOR	0.0%	0.1%	0.1%	0.3%	0.8%	1.3%	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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