eQinsight

Market View Q1 2019

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 7 February 2019. Where relevant the indicators show how our view changed since the previous meeting (30 October 2018). Please note: our views may change at any time.

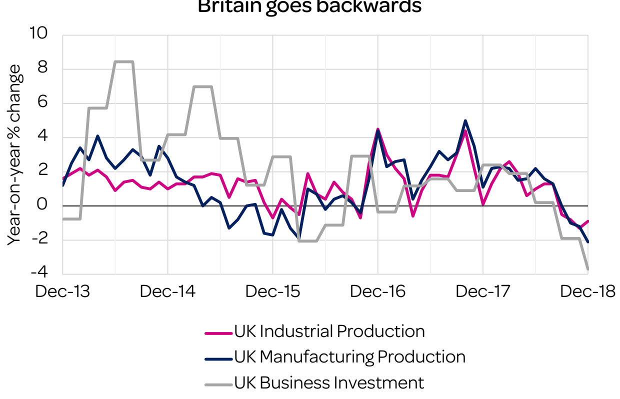
UK

We remain neutral on UK equities and as diversified as possible for any Brexit outcome.

We are balancing three considerations in the UK:

1) Equity valuations look very attractive versus other developed markets. Corporate profits are reasonably strong in some key industrial sectors such as consumer staples, and especially so in energy and materials after a significant slowdown during 2013-2017.

2) The UK economy has ground to a halt – driven by a combination of slowing business activity and consumer spending (despite rising real wages). This again is related to the ongoing uncertainty about the outcome of Brexit. We do not believe confidence will lift until we have left the EU and the government has made some progress redefining the UK's relationships with the rest of the world.



3) There is a risk of a big move in the value of sterling, in either direction – depending on what kind of Brexit we achieve. This would impact both UK equities and the relative value of foreign assets.

Taken together we have a neutral allocation, having balanced our portfolios across industrial sectors, sizes and financial profiles of companies. Our aim is to remain as diversified as possible, prepared for any Brexit outcome, and focused on incoming data to guide us further.

Cash

We've made a tactical increase to cash to provide an additional source of defensive characteristics to portfolios.

Two factors are currently driving greater levels of uncertainty in global markets:

1) The US Federal Reserve's approach to monetary tightening. Financial conditions deteriorated markedly over Q4 2018 but rebounded strongly once the Fed made more soothing comments in January, suggesting that it may now take a softer stance.

2) A wide range of opinion on how the trade war between the US and China could evolve, given its consequent impact on the future path of economic growth.

In combination, these two factors are perturbing otherwise stable market relationships. As a consequence, some defensive assets such as absolute return strategies may be less reliable as a source of portfolio diversification – so we have opted to increase our cash allocation instead.

Europe

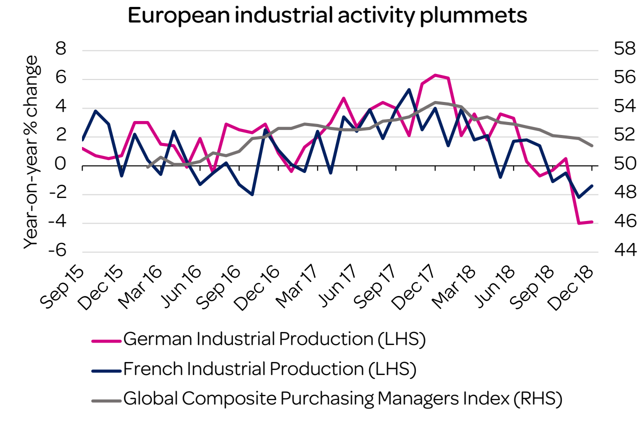
European business activity has slowed down alarmingly, but perhaps only temporarily. We have marginally reduced our European exposure.

Business activity in the Eurozone decelerated even further since our last update, while consumer confidence (which had been holding up relatively well) has started to weaken. There are competing arguments for the ultimate cause of the slowdown.

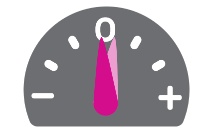
One argument focuses on the series of idiosyncratic, one time blows to activity that have now passed and so we should start to see a recovery in activity. The disruptions were caused by the 'gilets jaunes' protests in France, the auto emissions scandal in Germany and political uncertainty regarding Italian (and French) fiscal policy.

