HFS Milbourne
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STRATEGIC PORTFOLIO SERVICE
QUARTERLY INVESTMENT OUTLOOK

Spring 2019

Introduction

Our Strategic Portfolio Service has been established for ten years and provides active quarterly management of risk-graded portfolios alongside specialist fixed interest and income yielding portfolios. These are suitable for pension funds, ISAs and unit trusts, trust investments and self-invested personal pensions. We currently manage circa £265 million of funds in this way for our clients. This quarterly market outlook sets out our views of the market and the changes we recommend to our portfolios. If you would like more information on our Strategic Portfolio Service, please contact us on 01483 468888.

Executive Summary

Brexit news is dominating domestic headlines and UK markets, making it challenging for investors to look past our scheduled March 29 exit date from the European Union. Other global forces will also play a big part in determining the path that markets take for 2019. Significant US economic outperformance is unlikely to persist as the 'sugar rush' of the fiscal stimulus wanes. Growth should still be positive, but more lacklustre by recent standards due to Washington's more hostile approach to trade. Companies globally are deferring investments and becoming more hesitant about expanding operations. We anticipate that any slowdown in China will be mild given that authorities are now willing to use fiscal and monetary stimulus to prevent a hard landing. We see a low probability of the global economy entering a recession this year, yet rising fears of an economic downturn is the key risk for markets. Should geopolitical risk remain elevated and unresolved, the negative environment may lead to such a self-induced position.

The path of the US Fed has changed in recent weeks as the Central Bank approaches a 'neutral' position – the interest rate that neither stimulates nor restricts growth. We expect US policy to become more cautious and to pause their quarterly interest rate hikes until geopolitical matters stabilise once more. Equity valuations in emerging markets and Asia have fallen considerably and should concerns recede further, we believe opportunities in this region now look extremely attractive.

In summary:

- Asset allocation remains unaltered with no adjustments made. There are no changes to fund selection either.
- Portfolios therefore remain unchanged as we believe the balance of risk between our main asset classes continues to offer the most appropriate diversification for risk and reward.
- The straightforward rebalance of bringing funds back to neutral (taking profit from the winners) means we are re-establishing the desired position.
- All portfolios were negative for 2018, as both equities and bonds generated negative returns, which has only previously happened twice before, since 1900.
- Geopolitical risk will maintain a grip on markets next year, although we enter 2019 with many risks better reflected in asset prices than a year ago.
- China and other emerging market concerns are receding, but we have grown more concerned about Europe over the medium term.
- Portfolios generally remain neutral in equities, underweight bonds, whilst the overweight position in absolute style return funds has held up well in the sizeable downturn last quarter.
- UK equities may prosper in a relief rally should Brexit uncertainty diminish. Sterling's strength will act as a counterbalance for overseas held assets.

2018 Retrospection

Markets in 2018 started the year with some optimism as the US economy continued to outperform, buoyed by tax cuts and whilst unemployment continued to fall. What proved considerably more disruptive in 2018 was US foreign policy. Undeterred by the threat of higher costs for US consumers and businesses, Washington ramped up trade tensions. Trade aggression hit the Chinese economy at a point when growth was already slowing in response to tighter policy from Beijing. Emerging markets have endured the knock-on effects of slowing demand from China, their own rising borrowing costs as a result of higher US interest rates and a strong US dollar making them in turn uncompetitive.

Italian politics heated up as the new populist government attempted to ease financial conditions with the European commission. Whilst the Italian government have since scaled back their budget demands, elsewhere in Europe President Macron has had his own battle with "Gilets Jaunes" and their huge national protest. Elsewhere, North Korea came in from the cold and the potential crisis has been averted here for the time being.

Central banks were a rare source of stability and consistency in 2018, even if they were tightening policy. The US Federal Reserve had raised interest rates four times in 2018 despite complaints from President Trump in the second half of the year. Rate rises may now be on pause for the time being, but the continued quantitative tightening as the Fed also reduces the balance sheet, will continue to reduce liquidity. Meanwhile the ECB decided to taper its quantitative easing programme with an end to purchases in December.

Looking across major asset classes (to UK investors), commodities were the worst performing with a return of -11.2%, closely followed by the MSCI World Equity Index of -8.2%. Bonds were also in negative territory and gold also had a poor year, losing 1.7%. The US Nasdaq fell 2.8% despite the strong start to the year from the unsinkable FAANG stocks (Facebook, Apple, Amazon, Netflix and Google – now Alphabet). Investors' love affair with all things technology soured for a range of reasons. Apple investors have started to worry that the company is over-dependent on the i-Phone, whilst Alphabet and Facebook are struggling to justify the valuations following data breaches, law suits, privacy concerns and stricter tax enforcement, making life harder.

