eQInsight

Market View Q3 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 August. Where relevant the indicators show how our views have changed since our previous meeting in May. Please note that our views may change at any time.

Overview

We have taken a small amount of risk off the table and bolstered our defensive positioning, including cash.

There are three reasons why we, alongside other global investors, are proceeding with caution:

1) A possible escalation in the US-China trade war.
2) Poor global economic data, especially from Europe and China.
3) The about-face of central banks, and especially the US Federal Reserve, in reversing their interest rate changes from hikes to cuts.

Although trade talks have resumed between the US and China, in some ways their positions seem intractable. They are both seeking long-term, strategic dominance over key sectors. Damage has already been done and the ongoing uncertainty has weighed heavily on industrial activity. This has caused the deterioration in global economic data.

A potential consequence of the trade war is a slow unravelling of globalisation: reversing the trend towards offshore manufacturing and the bias towards service sectors in Western, developed markets. This could be costly and cause weakness in equity markets, so we think it is in everyone's interest for an agreement to be reached. But the fundamental downside risks are increasing, especially if the US trade brigade follow through on their threats to move on to other targets and impose trade barriers on Europe & Japan.

In the interim, support for growth assets will need to come from central banks (again) and corporate earnings. Unfortunately, earnings look vulnerable to us. The chart shows deteriorating earnings per share (EPS) growth. This shows a weakening in the fundamental foundation for equity markets, being underlying corporate profits.

That leaves central banks. We think they are poised to deliver monetary stimulus that could support markets in the short term. But there is a material risk that markets will be disappointed. This is because there is such a strong job market in the US that it could soon start to create inflationary pressure. And rising inflation would mean that central bankers are required to raise interest rates, not cut them!

Ultimately, monetary policy alone cannot compensate for the impact of trade barriers. Ongoing uncertainty due to the US-China trade war will continue to drag down business activity.

UK

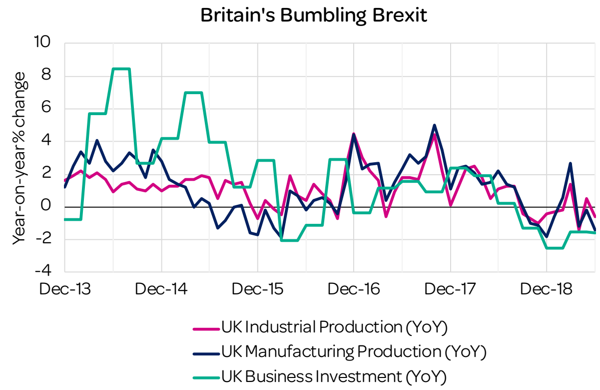
Britain is being bounced around by Brexit. Industrial activity fell as the uncertainty dragged on, then bounced in March and has fallen again since. We remain neutral on and balanced within UK equities, ready for any Brexit outcome.

At the time of writing we do not know the date of the next General Election, but it could happen any time and the outcome is highly uncertain. On Brexit the country is divided across the electorate as well as in parliament. It is difficult to see the current Government reaching any new agreement with the EU, and parliament's opposition to no deal could see Boris Johnson as the shortest ever serving Prime Minister.

While parliament bumbles along from one unwritten constitutional order to the next, one truth remains. The longer it takes to weave a path forward, the worse the economic damage will be in the interim, irrespective of any damage that may come after departing.

Valuations in the UK look very attractive versus other developed markets. But corporate profits have fallen similarly to other regions and continue to weaken in industrials as the economy stutters. Market expectations for future growth and recovery are still reasonably high, making us somewhat nervous that the market is getting ahead of itself.

We have slightly reduced our exposure to UK equities while maintaining portfolio balance 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.



