eQInsight

Market View Q4 2017

This document presents a high level summary of our investment views. As we are making decisions about what to buy and sell in your portfolio, we want to be accountable to you by explaining what we are doing, and why.

The EQ Asset Allocation Committee met on 6 November 2017. Where relevant the indicators show how our view changed since the previous meeting (26 July 2017). Please note: our views may change at any time.

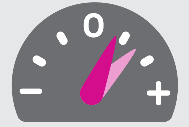
UK

The UK is benefiting from a global pickup in manufacturing – but consumers are the real engine of UK growth and they are struggling under the weight of rising inflation.

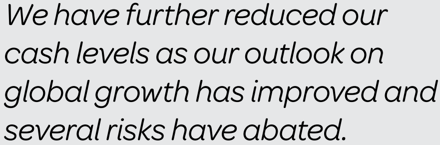
We remain underweight UK equities due to more positive views elsewhere. Wage growth is not matching high inflation, which is putting pressure on consumer spending as shown by weak retail sales growth and falling consumer confidence.

The economy looks weak but not recessionary. Manufacturing sectors are rebounding, supported by the fall in value of sterling and a pickup in global manufacturing. The equity market remains sensitive to Brexit negotiations: a deal which gives us good trade access to the EU should cause sterling to rally which will favour small-caps. Conversely, a deal without much trade access will send sterling down, favouring large-caps. We prefer not to try to forecast such events, so chose to allocate to markets with better growth stories that are less vulnerable to political shock.

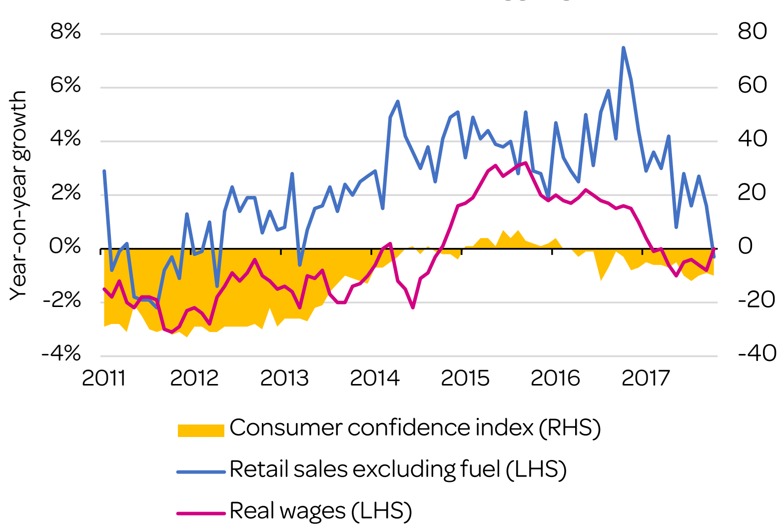
Cash



We have further reduced our cash levels as our outlook on global growth has improved and several risks have abated.



We are no longer overly concerned about knock-on effects of Brexit outside the UK, and the political landscape in Europe and the US seems stable. In this context global growth is strengthening and we see this supporting asset returns globally.

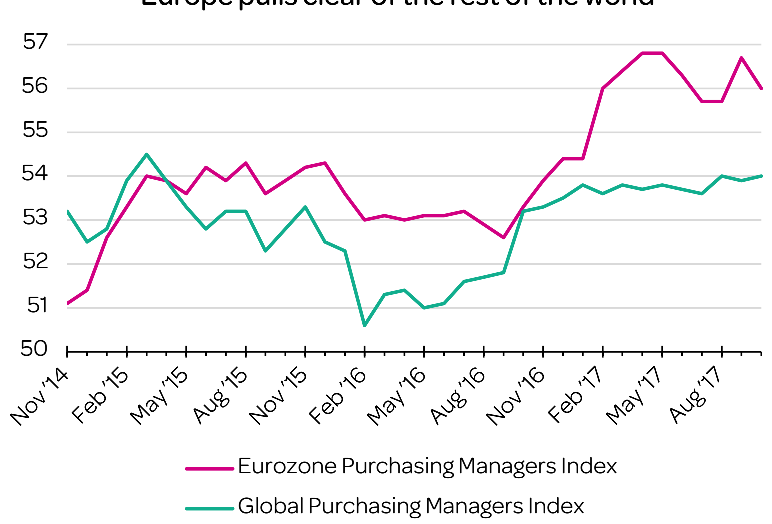


Europe

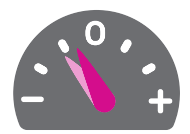
European equities have had a good run in 2017 as global growth has improved and political risks have subsided.

