FINANCIAL PARTNERS

momentum

October 2017

Asset Allocation Dashboard

Positive | Neutral | Negative

Asset class	View	Change	Comments		
Equities			Positive	Negative	Our view
Developed equities	Neutral	⟷	Low yields can sustain the current valuations which are not stretched relative to DM sovereign bonds or credit In aggregate central banks maintain an accommodative stance which continues to support risk markets globally. Global growth remains buoyant and synchronised with positive earnings momentum	The global macroeconomic environment is more uncertain than risk and volatility markets imply through market pricing. Markets have continued to perform strongly and there is a risk of momentum stalling if earnings disappoint. Valuations are somewhat expensive at current levels.	At these valuation levels we continue to believe a neutral allocation is appropriate. Valuations are not cheap but central bank policy remains supportive for risk assets and on a relative value basis vs both sovereign bonds and credit, equity returns remain attractive over the medium term. More elevated volatility should be expected in the future with policy and politics remaining central to risk pricing.
UK equities Relative to developed	Neutral	⟷	Valuations look reasonable today and the historically weak level of sterling today should continue to be supportive of UK businesses, more so the exporters and those that earn their revenues overseas. Low base rates should keep risk appetite and equity prices buoyed in the near term and relative to Gilts and UK corporate bonds UK equities remain an attractive proposition, particularly when viewed on a real forward return basis.	The UK continues to face uncertain times with regard to Brexit where progress remains slow. In the smaller cap indexes where businesses are more domestically exposed, one could argue that this risk may be under-priced today and if the earnings fail to materialise then the market looks expensive. The consumer and consumer facing sectors look increasingly pressured from a deepening squeeze in real wages and challenges to the traditional high street from online retailers and disruptive forces more broadly.	Brexit risks are now firmly focused on the negotiations and any ensuing trade deals that come from them. These risks will remain for some time and will affect business confidence, investment and hiring. The UK market remains disproportionately sensitive to commodity prices.
European equities Relative to developed	Neutral	⟷	The European growth recovery continues apace while the ECB continues to purchase corporate debt as part of its expansive QE program. Valuations remain reasonably attractive against the backdrop of generationally low yields and the potential for meaningful earnings growth is very real with European manufacturing indicators supporting strong future growth.	The market expects further reductions in the ECB's purchase programme before the end of the year which may cause some repricing of risk, albeit for the right reasons. Any further strengthening of the Euro may dampen future earnings if not kept in check. Political risks remain in Europe, albeit much reduced, but the Catalonia independence vote in Spain shows how quickly these issues can flare up again.	European equity valuations have compressed in recent months but remain reasonable at current levels, especially when viewed against corporate and sovereign European bond markets. We remain optimistic on the economics of the region but are less bullish on valuations today, preferring to add on weakness.

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Positive   Neutral   Negative

