Heartwood Investment Management

March 2018

Market Update

Monthly Strategy Review

Summary

- Global growth remains robust, although momentum is beginning to stabilise following the strong gains over the past year.
- Cyclical inflation pressures are rising moderately and the US Federal Reserve is leading efforts to normalise monetary conditions, albeit gradually.
- Risk assets remain supported by a solid growth backdrop and liquidity. However, we would not be surprised to see higher levels of volatility this year, as seen in early February, as financial markets adjust to higher interest rates and higher inflation.

Global momentum is stabilising

JP Morgan Global Manufacturing Purchasing Managers' Index

Source: FactSet

The US economy continues to add jobs

US employees on non-farm payrolls (thousands of persons)

Source: FactSet

Past performance is not a reliable indicator of future results.

Economic review and outlook

Following strong global growth gains over the past year, the latest survey data appears to show a stabilising trend. We continue to expect to see above-trend global growth this year, with US fiscal stimulus efforts lifting prospects. Cyclical inflation pressures are rising gradually and business surveys point towards moderate pipeline pressures. While wage growth remains contained across developed economies, we expect that ongoing labour market improvements should begin to exert upward pressure, thus supporting consumption. In the meantime, efforts to normalise monetary conditions are being led by the US Federal Reserve, although this process remains incremental and thereby keeps financial conditions supportive for markets.

US

US economic momentum remains robust, with recent tax changes and additional fiscal stimulus likely to help maintain an above-trend rate this year. At the start of the year, though, seasonal effects and bad weather have weighed on US survey and activity data. Manufacturing and industrial output have moderated in line with the global trend, although some of this has been offset by rising services activity. Bad weather and delays in issuing tax refunds are also cited as factors contributing to the slowdown in consumption since December, with retail sales data disappointing in both January and February. However, the moderation in spending also comes after a relatively strong fourth quarter, when activity was boosted by the post-hurricane impact.

We believe that the strength of the labour market will be an important underpin to domestic consumption going forward. Despite the relative maturity of the labour market cycle, job creation continues at a brisk pace: the US economy added 313,000 in February and prior months' readings were revised higher. The unemployment rate remained at a 17-year low for the fifth consecutive month, with a gradual rise in the labour force participation rate being another encouraging development. While wage growth mildly disappointed in February from January's strong reading (declining to 2.6% year-on-year from 2.8% year-on-year), the rise in the average work week suggests that labour income should be supported further out.

Tighter labour market conditions and the pass-through from a weaker US dollar and energy price rises over the past year are contributing to rising cyclical inflation pressures. While January's core inflation reading (excluding food and energy) sparked fears of a potentially faster US Federal Reserve (Fed) interest rate cycle, these concerns have been tempered by February's more moderate reading of 0.2% month-on-month. The US treasury market is fully priced for an interest rate rise in March. However, there is now more debate among investors as to whether Fed policymakers will adjust their median interest forecast of interest rates this year from three to four. Chair Jerome Powell's testimony to Congress hinted at four interest rate rises, and we expect that the US treasury market will be probably playing catch-up with the Fed.

UK

The UK economy is growing more slowly than the rest of the G7, with fourth quarter GDP expanding 0.4% quarter-on-quarter. Nonetheless, despite the overhang of Brexit uncertainty on businesses and households, the strength of the global economy appears to be helping to sustain improvements across manufacturing and business services. February's PMI surveys showed a slight moderation in manufacturing, which was in line with the global trend, but service sector activity expanded to a four-month high. The latter trend was further corroborated by a stronger-than-expected rise in the CBI's services output in the three months to February.

On the consumer side, retail sales growth underwhelmed in January (+0.1% month-on-month following December's decline), but mortgage approvals rebounded and the European Commission's UK consumer confidence indicator showed a modest improvement in February. Labour market conditions remain supportive, notwithstanding a small uptick in the unemployment rate to 4.4% in the three months to December.

