Heartwood
Investment Management

November 2018

Market Update

Strategy Review

Key takeaways

- Global growth is slowing: the US, which has done much of 2018's heavy lifting, cannot continue to do so indefinitely.
- Policymakers hold the key to the next phase in the cycle, from central bank timing in Europe to tax reforms in China.
- The US Federal Reserve remains on track for a fourth rate hike in December 2018, and three more in 2019.
- The rest of the world faces a combination of transitory and ongoing issues, ranging from the impact of trade wars to geopolitical concerns.
- While we retain a healthy exposure to risk assets, we are cautiously increasing our allocation to portfolio diversifiers.

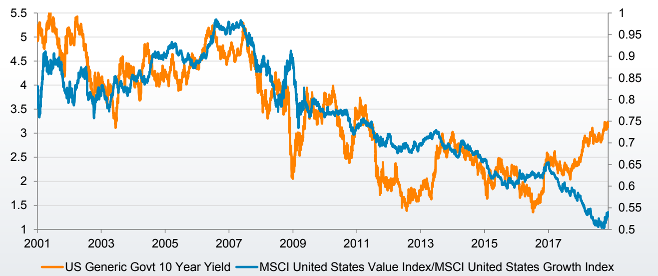
Asset class	Current positioning for Balanced strategy
Equities	+
Bonds	-
Property	-
Hedge Funds	-
Commodities	+
Cash	+

Market review

So far this year, markets have endured two material corrections amid weakening global growth and fading investor confidence. October began with a rush out of bond markets, with turbulence (the most significant since February's surprise sell-off) soon spreading to other asset classes too. In equities, this invited a switch into 'value' stocks as anxious investors stepped away from more expensive 'growth' sectors like technology.

Value stocks are slowly coming back into favour

Value versus growth stocks



Source: Macrobond and Bloomberg

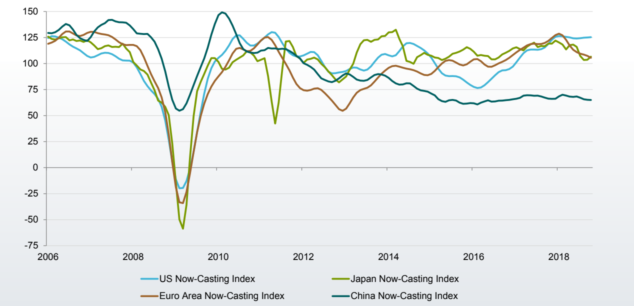
Past performance is not a reliable indicator of future results.

Quite unlike 2017, which was characterised by synchronised global growth, in 2018 the world economy has been driven virtually singlehandedly by the US. This cannot go on indefinitely: earlier in the year, a sugar rush of tax cuts and buoyant consumers allowed the US to do all the heavy lifting, but while US growth remains above trend, recently released Q3 data (3.5%) was slightly weaker than in Q2 (4.2%).

However, the rest of the world is currently facing below trend growth on aggregate. Emerging markets (EMs) have led the way down, hampered by a strong US dollar, higher bond yields and trade concerns. But large developed economies like Japan (which has faced a series of natural disasters) and the eurozone (held back by idiosyncratic issues ranging from Italian budget disputes to changing emissions regulations in German auto production), have been uninspiring too.

The US alone cannot continue to carry global growth

'Nowcasts' – high frequency, short-term economic forecasts



Source: Bloomberg, Macrobond, nowcasting.com

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The impact of ongoing tariff wars has also begun to show up in economic data. While Asian EMs in particular continue to suffer, in some senses the US itself is no longer 'winning' the trade war. The recent corporate earnings season saw relatively good results from US companies, despite some high profile 'misses', yet many saw share price falls as investors focused on outlooks and the cost and security of supply for inputs.

Recent history has also born witness to the tightening of financial conditions globally, led by the US Federal Reserve (Fed). Fed policy is not yet restrictive (i.e. hindering economic growth), but appears to be heading in that direction. Investors, though, have seemed not to accept Chair Powell's comments that the Fed remains a long way from 'neutral' policy rates – the market's interest rate expectations for the longer term (some way below the Fed's) remain unchanged. Financial conditions in the US impact all markets, and we continue to monitor any developments closely.

