eQInsight

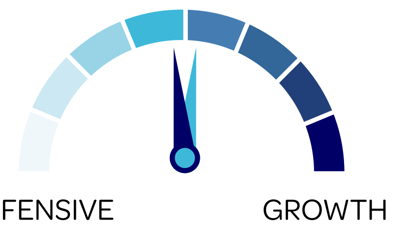
Market View Q4 2019

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 November. In response to feedback we have summarised our overall positioning on this page, with the detail to follow. Please note that our views may change at any time.

Overall positioning

We maintain our cautious stance and have reduced our growth bias.



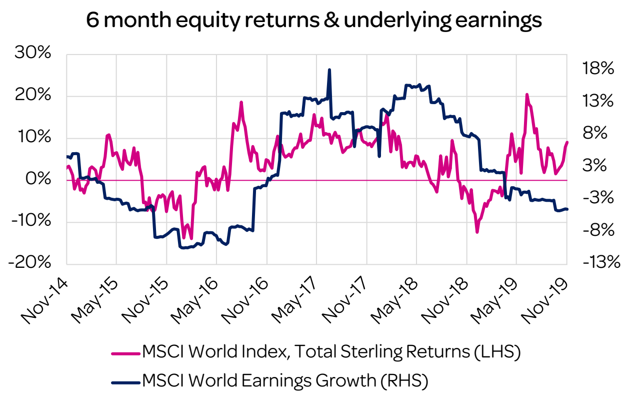
Market uncertainty due to Brexit has been ongoing for more than three years, and due to the US-China trade war for almost two. Both of these have real implications for companies' long term investment decisions, such as where to build a new factory or which suppliers to work with. This uncertainty has meant that companies have been delaying decisions and not making new investments. As a result, global economic activity has slowed.

The slowdown has been greatest in the industrial sector. Consumer-facing businesses continue to enjoy robust consumer spending as unemployment plumbs new lows. This divergence between an industrial slowdown and robust services sector, which we see pretty uniformly across the globe, cannot continue forever. At some point consumer services will start to slow down or industrial activity will pick up. Greater, prolonged uncertainty increases the chances of the former.

Meanwhile, support for growth assets must come either from central bank monetary policy (again), corporate earnings or fiscal policy.

Monetary policy doesn't have much additional room for manoeuvre (interest rates are already low). In any case, when it comes to making long term investment decisions cheaper borrowing on its own cannot compensate businesses for the impact of trade barriers.

Corporate profits are the foundations that underpin equity markets, but earnings look vulnerable. The chart shows that as markets have risen, earnings per share have deteriorated over the past six months:



There is a growing chorus of support for fiscal stimulus (government spending) that would increase economic activity – but lots of political machination is needed for this to happen, especially in Europe.

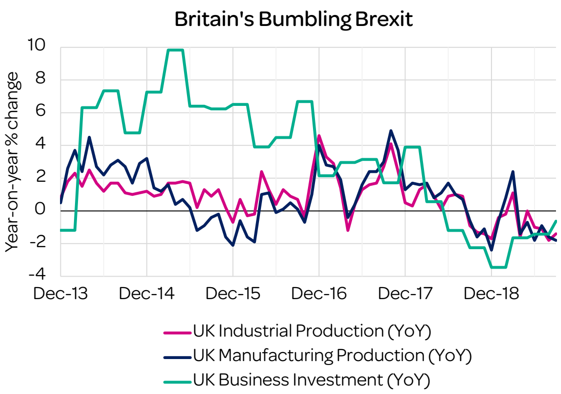
So while we are hopeful, we are not yet optimistic. The balance of risk remains on the downside so we have taken risk off the table once again: this time by focusing portfolios on managers with strong valuation discipline, and selling investments when they get expensive.

Growth assets

Equities make up the majority of growth assets in our portfolios. This section summarises our views on regional equity markets. The dials indicate whether we are currently overweight or underweight our long term, strategic allocation to each region.

UK

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



For now the risk of no-deal has fallen, and Boris Johnson has negotiated a new deal with the EU. But the general election on 12 December could well result in a hung parliament. A new coalition government, or deals between elected parties have the potential to alter the course of Brexit yet again.

Johnson's deal sees a more distant relationship between the UK and the EU – removing the UK from the European customs union. This may well increase tensions within the UK itself (especially in Scotland). And it also risks a higher cost of doing business with our largest trading partner. We think the long term upside potential for UK assets, including sterling, is now lower than before.

Notwithstanding, valuations in the UK still 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.