Asset class	View	Change	Comments		
Equities			**Positive**	**Negative**	**Our view**
US equities Relative to developed		↔	The broad US economic outlook remains solid and economic indicators suggest reasonable growth over the medium term. Q3 earnings growth to date has been robust at ~9% a level which can support the loftier valuation today. The weakness in the US dollar is akin to a loosening of financial conditions and should help drive the overseas earnings of US listed multinational corporations. Tax reforms are expected to be accretive to corporate earnings	The US remains one of the most expensive equity regions in aggregate, with high expectations already priced in, including to some extent the aforementioned tax reforms. With profit margins having peaked, US equities require meaningful and sustained double digit earnings growth to justify today's valuation. The Fed's interest rate policy will remain a potential source of uncertainty and any renewed dollar strength could be a headwind to future earnings. We are also awaiting a potentially new Fed chair which could temporarily destabilise markets.	Still the most expensive regional equity market in our valuation framework,driven at the headline index level this year by technology names. Monetary policy remains key, particularly with potential change in the Fed chair, and on the political front the Trump administration is likely to continue to be a source of surprise and potential price risk in financial markets.
Japanese equities Relative to developed		↔	Valuations remain attractive in Japan and our return expectations reasonable compared to other developed market regions. BoJ purchases of equity through ETF structures, as well as the continuing purchase of JGBs, should support prices as long as policy action remains accommodative, which should be expected with Shinzo Abe's recent and convincing election win. Yen weakness would be a boost to export oriented Japanese equities.	A strengthening yen is a problem for exporters and leaves equities exposed to the currency. In real terms the currency is not expensive so there is room for this to happen, but it is likely to come in a risk off situation when the yen traditionally offers some protection as offshore capital is repatriated. Longer term, Japan remains in a difficult position with an ageing population, low/no inflation and little or no economic growth. This could hold domestic equities down. The Japanese market is not immune from the heightened regional geopolitical tensions, albeit limited in impact and difficult to measure.	We continue to favour an allocation to this market with attractive valuations and the government's continuing program to increase equity allocations within pension portfolios and their policy initiatives to improve working practices and corporate governance. The government's pro liquidity policies are welcome but the yen's safe haven currency status could impede returns.
Emerging market equities		↔	Valuations remain attractive in emerging markets despite the already strong YTD performance. Leading indicators continue to support reasonable growth expectations in isolation as well as versus DM economies. Global policy action remains supportive towards riskier assets. EM currencies in aggregate remain cheap in real terms, which should be supportive for EM assets more broadly.	The asset class may face near term headwinds from any renewed bouts of US dollar strength. With the trend towards more moderate Chinese growth and the economic transition taking place there is a risk to EM more broadly, particularly in the face of tightening financial conditions and efforts to contain excessive credit growth on the Chinese mainland. US trade policy may prove to be a headwind to certain companies and countries should trade agreements be revoked or tariffs introduced. As witnessed with North Korea, geopolitical risk remains somewhat elevated today so some caution is required although the discount probably mostly reflects this.	Valuations are attractive in absolute and relative terms. With slowly improving fundamentals and improving appetite for EM assets among investors, we continue to like the prospective long term returns offered by the asset class today. EM assets remain sensitive to changes in global growth and are more exposed to commodity prices and the Dollar than most DM markets. This remains a volatile section of the equity market - care is required on position sizing – and evolving global trade and tariff policy remains a risk.

Positive Neutral Negative

Asset class	View	Change	Comments		
Fixed income			Positive	Negative	Our view
Government	Neutral	⟷	DM policy remains broadly accommodative in aggregate across DM economies. Bond yields today are under limited upward pressure as inflation remains contained, notwithstanding the UK where inflation has surprised to the upside High quality government paper remains the ultimate haven in times of elevated risk aversion Real treasury yields do not look unreasonable if growth remains muted and inflation is contained. Moderating inflation expectations have been supporting bond valuations of late.	Extraordinary monetary policy continues to support artificially low bond yields and long term government bonds remain expensive in our view. The reflationary theme has shown signs of re-emerging of late which may have mark to market implications for rate sensitive securities. Bonds have performed well in aggregate year to date as forward rate expectations have been pared back to what now appear somewhat overdone levels. There is limited margin of safety in core government bonds today and little to no term premium	Despite on-going supportive policy actions, on a medium term outlook the majority of government bond yields remain unattractive and the asymmetric risk of potential returns from this asset class remains elevated. There are some relative value opportunities for the more sophisticated investors but it is mostly the diversifying attributes of the higher quality sovereign bonds that warrant any holding today.
Index-linked Relative to government	Neutral	⟷	Realised levels of inflation in the developed world today are mostly low or rising, while inflation breakevens in aggregate look a little cheap. Given the historical stickiness of inflation at levels above breakeven inflation rates, inflation linked bonds in select markets look better value today than fixed rate government bonds.	Inflation linked bonds remain vulnerable to weak economic news flow and renewed weakness in commodity prices. Real yields in the UK are extremely negative and should be expected to rise as monetary policy normalises, causing MTM losses. It is difficult to use inflation linked bonds without accepting the higher duration risk that comes with most inflation linked bond funds.	Like their nominal counterparts, linkers are ultimately expensive. Nonetheless, compared to a conventional government bond, at these levels they do provide some protection against higher realised future inflation, and a cushion to the pure rate risk. In aggregate we think inflation linked bonds are reasonably valued today, with some markets offering better value than others.
Investment grade corporate Relative to government	Neutral	⟷	Investment grade spreads remain reasonably priced today despite richening in recent months At current levels we think investors are adequately paid for the fundamental risk of owning higher quality corporate bonds but with limited scope for further tightening. IG corporate bonds provide some diversification to riskier assets with their embedded rate risk and higher beta to sovereign bonds. Although leverage has moved higher debt remains very manageable and it makes sense for businesses to lock in the lower financing costs still available today.	In absolute terms the duration component of investment grade bonds may prove to be a headwind should government bond yields move higher than what is currently priced in. Global IG spreads have recently broken through cyclical lows and are now at the tightest levels since the crisis Financials make up a large part of the investment grade bond universe and we recognise the impact of lower sovereign rates on banks margins and profitability if base rate expectations disappointed. The US market is more progressed through the credit cycle today and leverage, whilst not at punitive levels, has been rising.	Investment grade debt remains a decent play against government bonds and an efficient way to earn a higher quality spread whilst retaining some underlying rate protection and diversification. We are cognisant of any debt issuance to support share buybacks, high aggregate debt levels, and increasing balance sheet leverage. Asset class duration remains near the highs meaning investors are more sensitive to rate moves today than in the past. We retain a neutral rating today and like the balance it provides in a multi asset portfolio, albeit at more stretched valuations.

