eQInsight

Market View Q1 2020

This year we are making a gradual but significant shift in our portfolio strategy: reducing our bias towards UK assets and moving towards a more global outlook. This decision reflects long term trends and the change will be phased over 2020.

This document presents a summary of our investment views. It explains our latest thinking on world markets and the most recent decisions we have made about what to buy and sell within your portfolio. Please note that our views may change at any time.

Future proofing portfolios

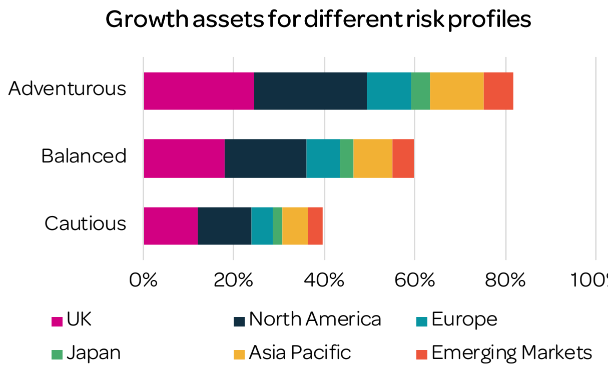
After careful analysis we've decided to reduce our allocation to UK equities across portfolios because we believe that will deliver better risk-adjusted returns for clients.

This is a strategic decision and we plan to rebalance portfolios over at least four quarters, depending on market conditions. For a brief summary of our reasoning behind this change, please see the article on future-proofing in our Spring 2020 newsletter. This and other relevant articles can be found on the EQ Blog:

eqinvestors.co.uk/blog

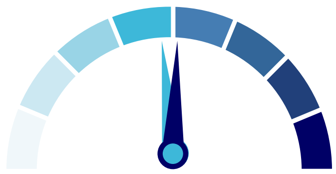
In practice this means that – while the total proportion of growth-focused assets in your portfolio will not change – the proportion invested in the UK will decrease and this will be reinvested across other regions.

Following the last quarterly rebalance, here are our current strategic allocations for regional growth assets in Cautious, Balanced and Adventurous portfolios:



Maintaining a cautious stance

Ongoing trade negotiations continue to dominate our thinking on markets while the coronavirus has emerged as a new threat.



A 'phase one' trade truce was agreed between the US and China. However, most of the tariffs announced so far remain in place. President Trump may be focused on re-election for the rest of the year but there is bipartisan support for a tough stance on China. So we expect 'phase two' negotiations could start up at any time.

Meanwhile, the UK has now left the EU and the government is going to try and negotiate new arrangements with the EU by the end of the year. The fastest major trade pact the EU has ever concluded was with South Korea: negotiations lasted 2½ years and the agreement came into force almost 2 years later. Nonetheless, the UK is already fully aligned with EU trade rules and maintaining partial alignment is arguably an easier process than starting from scratch. The upside for UK assets is attractive, but risky.

The coronavirus emanating from China caused the country to shut down in an unprecedented fashion. The initial travel bans occurred during the Chinese New Year celebrations, during which time business activity tends to fall every year anyway. So, it is the disruption to travel for the migrant work force while virus containment efforts continue that will determine how long it takes for China to get fully back up to speed.

Meanwhile, with China operating significantly below capacity, we are seeing large scale disruption to global supply chains which will cause companies in the rest of the world to reduce output or seek alternative suppliers. The virus has now spread almost worldwide and so it is the scale of the containment effort by national governments that will determine whether the virus can derail what would otherwise have been tentative signs of a return to growth. The longer and deeper the disruption, the bigger the hit will be and the greater the chance of prolonged market weakness.

Our base case is for the negative impact of the virus to be significant, but short lived, allowing the underlying recovery to broaden and support earnings. At the margin, we also expect monetary and fiscal policy to be more supportive. Consequently, we will hit an ‘air pocket’ over the coming months as the impact of the virus makes its way into market data. But if the virus remains under control, the market impact of that data should be limited considering the broader recovery in economic activity that will be evident by then.