The other argument points to the EU's reliance on trade. Hence, the curtailment of Chinese credit growth slowing the Chinese economy and the threat of tariffs with US trade are both having a knock-on impact on business activity in the Eurozone.

Although we don't think we are looking at another Eurozone sovereign debt crisis, we are waiting to see how activity progresses before having more confidence in European equity exposure.



North America

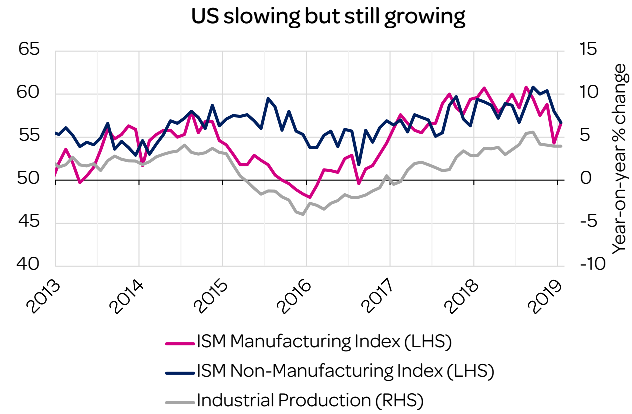


The US economy is slowing but still growing. Overall the US economy appears reasonably healthy, but still it faces significant headwinds. We have slightly reduced our position but remain close to neutral.

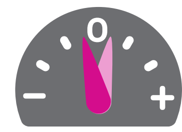
The US economy continues to display strength despite weakening from its supercharged growth of 2017 and early 2018. This weakness is seen in both forward looking surveys and measures of business activity. Market expectations for future corporate profits have come down considerably, which isn't great but does create a lower bar for companies to surprise investors on the upside.

Part of the slowdown can be attributed to weakness in the rest of the world, while the tightening of US monetary policy cannot be overlooked. With the Fed pausing along its path of increasing interest rates, there is still the expectation of higher government bond issuance which could cause further upward pressure on borrowing costs. At some point, increased borrowing costs could tip equities over the edge, although we don't think we're there yet.

The rise in production input costs given trade tariffs has created a significant headwind for some sectors, notably auto manufacturing. The broad risks to business of a potential escalation in US-China tension are significant. We think there are signals of some sort of trade truce in the short term, but the high degree of bipartisan support for continued action against China is preventing us from taking on more US exposure.



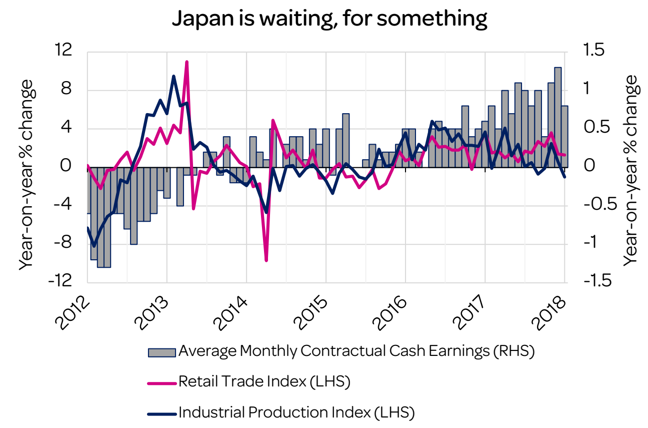
Japan



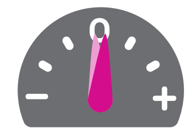
Japanese retail trade and industrial production were showing some signs of life, but recently turned down again. We have slightly reduced our exposure, remaining close to neutral as we wait for more positive signs of strength.

We believe Japanese industrial activity will take its cues from two drivers. The first is when Chinese economic growth stabilises (i.e. when its growth rate stops falling) – which will likely come when their recently enacted economic stimulus feeds through into activity levels. Given Japan's heavy ties to global trade, the second is seeing a receding risk of further escalation in the US-China trade war.

Inflation (or rather the lack of it) could start to create a real headache for policy makers in Japan. It is running at just 0.4% per annum despite rising wages – which makes sense if higher wages are not spent but used to deleverage household balance sheets. This means the Bank of Japan is unlikely to be restricting monetary policy any time soon.



