HFS Milbourne
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STRATEGIC PORTFOLIO SERVICE
QUARTERLY INVESTMENT OUTLOOK

Autumn 2020

Introduction

Our Strategic Portfolio Service has been established for eleven years and provides active quarterly management of risk-graded portfolios. These are suitable for pension funds, ISAs and unit trusts, trust investments and self-invested personal pensions. We currently manage funds of circa £300 million 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

The shortest sharpest recession in living memory has now given way to a new early cycle phase. We expect improving economic macro data and earnings in the second half of the year to push up risk assets, although uncertainty and lack of meaningful data suggests lingering volatility to contend with. Massive fiscal and monetary stimulus have been deployed to tackle the economic fallout of the pandemic. We expect this stimulus to persist for several months as Governments and central banks add additional measures to expand the recovery.

The first six months of 2020 altered the economic landscape more profoundly than any other six-month period in modern history. US unemployment has leapt from a 50-year low of sub 4% in February to a post-World War II high of 14.7% in April. More recent statistics suggest this has reduced to 11% with further falls to come. The massive policy response, coordinated with fiscal and monetary stimulus around the world will shape the global economy for years to come.

Immediately following the shutdown of much of the world's economy in March, the outlook appeared somewhat bleak. Today we have recorded the deepest economic contraction since World War I, but it also looks to be the shortest. In early June the market was pricing in a "V" shape recovery, although we expect this to be more gradual with a few stop/starts along the way as the virus has not yet been beaten. Leading economic data is already pointing to a second half rebound in activity and earnings and we believe that the recovery now has a strong enough foothold to be maintained. Bouts of volatility, particularly in the run up to the US election in November are expected, with a resumption of more normal activity in 2021.

To some, this scenario might paint an overly optimistic picture, but we acknowledge that the commitment from Governments and central banks shouldn't be underestimated, making us cautious about being underweight in risk assets. We believe there is sufficient economic momentum currently to sustain support for stock and credit markets, despite the uncertainty over elevated valuations. The looming political uncertainty of a Trump or Biden election victory, alongside rising tensions of a no-deal Brexit scenario and the constant unfolding of the Coronavirus story, mean that we are optimistic, but equally mindful of short-term setbacks.

A summary of portfolio news is below:

- At the time of writing, portfolios have recovered from the lows of late March and exhibit small positive gains for year-to-date.
- Many global equity indices were negative for the first half of 2020. Returns from the mainstream markets ranged from +3.5% for the US S&P 500 to -17% for the UK FTSE100.

- The technology-focused Nasdaq index recorded a remarkable +25.8% as tech companies benefited from the lockdown measures around the world and the trend of working from home.
- Active fund management saw mixed returns YTD, with extremely good performance from JPM Japan at +16%, Natixis US Leaders at +13%, whilst Axa Framlington Global Thematics and Fundsmith Equity were also securely in positive territory.
- Fixed interest funds have shown mixed results for the first half of the year, although we saw an exceptional performance from the Allianz Strategic Bond fund which secured 26% growth.
- Weighting to America is being pared back given high valuations. As a result, we replace JP Morgan US Equity Income in most portfolios with T.Rowe Price Global Focus Growth Equity, which has a wider geographical spread.
- UK equity and emerging market equity is cut by 1% each and reallocated to European equity.
- The overall response is to upgrade European equities back to neutral given the strength of fiscal support and cheaper valuations, whilst paring US equities back to neutral after a stretch of outperformance.
- M&G Optimal Income Fund is withdrawn from portfolios with allocations marginally increased to each of our remaining bond funds in that sector.
- UK property continues to be absent from portfolios as most funds remain suspended with valuers applying 'material uncertainty clauses'.

Economic Outlook

Governments face a trade-off between getting the economy back to work and the health risks of people coming into contact with Covid-19. The cost of programs to cushion the blow from unemployment and the loss of income as a result of the shut downs is evident in Government borrowing figures. The US Treasury will have borrowed $3 trillion in Q2 2020 alone. Meanwhile, the UK Government borrowed more in April than it had expected to do for the whole year, with a deficit of £300 billion now expected for this financial year.

