eQInsight

Market View Q3 2018

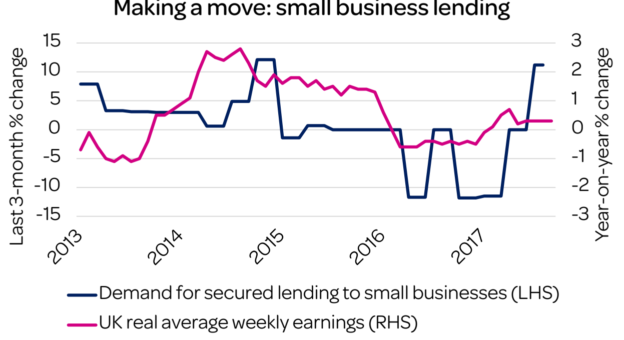
This document presents a high level summary of our investment views. As we are making decisions about what to buy and sell in your portfolio, we want to be accountable to you by explaining what we are doing, and why.

The EQ Asset Allocation Committee met on 31 Jul 2018. Where relevant the indicators show how our view changed since the previous meeting (30 Apr 2018). Please note: our views may change at any time.

UK

We have returned to neutral on UK equities as, in our view, they face a roughly balanced set of risks. The domestic economy and currency are susceptible to Brexit while the equity market is more sensitive to the global economy. Consumer and healthcare stocks are defensively exposed to global growth. On the upside, the energy and materials sectors will benefit if global growth continues.

Brexit poses underlying economic risks as well as growing political instability and associated risks to business stability and investment. Furthermore, the equity market is sensitive to fluctuations in the value of sterling, itself driven by Brexit negotiations and the inflation outlook in the UK. However, with UK interest rates unlikely to rise significantly, we see the funding environment for UK companies being relatively easy. Indeed, demand for borrowing from small businesses has steadily increased over the last few quarters.



Also, UK listed consumer companies enjoy global revenues. The economic recovery across several regions has led to falling unemployment and while real wages stay in the black, it should provide these companies with a decent tailwind.

The UK equity market also has decent exposure to commodities. Although volatile and susceptible to rhetoric around trade wars, commodities usually perform well in the later stages of business cycles as capacity constraints start to kick in. We think we are getting increasingly late cycle and so closing our underweight to this market seems appropriate.

We are focused on incoming data to guide us further, but in aggregate we think the risks to UK equities are balanced in the short term.

Cash

We remain neutral on cash. Although we expect elevated levels of volatility in equities, we think there is still a reasonable expectation of growth in selected markets.

The globally synchronised growth we witnessed in late 2017 and early this year has moderated in pace but we still see most economic regions in expansion territory.

The impact of trade wars has the potential to upset the path of growth and as a consequence we expect higher volatility in equity markets over the remainder of the year. Notwithstanding, we believe there are better sources for portfolio diversification.

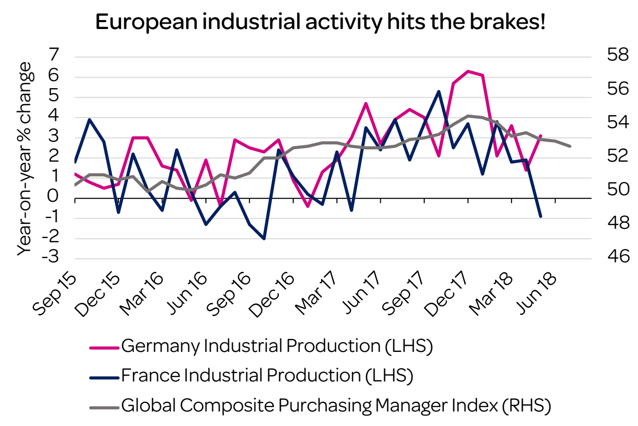
Europe

As trade wars loom, Europe's industrial base looks vulnerable on multiple fronts: direct conflict with the US, slowing activity in China. Add in the end of the European Central Bank's crisis-era monetary policies on top of existing risks to European equities: we have dialled back our exposure with the expectation of a better buying opportunity.