Asia Pacific

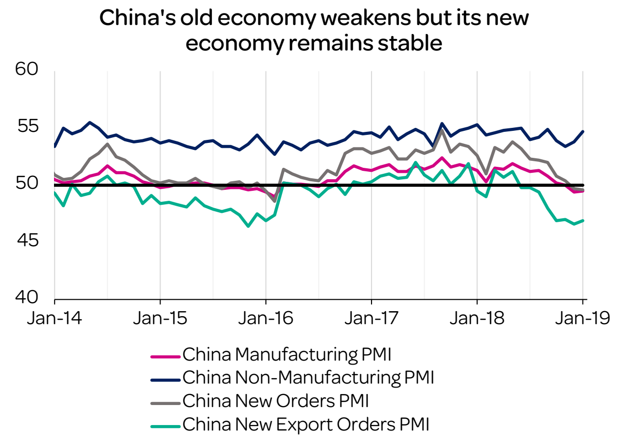


In a similar fashion to China's economic slowdown in 2015, we have seen manufacturing activity – especially exports – fall dramatically. Non-manufacturing activity, however, remains stable, and our position remains neutral.

The drop in Chinese exports is linked to its trade dispute with the US, but also to the broader global economic slowdown. Non-manufacturing activity in China remains pretty stable as companies in this part of the economy rely more heavily on domestic consumption than exports.

When there was a similar slowdown in activity in 2015, the Chinese politburo delivered a large economic stimulus package. But we have not seen (nor do we expect to see) a similar response on this occasion. Rather, the package recently announced has been far more targeted and aims more for stability rather than stimulus.

We maintain our neutral position, alert to incoming news-flow and data that could move us in either direction.

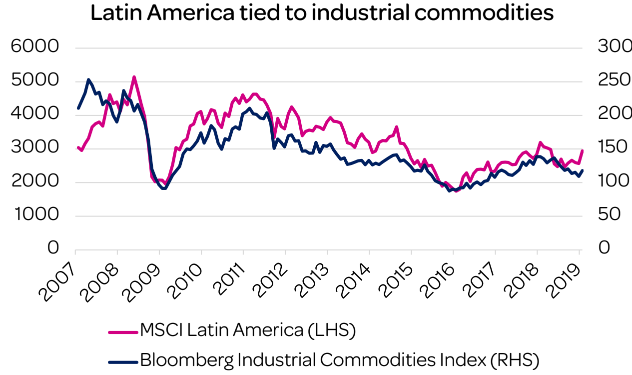


Other emerging markets

The new presidents of Mexico and Brazil came to power with reform agendas that handed them decisive victories in the general elections. But economic fundamentals still tie much of Latin America to the price of industrial metals. We have closed our underweight to the region on a tactical basis.

So far, it is Jair Bolsonaro in Brazil that the market is cheering loudest, mainly given he is right leaning compared to Andres Manuel Lopez Obrador in Mexico. Bolsonaro's aim is to restore fiscal sustainability and boost growth based on pension reform, privatisations, and simplifying and cutting taxes. There is scope for these sort of structural reforms to break the commodity driven relationship of Latin America in the long term, but the scale of economic damage suffered by Brazil is a deep hole to dig oneself out of.

Until then, equities in this region are highly correlated to industrial metals which are in turn highly dependent on moves in the US dollar and the capital expenditure cycle in China. We may see a period of dollar weakness as the US Federal Reserve pauses monetary tightening. We may also see a short term increase in infrastructure spending in China, as the government looks for ways to stimulate the economy. Both of which create potential for upside in the Latin American region.



Commodities

We have limited exposure to 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, there is a generalised cooling of fixed asset investment in China with a greater focus being paid to fostering domestic consumption. That said, there is a short term boost to infrastructure spending to stabilise the growth slowdown.

We remain neutral with a long term view.

Property

Our view on property remains neutral.

Valuations of properties in the industrials sector are getting expensive. There is a risk of price falls if consumption activity drops materially in a hard Brexit scenario. We maintain our preference for prime assets in the South East, long leases and the industrial and alternative sectors, as we see greater risks in the standard retail and office segments of the market.

