HFS Milbourne
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STRATEGIC PORTFOLIO SERVICE
QUARTERLY INVESTMENT OUTLOOK

Winter 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 £295 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

We believe the global economy is entering a temporary period of uncertainty which is likely to persist into 2020. The mixture of ongoing trade tensions and heightened political uncertainty continues to act as a drag on the world economy. However, no resolution does not mean an absence of progress. Central banks have turned dovish rhetoric into material action in both developed and emerging markets with the reintroduction of quantitative easing and lowering of interest rates. Economic data is pointing to flatlining, not declining activity.

Growth is weak and investors should remain on their guard, but employment figures have remained firm and consumer spending relatively solid across the world. We see a temporary deceleration in global trade and manufacturing, but the outlook is not one of a looming recession. The US economy continues to add new jobs, although modestly below expectation, and the unemployment rate is now 3.5% which is the lowest for 50 years. Overall, our portfolios reflect a cautiously optimistic view of the world, but it is late cycle, which implies tail risks have risen.

We do believe that the ongoing trade war between the US and China leaves Europe caught in the cross-fire and increasingly is a direct target of President Trump. A recent example is the US announcement that it will be placing 25% tariffs on a range of products that it imports from the EU, including cheese, olives, wine, whiskey and civil aircraft. The move came after the World Trade Organisation ruled that the US can place tariffs of $7.5 billion on EU imports in retaliation for government aid from certain EU countries to Boeing rival, Airbus.

The key now is to build resilience into portfolios rather than being outright defensive. A summary of portfolio news is below:

- We remain broadly neutral in equities deliberately avoiding being underweight whilst remaining regionally diversified.
- Short dated bonds and cash add liquidity and ballast to portfolios, allowing us to re-enter markets when the opportunity presents.
- Growth stocks have outperformed since the global financial crisis, so tilting portfolios towards quality and value at this stage of the cycle is eminently sensible.
- Income funds tend to broadly follow this principle, with an emphasis on dividends. We therefore switch out of Fidelity Global Special Situations to BNY Mellon Global Income Fund.
- Our position in Premier Defensive Growth is halved, allowing us to utilise Investec Diversified Income which generates a high yield using equity with bond strategies and currency positions.

- First State Global Listed Infrastructure has performed well, partially in response to the falling yields in bond markets, therefore 1% from this fund and 1% from Jupiter European is switched to the Legal & General UK 100 Indexed Tracker.
- We believe Europe is coming under pressure economically, coupled with the fact that the exceptional fund manager with Jupiter is retiring in November, with his replacement still under scrutiny.
- The UK is unloved by many international investors, with asset allocation weightings and valuations being proportionately the lowest for many years. Now is an opportune time to invest in the FTSE 100, with so much uncertainty in the air.
- Year to date performance for Portfolios 3, 5 and 7 is respectively +6.4%, +10.3% and +13%, indicating strong returns since the poor fourth quarter of 2018.
- The Income Portfolio has also achieved year to date figures of +9.9%, whilst the highly speculative portfolio of SPS 10 stands out at +18.7%.
- The M&G Property Fund has seen significant valuation cuts since late summer, whilst cash holdings have fallen ominously to below 10% of the fund. This validates our decision last quarter to exit this fund amid general concerns with the UK property sector. We continue to assess opportunities for a reversal of this policy in 2020.

Economic Outlook

Our base case view is that the world economy will grow at a sub-trend rate over the next few quarters and whilst tail risks have undoubtedly risen, we can see a path to a modest re-acceleration in growth towards the middle of 2020. The economy clearly remains in late cycle and despite easing monetary and interest rate policy, we do not see a re-run of the synchronised and substantial upswing to global growth that investors enjoyed in 2017. The primary issue for equity markets is that although growth on some metrics, notably US Consumer Data, is robust, other sectors of the global economy are doing less well. The escalation of tension between the US and China is weighing not only on global trade, but is affecting sentiment and investor reaction. The weakness in export geared economies, such as Germany and South Korea, is now a cause for concern as recessions loom in these areas.

Much has been made of the fact that the world is enjoying its longest expansion since records began in 1854, resulting in the longest equity bull market known; albeit one of the weakest expansions on record. Annualised real growth has been just under 2% compared to a typical expansion that averages between 3% and 4% of GDP. The latest surveys in the US indicate that business investment is set to decelerate. In contrast, households have been de-leveraging with the result that their debt burden is now substantially lower. The US consumer has benefited from solid wages, low interest rates and low inflation as existing trade tariffs have been largely absorbed by companies to date. However, with the most recently announced tariffs that are expected to take effect being largely on consumer goods, the trade war may start to have more of an impact.

