HFS Milbourne
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Advice | Strategy | Security

STRATEGIC PORTFOLIO SERVICE
QUARTERLY INVESTMENT OUTLOOK

Autumn 2021

Introduction

Our Strategic Portfolio Service has been established for twelve 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 £355 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 powerful economic restart is real and is broadening out – we remain pro-risk. A restart is not a traditional business cycle recovery, as you can only turn the lights back on once, so to speak! The post-global financial crisis playbook, particularly that of austerity, is quite different with both monetary and fiscal collaboration likely to lead to a high inflationary regime.

There is a more relaxed attitude towards debt and deficits, resulting in new policy paradigms where many central banks are now attempting to overshoot inflation targets to make up for past misses. Markets have not yet fully bought into this new narrative and are pricing early adjustments to policy. This mismatch and resulting uncertainty could stoke volatility, but we still expect equity markets to continue the upward path.

Inflation is likely to persist, making the role of fixed interest in a portfolio a challenged one. We see any bond yield rises driven by inflation rather than policy hikes, with a continuing negative real yield on nominal government bonds, which again supports equities. The structural case for Asia remains intact, despite reducing enthusiasm for the region at the moment due to worries over policy tightening, vaccine progress and regulation in China. In addition to this, the increased will to tackle climate change, aided by the 2021 United Nations Climate Change Conference in November, is likely to produce a raft of policy, regulation and investment announcements, again being a positive spur.

General data suggests that economic activity is surging, aggregate household balance sheets are in good health and economic output in developed markets is expected to surpass pre-pandemic levels very soon. Policy will stay accommodative as there are still unanswered questions relating to unemployment whilst furlough schemes are not yet fully unwound. Getting people back to work and reinforcing the recovery remains policy makers principle goals today.

A summary of portfolio changes is shown below:

- After a flat first quarter, the second quarter has seen distinct portfolio increases. For example, SPS 4 achieved 3% growth, SPS 6 at 4% whilst SPS 8 stands at 5%.
- Core fixed income is unattractive and therefore we wish to avoid long duration bonds. As a result, the ASI Global Inflation-Linked Bond has been replaced by L&G Global Inflation-Linked Bond Index, as it has a lower duration.
- Allocation of fixed interest is cut by 3% across most portfolios, whilst the M&G Emerging Market Bond fund is also replaced by the M&G UK Inflation-Linked Corporate Bond Fund.
- In addition, the Vontobel TwentyFour Absolute Return Credit fund seeking to achieve positive absolute returns with a preference for short dated investment grade bonds replaces the Allianz Strategic Bond Fund.
- Our definite preference for active equity investment strategies, sees the passive L&G UK 100 Index Trust replaced by Liontrust Special Situations fund in the main portfolios which has a quality growth investment style seeking companies with competitive strengths.

- However, in the Income Fund, Threadneedle UK Equity Income takes the place of L&G UK 100 Index Trust.
- In global equities, the Vanguard FTSE Developed World Ex-UK Tracker is replaced by TB Evenlode Global Income; a fund which concentrates on quality growth whilst minimising the mega cap US tech bias often seen in global funds such as the Vanguard tracker. This switch slightly reduces our US exposure in favour of attractive European growth opportunities.
- We add the Jupiter Gold and Silver Fund at a 3% allocation across low and medium-risk portfolios for further diversification which accommodates the move away from fixed interest assets.
- Fees on the active equity funds are naturally more expensive than the index tracker funds they replace, please see the appendix three for further details. However, we believe these changes will be beneficial in pursuing our objectives for the portfolio strategies and improve overall returns.
- The Vontobel Fund alongside the Jupiter Gold and Silver Fund are European-based collectives and fall under their legislation requirements. Once more, please see the appendix two for further details accordingly.

Economic Outlook

Like a football manager giving a pep talk, it is perhaps an opportune time to take a half time assessment of markets and pan out to the remainder of 2021. Although there is the risk of complacency, investors likely head into the rest of the year in a relatively buoyant mood. After all, the MSCI All Country World global equity index gained 11% (total return sterling) so far this year, supported by accommodative policy and rising growth expectations[1].

Though the global growth spurt caused by the receding pandemic may peak sometime in 2021, the fundamental backdrop remains positive for equities, despite some concerns over valuations. Private consumption, the driving force for the GDP expansion and company earnings, is underpinned by healthy finances. For instance, after falling $6.5trn in the first quarter of 2020 during the start of the pandemic, US aggregate household net worth has since recovered a cumulative $25.5trn up to the first quarter of 2021 on the back of rising asset prices: in May, existing house prices rose a staggering 24% from a year ago, the fastest rate from over 50 years of data[2]. Putting together financial resources available to consumers from housing wealth, take-home pay and consumer credit, this measure of US real consumer purchasing power rose at a record annual rate of 12.0% in the first quarter of 2021[3].

