Heartwood Investment Management

July 2019

Market Update

Strategy Review

Key takeaways

- While markets remain exposed to key geopolitical risks – from trade disputes to diplomatic tensions – the investment landscape is witnessing some important shifts.
- Global central banks, led by the US Federal Reserve, are now pointing towards ongoing support for the economy and investment markets.
- While surprises are always possible, for now we feel that reflation and recession are less likely in the near term.
- A 'lower for longer' environment should persist in the second half of 2019 – low interest rates, inflation, bond yields and economic growth.
- In the UK, the ongoing Brexit saga continues to take its toll on assets, as businesses and investors await much-needed clarity.

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

Market review

Since our last *Strategy Review*, some of the issues facing world markets have remained in situ. However, there have also been some subtle but important shifts in the investment landscape, providing fuel for our cautious optimism.

Geopolitics continue to hold sway

First, the ongoing issues. The trade war threat which has plagued investment markets for over a year remains undiminished. At the time of writing, China and the US have returned to the negotiating table, but common ground is still lacking on a number of key issues. US diplomacy is also being tested through tensions with Iran, with nuclear sanctions broken and rumours of military strikes ordered and then aborted.

If presidential 'tweets' are to be believed – new trade disputes could easily arise between the US and other regions, such as the eurozone. As well as weighing heavily on key international relationships, geopolitical disputes pose serious threats to global economic growth, and in turn threaten the health of investment markets.

Help may be at hand for China's economy

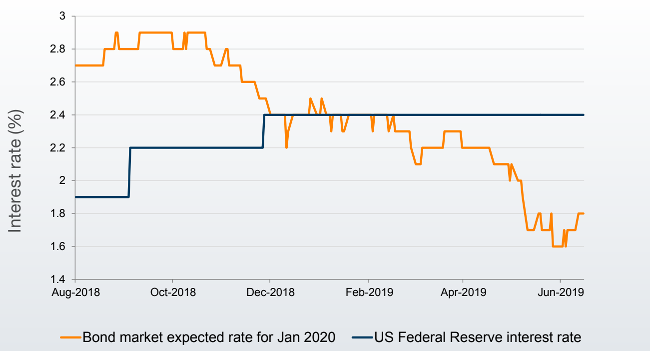
However, other issues posing challenges to investment markets are showing some signs of easing. Concerns about the health of China's economy remain valid, exacerbated by trade tensions with the US, but the threat of a dramatic slowdown appears to be lessening somewhat. This is due to tentative policy moves by Chinese authorities which – though low key – could help sentiment and growth. We assume these measures will amount to a moderate level of economic stimulus rather than a policy bazooka, but this is helpful for the Chinese economy nonetheless.

Developed world central banks stand ready to act

Most importantly, though, the US Federal Reserve (Fed) has continued to point towards ongoing supportive monetary policy ahead. The Fed's recent official statement that it will 'act as appropriate to sustain [economic] expansion' is akin to the famous 'whatever it takes' speech made by Mario Draghi (president of the European Central Bank (ECB)) in 2012, and feeds into the Fed's ongoing pivot away from the more restrictive policy stance eschewed by markets in late 2018.

Markets anticipate central bank support, led by the Fed

Bond market expectations for interest rates



Source: Bloomberg

What can investors expect next?

These shifts in the investment landscape support our view that the threat of an economic recession, particularly in the US, has been pushed back.

Despite relatively lacklustre global growth, the current period of economic expansion in the US is now officially the longest on record (or at least since 1854!). But weakening global trade and concerns over China's economy remain problematic, and have led to a trend for stockpiling. In turn, this has helped global growth in the near term, but built-up inventories will need to be unwound over the longer term, with potentially negative effects for future growth.

Taking good news from bad, though, global central banks can continue to use this kind of data to justify their more accommodative stances. While there are valid questions around the magnitude of success of each successive round of central bank support in the current economic cycle (with bond yields tellingly peaking at lower levels each time), we believe that the transmission mechanism between supportive central bank policy and real growth in the economy remains broadly intact. Support from credible monetary policymakers is a powerful weapon, and a timely interest rate cut from the Fed could further extend an already long economic cycle.

This is particularly the case if other developed world central banks follow the Fed's lead. Indeed, the ECB has already pointed to more accommodative policy ahead, even including the possible reactivation of its recently ended bond-buying programme.

