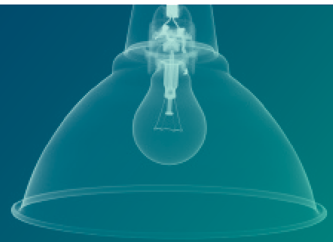
Heartwood Investment Management

July 2018



Market Update

Strategy Review

Key takeaways

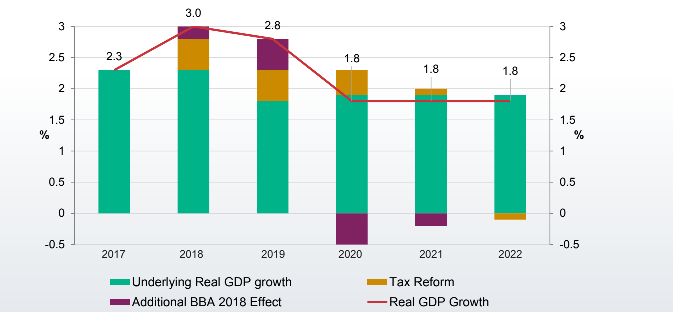
- The US is leading the pack in terms of global growth as shown by resilient macroeconomic and earnings data and a fiscal tailwind from the recent tax cuts.
- The Federal Reserve raised interest rates by 25 basis points in June and signalled two further rises this year.
- Investor sentiment is becoming more risk averse as the trade war between the US and China escalates.
- We are comfortable being slightly overweight risk assets in the portfolios, although we are more defensively positioned than we have been for a while.
- We maintain our preference for equities and commodities over bonds.

Asset class	Current positioning for Balanced strategy
Equities	+
Bonds	-
Property	-
Hedge Funds	-
Commodities	+
Cash	+

Market review

Global stock markets largely trod water over May and June with increased volatility and escalating trade-tariff rhetoric between the US and China. Bond markets continued to struggle even though risk aversion escalated in the latter part of June, while precious metals failed to capitalise on safe-haven demand.

US fiscal tailwind strengthens from tax cut boost



Source: Citi

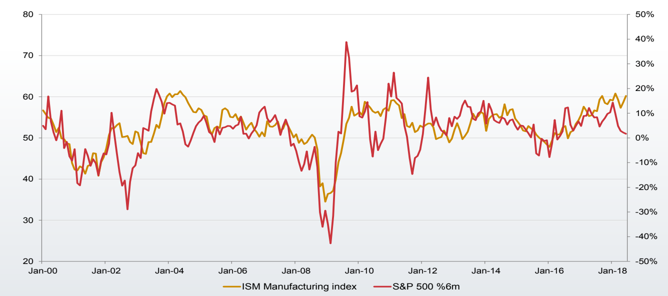
Past performance is not a reliable indicator of future results.

More resilient economic and earnings data, predominantly from the US, continue to drive the global growth backdrop. Output gaps and full employment indicators now point to a maturing, not peaking, economic cycle, which has been given added impetus by recent growth in capital expenditure and fiscal spending at a time when it would normally be in decline. Further strength is likely given the 2018/19 fiscal tailwinds from the tax cuts in early 2018, but importantly, there are also signs of strengthening in other economies, such as the UK, China and Germany.

The strength of the US economy allowed the Federal Reserve (Fed) to raise interest rates again in June and to signal two further hikes to come in 2018, followed by three more in 2019.

In contrast, the European Central Bank (ECB) announced that interest rates will not be going up until at least the summer of 2019, although they did confirm that eurozone quantitative easing would finish by the end of this year. In the UK, both the May and June policy meetings at the Bank of England were uneventful, squashing expectations of a rate rise.

Growth cycle is supportive for markets



Source: Bloomberg

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Looking at equity markets in detail, most regions have posted mediocre returns since our May review, although emerging markets continued to struggle with US dollar strength a significant headwind, particularly in the more vulnerable economies with large current account deficits. The escalation in global trade tensions has also been a drag on performance. In the UK, shares were buoyed as international investors reduced their underweight in the country, while the absence of the expected interest rate hike in May was a further positive, as it contributed to a renewed decline in the value of sterling against a strong US dollar, helping the more internationally exposed large-cap companies to outperform. At a sector level, energy continued to benefit from a rising oil price, however, other more cyclically-focused sectors struggled as risk aversion increased.

