# July 2019 Asset Allocation Commentary

## Macro Overview

Policy has continued to dominate macro news flow since the last meeting in late May. A decision by the US to defer further tariffs on China and continued talk of supportive Central Bank easing in most major economic zones more than offset a continuation of poor near term industrial activity.

UK Markit Manufacturing PMI below 50, a 14% drop in investment into the UK from foreign firms, the Japanese Tankan report, US Philadelphia Fed Index reading of 0.3 versus 10.4 expected, Chinese Manufacturing PMI below 50 and a 2.2% drop in German factory orders in June are all examples of industrial weakness.

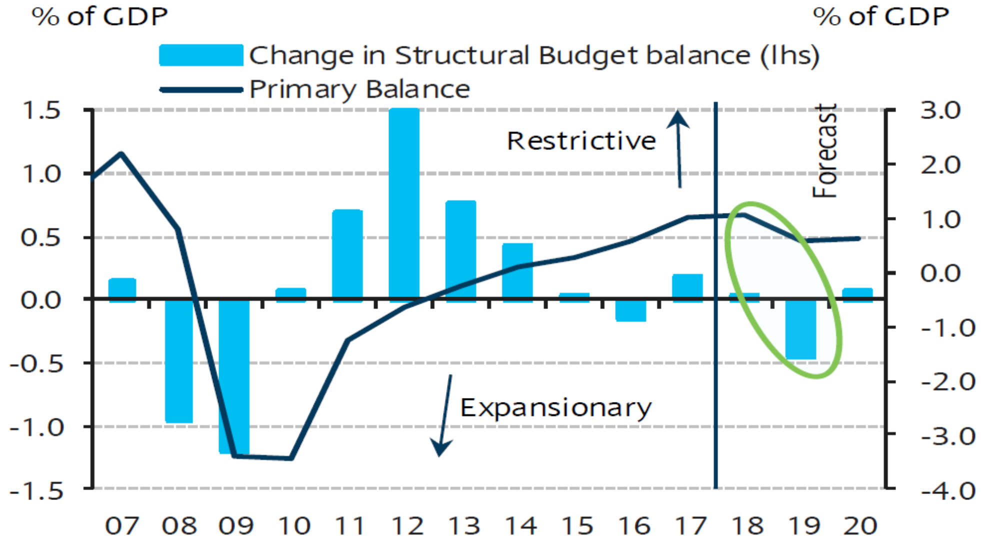
In the US, EU and China, however, non-manufacturing activity has slowed only slightly whilst inflationary readings have edged up in the prior two areas mentioned.

The UK could be weaker near term as Brexit inventories are run down and corporate nervousness intensifies.

Automotive activity was the first to fall last year, initially in Europe and then in China. Both regions have shown early signs of at least stabilising and this is to be welcomed. With regards to energy, we will soon anniversary 2018's sharp fall in oil prices and this passing will help stabilise both related activity and (falling of late) inflationary expectations. However, as mentioned in my Q2 commentary, clarity on both US trade intentions and/or Brexit will be required before a sustained and general uptick in investment and trade related activity ensues.

As well as badgering the Fed into easing, the US administration has managed to agree another increase in the debt ceiling and put through a small fiscal stimulus package for next year. Here in the UK a bigger fiscal package will come into being by early November at the latest. With regards Europe, not only is the ECB ready to unleash more stimulus but each of the big roles that were up for renewal on the Continent have been filled by people who are in favour of using fiscal policy in tandem with monetary actions to re-energise growth. Even the German President-elect of the European Commission, Ursula von der Leyen, was involved in introducing a minimum wage in Germany, increasing nursery places and also upping military expenditure.