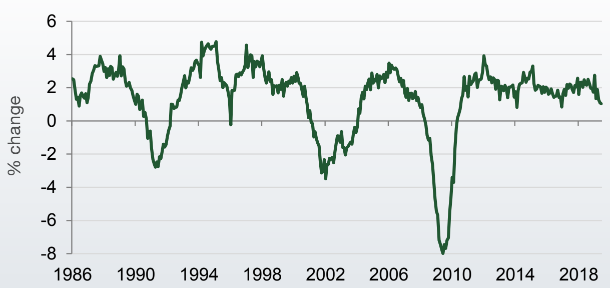
The US is at an interesting juncture, with policymakers set to act

Concerns about growth approaching 'stall speed' and a lack of inflation have led bond markets in particular to pressure the Fed back into easing mode. Manufacturing data in the US continues to be of concern too, even if the majority of the US economy (75%) lies outside this sector, and is holding up relatively well thanks to buoyant consumers.

The recent US jobs report offered a positive surprise, with a robust number of new jobs created in May. Markets initially received the news badly, believing that good news for the economy lowered the likely magnitude of Fed interest rate cuts. However, the report's underlying data paints a more mixed picture; the total number of hours worked has been on a downward trend in recent months, which usually occurs before periods of economic weakness – this could also influence the Fed. Indeed, the Fed has since reiterated the likelihood of a supportive policy move in the near future.

A downward trend in hours worked could influence the Fed

Growth in hours worked (% change, year on year)



Source: Macrobond

Meanwhile in the White House, President Trump's personal barometer for success hinges on winning competitions (elections) and stock market performance. To win the 2020 presidential election, Trump needs to present his voters with economic growth. A good trade deal could provide this, meaning that the US could become more cooperative with China. In the background, low probability but high risk events cannot be dismissed: Congress must act soon to raise the US debt ceiling in order to avoid the Treasury running out of cash.

The never-ending Brexit story

In the UK, the apparently interminable Brexit saga continues. The House of Commons has now voted both for and against a 'no-deal' Brexit, leaving its fundamental views very much open to interpretation.

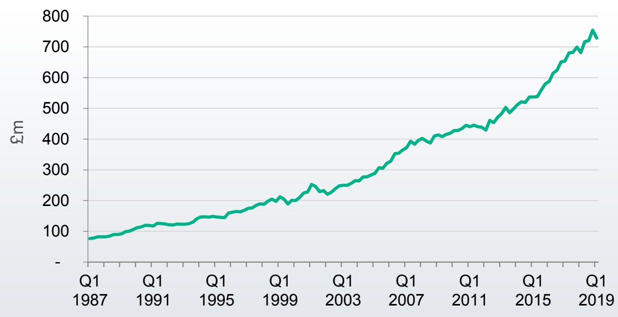
Other routes through the thorny Brexit issue remain equally fraught. A general election providing a fresh parliament could lead to either more cooperation or further division, and no Conservative MP would risk their career in calling one. Equally, a second referendum could cure political paralysis and business uncertainty, but would be a significant gamble for all camps.

On the European mainland, the EU has been clear that it has no intention of reopening Brexit negotiations. However, the notion that an incoming prime minister could bring in a new mandate for talks cannot be wholly ruled out.

As ever, the clarity on Brexit so sorely required by UK businesses and investment markets (and indeed the British public) remains absent. We still believe that UK assets are priced for a disorderly Brexit scenario, meaning that any positive outcome to the conundrum could see values positively reprice. Cash on corporate balance sheets also remains high, with the potential to be released into the economy if/when clarity is finally achieved.

Corporate cash could boost the UK economy if released

UK corporate cash levels



Source: ONS

Portfolio positioning

As we enter the second half of 2019, we expect the current 'lower for longer' scenario to persist (implying low interest rates, inflation, bond yields and economic growth). This leaves us cautiously optimistic about market sentiment in the months to come. While we maintain a careful approach, we are adding moderately to risk levels within portfolios, seeking to take advantage of a market buoyed by more accommodative central bank policy and a weaker US dollar.

Surprises – both positive and negative – remain entirely possible, but for now we feel reflation and recession are less likely in the near term. For asset types, this means that both bonds and shares should perform well, despite both currently looking relatively expensive.

Equities

Increasing exposure to world stock markets reflects our cautiously optimistic view

In keeping with our belief that central banks will unwind their previous interest rate hikes (and potentially pursue other accommodative policies too), we think global stock markets have further to run. With this in mind, we are modestly increasing our exposure here, with an emphasis on our preferred regions – the US and emerging markets. This reflects our hopeful but pragmatic view as we enter the second half of the year.

As well as our regional preferences, we retain our high conviction in core portfolio themes such as healthcare/biotechnology and the broader technology sector (with a software skew). Within the UK market, we also hold specific exposure to the shares of small- and mid-sized businesses, believing that this area of the stock market could be significantly boosted by any clarity or positivity on Brexit.

Bonds

Despite their relative expense, bond markets are in demand for good reason

Given lower inflation and interest rate expectations, it is no surprise to see bonds in demand, even given their relative expense. Government bonds in particular are enjoying extreme (high) valuations, with their yields compressing further in recent weeks. And although bond and stock markets have both risen substantially in the first half of 2019, monthly correlation data still indicates that bonds offer diversification benefits versus stock markets.

