September 2018

Heartwood
Investment Management

Market Update

Strategy Review

Key takeaways

- US equity markets have remained in centre stage, outperforming developed world peers and emerging markets.
- Investors have punished most commodities and emerging markets amid growing risk aversion, trade tensions and a strong US dollar.
- More questions than answers surround the ongoing Brexit process, with sterling continuing to serve as a barometer for investor confidence.
- Our market outlook is cautiously optimistic, reflecting the current stage of the economic cycle.
- We retain our allocation to risk assets, though we have trimmed our industrial metals exposure.

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

Market review

The significant outperformance of equity markets in the US versus the rest of the world has dominated investor thinking over the summer. This has been particularly gratifying for sterling-based investors, thanks to the translation effects of a stronger dollar into a weaker pound.

The US has eclipsed emerging markets in particular in 2018
US versus Chinese equity markets

Source: Macrobond

Past performance is not a reliable indicator of future results.

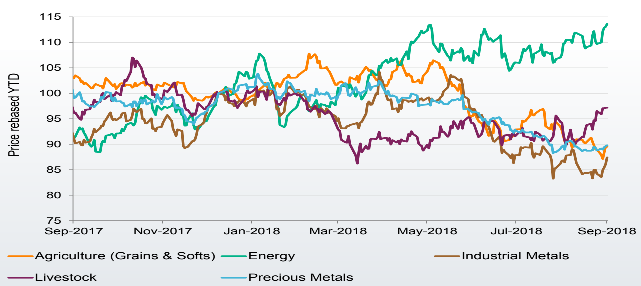
Against this backdrop, bond markets have remained broadly quiet, excepting some turbulence in a small number of struggling economies. Meanwhile, commodities and emerging markets have been buffeted by an unholy trinity of dollar strength, trade war risk, and a US Federal Reserve (Fed) intent on reducing stimulus.

There are solid reasons for US outperformance this year. President Trump's famed tax cuts have provided the US economy with a sugar rush of growth, and businesses and consumers are feeling buoyant. Corporate earnings growth has also been robust, not only in the US but across most developed markets. A significant portion of US equity returns in 2018 so far have come from the technology sector, where this summer Apple won the race to become the world's first trillion dollar company.

This burst of US growth cannot last indefinitely, but for now it appears to be extending the economic cycle. However, though a strong US economy may have been good for global growth, emerging markets have suffered. Trade war rhetoric, rising borrow costs for US dollar debtors, and contagion worries caused by 'problem children' like Argentina and Turkey have fuelled considerable investment outflows from emerging markets.

Commodities, though, were perhaps the summer's true casualty. In a turbulent geopolitical environment, risk aversion impacted not only industrial metals, but precious metals too. Even gold (traditionally a safe haven asset) failed to serve its usual defensive purpose in an unusual late cycle setting.

Most commodities have faced a challenging summer



Source: Macrobond

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No review of the summer months would be complete without reference to the ongoing EU-UK negotiations. Since our last update, sterling has continued to serve as a barometer for investor sentiment, buffeted by perceived advances and setbacks in talks (often surrounding the challenging Northern Irish border debate). For now, though, far more questions than answers continue to surround the Brexit process.

Clear Thinking

Market outlook

We remain cautiously optimistic, which we believe is appropriate for the current stage in the economic cycle. Indeed, this cycle is evolving, led by the US, where positive signals remain. We can see that spare capacity within some leading economies (e.g. the US and Germany) is eroding, but while this dœs tend to happen directly before a recession, overheating indicators are not widespread. Nor are recession signals from bond yield curves sounding alarms in fixed income markets. In Europe growth is firming, and in China the ruling authorities are enacting easing policies. The economic cycle is not over yet.

In the meantime, the US dollar remains resilient and the Fed is increasing its stock of dry powder for future deployment. Before too long, Fed policy is likely to become restrictive (i.e. having a decelerating effect on the economy), but this is not necessarily a near-term game changer. For now, quantitative tightening is in full flow and further interest rate rises are expected before the end of 2018. Effectively, the US is set to remain the only game in town for investment market, at least until November's mid-term elections.

Quantitative tightening is well underway in the US

US Federal Reserve balance sheet ($bn)

Source: Macrobond

Past performance is not a reliable indicator of future results.

Despite some signs of progress in trade talk terms, President Trump could still keep tariff rhetoric elevated ahead of the mid-term elections. In the six federal elections since 2006, the ruling party has been unseated five times. A Democratic victory in the mid-terms this time around could be good for bonds, real estate and defensive equities, but would be unlikely to lead to much immediate government action. What's more, Trump could 'go rogue' (more so than his usual modus operandi) if the Republican Party is unseated. The threat of his removal (via impeachment) is another near-term hurdle.

Trade and emerging markets: challenges ahead

If the President maintains his protectionist agenda and the US Federal Reserve continues to tighten monetary policy, recent challenges facing emerging markets could easily remain in situ.

Importantly, though, this is a very different picture to those seen in previous emerging market crises. For example, while the ongoing US-China tariff dispute has hit Asian emerging markets hardest, these economies' aggregate current account positions, foreign exchange reserves and overseas bank claims are in vastly better shape today than in the 1990s Asian crisis.

Brexit: deal or no deal?