We expect all four major central banks to keep interest rates unchanged for the foreseeable future, with further increases to quantitative easing materialising if needed. There are likely to be permanent scarring effects in certain sectors of the economy as businesses struggle with new regulations and health requirements. Many expect a "V" shape recovery which we believe is too optimistic even after a commendable policy response. This reflects the difficulty of lifting the lockdowns amidst fears of a second wave of infections and consequently we believe economic activity will return more slowly than expected. The virus may linger and some need for social distancing is sure to remain. In addition, high unemployment and the dramatic increase in public and private debt may serve to restrain spending during the recovery.

The experience of the virus will undoubtedly make some more cautious and spending habits will not immediately return back to normal. Support for businesses will be slowly rolled back, although new measures to support youth employment, reduce VAT, cut stamp duty and other measures will help support a recovering UK economy. At a corporate level, the uncertainty over the outlook will weigh on investment following a sharp increase in debt and could lead to a period of deleveraging for companies.

We acknowledge that the commitment from Government and central banks should not be underestimated. If more stimulus is needed, it will come, and whilst we remain nervous of short-term setbacks we do not wish to be underweight risk assets.

Geopolitics and Deglobalisation

The pandemic has added fuel to the geopolitical dynamics already unfolding. The world is becoming increasingly divided, with the US and China at opposite poles. Intense rivalry looks set to affect nearly every dimension of the relationship with decoupling on technology. A Biden win in November is now a realistic outcome, but a clear agenda for both candidates is being tough on China and tough on trade.

The pandemic and politics are poised to reverse globalisation as they magnify nationalist and protectionist trends. The crisis adds to existing pressures such as global trade tensions and popularism. Supply chains have been disrupted and may lead to the onshoring of the production of particular goods. However, whilst China is highly integrated in global trade, it does seem likely that China will come under scrutiny for their regulatory standards and their behaviour in Hong Kong. In the West, Government intervention in economies is likely to become more entrenched with policy support also having strings attached. Curbs on share buy-backs and dividend pay-outs may continue to influence corporate decision making for some time. Another topic that investors need to monitor closely is the proposed use of anti-trust legislation in the US to clamp down on 'big tech'. Therefore, the dominance of the large companies that drive the US stock market could be questioned in coming months.

The second half of the year may therefore put us in an unusual position in which the political risk premium may be higher in the US than it is in Europe or Asia. The European Recovery Fund is a significant step forward for the block en masse. Not only will it provide invaluable short-term help for countries such as Italy, but it provides a strong signal for the long-term with regards to the fiscal integration that is much needed to complement the monetary union.

Portfolio Strategy

The table below indicates our broad asset class allocation across the Strategic Portfolios. Portfolios maintain their broadly neutral equity position, whilst maintaining bond exposure and safety in elevated cash positions. Alternatives remain robust, whilst property in the UK continues to be off limits.

Strategy Portfolio												
Asset Class	1	2	3	4	5	6	7	8	9	10	Fixed Interest	SPS Income
Cash	65%	36%	19%	10%	6%	4%					12%	6%
Fixed Interest	28%	38%	35%	33%	28%	23%	18%	10%	4%		76%	28%
UK Equity		6%	9%	12%	15%	17%	19%	19%	19%	17%		18%
Global Equity		8%	23%	32%	40%	47%	54%	63%	71%	80%		32%
Absolute Total Return	7%	12%	14%	13%	11%	9%	9%	5%	3%		12%	16%
Property	0%	0%	0%	0%	0%	0%	0%	3%	3%	3%		

Market Implications

We are neutral on equities with cyclical indicators still pointing to a recessionary environment, but activity is bouncing back as lockdowns are easing. European authorities especially have surprised on the upside in terms of policy response. In general, stimulus and liquidity has swamped markets, thereby re-inflating asset prices. Within equities we are neutral on the US as levels have rebounded close to all-time highs. We expect other regions to catch up as the global economy reopens. Europe is now back in favour as the ECB continues to support liquidity and the prospect of fiscal coordination is alleviating political risk.