Eurozone industrial activity has slowed down, including in the German powerhouse, as the prospect of slowing growth in China and trade tariffs on auto exports hit activity and sentiment.

Consumer activity and sentiment remains healthy, led no doubt by falling unemployment levels across the region – especially in southern Europe which was hit hardest through the Great Financial and European sovereign debt crises.

The European Central Bank is expected to end its extraordinary bond purchase programme in September. This has the potential to add to existing risks posed by a strong euro and the rising cost of capital.



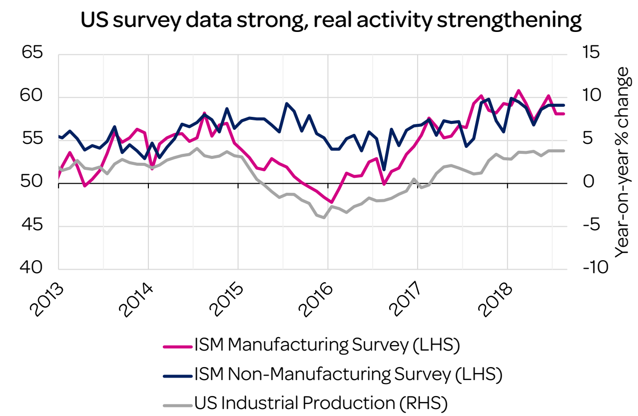
North America

The US economy appears robust and growth could become even more durable as companies look to invest more for the future. That said, there are risks given signs of late cycle behaviour, higher borrowing costs for companies, and of course the trade dispute with China. We have increased our exposure slightly, but remain close to neutral.

We think the US economy is healthy and we see very few signs of a slowdown. Inflationary pressures have not materialised though this could change given the labour market is very tight. There are strong earnings being reported by companies across market sectors, reflecting robust activity.

Tempering a more overtly bullish outlook is the known fact that the Federal Reserve is raising interest rates. We see potential for long term borrowing costs to be driven up further by a high level of government bond issuance to fund the US budget deficit.

Finally, there is also risk of the trade dispute with China getting out of control and increasing signs of late cycle behaviour such as rising merger & acquisition activity and loosening of credit standards.



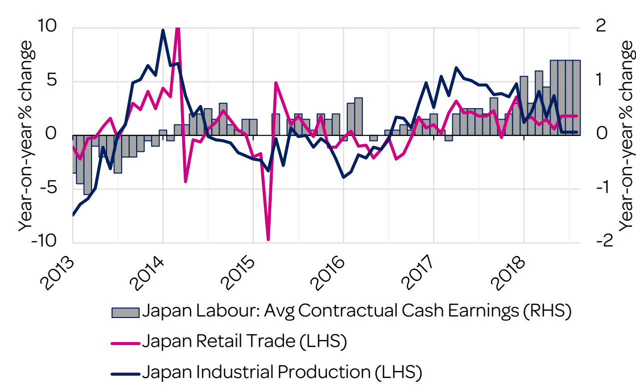
Japan

We think the long term outlook for Japan is still positive, but we see short term weakness. Our overweight has worked well, but we have now reduced this in search of signs of improving fundamentals.

Japanese industrial activity recently experienced a slowdown similar to that seen in Europe. The long term prospects for supply of industrial machinery for China's (still) growing economy are strong, but recent trade tensions between China and the US suggest the pace of expansion may moderate in the near future.

Meanwhile, notwithstanding the major structural reforms underway in Japan, the country appears to have hit a soft patch. Inflationary pressure was building (and was welcomed) but appears to be petering out. Employee wages are going up in what seems to be a massive labour shortage – although so far this is not feeding through into retail sales. Indeed, it seems that higher wages are offsetting slowing credit growth.

There are more positive changes to expect in the future such as more women in the workforce and an increase in the number of fulltime contracts, but for now, we are happy to bank some profits, return to a more neutral position and be patient.