Against this backdrop, we have carefully increased our government bond positions, exercising caution due to their vulnerability to economic surprises. We have also modestly raised our interest rate exposure – the result of our wider views on the likely path for interest rates ahead.

Property and infrastructure

Listed real estate looks more attractive in the current environment

Listed property tends to perform best in an environment which is neither too reflationary nor recessionary, making it potentially well-suited to the current ‘lower for longer’ landscape. The sector remains expensive relative to historic levels, but cheap relative to major asset types like bonds and shares. As a result, while our exposure to property continues to be highly selective – with a preference for long-lease assets, renewable infrastructure and social housing – some of our higher risk strategies have slightly increased their positions.

Meanwhile, within the infrastructure sector, we currently perceive a limited number of assets with attractive risk and reward dynamics, though we continue to watch for compelling opportunities.

Commodities

Pure gold exposure to aid portfolios during periods of market unease

For now, we avoid direct exposure to the broader commodities space, and gold remains our only explicit allocation to commodities. Gold should offer diversification and portfolio insurance benefits in periods of market nervousness.

Despite a strong opening first half of the year for oil, geopolitical tensions cannot be relied upon to keep prices high indefinitely. Equally, the price boost for industrial metals amid US-China trade deal optimism earlier this year only served to highlight their vulnerability to global economic factors.

Hedge funds

A strong first half of 2019, but we remain selective

Notwithstanding a challenging May, the first half of 2019 was broadly strong for hedge funds. However, the sector remains under pressure, with more funds liquidating than launching for the past three quarters running.

Within portfolios, we are highly selective in our hedge fund exposure, with a particular focus on strategies which can defend against large capital market falls.

Cash

Some deployment of our cash reserves, but retaining a healthy level of liquidity

We have been deploying some of our cash holdings in recent weeks as part of our gradual increase in exposure to global stock markets. Nonetheless, with so many factors currently able to influence investment market sentiment, we are cognisant of the need for our portfolios to remain nimble, and retain a core allocation to cash.

Asset class returns as at 30 June 2019 (in sterling)

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	4.0%	3.3%	13.0%	1.7%	10.1%	28.6%	33.0%	32.7%
Equity - US	MSCI North America	5.9%	6.8%	19.0%	14.0%	28.2%	55.3%	87.6%	116.1%
Equity - Japan	MSCI Japan	2.8%	3.5%	8.0%	-0.2%	8.8%	33.9%	43.9%	70.0%
Equity - Europe ex UK	MSCI Europe ex UK	6.4%	9.0%	17.8%	8.2%	11.1%	43.3%	51.7%	53.9%
Equity - Pacific ex Japan	MSCI Pacific ex JP	5.3%	7.7%	18.2%	12.2%	20.2%	47.9%	62.5%	64.8%
Equity - Emerging Markets	MSCI EM	5.3%	3.1%	10.8%	5.4%	12.6%	43.9%	49.5%	54.7%
Bonds - Conventional Government	Merrill Lynch UK Gilts	0.2%	1.4%	5.0%	5.2%	7.3%	6.3%	21.3%	32.5%
Bonds - Inflation Linked Government	Merrill Lynch UK Gilts, Inflation-Linked	-0.9%	1.9%	8.0%	8.7%	10.7%	18.1%	36.3%	55.6%
Bonds - Corporate Credit	Merrill Lynch Sterling Corporate Master	1.4%	2.3%	7.1%	6.6%	7.2%	14.3%	24.9%	32.8%
Commercial Property	IPD All Property & FactSet UK Real Estate Invest Trust Index	0.5%	-2.2%	4.1%	-2.2%	4.2%	10.3%	4.1%	17.0%
Commodities	GSCI Index	3.4%	0.9%	13.4%	-8.2%	17.5%	10.0%	-4.3%	-34.3%
Hedge Funds - Equity Long/Short	CSFB/Tremont Hd Fd Long/Short Eq	-0.1%	-1.0%	3.8%	-2.4%	3.4%	11.5%	6.2%	12.9%
Hedge Funds - Global Macro	CSFB/Tremont Hd Fd Global Macro	-0.1%	0.1%	2.3%	-0.5%	4.0%	7.2%	3.2%	8.5%
Hedge Funds - Multi-Strategy	CSFB/Tremont Hd Fd Multi-Strategy	-0.1%	0.6%	3.2%	-0.5%	1.8%	10.5%	12.0%	19.7%
Cash	1 Month LIBOR	0.1%	0.2%	0.4%	0.7%	1.1%	1.4%	1.9%	2.4%

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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