We are hesitantly neutral in the UK on economic weakness resulting from lockdown measures, whilst being compounded by renewed concerns over a no-deal Brexit. However, valuations are cheap and monetary policy continues to be supportive. We maintain our Japanese exposure and generally believe that Asia is emerging from the crisis in a relatively strong position. In other emerging markets, particularly South America, countries are in a weaker financial position and have poor public health systems, leaving them further exposed to the pandemic.

The traditional approach to building financial resilience in portfolios has been to rely on Government bonds. Valuations remain very expensive as yields are at historic lows. Prior to the financial crisis of 2008 a 10-year UK gilt yielded some 4% to 5%, which has now reduced to 0.2%. Quite separately, to further illustrate the collapse in long-term yield expectations, Austria recently managed to issue a 100 year Government bond with a coupon of just 0.85% per annum, with significant demand from investors!

The effectiveness of Government bonds as a hedge in portfolios have deteriorated. Also, the inverse correlation between bonds and equity decreases as yields reach their lower boundaries. Our strategic bond positioning moves to reflect a preference for investment grade corporate debt where yields are higher, whilst we also retain a positive view on emerging market bonds for their more generous yields.

The Federal Reserve has unleashed the full might of its balance sheet, confirming to the market that it will make unlimited purchases of Government bonds if necessary whilst also undertaking a programme of buying corporate bonds. This includes recently downgraded high yield debt (junk status), providing a strong underpinning across fixed interest markets.

Inflation concerns

There is a popular view that the current deflationary trends of the last decade could give way to a period of rising inflation. A combination of aggressive monetary stimulus, the need to secure domestic production of vital products in a globalised world, coupled with infrastructure spending could trigger such inflation. However, we believe it could take quite a few years before we see inflation rise sufficiently to warrant an increase in interest rates. Indeed, central banks suggest they will let inflation ride above target given the current shortfall, thereby maintaining a long-term average.

We can realistically imagine inflation rates in excess of 3% but not for a while as unemployment is likely to remain high. The expectation is that borrowing rates will remain at close to zero to maintain the low cost of financing debt with markets also pricing in absolutely minimal inflation for some time ahead. There will be a time to buy inflation linked bonds and other assets, but not immediately.

Tactical Asset Allocation Summary

The following chart is a representation of our current tactical position relative to the longer-term strategic model. It represents our general position assuming a moderate risk portfolio.

	Strong Underweight	Underweight	Neutral	Overweight	Strong Overweight	
Government & Investment Grade Bonds			✓			Government bonds now expensive. Investment grade spreads naturally more attractive. Central Banks committed to further purchases.
High Yield & Emerging Markets Bonds		✓				Some attractive yields available in US space. Positive on emerging market corporate debt providing economies hold up.
Developed Market Equities			✓			Reducing US exposure given strong rebound. Fiscal coordination in Europe alleviating political risk. UK weak domestic outlook & a 'no deal' Brexit risk.
Asia & Emerging Market Equities			✓			Asian developed economies successfully navigating lockdowns. Latin America has problems to overcome.
UK Property	✓					Rental income on high street now defaulting. Industrial, warehousing and data-storage have positive outlooks.
Absolute Return Strategies				✓		Flexibility in strategies and positive on particular themes. Current position and hedging strategies add diversification.

Conclusion

The main question that many clients ask is: Why have we seen recent market strength when there is so much economic weakness around, and surely volatility is about to return?