Clear Thinking

Market outlook

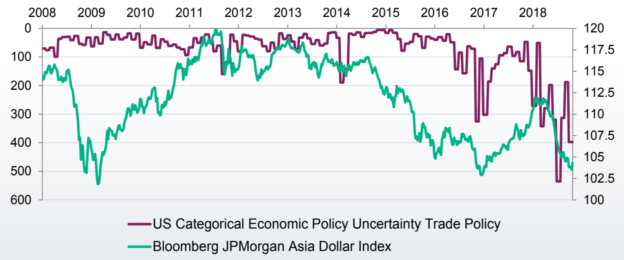
The recent deterioration of economic and market data leaves us more cautious than in the past, albeit many factors influencing investor confidence may be temporary. Brexit remains a relative unknown: for the time being we maintain relatively low exposure to UK assets, but could revisit this depending on developments.

Certain parts of the US economy are also beginning to show some strain following blistering growth earlier in 2018. This includes the housing sector (rising interest rates have raised mortgage rates) and manufacturing (new orders are bearing some of the weight of tariff wars). Capital expenditure has also deteriorated, but corporate debt levels remain unsettlingly high.

Trade issues have continued for longer than many expected, and remain a key challenge (particularly, but not exclusively for Asian EMs). It remains to be seen whether Trump will soften his tone on trade as the growth boost from his tax cuts wears off, or perpetuate his protectionist stance.

A lack of trade policy visibility is impacting Asian currencies

Trade policy uncertainty (lhs, inverted), Asian EM currencies vs US dollar (rhs)



Source: Bloomberg, policyuncertainty.com

Past performance is not a reliable indicator of future results.

In 2020, the US will also reach its national debt ceiling once again, which must be raised in order to avoid automatic cuts to spending. A newly Democrat House of Representatives could block the debt ceiling raise, but US politicians are likely to be incentivised to keep the economy on track in an election year.

Central banks tighten... while governments ease

The Fed is expected to tighten rates again in December – their fourth hike of 2018, with a further three signalled for 2019. With unemployment virtually as low as it can go, the Fed is likely to remain undeterred ahead.

Meanwhile, across the Atlantic, the European Central Bank (ECB) faces a significant policy challenge. It must begin raising interest rates, but sentiment in the region is deteriorating. Wage growth looks robust, and inflation could rise to worrying heights if unemployment falls. The ECB has made timing errors in the past, and will lose credibility if it does so again.

An ECB policy dilemma amid deteriorating sentiment

Economic sentiment (lhs) and policy rates (rhs, inverted)

Source: European Commission, Macrobond, Bloomberg

Past performance is not a reliable indicator of future results.

Can governments step up to fill the void?

In 2020, the US will also reach its national debt ceiling, which must be raised via Congressional approval to avoid automatic cuts to spending. A newly Democrat House of Representatives could be problematic, but politicians will likely be incentivised to keep the economy on track – a third of the Senate and the entire House of Representatives will be up for re-election that year.

As central banks continue to tighten their policies, though, governments could look to ease. Increased fiscal spend could boost growth in most regions and prolong the current cycle. (NB: globally, it is unlikely that this would happen rapidly or simultaneously). We are already seeing this shift in emphasis in the US – Trump's White House offered tax cuts to businesses earlier this year, and both developed and developing world peers could potentially ramp up government spending. China has already begun, with tax reforms to mitigate trade wars. In the UK, a much touted 'end of austerity' is in itself a form of policy loosening, while in Europe, notoriously fiscally cautious Germany has substantial firepower, should it choose to deploy it. Japan too is spending, as it rebuilds following a series of devastating natural disasters.

Emerging markets: China could lead the way

The medium-term outlook for EMs is subject to many variables. We are mindful, for example, of the significant levels of EM sovereign debt which requires refinancing over the next 12 months. Further, unless the US government makes an active decision to the contrary, tariffs on imports from China will automatically rise from 10% to 25% on 1 January. However, we maintain the view that recent weakness does not constitute an EM crisis. Any calming of geopolitical/trade tensions, or stability in the US dollar, would meaningfully ease EM woes.

In the meantime, Chinese authorities are leading the way with proactive policymaking, turning to tax reform (rather than debt) as a remedy for economic challenges. China is also increasingly focused on its relationships with other Asia-Pacific economies – a trade agreement with 16 other nations could be edging towards completion. If successfully achieved, this would be good news for both global and Chinese growth.

