Allenbridge
Part of MJ Hudson

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Investment Outlook

As is often the case, a strong end to the year has carried on into the new year. There is growing confidence in the sustainability of the current global upswing, some of the political risk has abated and the US Congress passing of Trump's tax cuts has boosted sentiment further. Market expectations had been for a correction in Q2 but this now appears to be pushed out, possibly as far as 2019.

The UK remains something of an outlier with slower growth and higher inflation but elsewhere inflation remains subdued while growth is picking up. Europe, for example, has seen seven quarters of rising activity levels. The main challenge to this positive outlook remains the pace of central bank tightening, whether through higher interest rates as in the US or in the withdrawal of global liquidity, through tapering of QE or, in the case of the US again, its reversal.

Brexit remains another risk of course, at least for the UK and Europe. The nature of the final trade deal, if there is one, remains elusive, though the preliminaries are at last over with the agreement on financial settlement, etc. It looks as though Mrs Merkel has engineered another coalition deal, removing one uncertainty at least. Political risk remains high in the Middle East, though in Korea it may have reduced.

Economy

The big news in the US is the tax cuts package, which of course is reflationary at a time when the economy is near full employment. It is angled towards the corporate sector and high earners, which mitigates some of its expansionary effect. Will corporations increase investment and boost productivity, which is the hope? Or will they merely increase dividends and share buybacks? In addition, of course, companies like Apple have been incentivised to repatriate huge overseas cash balances. The response of the Fed, under its new chair, will be key to how markets react. In December, it raised rates by another quarter percent and markets are predicting another three or four rate hikes this year. At the same time, it has talked of balance sheet contraction, ie reducing the vast stock of bonds it has acquired. Both will help limit the inflationary consequences of what, in fiscal terms, is an unnecessary stimulus.

In the UK, the budget passed off uneventfully while continuing the theme of deferring any fiscal tightening. Although CPI inflation is hovering around the 3% level, the Bank of England seems inclined to assume inflation is peaking, given the lack of response of wages, so that rate hikes will be much more modest than in the US.

While a Brexit transition agreement of some two years seems agreed, to the relief of business, considerable uncertainty continues over the longer term outcome. Europe runs a large surplus with us in manufactured goods while we run a large, if smaller, surplus with Europe in services. A simple trade agreement in goods would be a lot easier to agree than the comprehensive trade agreement that Mrs May aspires to, but would not be in our interests. The EU seems hostile to a bespoke deal involving services, while the option of remaining in the single market, which would deliver the economic benefits enjoyed currently, comes with a high political price. Business is maintaining an air of calm, though clearly spending decisions are being held back and some planning being done for the hard Brexit scenario, which could yet be the default but unwelcome outcome.

Elsewhere, as we indicated above, the European recovery looks in good shape. One rather unexpected risk to this is the strength of the euro. Despite the Fed's tightening phase, the dollar has weakened over the last twelve months from 1.05 to 1.22 against the euro. While the dollar has weakened generally, the euro has strengthened mainly because Mr. Draghi at the ECB signalled tapering of QE with bond purchases falling by half this year. While no similar announcement has been made, the BOJ has also started to cut back, though by a smaller extent, even

though Japan is a long way short of its inflation target. Japan's growth is modest, though allowance needs to be made for its shrinking labour force but at least seems to have achieved traction.

The emerging world is in recovery mode, like Brazil or Russia, or expanding fast still, like China and India. Dollar weakness always helps, while commodity prices are strengthening, not least oil, now at $70/bbl and exports to the developed world are picking up. For the first time since the crash, the global economy does appear to be in a synchronised upswing.

Markets

This macro environment remains supportive for risk assets like equities, which rose some 4% in the final quarter, including the UK which has lagged again for the year in local currency terms with a total return of some 12%. In sterling terms, this is a match for global equities though because sterling's recovery has reduced returns to an unhedged sterling investor. For example, the S&P returned some 17% in dollars but only 9% in sterling. Japan did better still in yen, but best performing markets again were emerging markets with some 25% in sterling terms. Europe has kept up, but lagged in the final quarter because of euro strength.

In contrast, only modest returns came from government bond and investment grade bond markets. High yield bonds returned 7% as spreads narrowed in still further to levels that may not price in enough risk of default. The recent experience of Carillon is a useful reminder of default risk even though construction and retail- where there have been several closures in the UK- may carry special risks. The elephant in the room is always the US government bond market. Ten year yields have now widened out to 2.5%, a full 1% above equivalent gilts, but it is the latter that seems mispriced. If US federal funds rise by 1% this year, then it is likely that US 10 year yields will move out to 3%, an appropriate level if inflation stabilises at some 2%. If the Fed sells its holding of bonds too aggressively, they could widen out still further, challenging risk assets.

It is harder to forecast the path of UK yields which have moved sideways for some months. They should be higher of course, given current inflation levels, but given Brexit risks, the BoE is acting cautiously while pension fund matched buying helps keep yields down. It is hard to see much in the way of positive returns and the same could be said of investment grade corporate bonds, especially if spreads start to widen on economic uncertainty.

Momentum and value drive equity markets along with earnings. Earnings growth has been positive, as has momentum, with only value causing sceptics to question the sustained rally seen in equities. Valuation is high but not so exceptional as to suggest a major correction, as earnings continue to catch up with markets. Since the bottom of the market in 2009, there have been around three corrections of the order of 10-15% but each time, markets have regrouped and surged to new highs. Central banks have effectively underwritten markets with the global liquidity they have created. Now that support is gradually being removed but it will need some catalyst to produce the next correction. That could be Brexit or excessive Fed tightening or some geopolitical shock. Meanwhile, markets look like holding these levels and even making more progress.

Property has followed a similar trajectory, with a good recovery from the Brexit shock and better returns last year than expected. Valuation continues to look challenging in some sectors buoyed by the same liquidity story while the UK market is vulnerable to an unpleasant surprise on the Brexit negotiations.

Asset Allocation

The Strategy Review has been approved and is now being implemented. The switch from investment grade corporate bonds into multi-asset credit has taken place, with a new manager looking at alternative credit areas, like loans on a floating rate basis, which removes duration risk. Decisions to increase exposure to property, private equity and infrastructure take time of course to implement, and are opportunity driven in terms of available properties or investments.

The recommendation to derisk the scheme by switching from equities to absolute return managers like our existing diversified growth manager is affected by the timing of the Brunel pooling. A delay might expose the scheme if equities do correct, and at a minimum we should reduce equities to the extent that we are above the top end of our agreed ranges, even if that means going into cash.

The final outstanding recommendation is to increase the inflation liability hedge ratio over time. Prior to that, which may require more collateral support, good work is being done in refreshing the liability benchmark, reducing the fee basis and putting in place a better monitoring framework.

For Further Information

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