**Chart 1: Change in Eurozone structural budget balance suggests most accommodative stance since 2009**




*Source; Haver Analytics, Barclays Research*

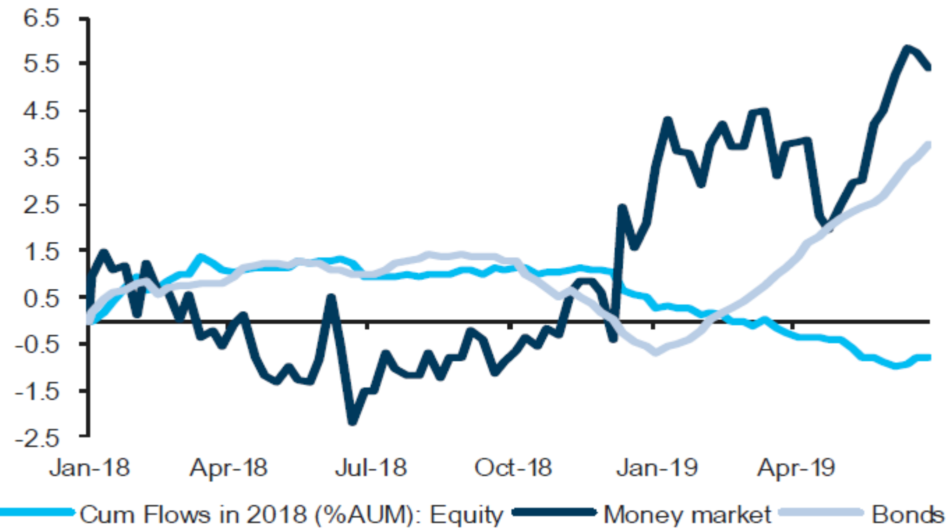
China will continue to stimulate and have of late encouraged local governments to provide support for the automotive, home appliance and electronics industries.

The FT reported that, by the end of June, 30 countries had cut interest rates in 2019. This number will continue to increase in Q3.

## Markets

Equities and bonds again moved up in tandem and although the former did better, safe havens dominated performance. This was true in the Yen being the strongest currency and the S&P being the strongest equity market, whilst large caps across the globe outperformed their smaller brethren.

**Chart 2: The flight to safety keeps going**



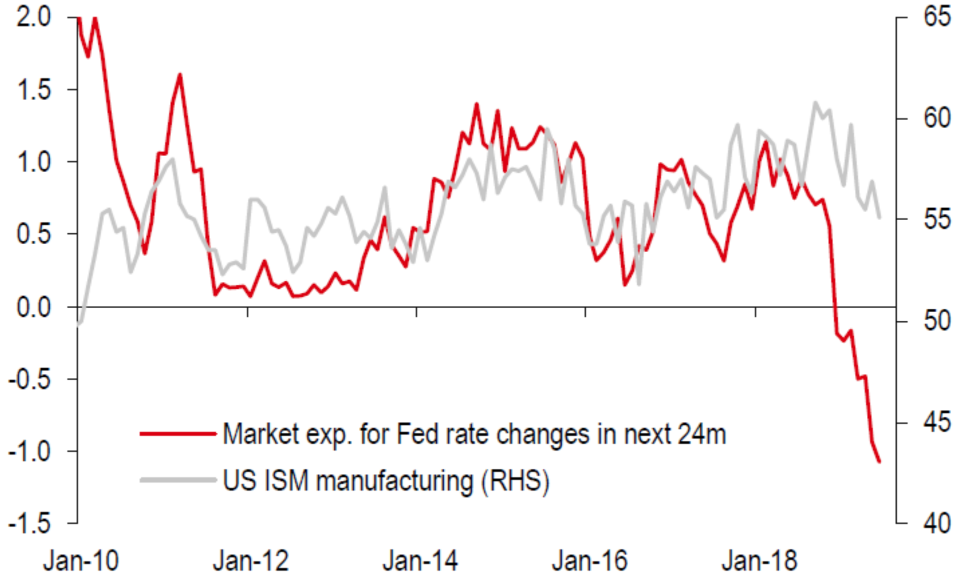

*Source; EPFR, Barclays Research*

The UK, although positive, lagged on Brexit uncertainty and allied political upheavals which resulted in Boris Johnston being chosen as the Prime Minister. Whilst his public statements range from there only being a million to one chance of a no deal Brexit to stating we must be prepared to walk away without a deal, markets have priced in a greater probability of a crash out and Sterling has weakened accordingly (analysts reckon about a 35% probability of a hard Brexit is priced in versus mid-teens in April). There has been a lot more talk since Boris became leader of an early election but, not only is the amount of available time an issue, I don't think there is high enough probability of a Conservative/Brexit Party alliance winning and I doubt he wants to go on record as having one of the shortest PM tenures in history.

