eQInsight

Market View Q4 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 30 October 2018. Where relevant the indicators show how our view changed since the previous meeting (31 July 2018). Please note: our views may change at any time.

UK

The domestic economy and currency are susceptible to Brexit while the equity market is more sensitive to the global economy. We think the UK equity market faces a roughly balanced set of risks.

We remain neutral on UK equities.

On the negative side, the underlying economy faces Brexit risks and consumers are getting weary with very low real wage growth and falling retail sales, even online. Political instability is at boiling point and is proliferating risk to business and investment.

On the positive side, we think this uncertainty creates downside risk for sterling and so larger companies can benefit through their foreign currency earnings.

We have balanced our portfolios across company size, industrial sectors and the financial profiles of companies to remain as diversified as possible for any Brexit outcome and we remain focused on incoming data to guide us further.

See our Strategy Insight Brexit update for more details on our thinking:

eqinvestors.co.uk/insight

Cash

We remain neutral on cash. Although we expect elevated levels of volatility in equities, we think there is still a reasonable chance of sterling weakness.

The globally synchronised growth we witnessed in late 2017 and early this year has turned into a modest slowdown in most regions with the exception of the US.

The impact of rising interest rates, trade wars and political risk in Europe and the UK has the potential to upset the path of growth and as a consequence we expect higher volatility in equity markets over the medium term.

Notwithstanding, we believe there are better sources of portfolio diversification.

Europe

We have marginally reduced our European exposure.

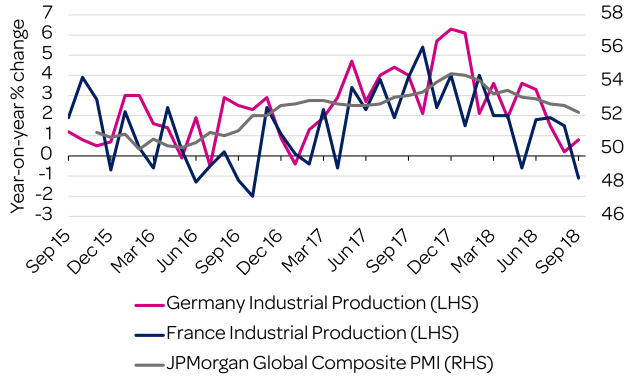
Eurozone industrial activity has decelerated further, while business surveys point to continued weakness. The weakness mainly comes from slowing manufacturing activity in China, but weakness in the auto industry linked to the emissions scandals is adding to the problem, especially in Germany.

Retail sales and consumer sentiment continue to show signs of weakness. We believe this is tied to falling industrial activity and concerns about the future, which shows up in a marginal increase in household savings.

Meanwhile, the Italian government's initial budget proposal was rejected by Brussels. This friction has led to elevated risk in the region given the scale of Italy's government bond market.

We don't think we are looking at another Eurozone sovereign debt crisis, but we have further dialled back our European equity exposure with the expectation of a better buying opportunity.

European industrial activity rolls over



North America

The US economy appears healthy and our overall position remains close to neutral.

The US economy continues to display remarkable strength. Both business surveys and measured economic activity are healthy. We see very few signs of a recession although some moderation in growth is possible from elevated levels.

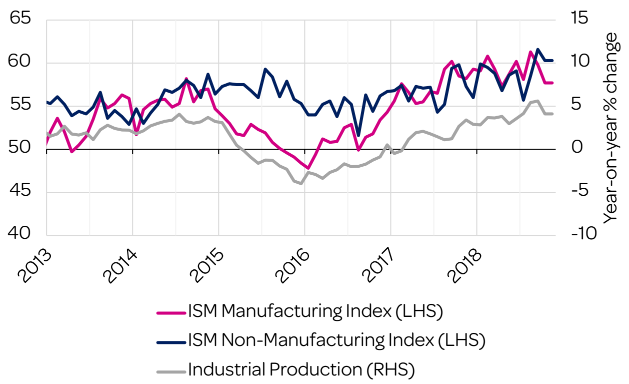
Inflationary pressure is weakening, driven by a fall in shelter costs. However this could change as the labour market is very tight and the full impact of trade tariffs may not have fed through into the economy as yet.

Companies are reporting strong earnings and through tax incentives we expect additional overseas cash repatriation that could lead to higher merger & acquisition or share buy-back activity.

