HFS Milbourne
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Advice | Strategy | Security

STRATEGIC PORTFOLIO SERVICE
QUARTERLY INVESTMENT OUTLOOK

Winter 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

As we head into the last quarter of this unprecedented year, marked by extreme volatility in March and followed by a revival of sentiment backed by significant policy support, recent signs indicate a slower pace of economic recovery from here. There has been a strong rebound as macro data continues to improve with the monetary support of central banks and fiscal stimulus of Governments which continue to fuel a powerful pick-up in growth.

Nevertheless, we see event risks in the fourth quarter, the US election looks one-sided at present, though past experience tells us that this can change quickly. The shape of any Brexit deal is likely to provide some nervous twists and turns in the coming days as negotiations head towards the final end game. Covid cases are also on the rise in Europe with the stop/start variations in lockdowns being unhelpful to the economic pick-up. Where there is uncertainty, there is also potential for an upside particularly relating to further stimulus and hopes of a genuine vaccine early in 2021.

While our constructive central case leads us to lean towards a risk on tilt in our portfolios, we maintain our diversification on the assumption that volatility will be ever present. We spread our risk between equities and fixed interest credit whilst extending our underweight to nominal Government bonds.

Since our last update, the Federal Reserve's Flexible Average Inflation Targeting framework (FAIT) has been introduced. Despite the near term deflationary impulse, we see a risk that inflation becomes a concern for investors which will test central banks credibility and ability to maintain control. The Bank of England is likely to find itself in a similar position.

A summary of portfolio news is below:

- At the time of writing mid-Oct, portfolios have performed extremely well against the current economic backdrop.
- The one-year performance of portfolio 1 is 1.93%, portfolio 5 is 6.45% whilst portfolio 10 has achieved 11.75%. There are similar year-to-date figures for these three portfolios being respectively 2.01%, 3.95% and 7.84%.
- The FTSE 100 in 2020 has recorded some -19%, whilst the world MSCI index is up 6%. Virtually all our active managed funds have beaten their respective indices. We therefore focus our attention on active managers who can avoid the more obvious casualties of the pandemic and select the beneficiaries for recovering assets.
- Across most portfolios, 2% is added to the Aberdeen Standard Global Inflation Linked Bond, putting to work some of the cash held aside.
- Equity allocations remain unaltered, although the focus to active funds sees a switch of at least half of the assets in the passive L&G Emerging Market Index Fund to that of the JPMorgan Emerging Market fund.
- We highlight in the table below the more noteworthy Funds Managers who have outperformed their indices year-to-date. None of the equity Fund Managers underperformed their respective indices.

SPS Funds 1-10	Performance YTD %
Index : MSCI Europe	-6.15
Jupiter European	7.96
US Index : S&P 500	8.18
Natixis Loomis Sayles U.S. Equity Leaders	23.46
Index : MSCI Japan	2.13
JPM Japan	27.04
Sector : Targeted Absolute Return	-0.89
JPM Global Macro Opportunities	6.38
Index : MSCI Emerging Markets	1.54
JPM Emerging Markets	11.07
Index : MSCI World	4.65
AXA Framlington Global Thematics	21.34
Fundsmith Equity	13.57
T. Rowe Price Global Focused Growth Equity	29.41
Index : MSCI AC Asia	5.86
Schroder Asian Alpha Plus	14.56
UK Index : FTSE 100	-20.21
Artemis Income	-18.42
LF Lindsell Train UK Equity	-5.67
Merian UK Mid Cap	-7.21

Source: FE Analytics 1/1/20 to 30/9/20
The dark blue headings show different Indices with our respective active fund managers shown below each Index, illustrating the outperformance.

Economic Outlook

The balance between improving macro momentum and near-term tail risk underpin the short and medium-term scenarios ahead. In our view, the economic recovery is gaining pace and we expect a robust expansion in 2021, but more immediate tail risks are creating uncertainty. Our cautious optimism on the underlying economic trajectory may seem at odds with the recent news flow, but away from this we do see the environment overall improving. Business and manufacturing is picking up, with Asia being particularly strong. Further, the level of monetary and fiscal stimulus is staggeringly large and dwarfs the previous programs in place after the 2008 financial crisis. The apparent growing levels of risk in the fourth quarter might suggest it is time to reduce portfolio risk levels. However, we remain prudently diversified as there are positive signs of a vaccine becoming available in the first half of 2021, further monetary accommodation and renewed fiscal support particularly in America is still under negotiation. We also note that corporate earnings are starting to rebound with some pick-up in capital expenditure and a rebuilding of inventories all proving positive.