Portfolio positioning

The Investment Team's mood is a little more cautious than in previous updates. We retain our marginal overweight to risk assets, but are looking to reduce risk by slightly increasing our exposure to portfolio diversifiers.

Equities

As we let the dust settle following a period of market turbulence, we maintain our modest overweight position in equities. Global markets sold off from late September into a volatile October, with the US equity market finally joining in with wider market falls after a valiant solo run. It remains a strong year for US equities overall, but positive US earnings are currently being outweighed by concerns over slowing global growth, higher bond yields and ongoing trade disputes.

Asian equities – especially EMs – have also struggled at the hands of the trade war. However, EMs in particular could easily bounce on good news, especially given their valuations are more attractive. We remain comfortable with our EM exposure at present.

European and Japanese equity markets are cyclical in nature, and have struggled to perform with global growth in doubt. We still perceive a positive longer-term outlook for Japan, which is priced cheaply despite record high returns on equity. European equities also remain out of favour, and have room to rally if the ongoing eurozone recovery continues to feed through into corporate earnings.

Meanwhile, value stocks have finally come back into favour, picking up versus their more expensive growth counterparts. As a style, value still lags growth over the year-to-date, but higher wages, higher inflation, and higher rates should continue to favour the former.

Broadly speaking, more defensive sectors like consumer staples, telecoms and utilities have outperformed, while cyclical sectors like energy, materials and industrials have underperformed. Nonetheless, recent underperformance has not weakened our conviction in energy, biotechnology and financials, which remain core portfolio themes.

Bonds

Bond yields are creeping up, with US Treasury yields close to recent highs. The US government deficit is rapidly expanding, placing further upward pressure on shorter-dated bond yields as the market digests new issuance. Markets expect a December rate rise from the Fed as signalled, but are currently pricing in just two further hikes in 2019, while the Fed has signalled three. Who proves to be correct could have significant consequences for bond markets next year.

In the UK, the Bank of England also appears ready to hike, but only if it perceives an orderly Brexit. Yields on UK bonds have moved higher than their US counterparts over the course of 2018 so far, suggesting that the UK is paying a Brexit premium in order to borrow money. The UK government bond market would almost certainly re-price on good Brexit news, and as such we maintain a short duration stance here to avoid being caught out.

Indeed, we have taken a short duration position in our fixed income holdings for some time, which has been helpful in a rising yield environment, where no material potential reward has been offered in exchange for taking on excessive duration risk.

Property

Since our last review, we have seen little change to the underlying fundamentals of the property market. The retail sector is now particularly fragile, while the office sector in south east of England in particular remains at the mercy of Brexit news, despite reasonable fundamentals.

Within portfolios, at least 50% of our property exposure is to industrial or alternative property assets (e.g. care homes, supermarkets, car parks), as part of our move away from retail exposure. Our property allocation is small in absolute terms, but our positions here broadly held up better than equities in the recent sell-off, and have provided a significant premium to their fixed income peers. We would also note that the next crisis – whenever it emerges – is unlikely to be driven by property.

Commodities

Within portfolios, we are slightly increasing our exposure to gold – one of very few diversifiers which has recently been working to offset market nerves. We believe gold is beginning to command a premium amid ongoing fears surrounding the outlook for global growth, alongside some concerns over US inflation ahead.

Since our last review, supply issues have led to a more volatile oil price, and an oil spike remains a global risk. Supply issues have included sanctions exemptions granted by the US (allowing oil dependent EMs to continue buying from Iran) as well as Saudi Arabia's presumably well-intended offer to turn on the production taps. Ahead, there is potential for further turbulence, including some demand issues related to growth, but we would expect these to lessen over the medium term.

Hedge Funds

Broad hedge fund indices performed badly in October, due to their high weighting to sectors like 'equity long/short' and general deleveraging following the recent spike in volatility.

It is important to remember that hedge funds cover a diverse range of investment styles, and more defensive positions such as arbitrage funds protected well during the period, although these are designed to protect against large crashes rather than 'ordinary' market shocks.

Cash

In the US in particular, recent turbulence alongside outlook concerns have seen cash become a viable asset class in its own right. We maintain reasonable levels of liquidity across our portfolios, which we believe will leave us well positioned to weather volatile markets.