Market View Q2 2019

This document presents a summary of our investment views. It explains our latest thinking on global markets and the most recent decisions we have made about what to buy and sell within your portfolio.

The EQ Asset Allocation Committee met in May. Where relevant the indicators show how our views have changed since our previous meeting in February. Please note that our views may change at any time.

Cash

We maintain a small overweight to cash on a tactical basis, given concerns with some assets that are traditionally defensive.

There are currently three factors driving perception of risk in equity markets:

1) The US Federal Reserve's neutral policy stance with regard to interest rates.
2) Poor global economic data, especially from Europe and China.
3) A possible escalation in the US-China trade war.

Judging by the performance of equity and bond markets over the last few months, we think they each reflect different opinions about the state of these factors. It is possible for such differences to persist for some time, but eventually they should coalesce.

We think both markets have probably gone a little too far. The bond market's expectation of interest rate cuts by the end of 2019 seems ambitious given the poor economic data has improved somewhat. Current expectations would also be reflective of the belief trade negotiations will fail.

Equities on the other hand seem jubilant, reflecting the modest turn in economic data, expecting trade risks to disappear or possibly that bond markets are pricing in rate cuts.

The Fed's mandate is to maximise employment, stabilise prices and moderate long-term interest rates. It is the first two of these which have a more immediate impact on the policy rate. Unemployment in the US is close to 50 year lows but inflationary pressures have yet to build significantly.

We think the bond market's expectation of rate cuts is too high. As a consequence, we think market risk perception is susceptible to change again in the near future and some defensive assets such as absolute return strategies may struggle.

UK

UK industrial activity bounced in March as Brexit got bumped to October. We remain neutral on and balanced within UK equities, ready for any Brexit outcome.

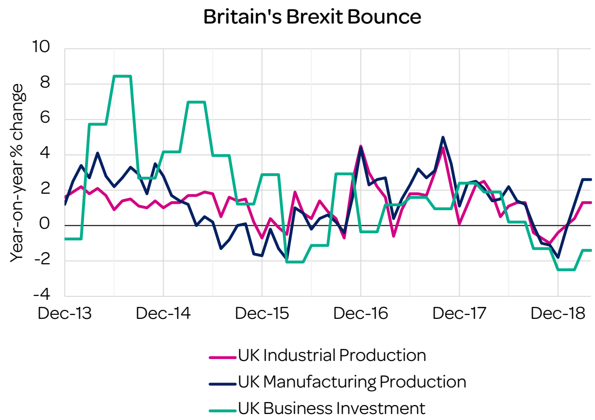
Britain is frustrated and remains divided. This is true across the electorate and Westminster. The boards of UK companies are probably divided too, but on one point there is widespread agreement. The longer it takes to find a way forward (either leave or remain), the worse the economic damage will be in the interim – irrespective of any damage that might come after departing.

UK *(continued)*

Valuations in the UK look very attractive versus other developed markets and corporate profits are reasonably strong in some key industrial sectors such as consumer staples, financial services, and especially so in energy and materials (after a significant slowdown since 2013). There is weakness, however, in UK industrials as the economy stutters.

There has been a recent bounce in economic data – but the devil is in the detail. The boost came from building inventory stocks ahead of the 29 March Brexit deadline. With that deadline now pushed out to October, we could see economic weakness over the summer as we work through the inventory bulge. We do not believe confidence will lift to deliver a sustained rise in economic activity until Brexit is resolved, one way or the other.

Until then and in the absence of compelling alternative regional ideas, we remain neutral on UK equities. We have balanced our portfolios across industrial sectors and company sizes. Our aim is to remain as diversified as possible, prepared for any Brexit outcome, and focused on incoming data to guide us further.



Europe

European business activity has slowed down alarmingly, but there are signs of change. European exports to China are a significant contributor to business activity. If the recent uptick in Chinese PMI data is sustained, we could see a recovery in European exports too.