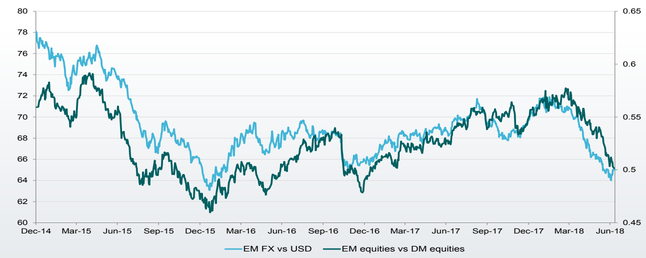
Market outlook

We are ‘cautiously optimistic’ on the outlook for markets for the remainder of this year. The growth cycle is supportive and inflation is rising but not strongly, but the most important point is that the cycle is maturing not peaking. We remain of the opinion that a recession is not imminent, but is something we expect in the second half of 2019, a view unchanged from January this year.

Strong US growth is leading the global expansion and powering corporate earnings, but uncertainty around the outlook is rising and financial conditions are tightening with the Fed reducing stimulus (approaching ‘neutral’), although policy is not yet restrictive. This is being reflected in a flatter yield curve with the spread between ten-year and two-year treasuries just under 30 basis points (as at 12 July 2018). However, with the support of a reasonable growth backdrop, this is not an immediate worry nor is it too detrimental to risk appetite. It does though, put markets on watch as a flattening yield curve suggests that expectations of higher growth and interest rates will stall over time. (An inverted yield curve, where short-term yields trade above long-term yields, is seen as a sign of a coming recession.)

US dollar strength

Emerging markets v. developed markets



Source: Bloomberg, Macrobond, JP Morgan

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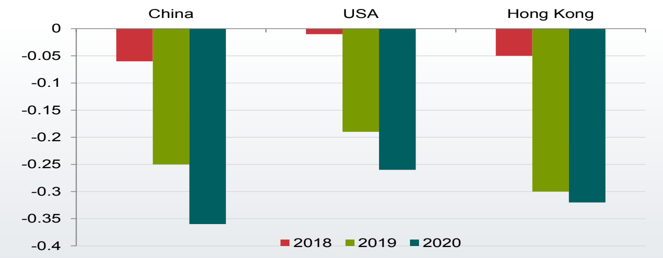
Speed bumps to overcome in the short term

Although we have a positive outlook for the next year or so, we do expect a number of ‘speed bumps’ in the short term, not least Brexit in the UK, political uncertainty in Europe and a strengthening dollar. The direction of the dollar is likely to remain important for relative equity performance and is particularly difficult to predict. For the time being, the outperformance of US growth and interest rates may support the dollar, but at some point ever-rising levels of government debt and a large current account deficit will likely weigh on the currency.

Casting a shadow over all of this is the increasing risk of a trade war - a potential game-changer. For example, the GDP impact of tariffs on $250bn of US imports from China translates into roughly 30 basis points off global growth. With real global GDP at around 4%, that is not the end of the world, however, if the $250bn becomes a trillion or two, we could be facing a global growth recession. The first tariffs on $34bn of Chinese goods came into force on 6 July, with a swift retaliation by China on the same value of US goods.

Trade wars

GDP impact of tariffs on $250bn of US imports from China



Source: Oxford Economics

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Our belief is that although the risks are increasing, we do not expect a full-blown trade war to materialise. We believe much of it is politicking by President Trump, who likely has a firm eye on the mid-term elections in November. More importantly, the economic fundamentals are what ultimately count and these remain broadly supportive, however, we feel that politics will likely continue to drive markets at least until November. Additionally, we believe the Fed will not continue with policy tightening if a trade war becomes a serious threat.

Portfolio positioning

Against this backdrop, we are comfortable being slightly overweight risk assets in the portfolios, although we are more defensively positioned than we have been for a while, with a high level of diversification between and within asset classes. We maintain our preference for equities and commodities over bonds.