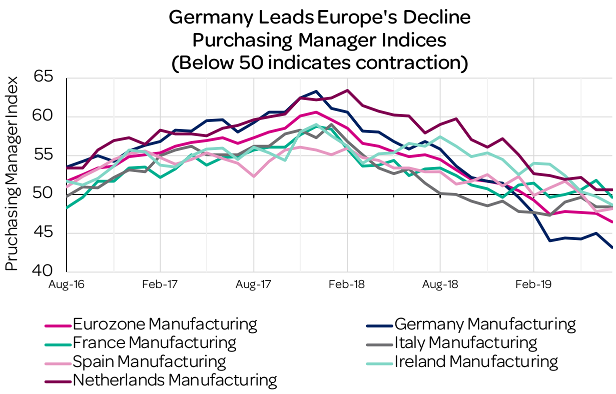
Europe

Strong labour markets are supporting consumer facing businesses but industrial companies have continued to slow, especially exporters. From an overweight position more than a year ago, we have been reducing our exposure to Europe consistently and now remain close to neutral.

We have discussed weakness in Europe since early in 2018. Slowing industrial production has been blamed on a variety of factors 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.

The fact remains that Europe is highly geared towards global growth and international trade. With the US acting in a more protectionist manner and showing signs of weakness itself, and with China focusing on domestic demand, Europe could be vulnerable to further weakness.

We think the European Central Bank will deliver some form of monetary easing. But since the slowdown is due to a weak external market, it is government spending that is of greater need to boost European business activity. There are some signs this could emerge, though fiscal restraint is more often the norm for this region. We will watch and wait and see what happens on this front before making further changes.



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.

The US economy has succumbed to global weakness, now also displaying weakness in its manufacturing sector. Consumers on the other hand, continue to display signs of strength.

Purchasing Manager Indices, which measure the economic health of the manufacturing and service sectors, continue to slow but remain in expansion territory. However, there is clear evidence of a more significant slowdown in manufacturing than in the consumer facing services (non-manufacturing) surveys.

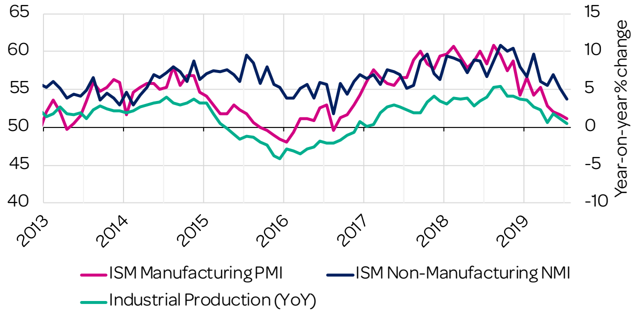
Small businesses are cautiously optimistic but still worried about the business outlook, driven in part by disappointment in earnings growth. Part of the weakness relates to the industrial slowdown and we cannot overlook the impact of trade wars that are taking their toll, notably on the semiconductor sector.

We think the change in direction of interest changes from hikes to cuts gives the market some breathing room, but the ongoing trade related uncertainties are clearly starting to have a negative impact on the business outlook.

We continue to think there is some chance of a trade truce given the economic damage that would be caused by the alternative scenario. However, given the high degree of bipartisan support for continued action against China and deteriorating relations during the negotiation process, we believe the downside risk to equities has increased.

We continue to favour companies with high quality earnings that are more focused on the consumer and less susceptible to the business cycle – for more details see our Q2 quarterly update on *Quality Companies*.

Slowdown in US manufacturing accelerates, consumer facing businesses are slowing but still growing



Japan

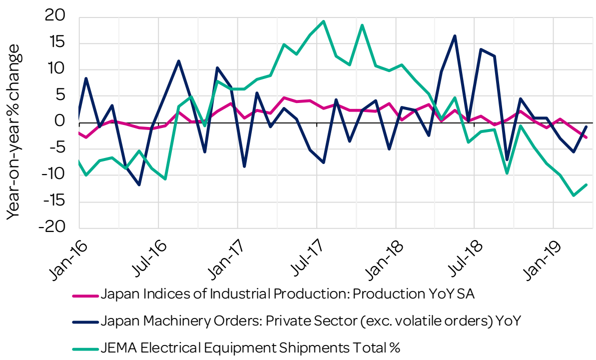
Much like the rest of the world, the Japanese manufacturing sector is facing considerable weakness while the services sector is holding up reasonably well.