Europe

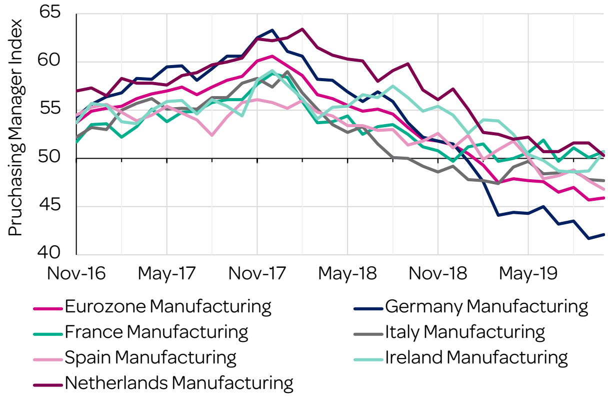
Strong labour markets are supporting consumer facing businesses but industrial companies have continued to slow, especially exporters. From an overweight position more than a year ago, we have been reducing our exposure to Europe consistently and now remain close to neutral.

As expected, the European Central Bank (ECB) delivered its final bout of monetary stimulus under its former President Mario Draghi. However, the degree of stimulus was greater than anyone expected with the ECB dropping its main policy rate further into negative territory, recommencing asset purchases (quantitative easing) and introducing a new scheme that tiers interest rate charges to banks to reduce the detrimental impact of negative interest rates. The actions were announced with a sense of finality; that there is nothing more that can be achieved with monetary policy and the baton must be picked up by coordinated fiscal spending by governments of EU member states.

Europe is a very export-sensitive market that is facing weak external demand. The US is acting in a more protectionist manner (showing signs of weakness itself) while China is focusing on stimulating domestic demand. If ever there was a justifiable reason to loosen the fiscal purse strings, this is it! We are listening closely for signs of a change in stance from EU officials.

The upside case for Europe relies on a US-China trade truce. This is possible, but we prefer to be cautious given how frequently we've seen either side flip flop on their intentions.

Germany Leads Europe's Decline
Purchasing Manager Indices
(below 50 indicates contraction)



United States

The US economy is still growing, just. As with other regions, this weakness is stemming from the industrial sector, but consumer sectors are starting to slow now too.

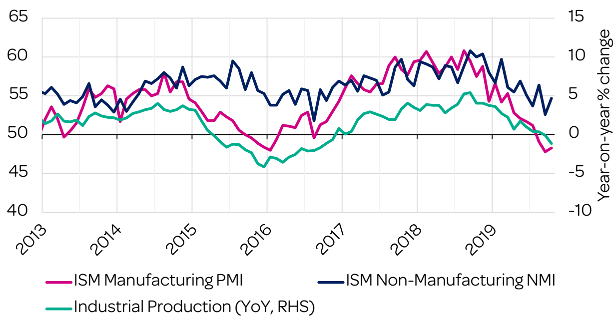
US manufacturing and industrial production surveys are now registering contraction (having only been slowing previously). Relative to other regions this contraction is marginal, and its consumer-facing services sector remains in expansion.

The Federal Reserve's change in stance from raising to cutting interest rates may give the market some breathing room, but ongoing trade-related uncertainties are having a significant negative impact on business outlook and corporate earnings.

There is still a chance of a trade truce given the economic damage that would be caused by any alternative scenario. But there is a high degree of bipartisan support for continued action against China. Deteriorating relations present a downside risk to US equities.

We continue to favour companies with high quality earnings that are more focused on the consumer and less susceptible to the business cycle. But many of these companies are now priced very expensively relative to their earnings. Hence, we have rotated our exposure to managers with better valuation discipline.

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 for now.

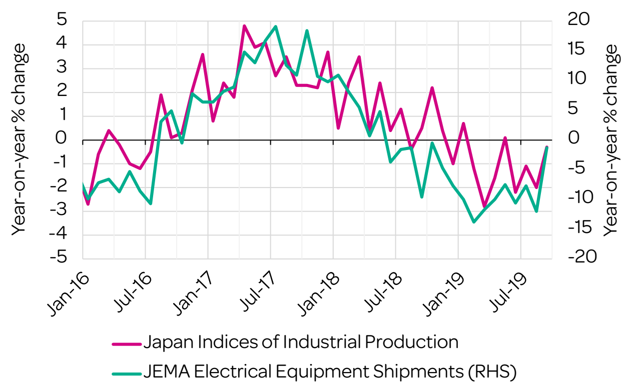
The global economy is key for Japan, so the global slowdown is impacting Japan's industrial sector heavily with activity falling. Falls are greatest with electrical equipment shipments, including both consumer electronics and industrial equipment such as electric motors. There is a more recent pick up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

We have held concerns about the consumer in Japan for a few quarters and have been surprised by the resilience of some service sector surveys. When we dug under the surface, we found a lot of support came over the 10-day Golden Week holiday period from late April and there has been some weakness since then. Retail sales more broadly have been poor, which is especially concerning given the consumption tax (VAT) hike that was implemented on 1 October.