We temper a more overtly bullish outlook given slowing growth in other markets and the known fact that the Fed is raising interest rates. Higher government bond issuance could cause further upward pressure on borrowing costs and at some point, this will tip equities over the edge. We don't think we are there yet, but the risks are certainly elevated.

International tensions have risen across multiple fronts. There is the trade dispute with China and to some extent also with Germany. Saudia Arabia has opened a front with the apparent murder of the journalist Jamal Khashoggi and threats over the price of oil. Negotiations with North Korea are still unresolved. Of them all, we think the trade dispute with China is the greatest threat and could easily escalate further given a high degree of bipartisan support for action.

Onward march!



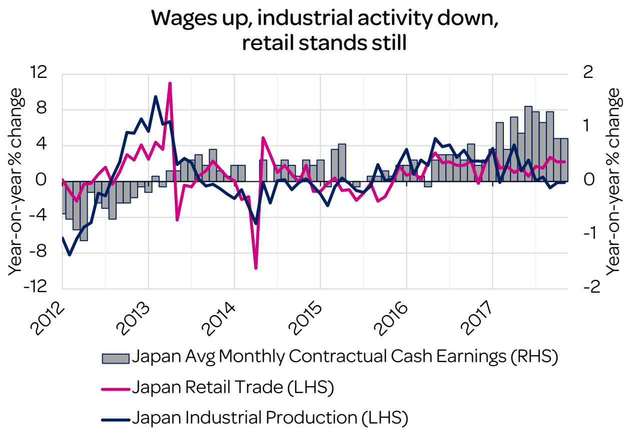
Japan

Japan is showing signs of short term weakness. Heavy ties to global trade and the absence of consumer driven demand are notes of caution.

Japanese industrial activity has continued to deteriorate, in large part due to a slowdown in China, which is its biggest export market. Boding well for the long term, however, is the significant increase in capital expenditure, driven by semiconductor related industries which expect to feed into the "Made in China 2025" industrial strategy.

Inflation has remained stubborn, stuck at 0% when excluding food & energy. Labour market shortages have also led to a decline in the growth in employment which could put a cap on growth at an aggregate level. Although wage growth is running at a low rate, for Japan this is still one of the fastest paces since 1997. It is not yet translating into sustained higher levels of retail sales, which could be due to weakened industrial activity.

We further reduce our overweight, patiently waiting for a sustained improvement in retail, a turn in industrial production and/ or some form of Chinese economic stimulus to support the region.



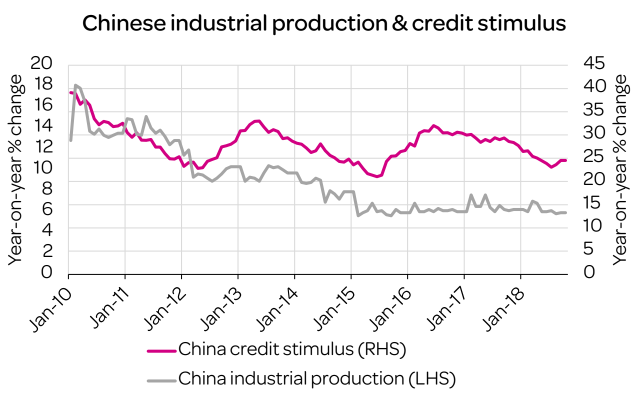
Asia Pacific

Pressure continues to mount on Asia through two primary channels: the US-Sino trade dispute and tighter US monetary policy. We are alert to any change in either and to possible economic stimulus in China, but in the meantime maintain a neutral position.

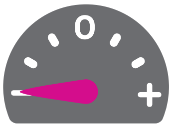
The long term trend of a shift from manufacturing to internal consumer driven demand remains intact in China. In the short term, however, it is the fear of slower industrial activity induced by the trade dispute with the US, coupled with tighter financial conditions created by tighter US monetary policy that have led to significant market weakness.

China is also cracking down on its shadow banking system with demands of balance sheet deleveraging. We can see this in a slowing rate of credit growth.

Government spending could increase to stem some of these negative impacts but announced stimulus so far has been relatively small.



Other Emerging Markets



A new political landscape promises change, but economic fundamentals tie much of Latin America to the price of industrial metals. These are themselves tied to growth in Chinese demand, which is weak. We stay underweight.

Political change in Mexico and Brazil have seen the election of populist presidents from the left and right, respectively. Although both president elects have some divisive traits, they both won decisively in the general elections with 53% and 55% of the vote, respectively.

