Heartwood Investment Management

July 2017

Market Update

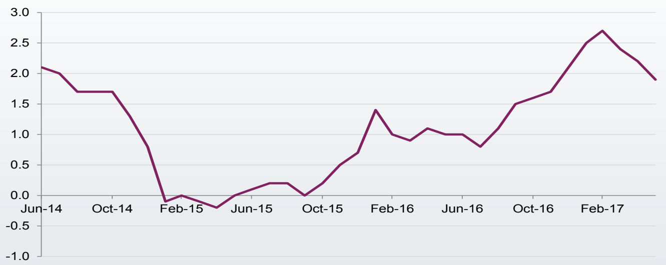
Monthly Strategy Review

Summary

- Global growth remains supportive, although we are seeing slightly more dispersion between economies than in the first quarter.
- Central banks are signalling their intent to begin to withdraw emergency stimulus and appear willing to overlook recent inflation disappointments.
- With more interest rate policy uncertainty and given higher valuations in some parts of financial markets, we believe it is prudent to begin a very gradual programme of risk reduction.

The Fed is looking through moderating inflation

US Consumer Price Index (CPI) YoY



Source: Bloomberg

UK economic activity is softening

UK Construction Output Index (3 month on 3 month series)

Source: Bloomberg

Past performance is not a reliable indicator of future performance.

Economic review and outlook

Global growth remains firm, although we are seeing slightly more dispersion between economies. The US and UK appear to have lost some momentum (the UK is looking more vulnerable as rising inflation puts pressure on real wages), while Europe continues to outperform expectations. Growth in Japan and the emerging markets is showing resilience. Despite a somewhat less synchronised picture of global growth, central banks are increasingly signalling their intent to withdraw emergency stimulus. It is notable that policymakers appear willing to overlook recent inflation disappointments, which they see as transitory, preferring to focus on the solidity of global growth.

US

Overall, the US economy is maintaining a solid growth trend, despite a few recent data disappointments. First quarter US GDP was revised higher to 1.4% (annualised) on an upward revision to consumption. Retail and vehicle sales both underwhelmed in June, but consumer confidence indicators continue to hold up well and personal income rose more than expected in May (0.4% month-on-month). Regional manufacturing surveys showed solid readings in June, with the New York survey rebounding strongly from the decline in May. National manufacturing surveys have provided mixed signals. The ISM survey corroborated the firm tone of the regional surveys, but the final PMI survey cooled in June, although it is still firmly within expansionary territory. Meanwhile, services activity remains firm.

The US Federal Reserve ('the Fed') raised interest rates in June by 25 basis points in a widely expected move. Although momentum has moderated at the margin, the rate move was justified on the basis of strengthening labour market conditions. A strong US payrolls report in June – with 222.000 job gains and upward revisions to the prior two months – provides further support to the Fed continuing its gradual tightening programme. Price pressures remain tame, however, and wage growth tepid at 2.5% year-on-year. Fed policymakers appear willing to overlook recent inflation disappointments - core inflation (excluding food and energy) rose only modestly by 0.1% on the month in May – and are expected to begin unwinding the balance sheet later this year. However, this reduction is likely to be very gradual and implemented in phased steps.

Europe

Business, consumer confidence and economic sentiment

Clear Thinking

surveys all remain at multi-year highs, supporting a positive outlook for domestic demand in the second half of the year. Consumption also remains underpinned by an improving labour market, with the trend in jobs growth at one of its highest levels in the past decade. Employment in manufacturing is seeing particular benefit from strengthening external demand. Credit trends are positive and eurozone activity data also remains robust, including the latest retail sales and industrial production reports.

In consequence, the European Central Bank (ECB) is taking an increasingly positive view of economic conditions in the region. The monetary policy statement from June's meeting removed the easing bias on interest rate policy but made no changes to the Bank's policy of quantitative easing, maintaining the flexibility to increase purchases if growth deteriorates. President Draghi signalled that some reduction in stimulus might be warranted given highly accommodative conditions, and the strong improvements seen in the eurozone economy in the last three years. However, inflation continues to remain subdued (1.2% year-on-year) and European policymakers remain cautious about implementing a tightening programme too soon.

UK

Relative to other developed economies, the UK economy is exhibiting signs of softer momentum. The final PMI surveys across manufacturing, services and construction all showed declines in June, which, in part, is being blamed on political and economic uncertainty. Construction output fell for the second consecutive month in May and there were also declines in industrial production and manufacturing output. The UK consumer continues to remain vulnerable to inflationary pressures, as wage growth struggles to keep pace. Higher import costs drove consumer prices to a four-year high of 2.9% year-on-year in May, while retail sales fell -1.2% on the month, which was a larger decline than expected. This suggests that April's strength was probably distorted by temporary factors, such as the Easter holidays. However, labour market conditions remain tight and employment gains contributed to a fall in the unemployment rate to 4.5% in the three months to May.