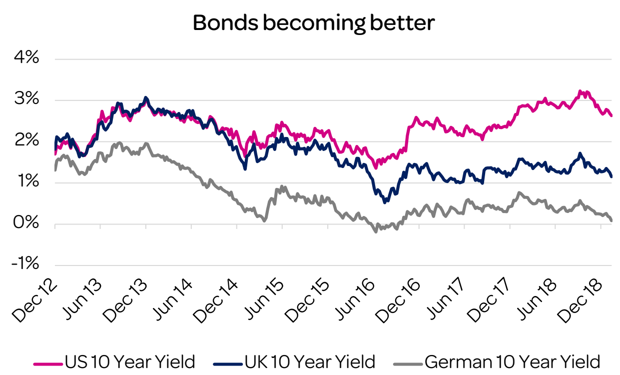
Bonds

We are effectively back to neutral on bonds as deteriorating macroeconomic fundamentals have taken the shine off risk assets. With interest rates rising considerably in the US, and with the aggregate market demonstrating late cycle characteristics, we prefer government bonds over corporate credit.

Government bonds

We have avoided significant holdings in government bonds since mid-2013 as they offered little compensation for the risk that the monetary policy tap could be turned off. Instead we found alternative sources of portfolio diversification. There has now been a change in the monetary landscape: yields in the US have risen consistently for around 2 years, while economic weakness in Europe & the UK has seen yields in these regions continue to plumb lows. As we approach the end of the cycle, the change in policy stance in the US starts to make US government bonds more interesting again.

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. For the risk that we see economic deterioration, we recommend adding some exposure to US government bonds in portfolios, though we are holding off making a more aggressive move for now.



Corporate bonds

The yields available in both high yield and investment grade are more attractive now than they have been the last couple of years. However, the composition of risk within the corporate bond market, especially in the US, looks very different compared to a decade ago, with a higher proportion of riskier borrowers.

As we approach the end of the cycle, we are less worried about the risk of company defaults, but more that corporate credit forms an additional source of correlated risk in portfolios. Given our neutral attitude towards equities, we would rather reduce our exposure to credit in favour of government bonds that we expect to hold their value better.

Alternatives

We have 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 again and we are now back to neutral.

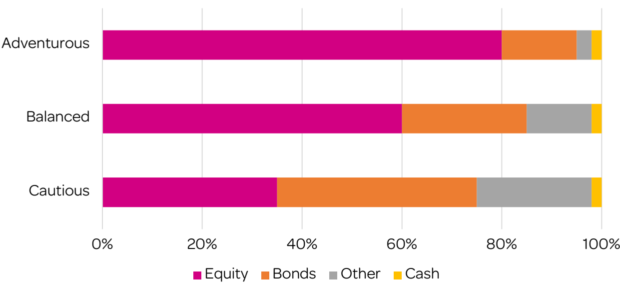
Higher uncertainty stemming from the impacts of trade wars, its impact on economic growth and consequently an uncertain US Federal Reserve policy path are perturbing otherwise stable market relationships. This means investment strategies relying on cross asset class diversification characteristics, such as some absolute return funds, may be a less reliable source of portfolio diversification.

How does this relate to my portfolio?

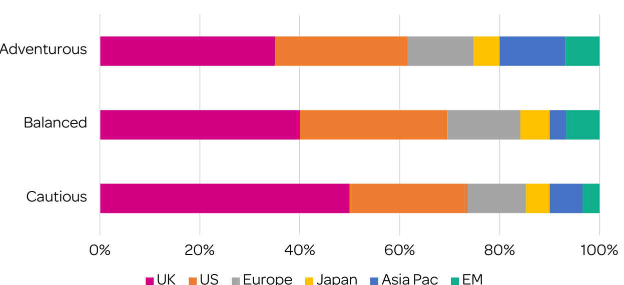
Portfolios are sometimes compared to recipes – you need the right balance of high quality ingredients to make a great meal. In the investment world there are many different types of investment or 'asset classes'. These are our ingredients: **equities** (stocks and shares), **bonds** (debt), **property**,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

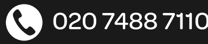
Current view: Q1 2019

Previous view: Q4 2018 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

EQ Investors, Centennium House, 100 Lower Thames Street, London EC3R 6DL



enquiries@eqinvestors.co.uk

@eqinvestors

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