A combination of weak growth and political risks made European equities very unpopular at the start of 2017. Sentiment has changed dramatically since the French election. Political concerns have eased, and the European Central Bank has announced plans to slow the pace of 'quantitative easing' without markets batting an eyelid.

Europe is enjoying a period of stellar growth (by its standards) supported by strong consumer spending and an increase in investment. This growth should continue which will support earnings growth and equity returns.



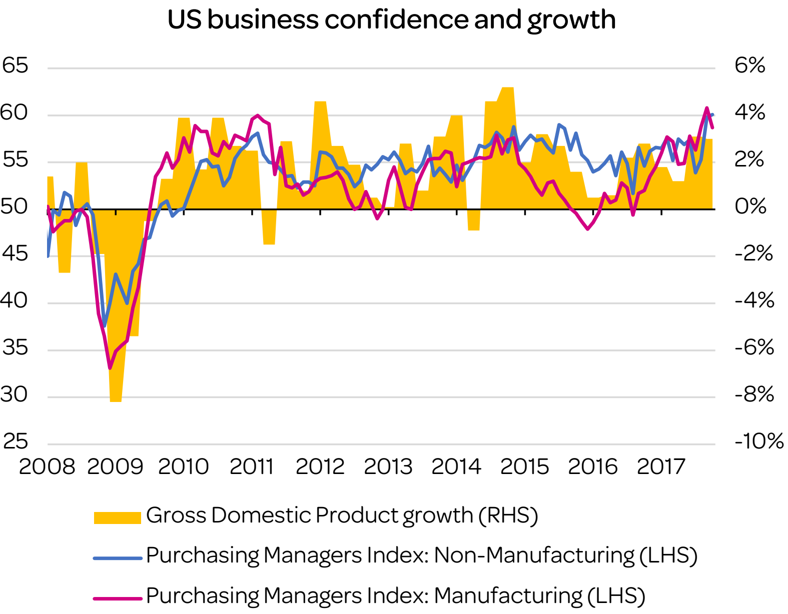
North America



Sentiment towards US assets has improved as economic data has picked up through the second half of the year. Tax reform may be on the horizon which would further boost equity market returns.

The US economy is rebounding after a difficult period. This is reflected in strong business and consumer confidence surveys which have correlated well with growth in the past. US equities have been sensitive to the prospect of tax cuts, moving up as they seem more likely and down as they seem less so. The Republicans need a successful legislative change before the midterm elections to boost their chances of retaining seats and power. This makes some kind of tax reform more likely.

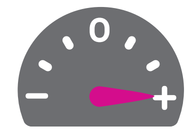
While it could boost returns, the potential for tax reform is certainly not the only reason that we are becoming more positive on US equities. We are also seeing strong earnings growth, the economy recovering, and sentiment towards the US improving.



Our exposure to US equities also gives us exposure to the US dollar. This should do well coming into year end, given the strong US economy and the US Federal Reserve's desire to hike interest rates.

Japan

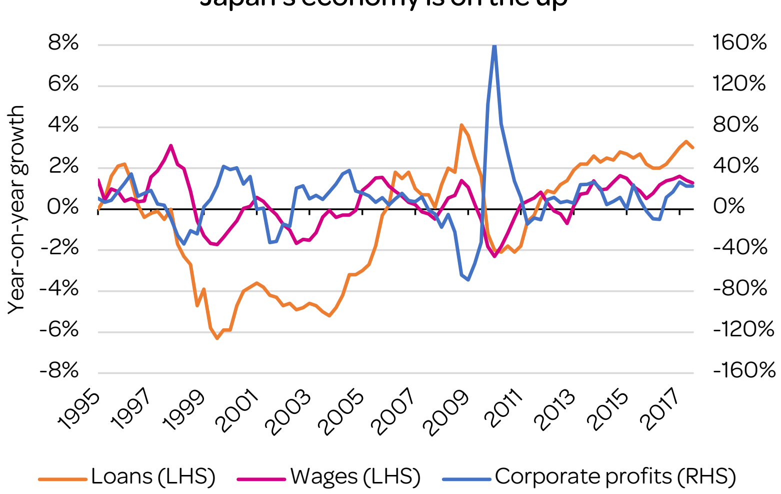
We remain very positive on Japanese equities. After over two decades of economic hardship, corporate behaviour seems to be changing for the better. We think this will support the equity market going forward.