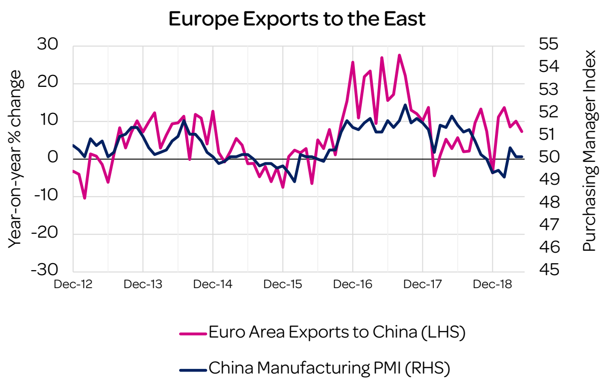
Europe has been a cause for concern since early in 2018 with a slowdown in industrial production. Several reasons have been cited, such as new auto emissions regulations, slowing exports to China, protests in France and low water levels in the river Rhine hindering transport of products.

Of all these reasons, we find the slowdown in exports to China as being the most significant and given new economic stimulus efforts by the Politburo in China, it is possible the headwinds to European industrial activity could abate.

Looking elsewhere across the European economy, we find continued strength on the consumer front with continued gains in employment and wage increases. Drilling down into the cause of recent weakness in consumer sentiment surveys, we find most of the weakness is linked to consumers' economic outlook.

We believe this is naturally linked to the industrial slowdown and consequently should also abate as Chinese industrial activity also stabilises.

Having been reducing our exposure to Europe through most of the last 12 months, we have now returned to neutral and are monitoring incoming data closely.



North America

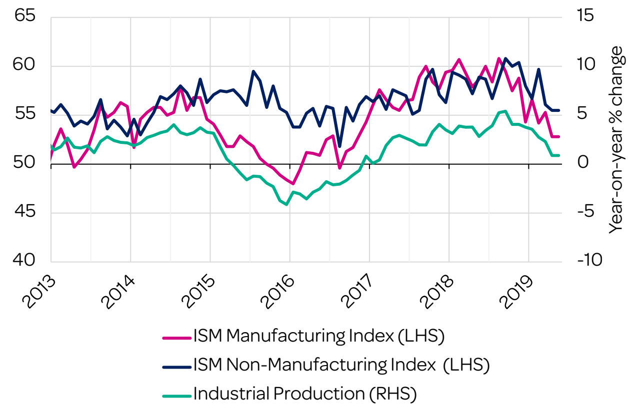
The US economy is still growing but weakening from the supercharged growth of 2017 and early 2018. As with other regions, the weakness is found mainly in the industrial sector but consumer facing sectors are starting to show some weakness also.

Generally, small businesses are cautiously optimistic but still worried about the business outlook, driven in part by disappointment in earnings growth. Given the medium term trend, this disappointment in year-on-year comparisons may be a 'hangover' from the 2017 tax cuts. Nonetheless, part of the weakness surely relates to the industrial slowdown and we cannot overlook the impact of trade wars that are starting to take their toll – notably on the semiconductor sector.

We think the pause in interest rate hikes by the Federal Reserve gives the market some breathing room, but the recent rise in trade rhetoric means the market's focus may be diverted from corporate fundamentals.

The high degree of bipartisan support for continued action against China and deteriorating relations during the negotiation process has prevented us from taking on more US exposure.

US slowing but still growing



Japan

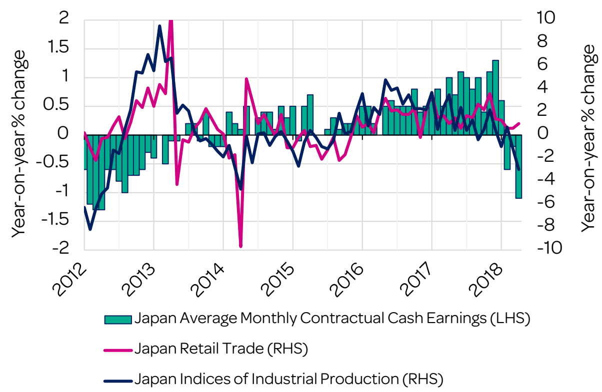
Japanese consumers weaken and industrial production dives. We have slightly reduced our exposure again, waiting for more positive signs of growth.