That leaves us expecting turbulence in the short term, while the longer term structural risks (e.g. trade wars, Brexit) are pushed out further on the horizon.

Growth assets

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

UK

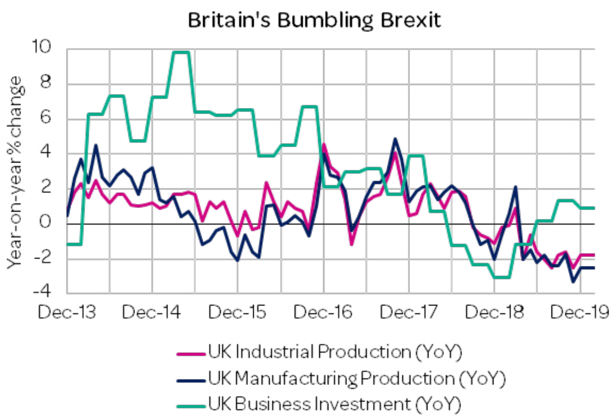
Although we are reducing our strategic exposure to UK equities as we adopt a more global portfolio approach, the new government majority and significant valuation discount of UK equities have improved our tactical outlook.

The UK has now left the EU and is in a ‘transition period’ where existing trade arrangements continue to apply until the end of the year. UK capital markets no longer face the risk of a Labour government under Mr Corbyn, who was proposing higher taxes, capital controls and state seizure of assets. This is positive, at the margin.

Boris Johnson’s Conservative majority means that legislation can now be passed without major hindrance. This has included an amendment to the Withdrawal Agreement Bill which rules out seeking an extension to the transition period. Even if the government changes its mind on this, the legal process to get an extension is quite complicated which means 31st December 2020 represents another cliff edge. Negotiations on the new trade relationship will need to quickly show material signs of progress if a hard Brexit is to be priced out.

Valuations in the UK still look attractive versus other developed markets. But corporate profits have fallen similarly to other regions over recent quarters and continue to weaken in industrials as the economy stutters. Furthermore, the UK market’s exposure to energy and materials is a headwind in the short term as global growth expectations weaken because of the coronavirus.

We remain balanced within UK equities across industrial sectors and company sizes. Our aim is to remain as diversified as possible, prepared for any outcome in the trade negotiations.



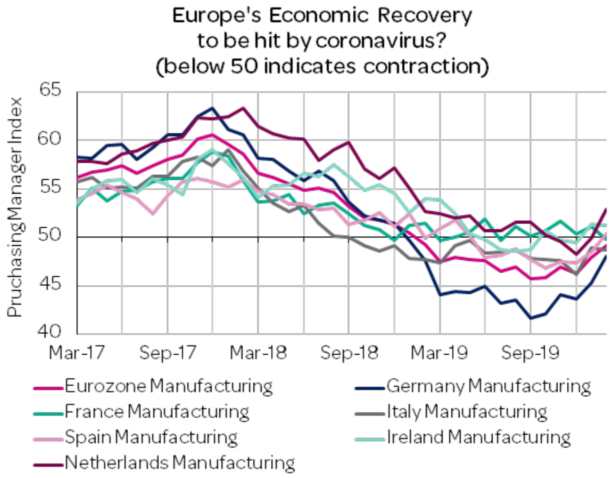
Europe

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.

Eurozone manufacturing activity surveys had started to materially improve as it became clearer that the US and China were heading towards a trade truce. Export orders appeared to have turned a corner.

But the impact of the coronavirus on China is severe, both in terms of its links throughout global supply chains and its impact on customer demand for global companies. The impact on Europe could be another dip down in growth, quashing the apparent recovery and creating the second double dip growth slowdown in Europe in a decade.

If ever there was a justifiable reason to loosen the fiscal purse strings, the industrial weakness across Europe and the potential for it to worsen is surely it. So we are listening closely for signs of a change in stance from EU government officials. Without it we see Europe as being vulnerable, as it is a very export-sensitive market and external demand is weak.