Meanwhile in the UK, no one – perhaps not even the negotiators themselves – will know the final outcome of Brexit talks until early 2019. For now, we believe a 'deal' scenario is still the more probable outcome. If the alternative comes to pass, leaving the EU without an explicit deal might mean lower UK government bond yields, and if sterling also falls (which is likely), then UK large cap stocks could actually receive a welcome boost.

Sterling continues to serve as a Brexit barometer

Sterling versus US dollar

Source: Macrobond

Past performance is not a reliable indicator of future results.

Once again, then, sterling holds the centre stage for investors watching the Brexit process, and is set to determine how UK equities perform ahead. We continue to monitor events closely, and are positioning portfolios to mitigate as much Brexit-related risk as possible.

Portfolio positioning

Portfolio positioning reflects our cautiously optimistic outlook, with a healthy, though not exuberant, allocation to risk assets. However, we are more defensively positioned now than when 2018 began, with a high level of diversification between and within asset classes.

Equities

Our overall view on equities remains unchanged since the last review, and we retain a modest overweight. Our highest conviction themes here are energy, biotech and financials, albeit investors are wary of the latter at this point in the cycle.

The summer bore witness to a robust corporate earnings season, and we are now seeing positive revisions in most regions (excluding emerging markets/Asia Pacific). Operating margins are also rising globally. In the developed world, equity markets are grinding higher, but the US has done all the heavy lifting. While elevated valuations prevent us from taking an overweight position in the US, some sectors (including small and mid-cap companies and technology) are well placed to benefit from ongoing benign fundamentals.

In the UK, the team is comfortable to maintain an underweight position. This is driven by a lack of clarity around Brexit and central bank policy as well as relatively soft economic data, though we are witnessing a better outlook for consumption amid falling inflation and better wage growth. Despite sterling weakness, the FTSE100 is not currently outperforming. Meanwhile in Europe, a recent bounce in banking stocks demonstrates the region's sensitivity to better sentiment.

We see signs of encouragement in Japan, which remains an overweight within portfolios. Although we have some short-term concerns around trade in the region, cheap valuations and the growing presence of international equity holders are appealing.

Even with the headwinds of US trade policy and a stronger dollar, fundamentals in emerging economies look relatively good, and we retain our overweight position. Ahead, we are looking for stability in the dollar exchange rate, an easing of trade tensions, and more convincing policy responses from the emerging world's 'problem children'.

Bonds

Bond markets saw little newsworthy change to curves over the summer months, while investment grade spreads were dormant and high yield spreads tightened. We do not currently perceive good value in any core areas of fixed income, and without any notable catalysts for change we maintain our underweight position here.

We did see some fixed income action in emerging markets, reflecting wider investment market concerns. The Turkish (local) 10-year government bond, for example, moved from 11% at the beginning of 2018 to 20% at the time of writing.

Within portfolios, we currently hold emerging market external debt (sterling hedged, via an active manager) due to its relative value over other areas of credit, as well as the longer-term potential for these countries to become better credits as they develop. Despite the yield here being around 1% higher than at the start of 2018, the team is not inclined to add to the position due to the cost of the sterling hedge, which has risen over year and would offset the potential pickup in yield.

Property

Within property markets, with continued positive performance on the ground being driven by just a few names, broader indices remain uninspiring. We do not believe that we should be attempting to play on potential volatility in property markets, and with income now a greater driver of total returns, we are actively looking to exploit this within portfolios instead.

While we are broadly happy with our overall property underweight, we remain alert to opportunities for targeted exposure to specific subsectors in the UK. We have no plans to meaningfully increase our holdings in the US or European real estate.

Commodities

Since our last review, commodities have continued to struggle. What's more, without fundamental economic underpinnings and truly global growth, the outlook for this asset class is not encouraging.

Commodities can serve a longer-term purpose as a reflation hedge, but in the face of dollar strength, trade war risks and a proactive US central bank, we see few obvious catalysts for near-term changes to the current picture. Given the prospect of continued challenges ahead, we have trimmed the portfolio's industrial metals exposure.

Some bright spots persist in the commodities, though, most notably energy (oil is expected to remain at the top end of the $40-60 range). And while gold is not currently performing in its role as a diversifier, perhaps due to US economic and currency strength, it should still perform in a crisis.

Hedge Funds

The broad hedge fund index has been relatively flat so far in 2018.

The merger arbitrage space has softened, with China-US relations apparently beginning to have an impact on some cross-border deals. We continue in our efforts to identify appropriate funds in this area for our lower risk strategies.

We currently have a preference for short-term trading strategies actively able to exploit short-term volatility expansion. Since the last review, we have introduced some 'left-tail' protection strategies to help offset the potential sharp falls in riskier asset classes. These strategies (built via options and other derivatives) serve as insurance, aiming to compensate investors in the event of extreme market moves, but come at a cost to portfolios during benign periods. These left-tail protection strategies improve convexity in portfolios (i.e. their return expectations accelerate as the size of the market move increases).

We continue to closely monitor the UK infrastructure space, which has enjoyed positive re-ratings. Current premium levels are attractive relative to the levels seen over the past few years, but political risks remain.

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.

Registered Head Office: No.1 Kingsway, London, WC2B 6AN | Registered in England Number: 4132340
020 7045 2600 | heartwoodgroup.co.uk | Part of the Handelsbanken Group.