Much like the industrial slowdown in Europe, we believe Japanese industrial activity will take its cues from two drivers. The first is when Chinese economic growth stabilises (i.e. the growth rate stops falling) which will likely come when their recently enacted economic stimulus feeds through into activity levels. But unlike Europe's broad industrial base, Japanese industry is heavily reliant on the electronics and automobile industries, whose supply chains are entangled in the US-China trade war. Therefore the second cue is seeing a receding risk of further escalation in the US-China trade war.

The other key difference with Europe is that the Japanese consumer is weak. Retail sales and broader household spending growth is anaemic and despite labour shortages, real wage growth is far from impressive. In fact, the most recent data indicate a fall in contractual earnings though we note with a high degree of caution that data sampling problems have led to a string of revisions to economic data releases, notably by the Labour Ministry.

We have slightly reduced our exposure to Japan until we can get more comfortable with either the state of the Japanese consumer or some resolution to the trade war.

Japan jumping over the edge?



Asia Pacific

China's recent economic stimulus has boosted manufacturing, but was much smaller and more targeted than that delivered in 2015. We turn slightly positive on the region, held back from further optimism given ongoing trade tensions with the US.

The economic stimulus injected by China is boosting sentiment in the region. However, unlike the stimulus of 2015, the current programme is far smaller and much more focused on internal demand stimulation. There has also been a recent boost to activity given the Lunar New Year holidays. Consequently we view the scale of the bounce with some speculation, having more confidence in longer-term trends.

The trade dispute with the US is far from over. We expect some form of resolution in the coming months, since it would help to arrest the economic slowdown in the US. Longer term, we anticipate flare-ups between the two superpowers, as each continues to push for technological supremacy.

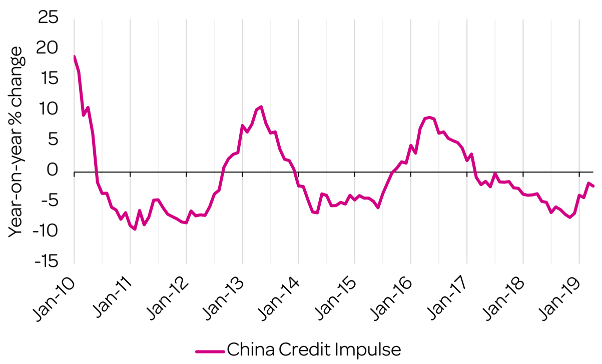
Other emerging markets

The economic fundamentals tie much of Latin America to the price of industrial metals. We maintain a neutral stance given weak industrial activity.

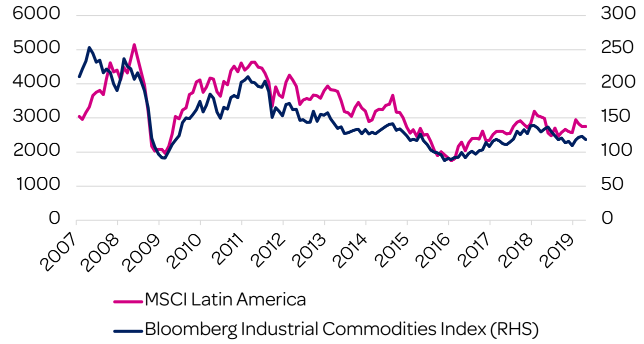
Mexico's economy relies on internal consumption as well as exports. The drop in exports and industrial production over 2018, together with a 2019 pickup is similar to that experienced in other regions. In Brazil on the other hand, there has been a material headwind caused by the failure of a Vale dam in January.