The Bank of England has been reassured by the strength of the global backdrop in supporting UK growth, particularly amid Brexit uncertainty. UK economic resilience together with above-target inflation have prompted Bank of England policymakers to signal support for another interest rate rise this year. We do not believe this move is yet assured, given the real income pressures on UK household budgets as well as more signs that UK inflation is peaking. January's consumer prices remained at 3.0% year-on-year and while inflation is likely to stay stubbornly above the Bank's target of 2% in the near term, we expect it to eventually roll over on the base effects of currency movements and energy prices. Near-term growth forecasts have been nudged higher (the UK government has just raised its 2018 forecast to 1.5%), but the longer-term outlook remains more uncertain. In particular, the Bank of England remains concerned about weak productivity growth, despite some improvements since the second half of 2017, which is likely to be further accentuated by a fall in labour supply from the European Union.

Europe

In contrast to recent months, business and consumer confidence surveys have moderated in February, although the extent of these declines are trivial when considered in the context of the longer-term trend. In particular, while the closely watched PMI composite output index for the eurozone fell from January's 12-year high, it continues to stand at an expansion high and points towards above-trend growth for the eurozone economy this year. There are signs that private consumption is moderating, as evidenced by the fourth quarter 2017 GDP report, where exports were one of the primary drivers of growth. Understandably there are concerns about the impact of euro currency strength on external demand, but we are encouraged by improving capital expenditure levels and rates of capital utilisation, which are now at levels last seen in 2007. Political risks have also resurfaced with an inconclusive election result in Italy, but so far the strength of the underlying eurozone economy remains intact.

The European Central Bank (ECB) left monetary policy unchanged in March and provided little indication about the timing of any potential exit from emergency stimulus measures. While the ECB reinforced its message of patience and data dependency, it removed the statement about standing ready to increase asset purchases if the economic outlook deteriorates. The underlying inflation trend remains a concern for policymakers, given subdued core inflation remains Importantly, though, the eurozone region is seeing meaningful improvements in labour market conditions, with the unemployment rate having fallen sharply over the past year to 8.6% in February.

Asia

As seen in other developed economies, rising capital expenditure in Japan is helping to boost both domestic and external demand. Fourth quarter GDP growth rose 1.6%, which represents eight consecutive quarters of positive growth in Japan for the first time since 1989. Business sentiment surveys showed some moderation in February and activity in industrial output, housing and retail sales fell from December to January, although bad weather was largely being blamed. Wage growth remains modest, despite an unemployment rate at a 25-year low, and this seems to be holding back domestic consumption. The Bank of Japan left its current policy stance unchanged in March and did not provide any guidance on the timing of any

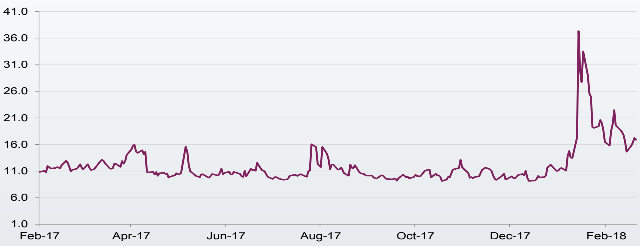
A sharp rise in 10-year US bond yields year-to-date

10-year US treasury yield

Source: FactSet

Equity market volatility has returned with rising yields

VIX - implied volatility levels of S&P 500



Source: FactSet

Past performance is not a reliable indicator of future results.

potential exit from extraordinary stimulus measures. However, outside of this meeting, Governor Kuroda has alluded to Japan reaching the Bank's inflation target of 2% by April 2019.