Until recently, there has been a uniform view among Bank of England policymakers to keep interest rates on hold. However, that consensus is now being challenged by the conflicting forces of rising inflationary pressures versus the dampening effect of higher prices on consumption. Although monetary policy was kept on hold in June, three dissenters voted in favour of an interest rate increase, with inflation concerns cited as their reason. More ambiguity around the interest outlook has since been raised by Governor Carney and the Chief Economist, Andrew Haldane, who have each signalled that a hike might be appropriate to reduce some stimulus. Our view is that much of this hawkish rhetoric is likely to be short-lived and that the Bank of England will continue to maintain accommodative financial conditions, as we expect that the downside risks to UK growth are more relevant to setting current policy. Consumer borrowing is a concern, but we expect any policy tightening will be implemented through macro-prudential measures – the capital buffer on UK lenders was raised from zero to 0.5% at the June meeting.

Asia

Economic activity in China continues to show a moderating but stable trend. Retail sales growth has been steady in the second quarter, but industrial production and fixed asset investment have moderated, particularly in May. Consumer and producer prices were unchanged in June and suggest stabilising inflationary trends. Furthermore, targeted policy measures to slow the pace of house price appreciation in the larger cities are also taking effect. We expect growth to continue to moderate in the second half of the year, although the authorities will be keen to ensure that a stable trend remains intact, especially as leadership changes take place within the Communist Party in October.

Japan's economy continues to benefit from stronger external demand. Large firms' sentiment improved in June, according to the Reuters Tankan Survey, and the Bank of Japan's real export index rose 1.9% on the month in May. The manufacturing PMI survey moderated in June, though showing rising export orders and ongoing job gains. Services activity was also strong in June. Consumer sentiment surveys are at multi-year highs and credit trends are turning positive. Consumers are being supported by tight labour market conditions, although wage growth remains lacklustre. Monthly wages per worker rose just 0.7% year-on-year in May, with some of this downward pressure on wage momentum explained by the larger share of part-time workers in the labour force. The Bank of Japan kept monetary policy on hold and kept its inflation assessment unchanged. However, in July, the rise in global bond yields prompted the Bank to launch a buying operation of 10-year fixed-rate bonds as part of its yield curve control (YCC) policy (keeping yields at or near zero for bond maturities of 10 years and below). This was the first intervention in the market since February and only the third operation since the YCC policy was implemented last October. It highlights the increasing interest rate policy divergence between developed economies.

Less dovish central banks prompt bond investors to reevaluate
German 10 year bund yield

Source: Bloomberg
Past performance is not a reliable indicator of future performance.

Gold price under pressure on expectations of tightening
US $ per Oz

Source: Bloomberg

Market Outlook

The growth backdrop remains supportive, although at the margin there appears to be some softening in momentum in the US and UK. This is resulting in the synchronicity of global growth appearing to be less pronounced than was the case earlier this year. What is notable, however, is that this slight slowing in momentum has done little to shift central banks from their willingness to exit emergency levels of stimulus. In their view, deflation risks have been largely defeated and this has been evidenced by the hardening tone of more hawkish iterations in recent weeks, albeit nuanced and modest. In short, the direction of travel is clearly in favour of policy normalisation.

In consequence, we believe that central bank policy risk is rising. Risks may come from less liquidity being added to financial markets as the Fed starts to unwind its balance sheet; the fact that central banks may not necessarily be the backstop they once were should global growth falter; and finally, the potential adverse impact of any further hawkish communications or policy actions on investor sentiment. Given greater interest rate policy uncertainty and recognising that valuation levels in some parts of financial markets are elevated, we believe it is appropriate to begin to reduce equity risk in portfolios, with a view to further reducing exposure in coming weeks. This begins a phased and incremental programme of risk reduction, though flexible enough to be re-calibrated in either direction to adapt to changing economic conditions. We also consider that by starting to reduce risk levels now, we expect to be in a better position to take advantage of market opportunities were we to see higher levels of volatility.