'Abenomics' – the economic policies advocated by Prime Minister Shinzo Abe since 2012 – seem to be having an impact and we are now seeing meaningful improvements in the economy after many years of hardship.

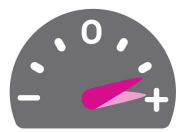
Unemployment is very low, wages are now growing, and corporate borrowing is increasing. The last two points suggest that corporates are increasing in confidence, which should support growth going forward.

Alongside the improvements in the underlying economy, the Bank of Japan appear to be intent upon continuing quantitative easing. The combination of strong growth and easy monetary policy creates a favourable environment for equities.



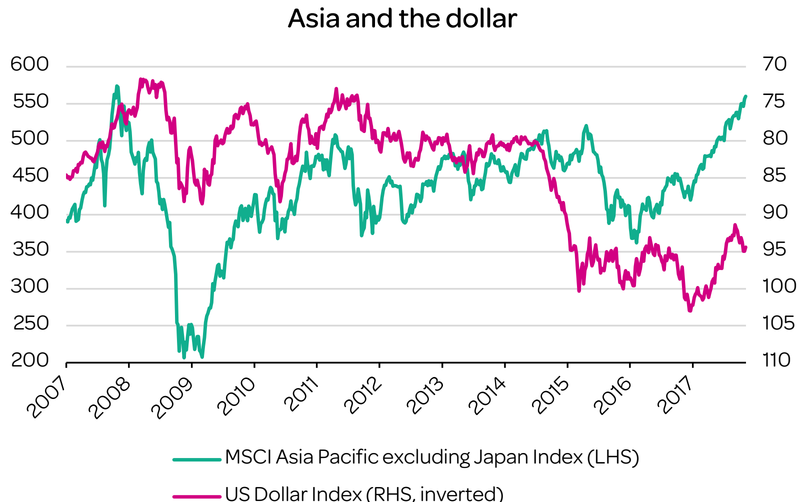
Asia Pacific

The recent uptick in global growth and trade is a big positive for the open economies of Asia. We broadly expect this environment to continue, but our view is tempered by two concerns.



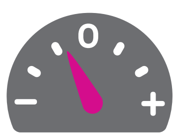
Improving global growth and gradual interest rate hikes have created a good environment for Asian equities. However, the Chinese property market is slowing and if investors again misread this as a sign of imminent Chinese implosion then Asian equities are likely to be disproportionately hit.

Asian equities can also suffer when the US dollar is strong, as this can attract money back to the US and out of Emerging Markets. These concerns have led us to reduce our overweight position slightly from last quarter.

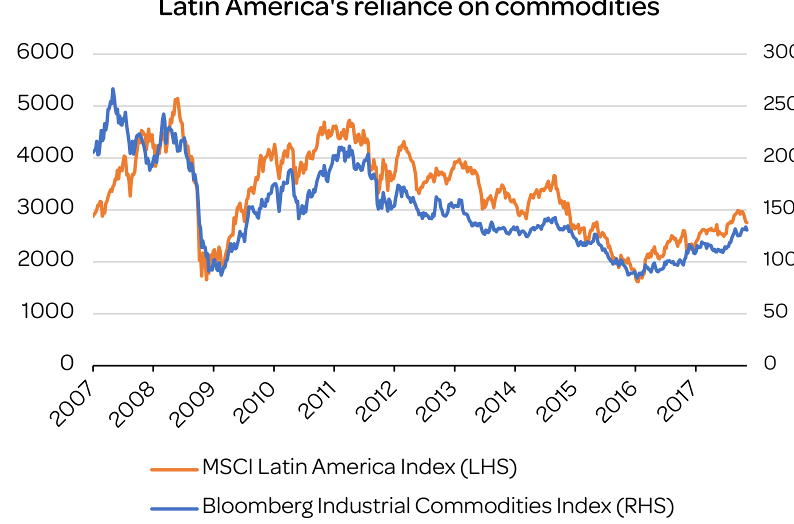


Emerging Markets

We are cautious about the commodity reliance of some Latin American economies and remain underweight.