Positive Neutral Negative

Asset class	View	Change	Comments		
Fixed income			Positive	Negative	Our view
High yield	Neutral	↑	High yield spreads in both the US and Europe offer a moderate pick up versus treasuries today and default rates and expectations thereof are low. The ever present 'search for yield' will continue to provide support to this asset class. Issuance remains mostly for refinancing and interest is well covered today with leverage not excessive by historical standards.	Spreads are tight today – recently breaching the levels reached in 2012 - and absolute valuations look pricey. All in yields in European HY paper makes the asset class an un-compelling real return proposition today. The risks are increasingly asymmetric. The large proportion of energy related issuers could again impact US index returns if the oil price fails to hold in the 40s or higher. Furthermore, the credit cycle is now somewhat extended in the US.	We prefer short duration to core high yield today as scenario analysis suggests a better risk return and valuations look stretched today. On the basis of expected total returns we prefer US over Europe today.
Loans	Neutral	↔	In the long term some value remains and the spread available on loans is reasonably attractive today with the additional benefit of a floating rate coupon. Seniority over unsecured high yield bonds also provides additional capital security if defaults pick up unexpectedly. Loans have limited exposure to the energy sector where the risk of capital impairment has been highest in recent years.	Loans sit in a less liquid part of the corporate debt market with wider bid/offer spreads whilst fundamental risks are much the same as for high yield. Covenant protection remains low. We are mindful of sector concentration in healthcare and technology and the use of new issue loan proceeds for acquisitive purposes.	We retain a modestly favourable view on the asset class and today prefer it to high yield bonds in portfolios which can own the asset class. Hold exposure if appropriate to mandate. The floating rate nature of the asset class will be accretive when interest rates rise more meaningfully.
Emerging market debt	Neutral	↔	Spreads and yields today on hard currency denominated emerging markets remain attractive when considering duration, reinvestment risks and opportunities in other asset classes. With the real effective level of EM currencies remaining near lows, this should provide some support to hard currency spreads and local bonds will benefit from any continued dollar weakness.	In the short term, EMD remains sensitive to disappointing global growth, bad economic data, a stronger dollar and 'risk aversion' trades as witnessed post-election. The large weight of the resources sector in a number of EM economies leaves them exposed to slower Chinese and global growth. The quality of the universe remains investment grade overall but has been deteriorating.	Moderate allocations are recommended at current valuations. Currency risks warrant some caution in local debt and as with high yield we favour combining a core duration strategy with a short duration exposure at this time given the relative tightness of spreads. Both flavours of sovereign debt should provide reasonable real returns and a decent pick up to DM sovereigns over the longer term, but it comes with greater volatility.
Convertible bonds	Neutral	↔	Convertible valuations in aggregate remain reasonably attractive today. Following several years of suppressed market volatility we should expect some pick up going forward which is usually good for option value embedded into convertible bonds. Following a sustained run higher in global equity valuations, the convexity offered by convertibles holds more appeal today.	The call optionality embedded in converts ultimately only has real value if markets increase and the particular stocks in question participate in these moves; if volatility remains at multi year lows, or there has been a structural shift lower, then that may fail to materialise The US convertibles market exhibits a high 'delta' meaning it is more exposed to a repricing in US equities today than it would have been in the past.	Convertible bonds are priced about fair value to their constituent parts. The asset class should always have a place in a multi asset portfolio given the upside participation and downside bond floor and the asymmetric properties they possess, arguably more so today given the extended run we've had in equity markets.