- **Equities:** While our central case of reasonable economic growth, supportive central bank policy and only modest upward pressure on inflation remains intact, we are more concerned about the possible impact of less predictable central bank rhetoric and actions, which may potentially lead to increased volatility across markets. Therefore, we are beginning a modest reduction in equities, although continuing our policy of targeting specific themes. We are viewing the US as a source of funds given valuations, but maintaining exposures in healthcare and smaller companies. We are retaining overweight positions in European and Japanese equities, as economic momentum continues to improve. In Japan, we have increased exposure to smaller companies in our higher risk strategies. UK equity remains an underweight position and we believe it is still too soon to repatriate overseas assets, given domestic political uncertainties. We are maintaining a bias to UK larger companies, which have performed well as sterling has weakened over the last year. We have trimmed some of our EM equity exposure following a strong run this year. We are comfortable at current levels and consider that the longer-term structural case remains intact, given improving growth prospects, expectations of policy easing in several economies as inflation trends ease and ongoing liquidity flows.

- **Bonds:** The hawkish tone of recent central bank communications has caused some re-evaluation across sovereign bond curves, pushing global yields higher especially in the intermediate-dated sector. These moves have been supportive of our long-running stance that the market is too dovish relative to central banks and we may expect further re-pricing in the second half of the year. Credit spreads have remained firm against a solid global backdrop. We believe that a short duration stance remains appropriate.

- **Property:** We retain our underweight position, believing this to be a prudent stance in light of UK political uncertainties, as well as acknowledging the maturity of the current economic cycle. While activity has slowed and there are questions about rent sustainability, our regional bias and reasonable discounts on certain instruments will provide some protection in the event that market yields move higher. At this stage, there is no appetite to add overseas exposure.

- **Commodities:** Factors weighing on the oil price continue to be concerns around the effectiveness of OPEC production cuts to counter rising US production; scepticism that Qatar and Iran will cooperate with Saudi cuts; and Nigeria and Libya ramping up production. Industrial metals have been performing better, especially copper, implying better news on China. We are maintaining our position in gold as we continue to see it as an important diversifier for portfolios.

- **Hedge funds:** While we have held a limited allocation to hedge funds in recent years on concerns around performance, we believe that increasing monetary policy divergence should create more opportunities in this sector 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).

- **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 June 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	-2.5%	0.8%	4.7%	16.7%	20.7%	20.5%	35.3%	56.5%
Equity - US	MSCI North America	0.1%	-0.9%	3.9%	21.1%	46.3%	68.6%	87.1%	131.0%
Equity - Japan	MSCI Japan	0.5%	1.3%	4.7%	23.1%	32.3%	56.2%	52.6%	93.2%
Equity - Europe ex UK	MSCI Europe ex UK	-1.3%	4.8%	12.6%	29.0%	36.5%	38.5%	61.7%	107.3%
Equity - Pacific ex Japan	MSCI Pacific ex JP	1.5%	-2.2%	8.0%	23.1%	35.2%	37.2%	44.8%	68.3%
Equity - Emerging Markets	MSCI EM	0.5%	2.4%	12.8%	27.8%	32.7%	37.4%	39.8%	49.2%
Bonds - Conventional Government	Merrill Lynch UK Gilts	-2.1%	-1.4%	0.3%	-1.0%	13.0%	23.5%	26.5%	23.4%
Bonds - Inflation Linked Government	Merrill Lynch UK Gilts, Inflation-Linked	-3.1%	-2.3%	-0.5%	6.7%	23.1%	40.6%	46.2%	50.2%
Bonds - Corporate Credit	Merrill Lynch Sterling Corporate Master	-1.2%	0.6%	2.7%	6.7%	16.5%	23.9%	33.5%	43.9%
Commercial Property	IPD All Property & FactSet UK Real Estate Invest Trust Index	-0.5%	3.7%	6.4%	5.6%	-0.4%	11.9%	43.3%	57.5%
Commodities	GSCI Index	-2.5%	-9.0%	-14.6%	-6.4%	-18.6%	-44.1%	-45.2%	-42.2%
Hedge Funds - Equity Long/Short	CSFB/Tremont Hd Fd Long/Short Eq	-0.1%	3.1%	6.5%	8.1%	2.9%	9.4%	24.5%	41.5%
Hedge Funds - Global Macro	CSFB/Tremont Hd Fd Global Macro	-0.1%	-1.3%	-1.2%	3.8%	0.0%	5.1%	9.6%	16.4%
Hedge Funds - Multi-Strategy	CSFB/Tremont Hd Fd Multi-Strategy	-0.1%	2.1%	4.8%	8.6%	10.1%	17.6%	30.1%	44.0%
Cash	1 Month LIBOR	0.0%	0.1%	0.1%	0.3%	0.8%	1.3%	1.8%	2.3%

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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