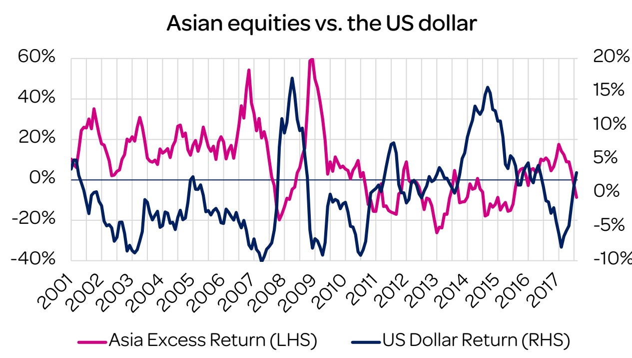
Asia Pacific

The long term growth picture for Asia is very strong but in the short term, tightening monetary policy in the US is leading to tighter financial conditions in Asia. And this does not include the potential impacts from the trade dispute with the US. So, we have closed our overweight and are waiting for a better steer on the future path for growth.

On the positive side, although the pace of global economic growth has slowed, the world economy is still growing and it is growing fastest in Asia. Internal consumer driven demand is increasingly important for various countries, especially China, and this is leading to a better quality of growth rather than relying purely on exports. This long term trend has not changed.

However, in the short term China's focus on corporate deleveraging has slowed the pace of activity – which comes at the same time as the trade conflict with the US. Government spending will stem some of these negative impacts but we see the trade conflict with China as still in its early innings. In the long term, companies will adapt to whatever the new playing field looks like, but uncertainty is certainly not a good thing.

Asian equities also usually suffer when the US dollar is strong. We don't have a firm view on the US dollar at this point, but are mindful that further dollar strength could lead to further equity weakness in the region.

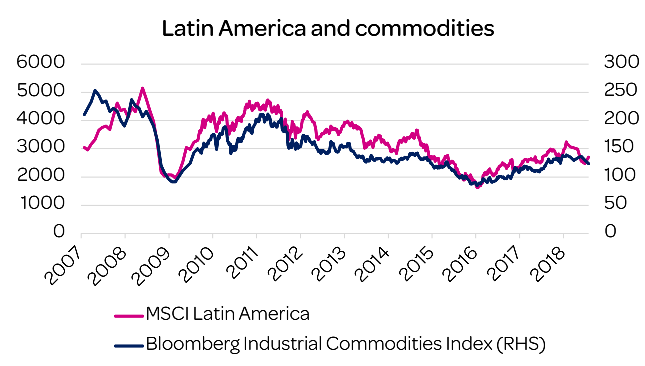


Emerging Markets

This section primarily covers Latin American equities, which are heavily dependent on commodity prices and particularly industrial metals. Although political risk in the region appears to be stabilising, fears around trade wars dominate the market's expectation for future demand. Additionally, a strong US dollar negatively impacts both emerging market equities as well as commodity prices, which is a double whammy for Latin America.

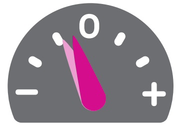
The change in political landscape in the region looks like it could create some long term positive changes, but finding a mutually agreeable resolution to NAFTA renegotiations is an important near term milestone to overcome.

The negative impact from fears over trade wars has also led to the demand for copper and other industrial metals drying up considerably, the scale of which seems like its overdone. So, we are waiting for more up to date supply & demand data to see whether activity is improving or remains at depressed levels.



Bonds

Overall we still hold a negative view on government bonds. Neither investment grade nor high yield bonds offer enough return to be attractive. However government bond yields in the US have increased recently, so we reduce our underweight.



Government bonds

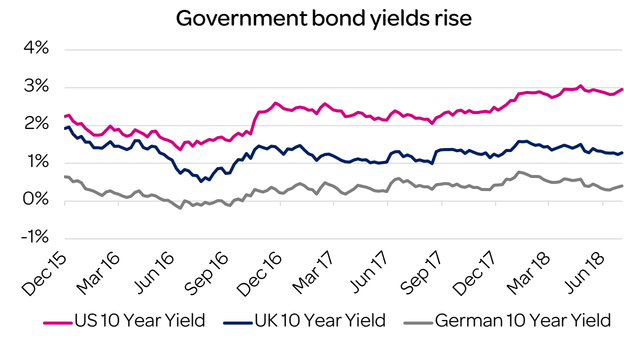
Global growth momentum has been upset through trade war escalation and with the exception of the US, inflationary pressures are moot. The US Federal Reserve is gradually reducing the size of its balance sheet, and increasing interest rates in a steady, well-telegraphed fashion. The European Central Bank has flagged the end of monetary easing but its policy remains accommodative.

