Asset Allocation

February 2018

Equities

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Developed Equities	» We retain a neutral allocation to global equities 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. » CB policy and politics will remain central to risk pricing, and volatility is likely to be more elevated. + 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 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 may 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 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. » CB policy and politics will remain central to risk pricing, and volatility is likely to be more elevated. + 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 further. – 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 equity returns face a valuation headwind today, and prices already discount strong earnings growth ahead. However, with the market having repriced sharply in recent weeks we lift our rating off the lowest level. » 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 remain extended despite recent market volatility. This will challenge longer term real returns and we see better long term opportunities elsewhere.
Japanese Equities	» Japanese equities remain attractive and we acknowledge the government's policies to improve working practices and governance. However, after posting strong returns in the final quarter (and full year) the valution 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. + Any Yen weakness will likely boost equities if the Fed does move in line with their stated intentions and the BoJ maintains their yield curve policy, that may play out through rate differentials. – In a protracted risk off scenario Yen strength would hit Japanese equities, as recently seen. The country also sits in an area of elevated geopolitical risk at the present time.
Emerging Market Equities	» Valuations remain reasonably attractive today, even after the stellar 2017 performance. For that reason we continue to favour EM assets but moderate our view slightly as the long term return relative opportunity is less pronounced today. » 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.

» Treasuries offer improved value today as yields approach the 3% level but aggregate global government bond yields remain low.

+ 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 remain somewhat stretched today. Marginally preferred to sovereigns today.

» Fundamentals remain solid but we would advocate owning more shorter dated credit at today's levels.

+ A reasonable alternative to owning sovereign bonds with diversifying qualities and spread.

– It is difficult to see spreads tightening much further, and with central bank buying slowing the risks are asymmetric.

High Yield Corporate

» Spreads remain tight in leveraged credit markets, despite a recent repricing, and whilst fundamentals remain robust, all in valuations are somewhat 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 is likely to outperform DM sovereign bonds and investment grade credit.

– 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 remaining tight 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 remains valuable today at a time of elevated valuations.

» Some caution is warranted given the concentration to the US market and technology names.

+ The natural convexity provided by convertibles should continue to provide reasonable protection against any protracted equity correction.

– The call optionality embedded into convertibles only really has any value if markets move higher. If volatility reverts again to the recent multi year lows then the optionality holds limited value.

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 in the form of 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

- » Infrastrucuture stocks trade at reasonable valuations today - broadly in line with global equities. 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 moved markedly higher 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 it has 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. As such we look for a better entry level.

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. However, in real terms the Yen looks cheap today.
- » Yen exposure is a useful portfolio diversifier but after a recent pick up in volatility this quality has mostly played out. Speculative positioning remains near the lows which may provide support.
- » We take a more cautious view today as the currency looks somewhat extended after rallying sharply in recent weeks.

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