The Latin American equity market remains highly correlated to industrial metals which are in turn highly dependent on moves in the US dollar and the capital expenditure cycle in China. There are reasons to think we may see a period of dollar weakness as the US Federal Reserve pauses monetary tightening. However, the economic stimulus in China is smaller than in 2015 and includes more consumer driven tax cuts. If more stimulus is deemed necessary, it may provide the opportunity for a short term pick up.

Smaller China Stimulus



Latin America tied to industrial commodities



Bonds

We have trimmed our exposure to corporate credit, while slightly increasing our exposure to US government bonds to take advantage of their defensive characteristics.

Government bonds

As we approach the end of the business cycle, the US monetary policy stance has started to make US government bonds more interesting again. The Federal Reserve has stopped raising interest rates, and economic data from multiple regions has weakened. This explains the tightening in government bond yields since Q4 2018. That said, there are some signs of improvement in activity and the market may still be over-estimating the chance of interest rate cuts. US yields may rise 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 defensive exposures in portfolios, in case we do see economic deterioration, we are adding some exposure to US government bonds. Given the chance that US yields could rise again, we are holding off making a more aggressive move for now.

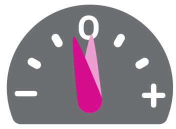
Corporate bonds

The yields available on investment grade bonds are more attractive now than they have been over 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.

European high yield is a bit on the expensive side, but offers a viable alternative to owning European equities in the short term.

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. Our preference, therefore, is to reduce our exposure to credit in favour of government bonds that we expect to provide better protection.

Property



Our view on other asset classes is more constructive than property so we have slightly reduced our exposure.

Valuations of UK 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 given our perception of greater risks in the standard retail and office segments of the market.

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.

Alternatives

We think that bonds will be more defensive in portfolios than alternatives, so we have slightly reduced our allocation.

We no longer hold a significantly negative view on bonds, so our counterbalancing allocation to alternatives remains neutral.

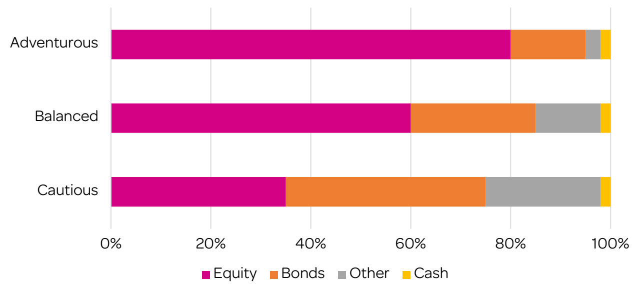
Higher uncertainty stemming from the impacts of trade wars, its impact on economic growth and consequently an uncertain Fed policy path are perturbing otherwise stable market relationships. This means some funds that manage risk solely by portfolio diversification, may be less reliable than historically.

How does this relate to my portfolio?

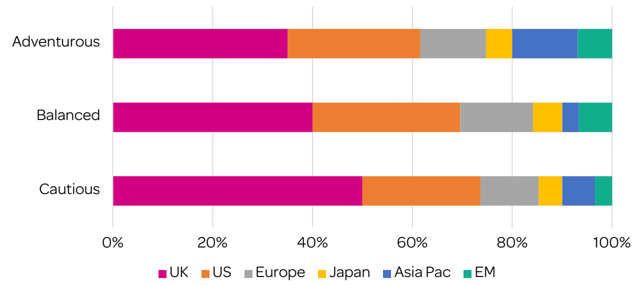
Portfolios are sometimes compared to recipes – you need the right balance of high quality ingredients to make a great meal. In the investment world there are many different types of investment or 'asset classes'. These are our ingredients: **equities** (stocks and shares), **bonds** (debt), **property**, **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 2019

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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