Closer to home, the worst performing market was the German DAX 30 Index, down 18.3% as a recession starts to bite. The French CAC 40 was down 8% whilst the FTSE All Share Index fell 9.5%. China's main indicies posted losses that approach 25% for 2018.

Perhaps we have learnt through 2018 that whilst Central Banks care about markets, they do not set policy for the sole purpose of pleasing investors. To them, a correction is normal rather than a signal that something is wrong. Political risk is still as important as ever for investment sentiment. Trade wars can have a far reaching effect on global growth and subsequently markets. Finally, Bitcoin still has no place in an investor's portfolio, especially when the crypto-currency fell 72.5% during the year.

Brexit Progress?

Parliament delivered the expected vote of rejecting overwhelmingly the ratification of the UK's Withdrawal Agreement with the European Union. It is worth noting that over 100 Conservative party MPs voted against their own Prime Minister, while only four opposition Labour party members rebelled and backed the deal.

Theresa May also survived a vote of no confidence thanks to Northern Ireland's DUP, and has now welcomed talks with MPs from all sides in the hope of finding a way out of the Brexit impasse. There are multiple issues that Parliament is divided on, many diametrically opposed. We wait to see if the Government can come up with a set of proposals that can change the mind of the hard Brexit Tory MPs, or those that want an even closer tie to the EU. In order for the EU to be willing to reopen the current agreement, the Government must demonstrate that there is sufficient support for proposed amendments to win a new vote in Parliament.

Political commentary and market expectation seems to suggest that the probability of falling out of the EU in a no-deal scenario is reducing. Tighter integration, perhaps maintaining a full customs union and access to all markets, or indeed no Brexit at all is gaining ground. For now, sterling is holding steady and even finding support. It would be expected to strengthen further should the prospect of a conciliatory deal look viable. If the Bank of England is to be believed, falling out of the EU with no deal could see sterling fall by 25%.

Economic indicators in recent weeks have fallen as both consumer and businesses are reticent to spend given the level of uncertainty that now exists.

In conclusion, should uncertainty somehow lift through the spring with a reasonably positive outcome, our portfolios are well-positioned with exposure to mid and small cap companies, which are likely to prosper as relief ensues.

Portfolio Strategy

The table below indicates the asset allocation and strategy portfolio position, which remain unchanged between major asset classes. We consider these strategies to be broadly neutral for equity content and underweight fixed interest, where we see a preference for cash in lower risk portfolios.

Strategy Portfolio												
Asset Class	*1*	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*	*Fixed Interest*	*SPS Income*
Cash	*72%*	*32%*	*13%*	*6%*							*12%*	
Fixed Interest	*16%*	*29%*	*29%*	*27%*	*24%*	*17%*	*11%*	*6%*	*4%*		*72%*	*24%*
UK Equity		*6%*	*8%*	*9%*	*13%*	*16%*	*17%*	*17%*	*17%*	*14%*		*14%*
Global Equity		*7%*	*23%*	*33%*	*40%*	*46%*	*54%*	*63%*	*71%*	*81%*		*36%*
Absolute Total Return	*8%*	*18%*	*19%*	*17%*	*15%*	*13%*	*10%*	*6%*	*2%*		*16%*	*18%*
Property	*4%*	*8%*	*8%*	*8%*	*8%*	*8%*	*8%*	*8%*	*6%*	*5%*		*8%*

Economic Outlook

We see few signs of overheating in the US economy today, with monetary policy still easier than it has been ahead of past recessions. This implies the current cycle still has room to run, with the probability of a US recession in 2019 extremely unlikely, although the odds increase thereafter. A rise in recessionary fears is in itself a major risk for markets in 2019. Stocks can still do well in late cycle, but a changing sentiment can be most damaging.

The rising tension between the US and China is probably the most important theme that affects this overall sentiment. The battle between the world's two largest economies is about much more than trade, it is a fight for supremacy, particularly regarding technology advancement. Rolling back the tide of globalisation may make geopolitical sense to Donald Trump, but it threatens the growth on which stock market valuations depend. Some of President Trump's advisers may not trust China to comply with any deal anyway. Others may believe criticising China is good politics in the run up to the 2020 Presidential Election. However, the recent stock market downturn provides a strong political incentive for President Trump to compromise on trade talks in order to re-establish his successful market credentials.