In our view, there are two main explanations for the surge in asset prices; unprecedented levels of liquidity and optimism about the future. Trillions of Dollars, Euros and Pounds have been created to support risk assets. This aggressive money printing has probably achieved enough to fill the economic output and hopefully sufficient to spur new growth. However, it is likely to take longer than expected, but a powerful recovery has convinced many it is on its way. Markets better reflect liquidity than immediate economic conditions and whist sentiment remains positive, momentum may drive markets onwards and upwards.

The possibility of a second wave of infections adds caution to our outlook. The reintroduction of selective lockdowns and America's inability to conclusively conquer the virus in the first place, again lead us to believe that this will be a longer road to recovery than expected. We remind clients of their long-term objectives and that some short-term volatility is to be expected. The lack of immediate data, both economic and corporate continues to unnerve commentators and investors alike. We need to see corporate profits rebound in an impressive manner as these are already factored into asset prices for 2021.

From an asset allocation perspective, we continue to maintain a broadly neutral position to cover all bases. There is a shift in preference for investment grade credit i.e. corporate debt with less emphasis on Government or sovereign debt. The substantial liquidity provision by the Fed and other central banks supports these assets. Moreover, we have added exposure to Europe and still seek a bias towards quality equities. Once more, we can say that these are unprecedented times and that normal business cycle dynamics do not apply. As ever, we wait to see how successful economies are at restarting activity whilst controlling the virus spread. Stimulus packages at the moment are still sufficient to be supportive but as ever much depends on a possible second wave of infections and policy fatigue setting in.

It is not forgotten that in parts of the world many thousands of people are still suffering, with over 10 million confirmed Covid-19 cases and over half a million deaths worldwide. The thoughts of our team are with all of those impacted by this global pandemic.

Iain Halket, Director
Chairman of HFS Milbourne Investment Committee
July 2020

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 Fund Introduced												
T. Rowe Price Global Focused Growth Equity ***		+1%	+2%	+3%	+3%	+4%	+4%	+4%	+5%	+5%		
Removal of Fund												
M&G Optimal Income	-2%	-5%	-5%	-5%	-5%	-4%	-4%	-3%	-2%		-10%	-4%
Change in Percentage Holding for Existing Funds												
AXA Sterling Short Dated Bond Fund		+3%	+1%	+1%	+1%	+1%						
M&G Emerging Markets Bond	+1%	+1%	+1%	+2%	+2%	+2%	+2%	+2%	+2%*		+2%	+1%
ASI Global Inflation Linked Bond	+1%	+2%	+2%	+1%	+1%	+1%	+1%				+2%	+1%
Twenty Four Dynamic Bond		+1%	+1%	+1%	+1%		-1%	+1%				
Allianz Strategic Bond		-2%					+2%*				+3%	+1%
Invesco Perpetual Monthly Income Plus											+3%	+1%
Legal & General UK 100 Index Trust		-1%	-1%	-1%	-1%	-2%	-1%	-1%	-1%	-1%		
JP Morgan US Equity Income		-1%**	-2%**	-2%**	-3%**	-3%**	-4%**	-4%**	-4%**	-4%**		-1%
Jupiter European		+1%*	+2%*	+2%	+2%	+2%	+2%	+2%	+2%	+2%		
Blackrock Continental European Income												+1%
L&G Global Emerging Markets Index			-1%	-1%	-1%	-1%	-1%	-1%	-1%	-1%		
JP Morgan Japan				-1%								
Artemis Income				+1%								
Natixis Loomis Sayles US Equity Leaders				-1%								
JP Morgan Global Macro Opportunities									-1%			
Fundsmith Equity										-1%		

Please note the above is based on the Old Mutual Wealth platform model (excluding Bespoke Pre 2012 Bonds)
** New fund introduced to these portfolios*
*** Fund removed from these portfolios*
****For Old Mutual Pre 2012 Bond clients we are introducing the Rathbone Global Opportunities fund instead of the T.Rowe Price Global Focused Growth Equity as these bonds have a restricted fund range and the T.Rowe Price fund is not available.*