The Federal Reserve has cut interest rates twice over the summer, with a further cut expected before Christmas. In Europe, persistently low long-term inflation expectations were reason enough for new easing of policy to be announced. It is unclear however whether the banking sector in Europe is sufficiently insulated from the ravages of even more negative cash rates and the effect this has on their business models. So, our US bias remains in place, tempting though it may be to call time on the outperformance of US equities and growth stocks in general. We firmly believe that with sub-trend growth and policy accommodation, US equities continue to set the pace.

Brexit nears its end game

The mood in Westminster is nothing short of hostile, although slim signs of a smooth exit are emerging (at the time of writing). The new Prime Minister has lost every vote in the House of Commons, an unprecedented run of defeats. The rebel alliance have successfully voted into law the Benn Act, which compels the government to seek a delay to the 31st October exit date if a deal cannot be reached and agreed with the EU. Without a working majority, a General Election is surely inevitable at some point. The exact direction and permutations of agreements, deals and votes in the House are too numerous to provide any certainty of what will happen next. Deal or no deal, a General Election, a second Referendum, even the cancelling of Article 50 means that the only certainty is uncertainty itself.

There are though, some possible scenarios on the economic impact likely to be faced. If the UK leaves the EU without a deal there will be no transition period, with current trade deals ceasing and customs borders a requirement. We would expect sterling to fall by 10-15% against both the Dollar and the Euro. Inflation would rise. As household spending is the biggest driver of GDP growth in the UK, the economy would suffer a recession. Interest rates would be lowered towards zero, whilst business investment may also contract sharply.

If the UK was to leave with a deal, then the situation is somewhat binary, with the opposite effect and sterling strengthening against the two major world currencies. Inflation could temporarily dip, helping households, whilst business investment would rebound. There should be a marked pick-up in the economy, as government spending would probably increase as indicated of late. EU negotiations would continue, but the immediate risk of disruption would be removed.

Amongst all the uncertainty, opportunities are created, particularly we believe in the FTSE 100 sector of the market. These companies are predominantly multi-national, with circa 73% of earnings coming from overseas. In a no-deal scenario, with sterling falling in value, such earnings become more valuable and should see profit margins rise as a result. The UK economy has little effect on such worldwide conglomerates.

Conversely, if sterling strengthens, the opposite effect occurs. However, we believe the long-term pent up demand for UK equities would reignite as uncertainty lifts. International investors now have the lowest proportionate holdings in the UK versus the world seen in the last 100 years. The yield on UK equities is in excess of 4%, which is the largest gap to bond yields for the last 100 years as well. The UK stock market is offering significant discounts to its true value and provides an unprecedented opportunity.

Portfolio Strategy

Strategy Portfolio												
Asset Class	1	2	3	4	5	6	7	8	9	10	Fixed Interest	SPS Income
Cash	64%	34%	18%	10%	6%	4%	2%				12%	4%
Fixed Interest	28%	38%	35%	33%	28%	23%	18%	12%	6%		72%	28%
UK Equity		7%	10%	12%	16%	19%	20%	20%	20%	16%		16%
Global Equity		7%	22%	32%	39%	45%	53%	62%	69%	79%		34%
Absolute Total Return	8%	14%	15%	13%	11%	9%	7%	3%	2%		16%	18%
Property	0%	0%	0%	0%	0%	0%	0%	3%	3%	5%		0%

Portfolio Positioning

The last quarter was marked by escalating tensions and uncertainty, but central bankers have responded with bold steps towards more accommodative policy. The cutting of interest rates in America and the restarting of quantitative easing in Europe have helped to settle markets for the time being. Markets were also buoyed in September with the perceived easing of the US/China tensions, but while a short-term truce remains possible, we are not so sure that the prospect for a comprehensive deal to resolve the long-lasting structural tensions is ever going to fully resolve matters.

The current expansion of the world economy is a decade old, with economic activity showing signs of fatigue. Yet we do not see recession as an immediate market risk, given the accommodative policy posture as well as the absence of major financial imbalances. We also do not see a risk of inflation worldwide, which in combination provides a positive back-drop for risk assets. We remain positive on US equities, where we still see robust earnings growth for next year despite downgrades seeping into recent announcements. The US holds a strong position relative to other developed markets, with reducing interest rates likely to support market sentiment. We remain cognisant of risks to the long-running expansion, including ongoing trade conflicts and protectionism that President Trump seems to favour. Therefore, our switch to BNY Mellon Global Income and the recent utilisation of JP Morgan US Equity Income continues the theme of quality companies with strong balance sheet fundamentals in defensive sectors as we build resilience to portfolios amid macro uncertainty.