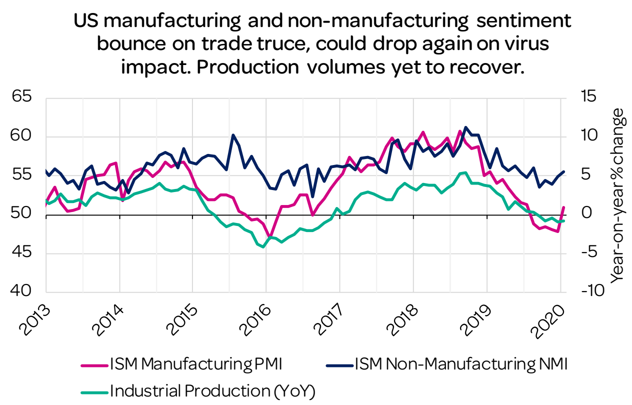
United States

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.

Resilience of the US consumer has helped sustain economic activity. Manufacturing activity slowed dramatically due to uncertainty caused by the trade war. This has been hurting multinationals more than domestic companies. The bounce in survey data (see chart) is good news and is no doubt driven by the trade truce.

Relative to other regions, the contraction was marginal and, in the absence of other factors, suggests the recovery should be sustained, especially with acccomodative monetary policy from the Federal Reserve. The US government's response to the spread of the coronavirus within the US will determine whether the recovery can take hold. Drastic containment efforts could sap US consumer demand, which has hitherto upheld the economy.

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 tilted our exposure towards managers with better valuation discipline.



Asia Pacific

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

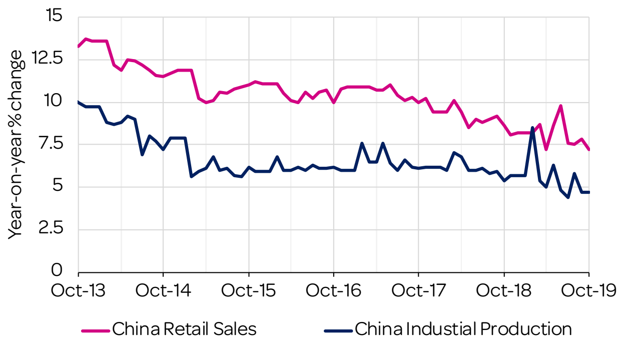
Chinese Central bank policy has loosened since late 2018, but rather than shock & awe rate cuts, incremental measures have been rolled out that deliver targeted support to various parts of the economy. The intention has been to bring stability without stimulating real estate investment. This has worked – the economy was slowing but stable. With the US and China having signed a trade truce, businesses were starting to get back to production. New orders, especially new export orders had pretty much recovered from the trade war.

But the Chinese government's response to the coronavirus outbreak has caused a significant shock to economic activity. The outbreak accelerated during January and February 2020, with significant restrictions being enforced over the Lunar New Year holiday. Chinese industrial activity usually falls dramatically at this time of year, as factories close and people travel home over a two week period.

Based on measures such as coal consumption for electricity, the downshift in activity for 2020 was normal. However, the ramp up in production that should have seen the economy fully operational by now has not occurred. By this measure, the world's second largest economy is still operating at 60% capacity. However, the recent trend is positive as restrictions are relaxed to get China back online. The impact on consumer-facing industries (leisure, tourism, etc.) will continue to be massive due to travel restrictions. But there are signs of a gradual return to normal, leading us to shift from a very slight underweight to a very slight overweight.

Longer term, we continue to anticipate flare-ups between the US & China as they each push for technological supremacy. Hence, we are researching whether to target exposure to domestic, consumer-facing Chinese stocks.