The global economy is key for Japan, so the global slowdown is impacting Japan's industrial sector heavily with activity falling. Falls are biggest with electrical equipment shipments, which includes consumer electronics as well as industrial equipment such as electric motors. There is a more recent pick up in machinery and auto production, but some indicators point to this being stocked as inventory rather than leading to sales.

The consumer in Japan continues to concern us. Although Japanese household spending increased earlier this year, we observe much of the increase relates to transportation over the 10-day Golden Week holiday period from late April. Retail sales more broadly have been weak, arguably linked to a drop in wages. This is especially concerning given the consumption tax (VAT) hike currently planned for October.

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.

Japanese electronics dragged down by trade war



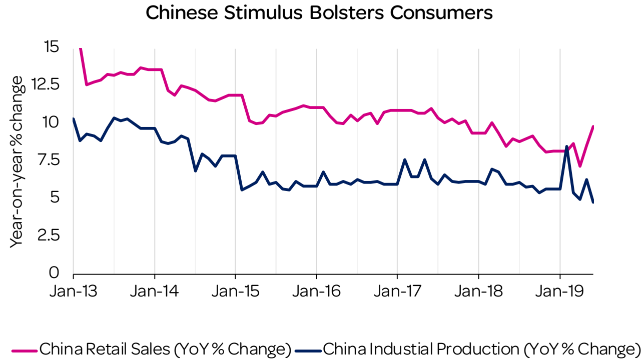
Asia Pacific

Chinese economic stimulus is supporting consumption activity, but manufacturing, particularly exports, are weak. We turn back to neutral on the region, given the US and China don't appear to be progressing towards a trade agreement.

The economic stimulus injected by China has been more targeted towards consumers than in the previous 2015/16 stimulus. Consequently there has not been as much of a boost to broad activity, with growth in infrastructure spending merely stabilising rather than increasing. However, consumer spending has remained stable overall.

On trade China and the US seem intractable. China wants a lower commitment to US goods purchases, immediate tariff relief and an agreement that "respects Chinese dignity". But agreeing to the first and last of these will invite criticism of Trump from US hardliners, while only a gradual reduction in tariffs will give the US some assurance that China will adhere to the agreement. So unless the US economy weakens enough to invite voter criticism of Trump, and this results in a change in US trade policy, a recovery Asian manufacturing will be weak at best.

We continue to expect some form of trade war resolution in the months or quarters ahead as weakness in the US is slowly taking hold and surely will begin to influence voting intentions in the run up to Trump's re-election campaign. Longer term, we anticipate future flare-ups as the two rival powers push for technological supremacy.

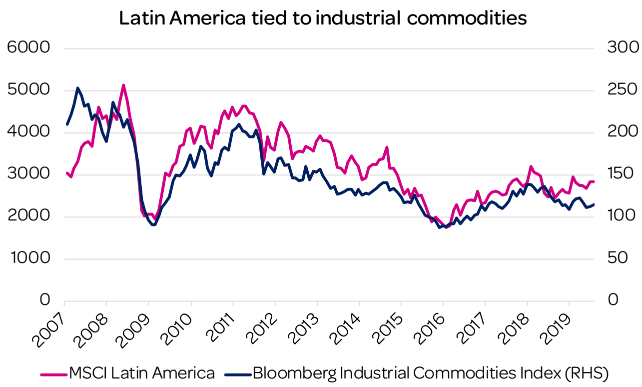


Other emerging markets

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.



Bonds

Given we have slightly reduced our weighting to growth assets (equities), we have slightly increased our exposure to the defensive qualities of bonds.