This section primarily covers Latin American equities which are heavily dependent on commodity prices and particularly industrial metals. As such, when commodities fall, Latin American equities tend to fall as well. Over the last decade, industrial metals have been well correlated with Chinese property investment which we anticipate will continue to slow. If we are correct, industrial metals will probably follow investment down, dragging Latin American equities with them.



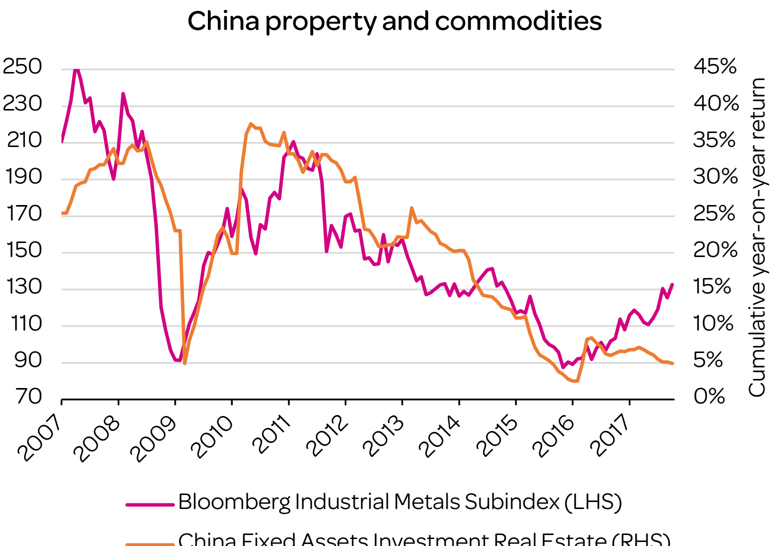
Politics present another set of issues. Donald Trump seems intent on renegotiating the North American Free Trade Agreement which could have adverse effects on Mexico's economy. Meanwhile Brazil remains embroiled in corruption scandals. Political outcomes are hard to predict and add risk to holding Latin American Equities.

Commodities

We have limited exposure to energy equities.

The oil market is in balance for the first time since 2015 and inventories have begun to reduce. While this might improve the outlook for oil, we have concerns about the future of the industry given the rising adoption of renewable energy technologies.

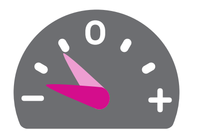
The chart opposite shows the historical correlation between industrial commodity prices and Chinese property investment. Interestingly, in spite of slowing growth in property investment, industrial commodities have done very well over the past 12 months. We are concerned that this diversion is not sustainable so prefer not to be invested in these commodities.



Bonds

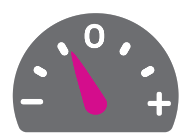
We still hold a slightly negative view on government bonds, while neither investment grade nor high yield bonds offer enough return to be attractive.

Government bonds



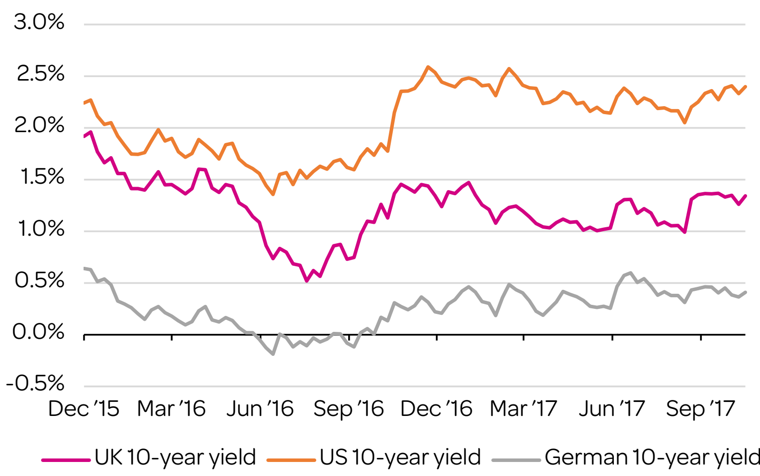
Synchronised global growth and tight employment markets will ultimately cause inflation. This is especially the case in the US where unemployment is extremely low and we are seeing wage pressure. Rising inflation is likely to push up yields, driving the price of bonds down.

Corporate bonds



We see both high yield and investment grade bonds as expensive versus history and so are slightly underweight both asset classes. Investment grade debt offers a very minimal return above government bonds and high yield offer equity-like risk for much lower returns.