Common to both campaigns was a crack-down on corruption and crime that has become extreme in recent years. Any significant economic reform, however, will take time to become established. In the interim, the economic fundamentals of the region tie their fortunes to the price of industrial metals.

The negative impact from fears over trade wars and slowing growth in China has led to the demand for copper and other industrial metals drying up considerably. So, we are monitoring changes in supply & demand data and looking for signs of economic stimulus in China before revising our underweight to the region.

Bonds

Overall we are still slightly underweight bonds, but with interest rates having risen considerably in the US and with the aggregate market demonstrating late cycle characteristics, we have reduced our underweight to build additional resilience in portfolios.

Government bonds

The moderation in global growth comes at a time of rising US Fed interest rates. This creates downside risk for US treasuries and increases hedging costs for foreign investors.

Monetary policy at the ECB remains accommodative but bond yields are incredibly low for highly rated sovereigns such as Germany.

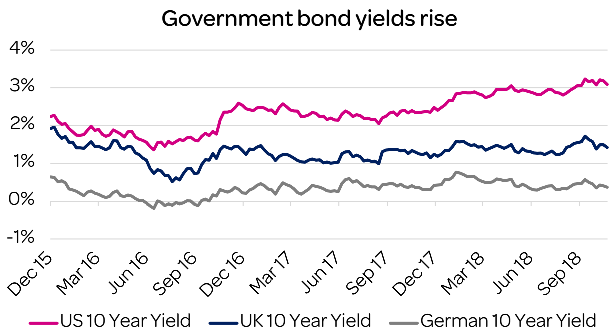
In the UK, there are material risks to the outlook for gilts in the face of Brexit and possible interest rate moves by the Bank of England.

If we see continued economic deterioration, our position will change but in the interim we are comfortable holding a low exposure to government bonds.

Corporate bonds

Both high yield and investment grade bonds have extended their losses recently. Bonds of large (investment grade) companies have sold off most and are looking increasingly attractive in the UK and Europe. Bonds of smaller (high yield) companies remain expensive versus history.

We move closer to neutral for both asset classes.



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 have slightly reduced our overweight to alternatives, mainly due to a less negative view on bonds.

We no longer hold a significantly negative view on bonds, so our counterbalancing allocation to alternatives has been reduced.

We remain overweight, however, due to concerns in the equity market. We also note that with less influence on asset prices from central bank monetary policy, there should be greater alpha opportunities on which these strategies thrive.

Property

Our view on property remains neutral.

In 2018, we have seen meagre capital growth 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.

As an asset class, property is still relatively attractive compared to bonds, but we are concerned about the impact that Brexit and the trajectory of the UK economy may have on property returns.

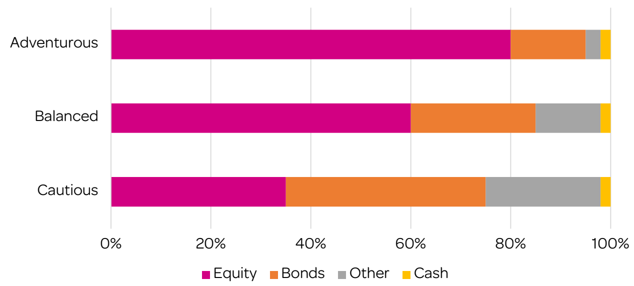
EQ investors

How does this relate to my portfolio?

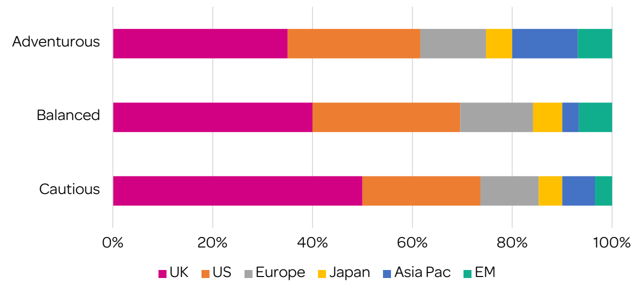
Portfolios are sometimes compared to recipes – you need the right balance of high quality ingredients to make a great meal. In the investment world there are many different types of investment or 'asset classes'. These are our ingredients: **equities** (stocks and shares), **bonds** (debt), **property**, **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: Q4

Previous view: Q3
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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