Amidst all this angst Gold and latterly even Silver have perked up as real interest rates have fallen and Mr Trump has tried, with very little success, to talk the dollar down (or more accurately the Chinese Yuan and Euro up).

Bond yields have continued to fall, although the rate of descent has slowed considerably and even halted in the US. This is likely because economic news is not uniformly bad and actual inflation is holding up more than investor expectations of future inflation. Whilst we have to acknowledge they are a lagging indicator, wage growth has held up well in most economies too, with UK and US wage growth remaining above 3% and the EU at 2.5%.

**Chart 3: Disconnect between easing expectations and economic data**




*Source; Bloomberg, HSBC*

In terms of investor perceptions, the underperformance of the value style versus growth was the worst since the 2009 financial crises - despite actual economic activity being far better than then.

Investors are in fear of imminent global recession because the US has not had a general recession in over a decade - a record stretch. However, it seems to have been overlooked that most other parts of the world have been through at least one policy induced slowdown since then (China twice) plus the whole world experienced the OPEC inspired commodity collapse of 2015-16. We are also twelve months into a policy induced trade relapse so it is tough to see where the big excesses are. Any recession is likely to be very short and mild compared to the last one, with Central Banks being more pro active than at any other time in my 30 year career; indeed it is not clear that a recession is due anytime soon.

The table below shows performance of several key asset classes from close on the 30th May until close on 29th July.

**Figure 1: Percentage change in markets and currencies since the last Asset Allocation meeting**

| | | | |
|---|---|---|---|
| **FTSE 100** | +6.49% | **Euro : £** | +3.25% |
| **S&P 500** | +8.32% | **Euro : US $** | -0.04% |
| **CAC 40** | +6.71% | **Yen : £** | +4.02% |
| **DAX 30** | +4.33% | **US $ : £** | +3.22% |
| **Hang Seng** | +3.66% | **UK 10 Year Gilt Yield** | -25 basis points |
| **NIKKEI 225** | +3.22% | **US 10 Year Bond Yield** | -16 basis points |
| **Brent Oil** | -2.74% | *All prices are in local currency* | |

