

# Asset Allocation

January 2018



## Equities



### Developed Equities



- » We believe a neutral allocation to global equities is appropriate today. Valuations vary across regions and sectors and whilst in aggregate they look marginally rich, central bank policy remains accommodative and rates remain low which can support current valuations.
- » More elevated volatility should be expected going forward, with CB policy and politics remaining central to risk pricing.
- + Earnings growth has been robust and the global macro backdrop remains in something of a sweet spot for global equities.
- Valuations are somewhat expensive at current levels and the market is arguably overdue a correction.

### UK Equities



- » UK equities are reasonably priced today on a forward looking basis but some caution is warranted given the uncertainty surrounding the UK's eventual Brexit terms. While the larger cap market constituents are more globally focused than they are UK, and have earnings shielded in large part from FX swings, the more domestically oriented names face bigger challenges. On the plus side economic data has been resilient and better than many hoped.
- » The UK market remains sensitive to commodity prices.
- + The UK market is very much exposed to global markets and factors and somewhat insulated from the headline Brexit concerns, not least benefiting from any Sterling weakness.
- Today the chief worries lie with the ongoing (and slow) Brexit negotiations.

### European Equities



- » European equity valuations have compressed through 2017 but remain favourable when viewed against corporate and sovereign European bond markets. From a more cyclical point of view Europe continues to recover from its post crisis lows, and investor appetite for European assets is positive today.
- » More elevated volatility should be expected going forward, with CB policy and politics remaining central to risk pricing.
- + European earnings have scope to recover meaningfully from their lows.
- European assets, including equities, may come under pressure should the ECB's bond programme reduction accelerate, or the Euro strengthens aggressively.
- Italian elections in March may cause some increased volatility within the Eurozone, albeit anti European sentiment is running far lower today than a year ago.

### US Equities



- » The US remains the most expensive of the major developed markets, even when adjusted for the strong tech sector performance. The US economy is in rude health but forward looking equity returns face a heavy valuation headwind today, and prices already discount strong earnings growth ahead.
- » Monetary policy remains crucial to keeping markets in check and volatility under control. To date the Fed has managed this well but there is always a risk of policy error, or an outside risk of higher inflation leaving the Fed little alternative to raising rates more quickly than docile rates markets are pricing.
- + The economy is strong and leading indicators positive. Tax repatriation could spur investment and share buyback programmes.
- Valuations are extended. This will challenge longer term real returns and we see better opportunities elsewhere.

### Japanese Equities



- » We still like the return prospects from Japanese equities and acknowledge the government's policies to improve working practices and governance (the 'third arrow'). However, after posting strong returns in the final quarter (and full year) the valuation is more in line with other ex US markets today.
- » Japanese assets should remain well buoyed by BoJ policy which remains aggressive when compared to the other main DM central banks. Any Yen weakness will likely boost equities as well, though not a base case.
- + Yen weakness will likely boost equities, and although not our base case, if the Fed does move in line with their stated intentions and the BoJ maintains their yield curve policy, that may play out.
- In a risk off scenario Yen strength would hit Japanese equities, and the country sits in an area of elevated geopolitical risk at present.

### Emerging Market Equities

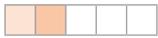


- » Valuations remain attractive today, even after the stellar 2017 performance. For that reason we continue to favour EM assets but moderate our view.
- » More elevated volatility should be expected going forward, with CB policy and politics remaining central to risk pricing.
- EM currencies remain somewhat cheap in aggregate which acts as a key support in a decision to allocate to EM.
- Emerging markets remain prone to bouts of volatility and flow reversal at times of heightened perceived risk.
- The Dollar has been extremely weak. Any reversal may see EM assets come under pressure.



## Fixed Income

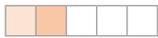
### Government



- » Despite on-going supportive policy actions, on a medium term outlook the majority of DM government bonds look unattractive today.
- » We prefer treasuries over gilts, but prefer both of them to Bunds or JGBs which remain extremely expensive and offer almost no prospect of real long term returns.
- + Quality government bonds remain one of the best diversifiers in a multi asset portfolio.
- 2018 is likely to mark the year that net central bank bond purchases turns negative. That provides a headwind for all rate sensitive debt.

### Index-linked

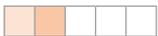
Relative to government



- » Index linked bonds offer some selective value today but, like their nominal counterparts, they are expensive today.
- » UK linkers remain one of the more expensive DM markets.
- + Index linked bonds are one of the few ways to meaningfully protect against inflation risk.
- Inflationary forces remain weak and on any renewed concerns over global growth would likely underperform nominal bonds.

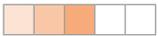
### Investment Grade Corporate

Relative to government



- » Investment grade bonds provide some diversification benefit in a multi asset portfolio but valuations are somewhat stretched today. Marginally preferred to sovereigns today.
- » Fundamentals remain OK but we would advocate owning more shorter dated credit at today's levels.
- A reasonable alternative to owning sovereign bonds with diversifying qualities.
- It is difficult to see spreads tightening much further, and with central bank buying slowing the risks are asymmetric.