Overall, we feel that bond yields are already too low and do not reflect these risks, or the current economic environment. The chart highlights this well; global growth is undoubtedly stronger than it was at the start of 2017 but long term yields are lower. Part of the mismatch between economic reality and bond prices can be attributed to the enormous Central Bank purchases over the last 10-years. The pace of global purchases is now slowing which presents a further risk to government bond prices. Overall, we remain underweight, preferring to allocate elsewhere.



Property

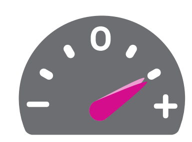
Our view on property remains slightly negative.

Property has performed better than expected in 2017 due to increased capital and rental growth. Industrial assets have done particularly well, boosted by the global manufacturing pick up and sterling weakness.

The housing market is now experiencing a slight slowdown and construction has fallen so we anticipate that future returns are likely to be dependent on yield rather than capital growth.

Though we do see opportunities, we remain concerned about the impact that Brexit and the trajectory of the UK economy may have on property returns.

Alternatives



We are overweight alternatives, mainly due to our negative views on other asset classes.

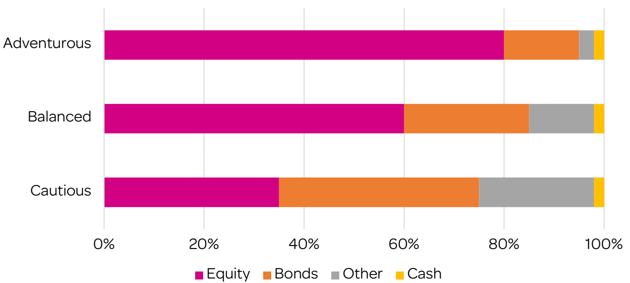
We see risks to many equity and bond markets, and could even envisage a situation where both move down together. Given these concerns we are maintaining a higher allocation to alternatives which typically exhibit a low correlation to conventional asset classes.

How does this relate to my portfolio?

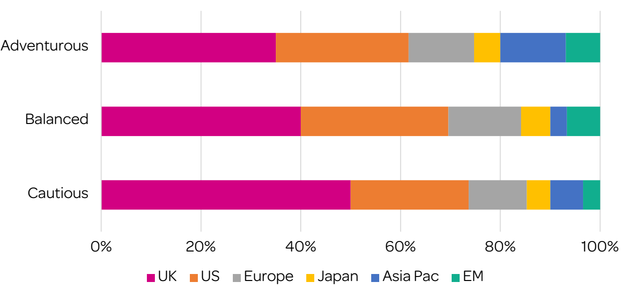
Portfolios are sometimes compared to recipes – you need the right balance of high quality ingredients to make a great meal. In the investment world there are many different types of investment or 'asset classes'. These are our ingredients: **equities** (stocks and shares), **bonds** (debt), **property**, **commodities** (raw materials) and **alternatives** (a catch-all class for more complicated financial instruments).

Since equities are usually the largest part of any portfolio, we further distinguish between geographic regions according to the size and relevance of their markets to UK investors. This includes the **UK** itself, **North America**, **Europe**, **Japan**, **Asia Pacific** (i.e. China) and '**emerging markets**' (a basket of countries that includes Brazil, Mexico, Chile, South Africa, India and others).

The overall 'flavour' of a portfolio is determined by its risk profile. More cautious investors will have more lower risk investments (like bonds), while more adventurous investors will have more higher risk investments (like equities). To illustrate this, here is what three typical portfolios might look like:



The mix of equities also changes as risk moves from low to high. Cautious portfolios will have more developed market equities, while adventurous portfolios will have slightly more developing market equities. Again, here are three examples to illustrate this:



This is important because our views – as outlined in this document – will influence your portfolio **based on its default positioning**. So for example: say our view on UK equities is negative:

Current view: Q3

Previous view: Q2 faded (if different)

Since we're slightly concerned about the state of the UK economy, you're likely to have fewer UK equities than usual. However, if you are an adventurous investor then you will still have more than a cautious investor, because adventurous portfolios have a larger proportion of equities overall.

For the latest information on our market views and positioning please visit:

eqinvestors.co.uk

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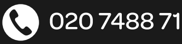
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Please remember that past performance is not a guide to future returns. The value of investments and income derived from them can fall as well as rise, and you may get back lass than you originally invested.