In China, activity indicators for January and February came in stronger than expected, countering the manufacturing PMI survey data which suggested a slowdown at the start of the year. Industrial production and fixed asset investment surprised above expectations (7.2% and 7.9% year-on-year, respectively), suggesting that both external and domestic demand conditions are providing a supportive backdrop. Exports grew 9.5% month-on-month (seasonally-adjusted) in the first two months of the year. Consumer measures moderated, however, with retail sales growth slowing due to weaker car sales. Home sales also moderated as the effects of targeted tightening measures continue to be felt. We expect a moderate slowdown in growth this year, as excess capacity and leverage are reduced. China's authorities are expected to carefully manage the rebalancing of the economy against a supportive external backdrop (absent trade tariff risks), but we could also see more volatility in the data as the year progresses.

Market Outlook

Global growth momentum is starting to stabilise, as shown by the moderation in global manufacturing surveys. This trend is to be expected following elevated readings in recent months. Global economic fundamentals are intact and we are encouraged by rising capital expenditure levels, gradual reflation, and the likely positive impact of US fiscal stimulus, all of which should lead to further improvements in corporate profitability. While global consumption has seen some slowing at the start of the year, we expect that ongoing labour market improvements will lead to moderate wage gains, providing an important underpinning to domestic demand.

The solidity of global growth and supportive liquidity conditions continue to support risk assets, notwithstanding the maturity of the current cycle. The early February wobble, which was triggered by rising bond yields, jolted investors out of their comfort zone following unusually low levels of volatility throughout 2017. We would not be surprised to see more of these types of episodes as the year progresses, especially as financial markets adjust to a different stage of the market cycle, characterised by more 'normal' conditions of higher interest rates and higher inflation. Risks have also heightened around global trade and protectionism, although so far the US administration's actions should have a fairly limited economic impact. We are comfortable with maintaining our portfolios' current risk levels: a short duration position in bonds, a modest overweight in equities and an underweight allocation to UK commercial property. We continue to actively source diversified return streams from alternative assets, which we expect are better positioned to withstand higher levels of market volatility. With valuations remaining elevated in some parts of the market, we continue to retain a moderate value tilt within portfolios.

- **Equities:** We have obviously witnessed a change of dynamic in markets since mid-January. While US tax changes are positive for growth and corporate earnings are seeing upgrades, the reappearance of volatility from decade-lows has unnerved investors. Energy and utilities have been the weak spots unusually, while technology and smaller companies have shown more defensive characteristics. Overall, we maintain our view that a modest overweight allocation to equities remains appropriate, though mindful that the backdrop of strong fundamentals and liquidity is set against the risks of high valuations. We are still not pushing for a shift back to UK equities at the expense of overseas, remaining underweight relative to other regions. We retain overweight positions in European and Japanese equities, with neutral exposure in US equities targeted to specific themes, such as biotech, energy and insurance. We continue to view our US exposure as a future source of funds on valuation grounds. Our emerging market equity exposure remains tilted towards Asia.

- **Bonds:** Developed sovereign bond yields have seen notable rises, with the most pronounced moves in the US. Higher inflation expectations and growing confidence in the economic outlook among Fed policymakers have contributed to higher yields. Rising interest rates has also led to high yield bonds and emerging sovereign debt incurring small losses on a total return basis year-to-date. Despite the back-up in yields, we continue to believe that developed sovereign bond valuations remain unattractive and maintain our short duration position. We are targeting 'niche' return drivers, such as asset-backed securities and infrastructure loans, until value returns to conventional credit.

- **Property:** Listed UK commercial property has had a weak start to the year, with performance weighed down by the large developers. We are comfortable maintaining our underweight position in UK commercial property, favouring a targeted approach towards diversified, long-term income strategies. Our preference remains for those sectors where there are supply/demand imbalances (industrials and UK regions) and that are less exposed to broader macroeconomic events, such as alternative property exposures. While capital appreciation opportunities are diminishing given the maturity of the cycle, we continue to believe that UK commercial property offers attractive yields over UK gilts (notwithstanding the recent rise in bond yields), which continue to be above historic averages in most sectors.