Not surprisingly, government bonds have performed poorly during the strengthening global expansion and rising inflation concerns. Arguably, the bond market has yet to discount a much higher inflationary environment. The 5% annual May headline US CPI inflation has left 10-year Treasury real yields at -3.5%, its lowest reading since 1980[4]. With nominal Treasury yields at 1.5%, the bond market seems to think that inflation is transitory and does not warrant higher yields to compensate for negative rates[5].

Nevertheless, should inflation take another leg up, it could lead to more market volatility, since there would be growing expectations for central banks to reign back on monetary stimulus. This is happening already in China, where state banks have been instructed to pull back on credit growth. Nevertheless, Beijing's leadership is unlikely to want to slam on the monetary brakes too tightly so soon after the pandemic.

Elsewhere, the Fed decided in June that it would continue to keep policy accommodative, but the FOMC talked about tapering asset purchases and brought forward the FOMC's expected interest rate increases into 2023 from 2024. Equally, the Bank of England left monetary policy unchanged last month and expressed no particular concern about inflation. For now, while higher inflation is a market risk, the macro outlook continues to support equities over bonds.

Opportunities in non-US stocks

Drilling beneath the performance data, a landmark was reached last month when non-US equities finally recovered to their pre-Global Financial Crisis peak at the end of October of 2007. To put that flat return into perspective, US equities rose more than 180% in that time, largely to reflect the ability of US companies (and particularly Big Tech) to deliver better earnings than non-US firms.

Going forward, non-US equities could outperform their US peers from here for three key reasons.

- First, the period of US Earnings per Share outperformance may be ending. Taking consensus estimates, non-US EPS is forecast to grow by 20% per annum on average during 2021-23, compared to 19% for the US[6].
- Second, superior historic US EPS growth is already discounted in market valuations. US stocks trade on elevated Price-to-Earnings multiple that is around 40% higher than non-US[7].

- And third, US companies are caught in the crosshairs to pay higher taxes on their global earnings, making their current valuations even more demanding. This follows an historic agreement by G7 leaders last month in a summit in Cornwall to seek a minimum 15% global tax on "stateless" multinational corporations (i.e. Facebook et al) in each country they operate. A sample of firms in the MSCI All Country World Index from Bloomberg showed that 66% of listed companies that pay less than 15% tax were from the US[8]. Moreover, oligopolistic US Big Tech earnings are also vulnerable from the increased chance of greater regulations in a post-pandemic world.

Arguably, there is more potential downside risk to future US economic growth. The Biden administration wants to raise taxes and has scaled back ambitious fiscal expenditure legislation to garner the support of centrist Democrats. In contrast, non-US stimulus has got further to go. For example, the EU's flagship €750bn (5.5% of GDP) Next Generation EU multi-year fiscal package was finally ratified by member countries in May[9]. The fund is front loaded with non-repayable grants (rather than loans) and can now be spent by national governments.

In short, the start of a new business cycle creates opportunities outside the US. And given the prospect of higher interest rates that could disproportionally affect the US at some point, this should work to the benefit of non-US stocks.

Portfolio Strategy

The table below indicates our broad asset class allocation across the Strategic Portfolios. We remain overweight generally in equity positions and are comfortable now that the UK equity content has returned to an active bias. Fixed interest exposure is reduced, whilst adding further to alternatives, namely gold and silver, to provide the necessary diversification required.

Strategy Portfolio											
Asset Class	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**SPS Income**
Cash	58%	30%	13%	4%							
Fixed Interest	30%	37%	34%	32%	27%	20%	12%	6%	2%		30%
UK Equity	2%	10%	13%	16%	19%	21%	23%	23%	23%	23%	22%
Global Equity		8%	23%	32%	40%	47%	53%	61%	69%	74%	30%
Absolute Total Return	10%	15%	17%	16%	14%	12%	12%	7%	3%		18%
Property								3%	3%	3%	

Asset allocation is subject to change.

Market Implications

Mid-cycle dynamics tends to support stocks moving higher and rates rising along the yield curve – something we expect to see. However, with elevated inflation in the near-term, pent-up demand and an excess of global liquidity, the implication is that there are likely to be upside benefits compared to the normal steady grind of mid-cycle returns. With capital expenditure from companies and strong consumer demand, we continue to overweight equities with a strong conviction for now. While the value style factor remains attractive relative to that of growth, we are inclined to focus more on the quality factor. We believe quality of earnings and a renewed focus on secular growth themes, renewable energy, infrastructure spending and carbon net zero goals will provide support for some time.

There are other interesting factors to consider too. Businesses cutting inventory during the pandemic, now need to be rebuilt. Companies are also likely to seek greater assurances over supply, as current production activity in some industries is cut back forcibly due to a shortage of key components. Furthermore, as earnings continue to boom, market analysts typically don't appreciate the full extent of knock-on effects. These factors coupled with the new 'Fed in town' theme, which will remain accommodative, encourages even further expansion. Equity valuations should improve, even though they may trade sideways for some periods, but overall earnings will grow, allowing valuations to adjust lower, thereby resetting expectation.