Emerging market equities, in particular Asia, still offer opportunities. Market expectations for EM Central Bank monetary easing are also helped by the Fed and ECB action. Alongside global easing efforts, increased acknowledgement of Chinese assets in global benchmarks will add further to investor inclusion. Increasing Chinese allocation to global benchmarks is expected to drive more than $200 billion of flows into Chinese assets from foreign investors by year end. China has the second largest stock and bond markets in the world, yet only 2% of these markets are under foreign ownership. As China increasingly opens up its domestic markets, greater internationalisation of Chinese assets could also provide a tailwind effect.

A number of adjustments over the past 12 months have seen us move to positions which provide resilience and some defensive characteristics as sentiment and volatility take their effect on markets. The risks posed by today's geopolitical tensions are compounded by long-term uncertainties, including potential de-globalisation and regime change. By this, we mean, President Trump's impeachment or re-election, either being quite feasible outcomes, to the ever-changing Brexit scenario. Resilience refers to the ability to withstand varying market conditions and a quick recovery. These positions are measured as we hold diverse exposures and adapt to changing market conditions.

Some defensiveness is also introduced to provide safety and preservation of assets. The Investec Diversified Income Fund does exactly this, utilising long equity positions with specific stock selection, whilst also 'shorting' markets to add protection. Other strategies, such as currency trading and the use of derivatives to control risk are useful levers in such an environment. The aim is to reduce the severity of potential drawdowns, with naturally a more conservative approach to investments. The top diversifiers of equity risk include US treasuries, particularly inflation-linked assets, which we hold in the re-named Aberdeen Standard Investment Global Index-linked Bond Fund.

The US dollar and Japanese Yen, which we have exposure to, have been the most effective currency diversifiers when markets go through periods of stress. In equity markets, the US large cap quality/value biased stocks have outperformed in downturns versus other regional markets as these are seen to be relatively defensive. We hold all these assets to provide portfolio stability.

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 lower amid slowing global growth, credit fundamentals still supportive, provides buffer to equity volatility.
High Yield & Emerging Markets Bonds		✓				Currencies remain attractive, central banks supportive, but political uncertainty remains a headwind.
Developed Market Equities			✓			Adversarial geopolitical risks in US and UK. Monetary policy is increasingly accommodative again.
Asia & Emerging Market Equities			✓			Chinese stimulus measures offsetting trade tensions. Equity valuations relatively attractive.
UK Property	✓					UK property vulnerable to deterioration in economic fundamentals. Illiquidity concerns rising.
Absolute Return Strategies				✓		Diversity of risk using currencies, shorting techniques and alternative strategies helps balance portfolios.

Conclusion

With a world economy that is possibly losing momentum against a late cycle backdrop, we continue to advocate building more resilience into portfolios. We remain neutral in our overall equity exposure as a whole, but biased now towards large cap, quality stocks. The use of alternative assets also provides an extremely useful diversifier to investment risk, with volatility likely to be on the increase.

Hopes of a trade deal between the US and China have helped risk assets of late, but there is little evidence of any substantial recovery in the data. The probability of long-term ideological differences being put aside to find a meaningful resolution that would last is unlikely in the near term. More likely is a series of temporary measures or phased agreements being required to maintain a truce. The US cycle has been long, but also weak, as households have spent the decade deleveraging. Stronger activity may have to wait for fiscal support after the presidential election.

A final resolution to Brexit may be days or weeks away, meaning that at last some direction for businesses and investment can be achieved, removing the stalemate that has existed since the summer of 2016. However, a General Election is now surely unavoidable.

Iain Halket, Director
Chairman of HFS Milbourne Investment Committee
October 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**

Summary of movements recommended this quarter:

Strategy Portfolio												
	1	2	3	4	5	6	7	8	9	10	Fixed Interest	Income
New Funds Introduced												
BNY Mellon Global Income*		+1%	+2%	+3%	+4%	+4%	+5%	+6%	+6%	+7%		
Investec Diversified Income*	+3%	+5%	+5%	+4%	+3%	+2%	+3%					+2%***
Removal of Fund												
Fidelity Global Special Situations		-1%	-2%	-3%	-4%	-4%	-5%	-6%	-6%	-7%		
Change in Percentage Holding for Existing Funds												
Legal & General UK 100 Index Trust		+1%	+2%	+2%	+2%	+2%	+2%	+2%	+2%	+2%		+2%
Premier Defensive Growth	-3%	-5%	-5%	-4%	-3%	-2%	-3%**					-2%
First State Global Listed Infrastructure			-1%	-1%	-1%	-1%	-1%	-1%	-1%	-1%		-2%
Jupiter European		-1%**	-1%**	-1%	-1%	-1%	-1%	-1%	-1%	-1%		

Please note the above is based on the Old Mutual Wealth platform model (excluding Bespoke Pre 2012 Bonds)
** Existing fund held in SPS Income Strategy*
*** Fund removed from these portfolios*
**** Change in percentage holding for existing fund.*