Corporate share buy-back activity has been strong, however, which provides support to the market and to earnings.

We return close to neutral exposure. We would need either to get more comfortable with the state of the Japanese consumer or see some resolution to the trade war for more optimism.

Japanese electronics dragged down by trade war



Asia Pacific

We stay close to neutral. Economic data is showing some sign of stability but the region remains susceptible to trade war news flow.

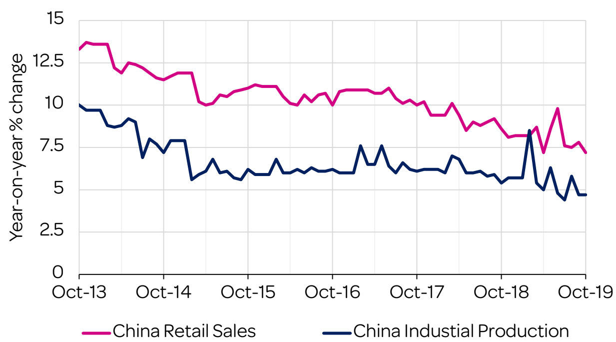
There are some signs of success in Asia, that China's recent economic policies have achieved their desired result of bringing stability to the region. The services sector in China has remained very strong and although there has been a marked slowdown in manufacturing (as with all other regions), they do seem to be turning back to growth.

However, the region remains susceptible to trade war news flow that has a habit of turning from positive to negative, sometimes within hours.

We expect some form of trade war resolution in the months 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. The negotiation process is complex since China wants a lower commitment to US goods purchases, immediate tariff relief and an agreement that "respects Chinese dignity". 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 in Asian manufacturing will be weak at best.

Longer term, we anticipate future flare-ups as the two rival powers push for technological supremacy. Hence, when the time comes to increase exposure to the region, our current intention is to target exposure to domestic facing Chinese stocks.

Chinese stimulus bolsters consumers



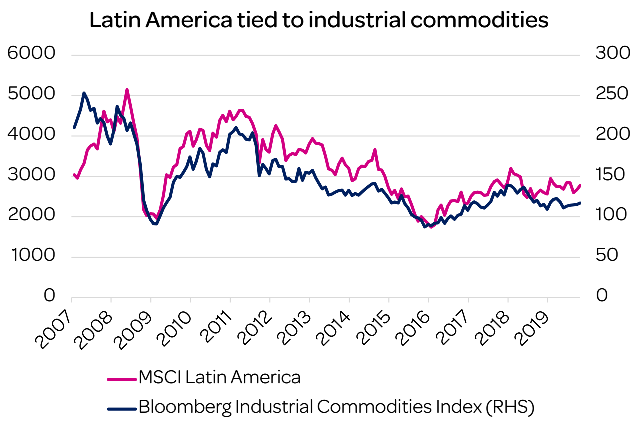
Other Emerging Markets

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

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 greater stimulus in the form of infrastructure spending is deemed necessary, it may provide a sufficient enough boost to change our outlook for these emerging markets.

From an economic perspective, Mexico relies on internal consumption as well as exports. The drop in exports and industrial production is similar to that experienced in other regions. Brazil experienced a material headwind through the first half of 2019 due to the failure of a Vale dam but has some more encouraging activity data recently.



Defensive Assets

As we have reduced our overall weighting to growth assets, we have increased our weighting to defensive assets such as bonds.

Government bonds

The recent rise in government bond yields was a risk we highlighted last quarter. Market expectations for further rate cuts had, in our view, gone too far. We see things being more balanced now.

On one hand, we think weakness in economic data will persist in the absence of a trade deal. The recent cuts in interest rates in both the US & China should provide some reprieve though we are sceptical of how much of an effect this or further cuts will really have on business confidence.

On the other hand, if we do see a trade deal, even one that is done in phases, it could lift enough of the cloud of uncertainty to get industrial business activity growing again. In this scenario, we think there are upside risks to inflation versus current expectations. Central banks have effectively guaranteed they will not be raising interest rates until they are confident in the economic recovery. Hence, we have a preference for inflation linked bonds versus nominal bonds in the US.

The asymmetry of our view leads us to maintain a significant holding in shorter dated bonds that are less sensitive to changes in yields.