The second most important question is whether the Federal Reserve sticks to its expected interest rate tightening path. The Fed has become more dovish in recent weeks, but raising rates to a neutral position is clearly the bank's preferred outcome, because when the next downturn ensues, it has ammunition to shape potential interest rate cuts. Markets however are less convinced, thinking that a slowing economy and volatile markets would prompt an even more cautious approach, even a rate cut. One potential solace to markets has come in the form of the recent decline in the oil price, alongside the strength of the US dollar, which is likely to mean that headline inflation remains close to 2%, as targeted. We expect the Fed to edge closer to 3% (currently 2.5%) for interest rates by the end of the year, but will be more data dependent in its outlook. The trajectory of US interest rates matters for a few reasons; it drives the value of the dollar, which has been a headwind for overseas, especially emerging market assets; it has a direct impact on consumer sentiment and determines the relative attraction of other income streams.

Whilst fiscal stimulus in the US is fading, Beijing's policy makers have put their foot firmly back on the accelerator to see off the impact of slowing exports. Credit and lending had become excessive, but Chinese authorities now wish to stimulate the economy to balance the slowdown from America's declining purchases. Growth remains supportive around 6%, with new infrastructure projects, especially rail, being recently announced. Further tax cuts, both corporate and personal will also help encourage spending.

Tactical Asset Allocation Summary

The chart below is a representation of our tactical position relative to the longer term strategic model, ranging from strongly underweight to strongly overweight. It represents our general position, assuming a moderate risk portfolio.

	Strong Underweight	Underweight	Neutral	Overweight	Strong Overweight	
Government & Investment Grade Bonds		✓				Yields now lower after risk-off Q4. Reasonable value in US inflation-linked debt. Longer maturities are growing in appeal.
High Yield & Emerging Markets Bonds		✓				EM currencies have been unduly punished, making valuations more attractive. Attractive spreads above investment grade bonds.
Developed Market Equities			✓			Equity growth decelerating, but still positive single digit. Cyclical growth and political risk remains. European momentum stalling.
Asia & Emerging Market Equities				✓		Encouraging economic backdrop with Chinese resilience stepping up. More dovish Fed and softer US dollar encouraging if trade tensions ease.
UK Property			✓			London prices softening on Brexit fears, although secondary cities holding up with reliable income.
Absolute Return Strategies				✓		Diversification and alternative strategies provide balance to risks elsewhere. Contrarian approach, currencies, shorting techniques all diversify risk.

Conclusion

In 2019, the US economy and indeed the UK, is not expected to perform on the scale it did in 2017 and 2018. So a reasonably diversified portfolio makes more sense, particularly given the potential for a change in direction on US policy and the dollar. It is important to be wary of becoming over-reactive to political noise and opting for dramatic shifts in allocation. Sentiment can change quickly; in particular, US and Chinese authorities may negotiate a sensible solution and stem trade tensions. Indeed, the more the bad news builds in the near term, from either the economy or markets, the higher the incentive for politicians to consider a more amicable conversation. The other key point is that governments seeking growth are no longer making long-term economic reforms to increase competition or make labour markets more flexible. The approach today is to deliver a quick fix through a tax cut, increase public spending, cut regulation, or pass a rise in the minimum wage rate. Governments are seldom strong enough to withstand populist pressures for a fiscal solution, as we have seen in France.

Diversification is the most important word in investment. We have looked at the returns from a range of different asset classes over the years and choose ones which should be uncorrelated. We believe our portfolios are well-balanced, especially with the use of our alternative funds offering something different.

As we head towards the end of the economic cycle, historical figures suggest that returns from cheap and unloved shares outperform those of high growth companies because the latter tend to become overpriced. The trend is for mean reversion whilst investors live to regret paying up for apparent quality as valuations swing back to the average. Since the financial crisis this has not been the case. We are in a low growth environment where investors have been rewarded for sticking to the best. We feel that as economic growth starts to moderate further in the face of rising interest rates, then real quality and company growth potential will still attract a premium. As Warren Buffett once said, “It is better to buy a great company at a reasonable price, than a poor company at a cheap price”.

At this stage therefore, we feel the current mix of funds offer resilient portfolios, but as we move through 2019 we will want to populate portfolios with a combination of quality and value funds that are growing dividends over pure momentum stocks.

Fixed income will start to play a greater role, with yields now starting to look more attractive, whilst our global and macro funds add ballast to the portfolios. As ever, whichever funds we utilise, quality is the key as the cycle matures.

Iain Halket, Director
Chairman of HFS Milbourne Investment Committee
January 2019

Risk warning: Property funds
In the event the fund has insufficient liquidity to cover all withdrawal notices on a particular date; redemptions may be deferred until there is sufficient liquidity within the funds. Property valuations are determined by independent property experts and are based on opinion rather than fact.

Glossary: A full financial glossary is available on our website at **www.hfsmilbourne.co.uk/tools**