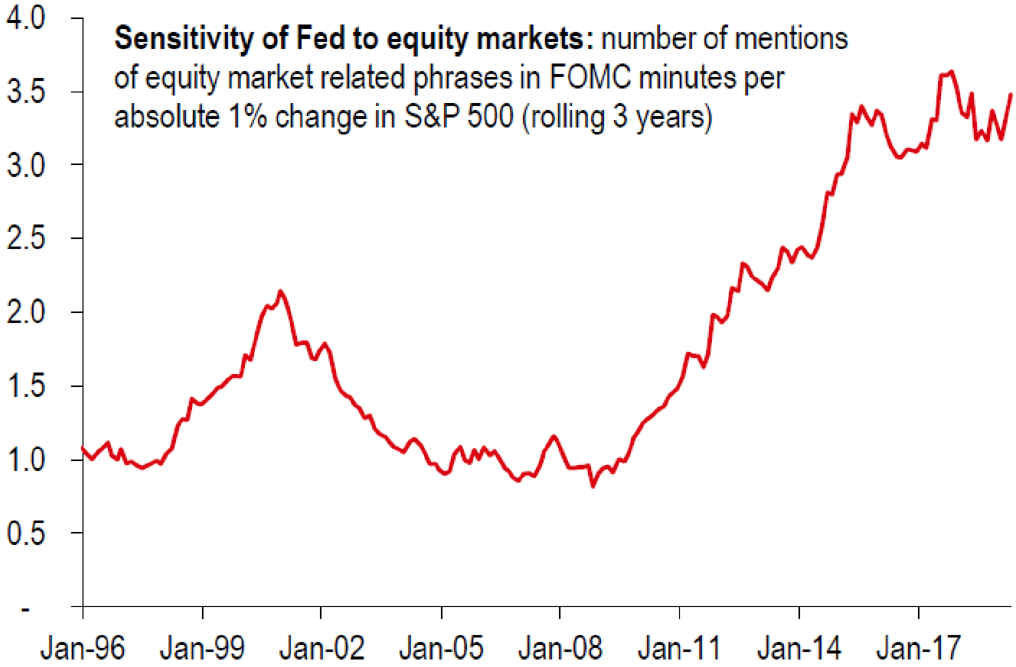
## Activity & Positioning

We mostly acted to take a little money off the table after a good run across asset classes.

The outlook more than ever depends on policy. Corporate management can't fully commit to strategic spending until they have clarity on what trading environment they are operating in. However, excluding the possibility of an exogenous shock, some productivity enhancing investment will continue along with tactical spend.

As mentioned before, I don't think more monetary accommodation will yield as much (no pun intended) as prior moves but it does serve as a siren that Central Banks have the markets' backs covered (perhaps too much so - will they cut at every period of financial market turbulence when average holding periods are below nine months and JP Morgan estimates 90% of all daily flows are passive?).

**Chart 4: Sensitivity of Fed to equity markets is rising**




*Source; MSCI, Refinitiv Datastream, Federal Reserve, HSBC*

Fiscal stimulus is still on tap in the US, China, UK and Continental Europe so it is difficult to see a full blown recession emerging. Manufacturing has already been in a downturn for almost a year and was showing tentative signs of recovery until the early May trade blow ups. Tariff dodging inventory build-up has meant there is still work to do to bring production into line with end demand but investors will be very forgiving if policy is benign re trade.

Indeed if this benign outcome turns into reality I will bet that, within six months, investor sentiment will turn 180 degrees away from a series of rate cuts and deflation.

Domestic UK equities are particularly cheap and have been hit further of late, not only by investors pricing in an increased chance of a hard Brexit, but also by the unloading of Woodford holdings at below prevailing prices by managers who assumed responsibility for portfolios previously ran by him. Although very cheap there was no point in standing in the way of large sellers and so we have just watched developments so far. We are approaching time to buy as they offer significant upside potential from here over the medium term (1-3 years) in any Brexit outcome. Nonetheless, we will proceed gradually as near term volatility will likely persist through October 31st.

Conversely, dollar earners have been moving forever higher despite very lacklustre results from the likes of Unilever and Reckitt Benckiser. Although this is hurting relative performance short term, buying stocks at the high end of their valuation ranges when they are exhibiting sub par results would not give me confidence that good risk adjusted long term returns can be achieved.

”High Yield” bonds offering less than 1% yields make no sense to me and are an example of where risk is being mispriced in the fixed income market due to Central Bank policy. Mind you, negative yielding government bonds don’t make any sense to me either in a world of positive inflation. If we didn’t experience deflation after the Financial Crisis of 2009 or the Commodity Price collapse post the November 2014 change in OPEC policy then I find it very difficult to see where it is going to come from in the future. Especially given that governments are now spending again.