Equities

There is no change to our view on equities since our last review in May so we are sticking with a modest overweight.

At a regional level, we remain underweight the UK where a lack of clarity around Brexit policy remains frustrating and a key risk. However, we expect full employment, wage growth and falling inflation to rejuvenate the heavily consumer-dependent economy. We continue to favour a value approach in this market.

In the US, in relative terms, the market has become more attractive versus the rest of the world, with capital expenditure coming through and a fiscal tailwind from the earlier tax cuts. Valuations have continued to move higher so we are maintaining a targeted approach within a neutral exposure.

We retain our overweight to Europe, Japan and emerging markets. European equities have been resilient despite negative headlines around economic momentum and growing concerns about the possibility of trade tariffs with the US. We continue to look for opportunities to add to our domestic small- and mid-cap exposure given the position in the cycle and that sector’s relative insulation from the trade war risk. In emerging markets where we remain tilted towards Asia, the region is facing some short-term headwinds as US policy continues to evolve and the trade war escalates. From a thematic perspective, our strongest conviction is for energy, biotech and financials. We have less conviction on technology, although the regulatory threat to the sector appears to have subsided, at least for now. However, late-cycle dynamics could make it harder for earnings expectations to be surpassed from this point.

Bonds

No core areas of fixed income appear to be 'good' value and we have seen weak returns across the asset class. We are maintaining our underweight to bonds as valuations remain unattractive and we expect higher inflation could push yields higher still.

Since our May review, the UK and US yield curves have flattened slightly and in the US, the spread between the 2-year and 10-year treasuries has narrowed quite markedly. German bunds have rallied the most, while Italian yields have moved higher (prices fell) following political uncertainty in the country. Elsewhere, high-yield spreads softened across all sectors and yields and spreads softened in emerging markets albeit at a slower pace. However, we do not view this recent yield/spread softness as significant and therefore continue with our policy of targeting 'niche' return drivers until value returns to conventional credit.

Within our debt exposure, we recently sold emerging market bonds with a greater sensitivity to interest rates and purchased those with less sensitivity. This was to reduce our vulnerability to future rate increases, whilst maintaining exposure to emerging markets where we see strong fundamentals, relative valuations and increasing investor attention.

Property

We are comfortable maintaining our underweight position to UK property with a preference towards industrials. There has been no material change in underlying market trends over recent months. While investment volumes are down slightly relative to 2017, overall activity remains robust driven by some large office transactions and a wide range of assets changing hands in the industrials sector. Despite some weak economic data in the UK (particularly in Q1 2018), property fundamentals have held up, outlining the importance of micro supply and demand factors. Industrials continue to outperform, benefitting from undersupply and long-term positive demand.

Commercial real estate activity in the UK continues to be relatively solid, with both investment volumes and yields holding up. The yield gap (property yields vs gilt yields) continues to be quite wide from an historical perspective and may remain so with the recent fall in expectations for interest rate rises. As mentioned in the May review, the UK commercial property yield gap remains above its historical average. However, it is worth noting that there is significant divergence between sectors and their underlying risks. Sectors with already tight yields may yet face the additional headwind of NAV depletive negative rental growth.

Commodities

Commodities have struggled recently with energy the clear outperformer. The market for oil remains tight and recent supply hikes from OPEC are merely correcting prior overcompliance.

Precious metals have lost a little of their lustre. Our precious metals exposure is counter to our views on dollar strength and higher real yields, but acts as a key diversifier. For example, gold should perform if we see a financial crisis or geopolitical event, even if the dollar spikes at the same time. Elsewhere, industrial metals have weakened as the US/China trade tariff war has escalated, however, longer term, China's 'blue sky' agenda restricting the supply of industrial metals on pollution grounds, will continue to be an important factor.

Overall, we are comfortable with our overweight exposure to commodities and notably, our energy position has added significantly to portfolio performance so far this year.

Hedge Funds

We have seen mixed performance from our hedge fund holdings, with a strong recovery from merger arbitrage following a challenging April and good returns from directional credit and macro. However, the sudden risk-off move following raised political concerns in Italy, was particularly painful for CTAs. 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 more volatile markets.

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