While the general trajectory of the global economy seems to be towards higher inflation and yields, the opposite is true in the UK, where currency induced inflation has started to fall away.

The economic climate remains unfavourable for government bonds and so we are comfortable being underweight.

Corporate bonds

Both high yield and investment grade bonds have sold off recently but remain expensive versus history and so we 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.

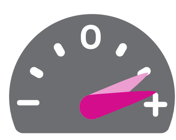


Commodities

We have limited exposure to both physical commodities and commodity equities.

Commodities usually perform well in the later stages of the business cycle as increases in demand bump up against supply constraints. However with the massive uncertainty created by the prospect of trade wars, mainly between the US and China, the commodity markets have been very weak. The outlook may well change materially so we are monitoring the situation closely, looking for signs that demand is returning.

Alternatives



We are overweight alternatives, mainly due to our negative views on bonds.

We have brought our equity allocations back towards neutral. Our negative view on bonds is counterbalanced by a positive view on alternatives.

With less influence on asset prices from central bank monetary policy, there should be greater alpha opportunities on which such strategies thrive.

Property

Our view on property remains neutral.

Property performed better than expected in 2017 due to increased capital and rental growth. 2018 is seeing capital growth continue albeit at a meagre pace with the majority of total return coming from rental growth.

Industrial assets did particularly well boosted by the massive growth in e-commerce requiring storage space while retail assets on UK high streets continue to suffer. The residential housing market is 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.

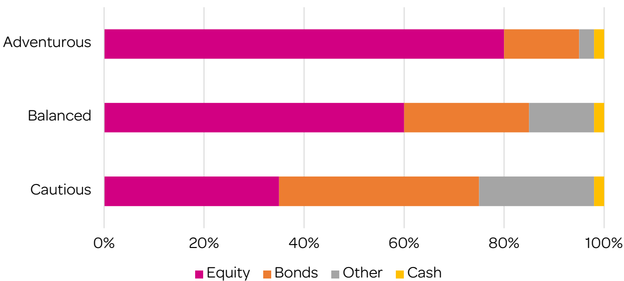
Though we do see opportunities, we remain concerned about the impact that Brexit and the trajectory of the UK economy may have on property returns, especially given the market feels like its being held up by industrial assets.

How does this relate to my portfolio?

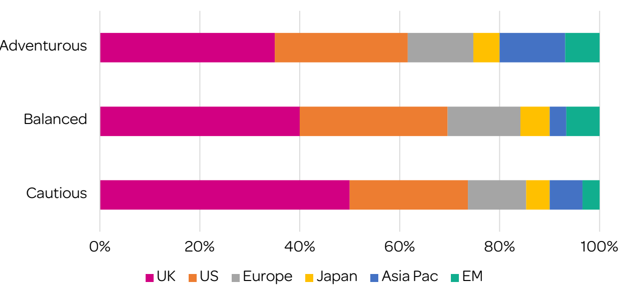
Portfolios are sometimes compared to recipes – you need the right balance of high quality ingredients to make a great meal. In the investment world there are many different types of investment or 'asset classes'. These are our ingredients: **equities** (stocks and shares), **bonds** (debt), **property**, **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**. Let's look at a hypothetical example: say we had some concerns about the UK economy such that our view on UK equities had turned marginally negative:

Current view: Q2

Previous view: Q1 faded (if different)

In this hypothetical example, we might well decide to reduce your exposure to UK equities. However, if you were an adventurous investor then you would still hold more UK equities than a cautious investor – simply because, all other things being equal, 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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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 less than you originally invested.