Chinese stimulus bolsters consumers



Japan

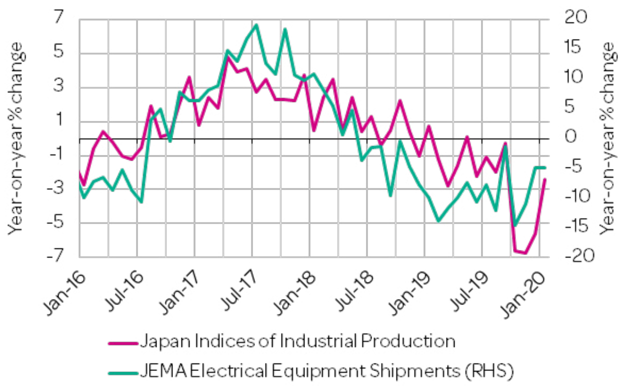
Much like the rest of the world, the Japanese manufacturing sector is facing considerable weakness while the services sector is holding up for now.

Our prior concern about the health of the Japanese consumer appears to have been misplaced: this was predicated on historic consumption patterns before and after the implementation of VAT hikes. Historically, consumption was brought forward by around 6 months before the hike and fell afterwards. In 2019, Japanese consumers waited until the last minute before making their purchases.

Similar to the US & Europe, indicators of economic activity in Japan had been picking up towards the end of 2019, driven largely by the trade truce and how important global trade is to the Japanese economy. Meagre growth had led the government to announce a fiscal stimulus package, marking the first major government to embrace fiscal spending to boost economic output in the face of trade driven weakness.

Japan has not escaped the slowdown created by the coronavirus (and the shutdown in China). Economic activity could recover if the virus is brought under control, but for now it is still spreading outside China. Several major economies are rescheduling or cancelling events. For Japan, this is particularly worrisome given the Tokyo Olympics are due to take place in July.

Japanese electronics dragged down by trade war



Emerging Markets

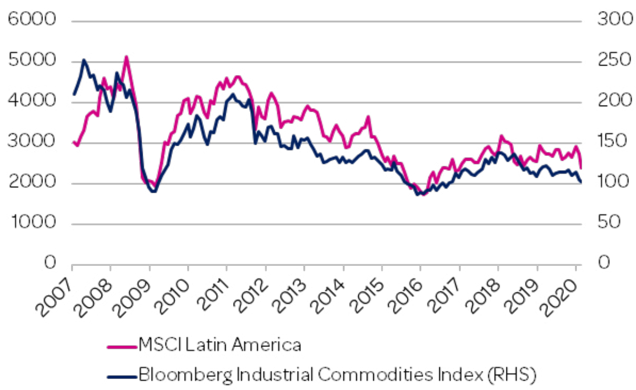
Economic fundamentals tie much of Latin America to the price of industrial metals. We maintain a neutral stance given weak industrial activity.

The Latin American equity market remains highly correlated to industrial metals which are in turn highly dependent on moves in the US dollar and capital expenditure in China.

We may see a temporarily weaker dollar if the US Federal Reserve eases monetary policy in response to the coronavirus. Moreover, the impact of the virus on China's economic growth may be significant enough for them to loosen spending on infrastructure. However in the short term, stimulus efforts are very much targeted at avoiding a credit crunch through lending provisions.

We are keeping a close eye on Chinese infrastructure spending plans to inform our outlook for Latin America.

Latin America tied to industrial commodities



Defensive assets

Our largely unchanged view across growth assets leads to no material change in our exposure to defensive assets.

Government bonds

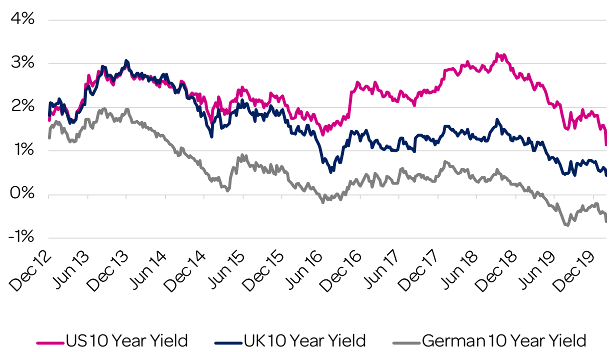
Bond yields have collapsed as investors have sought safety. Current yields imply no or very low growth in the near future, though we see chances of a moderate rebound led by China coming back online.