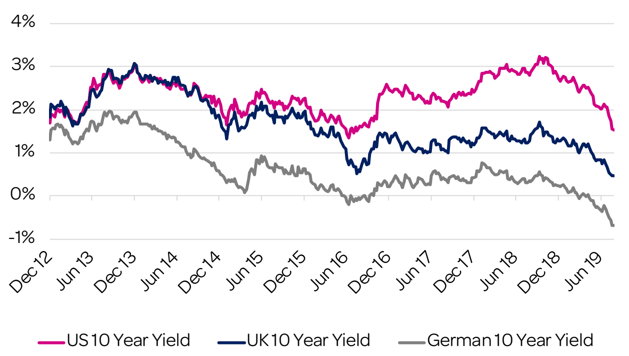
Government bonds

The change in policy stance from the world's major central banks, coupled with deteriorating macroeconomic data and a seemingly intractable trade war between the US & China has led the world's government bond markets to perform strongly, shown by the marked drop in the yield or interest rate earned by owning them today.

We think there are some risks of a short term reversal of fortune for government bonds. This is because we think the market is expecting more monetary stimulus than central banks are likely to deliver without a more material slowdown in consumption activity.

Having previously added exposure to US government bonds, we have slightly reduced exposure now. This comes mainly from long dated bonds in favour of shorter dated bonds that are less sensitive to changes in yields.

Bonds race to the bottom



Corporate bonds

The yields available on investment grade bonds 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.

Given the lower level of interest rates compared to the last economic downturn, we are less worried about the risk of company defaults, but more that corporate credit forms an additional source of correlated risk in portfolios. Therefore, we prefer to reduce our exposure to credit in favour of government bonds and short dated bonds that we expect to provide better protection.

Property

We have sold out of open-ended property funds due to liquidity concerns, but retain a neutral exposure to listed funds.

Total return expectations for commercial property have been revised lower compared to earlier in the year. Although the yield available is higher than in most bond markets, property is an illiquid asset class. For this reason, we currently have a nuanced view on the sector.

With the UK's exit from the EU potentially on the horizon, we are concerned about the risk of shareholder outflows from open ended property funds. This poses the risk of these funds needing to suspend redemptions as some of them did in the immediate aftermath of the EU referendum. As such we have sold funds of this type.

Meanwhile, it is buyers and sellers of shares in property funds' listed on stock exchanges that provide liquidity to one another and hence there is no risk of suspensions, though there is a risk of share price falls. We maintain a neutral view on funds of this type in the short term.

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. We remain neutral with a long term view.

Alternatives

We maintain a neutral weight, with a focus on low risk strategies.

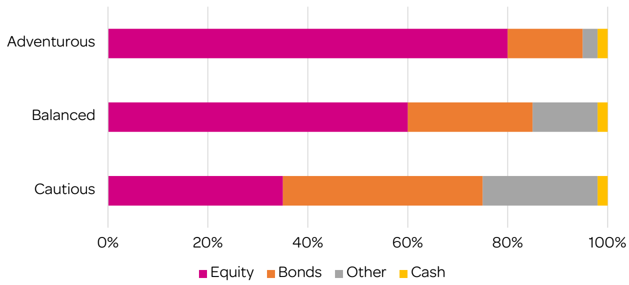
Higher uncertainty is stemming from several sources such as Brexit, trade wars, the outlook for economic growth and risk of disappointment from central bank policy easing. These are all perturbing otherwise stable market relationships. This means some funds that manage risk solely by portfolio diversification, may be less reliable than historically. Our preference is for discretionary strategies over systematic and for lower risk where we can find it.

How does this relate to my portfolio?

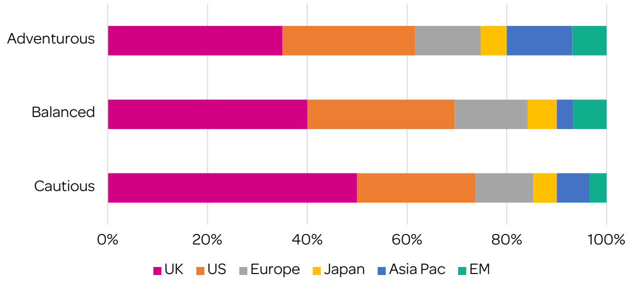
Portfolios are sometimes compared to recipes – you need the right balance of high quality ingredients to make a great meal. In the investment world there are many different types of investment or 'asset classes'. These are our ingredients: **equities** (stocks and shares), **bonds** (debt), **property**, **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: Q3 2019

Previous view: Q2 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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