Positive Neutral Negative

Asset class	View	View	Comments		
Alternatives			Positive	Negative	Our view
Commodities	Neutral	⟷	The sustained global recovery should be supportive of commodity prices in the near term. Commodities can provide an inflation hedge in client portfolios. Gold can also provide a hedge against event risk in what has become a macro environment sensitive to policy error and news flow. With the US Dollar coming off cyclical highs in real effective terms, commodities have room to price higher should the Greenback continue to weaken.	Strength of final demand is still questionable especially with respect to China where commodity imports have slowed, growth continues to moderate and policy is focused on paring back excessive credit growth. The asset class more broadly remains prone to bouts of dollar strength that may accompany changing Fed rate expectations. When rates move more meaningfully higher the opportunity cost of taking commodity exposure is higher and commodities may see outflows.	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. The dollar will likely be the single biggest influence on future returns for the asset class as a whole.
Property (UK)	Neutral	⟷	Yields and returns remain reasonably attractive, more so outside the capital, and comfortably above what can be achieved in higher quality UK bonds today. Any renewed pressure on sterling would likely see additional support for property from the overseas buyer.	The UK's economic outlook remains uncertain as the Brexit negotiations slowly move forward We have warned in the past of the dangers of liquidity mismatch and this continues to be a risk in this sector. As a longer duration asset class property remains susceptible to any repricing in long term bond yields.	Income is attractive versus gilts but there is limited room for capital growth. We also recognise the 'search for yield' lends support to the asset class.

Asset class	View	Change	
Currencies			
USDGBP	Neutral	⟷	The Dollar remains soft year to date as the 'Trump trade' deflates and inflation fails to gain a hold, though the Greenback appears to have bottomed out its recent run lower in mid September. The Dollar remains expensive in real terms however so the trend lower may continue. Sterling gave up some of its recent gains following the rapid repricing of near term rate expectations and the Dollar is on the front foot today. However, should the BoE commit to the expected base rate rise in November there will likely be a pick-up in forward vol.
EURGBP	Neutral	⟷	Rate differentials continue to provide no carry advantage for the Euro but any additional and unexpected QE tapering will see the common currency push higher again. In real terms the currency still has some upside potential but the shifting MPC rhetoric has in the short term driven this pairing lower and near term volatility will likely remain. With Brexit uncertainty set to remain for some time, the Euro looks likely to perform better over the medium term, but with an expected BoE hike next month and expected tapering from the ECB before the end of the year, the direction of this pairing over the near term is difficult to forecast and a better directional opportunity will likely come once the near fully priced policy changes have occurred.
JPYGBP	Neutral	⟷	With the BoJ maintaining a yield target on its QE bond program and no change in policy rates it is hard to see a fundamental reason for the Yen to outperform meaningfully, other than on macro risk concerns as it did recently in August. In real terms the currency remains somewhat undervalued. With both currencies looking somewhat cheap on a long term real basis it is difficult to take a strong long term directional view on this pair today We may find better direction if and when rates are hiked in the UK.

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