**Figure 2: Portfolio changes since last Asset Allocation meeting – RJIS**

| Harpsden Portfolio Strategy | Bought | Sold |
|---|---|---|
| **90% Equity** | Nil | Nil |
| **Growth** | 3% Schroders QEP Equity Market Neutral<br>1.5% JOHCM UK Equity Income<br>1.5% SLI UK Equity Income Unconstrained | 1.5% Unicorn UK Equity Income<br>3% Woodford Income Focus<br>1.5% Blackrock Continental Europe Inc |
| **Income & Growth** | 3% Schroders QEP Equity Market Neutral<br>1.5% JOHCM UK Equity Income<br>1.5% SLI UK Equity Income Unconstrained | 1.5% Unicorn UK Equity Income<br>3% Woodford Income Focus<br>1.5% Blackrock Continental Europe Inc |
| **Income** | 1.5% Schroders QEP Equity Market Neutral<br>4.25% JOHCM UK Equity Income | 1.5% Unicorn UK Equity Income<br>4.25% Woodford Income Focus<br>1.5% Blackrock Continental Europe Inc |
| **0-35% Equity** | 3% Schroders QEP Equity Market Neutral<br>1.5% JOHCM UK Equity Income | 1.5% Woodford Income Focus<br>2% SLI GARS |
| **Ethical** | 3% Wellington Global Impact | 3% Janus Henderson Responsible Income |

## Conclusion

So I am going to use the coming months to buy assets that are well capitalised and which have valuation upside after being unduly punished for not portraying the aura of safety.

Whilst not wishing to call the markets near term, seasonally the coming three months quite often offer a good buying opportunity after a bout of short term turbulence.

We stand ready to take advantage should history repeat itself again this year.

Best Regards,

**Ian Brady**
**Chief Investment Officer**
**30th July 2019**

## Current Asset Allocation

| Asset class | 90% Equity | Growth Strategy | Income & Growth Strategy | Income Strategy | 0% to 35% Equity | Ethical Strategy |
|---|---|---|---|---|---|---|
| **Property** | **0** | **0** | **0** | **0** | **0** | **0** |
| **Cash/Dollars/€** | **9.25** | **20** | **22.5** | **29.25** | **12** | **20.5** |
| **Fixed Interest** | **0** | **3** | **10** | **16** | **32** | **20** |
| High Yield | 0 | 0 | 0 | 3 | 6 | 0 |
| Index Linked | 0 | 0 | 0 | 0 | 0 | 0 |
| Corporate/Strategic | 0 | 3 | 10 | 13 | 16 | 20 |
| Government | 0 | 0 | 0 | 0 | 10 | 0 |
| **Equities** | **85.25** | **68.5** | **59** | **46.25** | **37.5** | **59.5** |
| UK | 38 | 28.25 | 24.75 | 29.25 | 19.5 | 30.5 |
| North America | 15 | 11.5 | 9.5 | 7.5 | 0 | 0 |
| Europe | 8 | 7.5 | 9 | 5.5 | 4 | 0 |
| Asia (excl Japan) | 0 | 9 | 6 | 2 | 3 | 6 |
| Japan | 12.75 | 6.25 | 7.25 | 2 | 3 | 0 |
| International | 0 | 0 | 0 | 0 | 0 | 23 |
| Emerging | 10 | 4.5 | 1.5 | 0 | 0 | 0 |
| Global Low Beta | 0 | 0 | 0 | 0 | 8 | 0 |
| Energy/Commodity | 1.5 | 1.5 | 1 | 0 | 0 | 0 |
| **Commodities** | **3.5** | **3.5** | **3.5** | **3.5** | **3.5** | **0** |
| Gold | 3.5 | 3.5 | 3.5 | 3.5 | 3.5 | 0 |
| **Absolute Return** | **2** | **5** | **5** | **5** | **15** | **0** |
| **Total** | **100** | **100** | **100** | **100** | **100** | **100** |

**Important Information/Risk Factors:**

Past performance is not a guide to future performance and investment markets and conditions can change rapidly. Investments in equity markets will be more volatile than an investment in cash or fixed deposits. The value of your investment may go down as well as up. There is no guarantee you will get back the amount invested. If your fund invests in overseas markets, currents movements may affect both the income received and the capital value of your investment. If it invests in the shares of small companies, in emerging markets, or in a single country or sector, it may be less liquid and more volatile than a broadly diversified fund investing in developed equity markets.

The views expressed herein should not be relied upon when making investment decisions. The article is not intended as individual advice and if you require advice or further information you should contact us.