### High Yield Corporate



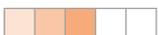
- » Spreads have continued to tighten in leveraged credit markets and whilst fundamentals remain robust, valuations are starting to look more expensive.
- » We favour owning shorter duration credit where the risk return looks more favourable today, and loans where permissible.
- + In the absence of a systemic market shock high yield returns will likely trump most of other fixed income
- Issuance terms are increasingly favouring the issuer, and valuations look somewhat expensive.

### Emerging Market Debt



- » Emerging market bonds - both hard currency and local flavours - have had strong returns amidst a favourable macro backdrop and sentiment. Despite their rally, EM bonds still rank as one of the better real return opportunities.
- » With spreads having tightened sharply we favour reducing spread duration. A short duration strategy can help achieve this.
- + EM bonds continue to offer some of the best return opportunities in core bond markets today.
- A resurgent dollar is likely to cause some temporary repricing in EM assets, and local bonds would likely bear the brunt of that.

### Convertible Bonds



- » Convertible bonds are priced slightly rich to their constituent parts today but we continue to favour an allocation to this asset class in a multi asset portfolio for the convexity it brings, which is arguably more valuable today at a time of more stretched valuations and low historical volatility.
- » Some caution is warranted given the concentration to the US market and technology names.
- + The natural convexity provided by convertibles should provide reasonable protection against any equity correction.
- The call optionality embedded into convertibles only really has any value if markets move higher. If volatility remains at multi year lows then the optionality holds limited value especially in flat markets.



## Real Asset / Alternatives

### Commodities



- » Commodity prices are primarily supply and demand driven, and idiosyncratic factors will drive commodity prices as much or more so than the global economic cycle. Commodities remain sensitive to negative news on global growth.
- » With inflation risk at the lower end of historical levels there is little upward pressure on underlying prices at present.
- + With the US Dollar coming down from cyclical highs, and growth reasonably strong globally, commodities have scope to generate positive returns. Gold remains a good hedge against risk off outcomes.
- Should the Dollar's decline come to a halt or reverse, commodities would likely come under pressure.

### Property UK



- » Property remains an attractive asset class for investors requiring yield. In the UK returns look more attractive outside the capital at this time, where prices have come under pressure.
- » Total returns will come mostly from income with limited scope for capital growth. When viewed against high quality longer duration Sterling assets and inflation linked bonds, property has appeal.
- + The retail property and mall sector has been supported in recent months with the announcement of several deals consolidating the larger players.
- + As a long duration asset class property remains susceptible to any repricing in long term bond yields.

### Infrastructure



- » Infrastructure stocks trade at reasonable valuations today - broadly in line with global equities - with low but positive real return expectations over the medium term. Their income generating potential should continue to support the sector and attract buyers of quality infrastructure assets.
- + In a multi asset portfolio the relatively defensive nature of the asset class and a degree of inflation protection make the asset class appealing.
- Regulation can work both for and against the underlying investments.

### Liquid Alternatives



- » We define this section as less/non-directional, absolute return type strategies that seek to capture long term risk premia or market mispricings, and includes hedge fund alternatives in predominantly UCITS vehicles.
- » With valuations in the more core asset classes at more extended levels today, particularly in fixed income which is the traditional diversifier, we favour an allocation to a basket of liquid strategies today.
- + These strategies provide additional diversification with reasonable return potential.
- The sector is relatively young and growing. It remains somewhat untested so thorough due diligence is vital, and blend is recommended.



## Currencies

### USD/GBP



- » Sterling has been on a tear in recent months, both a function of continued Dollar weakness and some softening around the Brexit margins (though real progress remains limited).
- » In real terms the currency remains at the lower end of valuations and has room to appreciate over the medium to long term, but politics and rate policy are likely to dominate its nearer term path, and remain a source of volatility.
- » Valuation supports a long position but with the USD looking somewhat oversold, Sterling positioning having rebounded markedly, and Brexit front and centre, we rate slightly under neutral today

### EUR/GBP



- » As with Sterling the Euro has benefitted most from the weaker Dollar but its own fundamentals have supported its gains. Whilst any change in explicit rate policy still remains some way off, the reducing quantum of bonds the ECB is now buying exerts some marginal upside to rates, certainly in sentiment, and the economic backdrop is as good as its been for a number of years
- » In real terms the common currency looks about fair value today and is not a compelling long term buy.
- » Positioning is ultra extended today and versus the Dollar the currency looks somewhat overbought. We rate more cautiously today

### JPY/GBP



- » Rate differentials continue to offer little reason to buy the Yen as the Bank of Japan's yield curve policy means short rates will offer no real value for some time.
- » In real terms the Yen looks cheap today, plus it has good diversifying qualities at a time of extended risk asset performance. Speculative positioning remaining near the lows.
- » Valuation mostly offsets the weaker fundamentals and rate differentials. As such we rate neutral today.

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