Inflation – Missing in Action

After more than a decade of monetary policy stimulus and ever expanding central balance sheets, we review our views on inflation. On the monetary policy front, the big news over the quarter was the Federal Reserve's shift to Average Inflation Targeting, allowing inflation to run above target for a while to compensate for periods of below target inflation. The key implication is that rates, currently on the floor, are likely to remain lower for even longer, at least three years, possibly five years and some suggesting ten years. This has come about for a number of reasons.

Production costs are set to rise globally as companies protect their supply chain and move production closer to home. Less "off-shoring" could mean that domestic workers have more bargaining power to increase wages, whilst the political pendulum is also swinging towards addressing inequality. Larger companies which have more pricing power will push through costs on to customers. Goods from abroad, notably China are likely to become more expensive as the political environment becomes more difficult.

The Federal Reserve has adopted a new policy framework where it will deliberately push inflation above its 2% target to make up for past shortfalls. Monetary stimulus pumps money into the financial system and normally ends up with banks and wealthy investors which in turn supports asset prices. The potential difference this time around is the combination of the liquidity tidal wave being combined with both increasing Government fiscal support and the dawn of fresh bank credit guarantees. Governments are now being pressured to spend more, not less, with the days of austerity well and truly over. Governments around the world obviously have no money to fund their spending commitments, so they are forced to rely on quantitative easing programs and financial alchemy of central banks.

As commercial banks are encouraged to lend, they are now backed by Government guarantees and therefore the transmission mechanism to the real economy is being actively encouraged. The central banks are also acutely aware of the need to maintain low interest rates given the size and servicing requirements of Government borrowing. Such inflation dynamics will not come into play immediately, but it will be too late for investors to react when they do. We doubt nominal Government bonds will provide the portfolio balance that they have done historically and therefore we prefer inflation linked bonds and emerging market bonds for diversification and sources of resilience. We know that the Federal Reserve and other central banks will ignore any short-term rises in prices, not least because they need inflation to deflate the excessive debt piles that have amassed over the past 12 years. Full employment is also a consideration.

Presidential Uncertainty

There are salient policy differences between the presidential candidates for the US November election, which could have important implications for investors. The balance of power within the Senate will also influence whether the next President can accomplish his agenda. Biden has proposed raising corporate taxes from the current 21% to 28%, still leaving the rate meaningfully lower than the pre-Trump era of 35%. Biden has earmarked such tax proposals as revenue raisers to fund research and development, education, health care and childcare. The effects would be manageable on corporate earnings and possibly off-set by Government fiscal stimulus. Biden would still need a Democratic majority in the Senate to pass his tax proposals which is looking likely as the key swing states no longer favour President Trump. If the Senate is tied, the Vice President will get the deciding vote.

The race for the White House and control of the Senate has gained even more importance than usual in light of the pandemic and the recent inability of the Democrat controlled House and Republican Senate to agree on fiscal stimulus to support those who have lost their jobs. We believe the US Congress will pass further fiscal stimulus post-election, which will be an important pillar for the economy and markets as we enter 2021.

Brexit and the UK

The probability of a Brexit deal being achieved is still positive, although the possibility of a no-deal remains. In addition, in the UK the fiscal stimulus is also fading. The newly announced Jobs Support Scheme is less generous than the furlough scheme. At the end of October there is likely to be a rise in unemployment and this may be the key headwind for the UK over the winter months. Covid has added millions to the official unemployment statistics, while many economists think that the real picture is worse than the data is showing. Employers are likely to take the hard decision that some of the positions they have held open on the back of Government support are no longer viable. Much depends on confidence and that business continues to operate undisturbed in a new regime starting in January. We still think the most likely scenario is a limited free trade agreement with considerable transition arrangements to ease the day 1 burden of change. However, the risk of a more adverse scenario remains ever present.

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 direct commercial 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	64%	34%	17%	8%	4%	2%					8%	4%
Fixed Interest	29%	40%	37%	35%	30%	25%	18%	10%	4%		80%	30%
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

The US market stands out the most, being expensive, but this in itself is not new. The FAANG stocks (Facebook, Amazon, Apple, Netflix, Google) plus Microsoft have all been beneficiaries of many trends which have accelerated this year. The use of technology, cloud computing, working from home, online shopping and so on has accelerated their growth.