- **Commodities:** We are maintaining exposure at current levels, having modestly increased allocation at the start of the year. Commodity prices have been circling near two-year highs over recent weeks, with agriculture being an area of strength. OPEC compliance remains high and supply discipline is a key pillar supporting the near-term outlook. A higher oil price would also be welcomed by Saudi Arabia due to fiscal deficit pressures and in advance of the floatation of the state oil giant Saudi Aramco. Over the longer term, US shale production is likely to reawaken supply pressures. Industrial metals are sensitive to rebalancing and deleveraging in China, but environmental controls introduce supply-side constraints which could be supportive to prices. Gold continues to play a protective role in portfolios in the event of any financial or geopolitical crisis.

- **Hedge funds:** We made no change to our current allocation, although we expect more opportunities to arise owing to increasing monetary policy divergence and sector and stock dispersion. Our preference remains for macro/CTA strategies for portfolio diversification, as well as equity hedge strategies that have the potential to benefit from increased stock dispersion.

- **Cash:** We are maintaining reasonable levels of liquidity across our portfolios both in cash and short-dated bonds, which we believe will leave us well positioned in higher volatility market environments.

Asset class returns as at 28 February 2018 (in sterling)

Asset Class	Index	1 Mth	3 Mths	6 Mths	1 Yr	2 Yrs	3 Yrs	4 Yrs	5 Yrs
		Historic Returns							
Equity - UK	MSCI UK	-3.4%	-0.5%	-1.4%	3.2%	28.1%	16.4%	22.7%	35.6%
Equity - US	MSCI North America	-0.8%	0.8%	3.1%	5.2%	47.7%	51.1%	87.1%	110.4%
Equity - Japan	MSCI Japan	1.7%	1.9%	6.7%	10.3%	49.2%	49.5%	77.1%	83.6%
Equity - Europe ex UK	MSCI Europe ex UK	-2.6%	-1.2%	-2.1%	12.1%	42.6%	35.2%	42.3%	65.5%
Equity - Pacific ex Japan	MSCI Pacific ex JP	-0.2%	2.4%	-0.3%	5.0%	51.8%	34.5%	51.0%	35.1%
Equity - Emerging Markets	MSCI EM	-1.5%	5.2%	3.5%	18.3%	72.1%	46.7%	67.7%	43.3%
Bonds - Conventional Government	Merrill Lynch UK Gilts	0.3%	-0.4%	-2.5%	-1.2%	5.1%	11.0%	24.7%	23.5%
Bonds - Inflation Linked Government	Merrill Lynch UK Gilts, Inflation-Linked	0.3%	-0.4%	-3.0%	-1.2%	19.3%	24.8%	44.8%	42.5%
Bonds - Corporate Credit	Merrill Lynch Sterling Corporate Master	-1.1%	-0.4%	-1.8%	1.2%	14.7%	13.3%	26.9%	32.1%
Commercial Property	IPD All Property & FactSet UK Real Estate Invest Trust Index	-4.2%	1.5%	4.4%	10.4%	11.4%	7.3%	24.6%	56.8%
Commodities	GSCI Index	-0.2%	2.5%	6.2%	-3.4%	28.2%	-10.0%	-37.4%	-42.3%
Hedge Funds - Equity Long/Short	CSFB/Tremont Hd Fd Long/Short Eq	-0.1%	3.7%	6.2%	13.1%	17.0%	13.4%	19.5%	39.9%
Hedge Funds - Global Macro	CSFB/Tremont Hd Fd Global Macro	-0.1%	3.9%	4.7%	4.3%	10.2%	5.1%	12.6%	16.0%
Hedge Funds - Multi-Strategy	CSFB/Tremont Hd Fd Multi-Strategy	-0.1%	2.1%	2.5%	7.1%	15.0%	16.0%	23.1%	37.0%
Cash	1 Month LIBOR	0.0%	0.1%	0.2%	0.3%	0.7%	1.2%	1.7%	2.2%

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 results.**

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