Bond yields were retracing higher as economic data was improving and people were investing in riskier growth assets. Restrictions on the movement of people to contain the spread of coronavirus in China have caused a significant shock to economic activity. As the virus is now spreading outside China, financial markets are increasingly worried about the impact on global supply chains as well as the possibility that western countries may need to take protective measures of our own. This has sent government bond yields tumbling to new lows as investors seek safe havens and expect central banks to cut interest rates to support the economy.

We think there could also be an increase in fiscal support for economies. At the margin this would be negative for government bond yields but with limited inflationary pressure in the short term and interest rates unlikely to rise materially, we see policy risk to government bonds as minimal. We do, however, think there is risk for yields to retrace from these lows if the momentum of news flow about the virus turns from negative to positive.

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

Bond yields plumb new lows



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 corporate bonds have improved slightly as credit markets start to price in the coronavirus disruption. In absolute terms however, they remain very low. This is especially true for US corporate bonds after accounting for the cost of hedging currency risk. Additionally, the composition of risk within the corporate bond market looks very different compared to a decade ago, with a higher proportion of riskier borrowers.

We don't see interest rates rising significantly in the near term and so we are less worried about companies defaulting on their borrowings but some may face difficulties as they down-throttle in response to weak economic growth. Corporate credit can form an additional source of correlated risk in portfolios, so we prefer to reduce our exposure to credit in favour of government bonds and short dated bonds that we expect to provide better protection.

Alternative assets

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

Property

Our view on other asset classes is more constructive than property and so we maintain a low exposure.

Total return expectations for commercial property have been revised lower again, compared to forecasts from 2019. 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 and others have done again more recently. 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 maintain a neutral weight, with a focus on low risk strategies.

Higher levels of uncertainty continue to cloud over financial markets, and this is upsetting 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.

Commodities

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

There has been a generalised cooling of fixed asset investment in China with a greater focus being paid to fostering domestic consumption. However, the impact of the virus may change this. So far efforts in China are focused on avoiding a credit market freeze given the scale of the drop in economic activity. As focus shifts away from stabilising the short term and boosting growth, we could see infrastructure spending return to the Chinese policy toolbox which would be positive for industrial commodities.

With precious metals, we know that gold has a negative relationship with real yields, i.e. gold rises when real yields fall. For real yields to fall, interest rates need to fall faster than inflation or rise slower than inflation. Inflation expectations were rising gently as expectations of economic recovery were taking hold. Expectations have weakened again in anticipation of virus induced lower activity levels. We do not see significant risk of a rise in central bank policy rates, while we do think they now consider their inflation goals as a symmetric target.

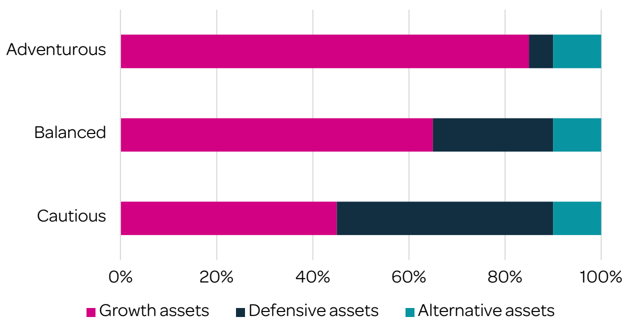
This means if activity and inflation pick up, interest rates are unlikely to rise quickly. This would lead to a fall in the real interest rate and be positive for gold.

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 in equities regionally, based on the size and relevance of different markets to UK investors. Growth assets 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 views outlined in this document will influence how we manage your portfolio. For example, we may decide to increase your exposure to one region at the expense of another. The dials give an indication of whether we are positive or negative on each asset class:

However, our job as your investment manager is to make sure that the risk profile (or overall 'flavour') of your portfolio stays consistent.

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