Corporate bonds

We have reduced our exposure to credit in favour of government bonds and short dated bonds that we expect to provide better protection.

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.

Alternative Assets

We maintain some exposure to three main classes of alternative assets to add further diversification to portfolios. We do not change the overall weighting of this asset class on a tactical basis.

Property

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

Total return expectations for commercial property have been revised lower again, 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 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.

Absolute Return

We focus on low risk strategies.

Higher levels of uncertainty continue to cloud financial markets and cause perturbations in otherwise stable market relationships. As a result, some funds that manage risk solely by portfolio diversification may be less reliable than historically. Our preference is for discretionary over systematic strategies, and for lower risk where we can find it.

Commodities

We have limited exposure to commodities, favouring precious metals over industrial commodities.

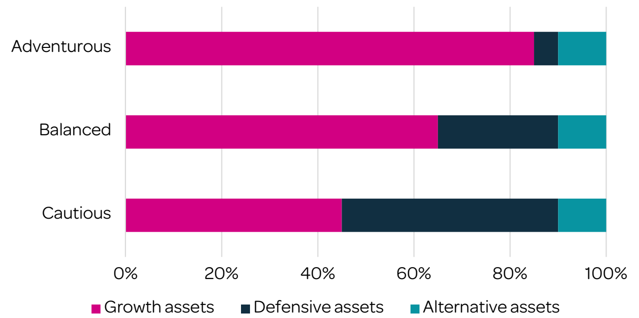
Commodities usually perform well in the later stages of the business cycle as increases in demand bump up against supply constraints. However, there is a generalised cooling of fixed asset investment in China with a greater focus on bolstering domestic consumption. This leads us to hold a negative view on industrial commodities in the short term.

With precious metals, we know that gold has a negative relationship with real yields, i.e. gold rises when real yields fall. Inflation expectations are already low in the US, so if we see the economic environment deteriorate, we'll likely see interest rates fall faster than inflation which is positive for gold. Further, many major central banks have made it clear they would be happy for inflation to overshoot their targets (2% in most cases) before they change their policy. This could mean that if there is a trade deal between the US and China that stimulates economic activity and inflation, interest rates are unlikely to rise as an immediate response. Again, this would lead to a fall in the real interest rate which is positive for gold.

How does this relate to my portfolio?

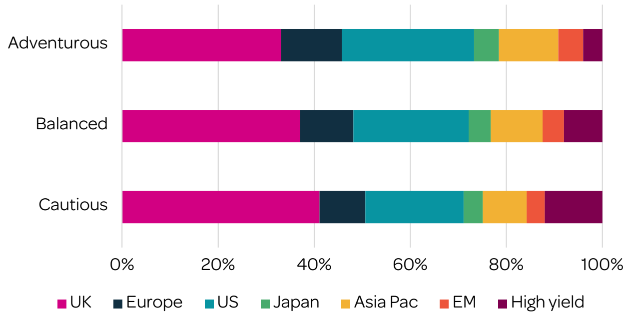
Portfolios are sometimes compared to recipes – you need the right balance of high quality ingredients to make a great meal. In the investment world these ingredients fall into three broad categories: **growth assets** (used to build capital), **defensive assets** (used to preserve capital) and **alternative assets** (that sit somewhere in between).

The overall 'flavour' of a portfolio is determined by its **risk profile**. Broadly speaking, more cautious investors will have more defensive assets in their portfolios, while more adventurous investors will have more growth assets. Here is what three typical portfolios might look like:



Growth assets consist mainly of **equities** (shares in public companies). We invest regionally, based on the size and relevance of different markets to UK investors. These regions are the **UK**, **Europe**, **US**, **Japan**, **Asia Pacific** (including China) and **Emerging Markets** (a basket of countries including Brazil, Mexico, Chile, South Africa, India and others). Growth assets can also include other riskier investments such as **high yield bonds**. Defensive assets consist of other types of **bonds**. Alternative assets include **property**, **commodities** (raw materials) as well as more complex financial instruments such as **hedge funds**.

The blend of growth assets also varies for different risk profiles. In general, cautious portfolios have more developed market equities (i.e. less risky), while adventurous portfolios have slightly more developing market equities (i.e. more risky). Here are three examples to illustrate this:



In a nutshell

Our views – as outlined in this document – will influence your portfolio **based on its default positioning**. Let's take a hypothetical example: imagine we had some concerns about the UK economy such that our view on UK equities had turned marginally negative:

Current view: Q4 (dark blue)

Previous view: Q3 (light blue, 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 because – all other things being equal – your adventurous portfolio would hold more growth assets across the board.

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