We do not see any bursting of a technology bubble or other equity blow ups. However, we are seeing crowding in some of the most highly performing growth stocks that have driven the stock market rally in recent months. It is likely that technological innovation continues as 5G begins to be unrolled. Naturally earnings amongst most companies is expected to be down, whilst FAANG stocks have reported an average growth of 20% in earnings. Although growth stock valuations appear stretched, fundamentals remain strong and many expect the current low growth and low rate environment to continue, which has historically favoured growth stocks. While value stocks have been written off by the market, progress on a Covid vaccine could have them poised for a much overdue rally. However, it is unlikely to be the start of a broad value cycle but a selective rally in quality value names.

We remain confident of our exposure and marginal overweight in technology and health stocks, but we are tilted in this direction rather than over committed. Our active stock picking fund managers have driven the outperformance of portfolios across all sectors, emphasizing that this strategy and a diversified approach has been a successful strategy in these difficult times. We feel comfortable with our medium-term outlook for the global economy, market strategy and especially for the path of the funds that we own. We want to own quality stocks with strong balance sheets, whilst continuing to believe in the powerful changes that are evolving in this post-Covid world.

Finally, a saving grace for stocks is that pretty much everything else looks expensive too. Cash rates and bond yields are depressingly low from an investment perspective. The lack of attractive alternatives helps underpin stock prices despite the strain on valuation. It is hard to see this changing any time soon.

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 provide little cushion against market risks. Medium-term inflation risk could decimate returns, therefore we increase protection in this area.
High Yield & Emerging Markets Bonds			✓			Default rates overly pessimistic. Upside potential as economy recovers with attractive valuations.
Developed Market Equities			✓			Neutral on US equities, but more positive on Europe and Japan. UK domestic weakness and Brexit concerns remain.
Asia & Emerging Market Equities			✓			Asia leads global growth. Covid under better control. Valuations attractive with increased business resumption.
UK Property	✓					Retail and High Street continues to struggle for survival. Office occupation is being questioned. Property funds becoming unviable due to regulation.
Absolute Return Strategies				✓		Selective themes and hedging strategies invaluable.

Conclusion

It is difficult to know how long the impact of Social Distancing and restrictions on leisure and business activity will last. The sooner the virus is contained the quicker the recovery in economic activity, although the winter months will be more difficult than usual as we all face further variable restrictions. Governments and central banks are acting decisively to shore up finances although communication is often misleading.

Global policy makers are to thank for the market's resilience against this economic backdrop and their commitment should not be underestimated. We believe that more stimulus will come if needed and this makes us reticent to be underweight in risk assets. Valuations and uncertainty around the economic and earnings outlook see us maintain our neutral stance in portfolios.

Core Government bonds have performed strongly but are now seen as risk assets offering a poor return. We retain little exposure as we have seen our strategic bond managers move to investment grade credit and to higher yielding assets. However, central banks may shift their guidance and move interest rates into negative territory.

The final quarter of the year could be particularly eventful. By January we should know the outcome of the US election. Whilst Biden looks to have a clear lead in the polls at present, our main concern relates to a close vote and that Trump may not go quietly. He is likely to contest the outcome of the election (if close) and its validity, promoting alleged engineering of "mail-in votes". The constitutional crisis that could escalate is possibly the largest risk for the world economy. Next to this, we will know whether a no-deal Brexit was avoided and whether US Congress has passed more fiscal stimulus. The ongoing news and success of a vaccine becoming available in the first half of 2021 will also spur markets forwards. For now, we continue to believe the focus should be on diversification, both regionally and by asset class with absolute return strategies also playing an important role given the lack of UK property available to spread risk further.

Iain Halket, Director
Chairman of HFS Milbourne Investment Committee
October 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
Change in Percentage Holding for Existing Funds												
AXA Sterling Short Dated Bond Fund							-1%					
M&G Emerging Markets Bond								-1%				
ASI Global Inflation Linked Bond	+1%	+2%	+2%	+2%	+2%	+2%	+2%	+2%*			+4%	+2%
Twenty Four Dynamic Bond							-1%	-1%				
JP Morgan Emerging Markets			+1%*	+2%*	+3%*	+4%*	+3%	+2%	+2%	+2%		
L&G Global Emerging Markets Index			-1%	-2%	-3%	-4%	-3%	-2%	-2%	-2%		
Blackrock Cash	-1%	-1%	-1%	-1%	-1%						-2%	-1%
Royal London Short term Money Market		-1%	-1%	-1%	-1%	-2%**					-2%	-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 Wealth Strategic Portfolio Income portfolios this quarter we are switching the existing JP Morgan Japan fund from the accumulation unit to the income unit as this is now available.