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		✓				Core fixed income distinctly unattractive. Avoid long duration. Tactically we prefer inflation-linked bonds, both US and UK.
High Yield & Emerging Markets Bonds		✓				Spreads in high yield now tight and generally offer little attraction. Interest rates in emerging countries may rise soon. US dollar outlook uncertain.
Developed Market Equities				✓		We like developed market equities and some tech themes as better positioned for the green transition. Broad restart improving outside US.
Asia & Emerging Market Equities				✓		China, despite a crackdown on tech giants, leads the way with inward investment and reforms. Covid exposure to some EM countries still uncontained.
UK Property	✓					Some areas looking more positive as the economy reopens, although still un-investible given retail and office space disruption.
Absolute Return Strategies				✓		Hedging tactics and alternative themes remain essential to diversify risk, now including a gold/silver position.

Conclusion

Overall, we think the outlook for near-term global growth remains strong. The bounce-back from pent-up consumer spending will continue, alongside government and business investment. Focussed on a 'Building Back Better' mantra, governments are lining up multi-year infrastructure projects. This marks a stark contrast to the last cycle, in which government austerity proved a consistent drag on activity and inflation. Indeed, if inflation is the greatest risk for investors to monitor, investment spending is the likely antithesis, since it could potentially herald the start of a new era of productivity growth and indeed help to alleviate such inflationary pressures. Unions do not have the clout they had many years ago alongside the continuing growth of the gig-economy and technology improvements reducing price pressures, should keep inflation from getting out of hand.

Overall, the macro backdrop for the second half of the year remains strong. Growth into 2022 may slow from its current high levels but is likely to remain above-trend. This in turn broadens out and becomes more evenly distributed across geographies, both developed and emerging ones. Inflation concerns are likely to linger but ultimately, we think it would take a lot of bad news for central banks to meaningfully alter their current plans for a slow and measure removal of stimulus. There will always be further risk down the road to counter the bullish tendencies, but economic activity and corporate earnings are well-supported for now.

Iain Halket, Director
Chairman of HFS Milbourne Investment Committee
July 2021

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

Strategy Portfolio											
	1	2	3	4	5	6	7	8	9	10	Income
New Funds Introduced											
M&G UK Inflation Linked Corporate Bond	+3%	+3%	+3%	+4%	+4%	+3%	+2%	+2%			
L&G Global Inflation Linked Bond Index	+8%	+8%	+8%	+7%	+6%	+6%	+4%	+2%	+2%		+8%
Vontobel TwentyFour Absolute Return Credit	+8%	+8%	+6%	+5%	+4%	+3%	+2%				+6%
Jupiter Gold and Silver	+2%	+3%	+3%	+3%	+3%	+3%	+3%	+2%			+2%
TB Evenlode Global Income		+1%	+2%	+3%	+4%	+5%	+5%	+6%	+6%	+6%	+4%
Threadneedle UK Equity Income											+8%
Liontrust Special Situations	+1%	+5%	+5%	+5%	+6%	+6%	+7%	+7%	+7%	+5%	
Removal of Fund											
M&G Emerging Markets Bond	-3%	-4%	-4%	-5%	-5%	-4%	-4%	-3%	-1%		-5%
ASI Global Inflation Linked Bond	-8%	-8%	-8%	-7%	-6%	-6%	-4%	-2%			-6%
Allianz Strategic Bond	-10%	-10%	-8%	-7%	-6%	-5%	-3%				-6%
L&G UK 100 Index Trust	-1%	-5%	-5%	-5%	-6%	6%	-7%	-7%	-7%	-5%	-8%
Vanguard FTSE Developed World Ex-UK		-1%	-2%	-3%	-4%	-5%	-5%	-6%	-6%	-6%	
Change in Percentage Holding for Existing Funds											
Fidelity Global Dividend											-4%
MI Twenty Four Dynamic Bond								-1%	-1*%		+1%

** Fund removed from portfolio.*

Please note the above is based on the Quilter platform model (excluding Bespoke Pre 2012 Bonds)

For Quilter Pre 2012 Bond clients, we are introducing the Fidelity Strategic Bond fund instead of the Vontobel TwentyFour Absolute Return Credit fund, Fidelity Global Dividend fund instead of the Blackrock Global Equity fund (now TB Evenlode Global Income fund in main portfolios) and retaining the ASI Global Inflation Linked Bond Index instead of the L&G Global Inflation Linked Bond Index as these bonds have a restricted fund range and the recommended funds are not available.

For Quilter International Bond clients, we are introducing the Fidelity Strategic Bond fund instead of the Vontobel TwentyFour Absolute Return Credit Fund as these bonds have a restricted fund range and the recommended fund is not available.

Appendix One Sources of Information:
[1]-[7] Refinitiv Datastream, data as at 29 June 2021
[8] HSBC, Bloomberg, Five in Five: Corporate Taxes, data as at 10 June 2021
[9] UBS, European Commission, EU recovery fund: Where will all the money go? data as at 14 June 2021

Appendix Two
The Jupiter Gold and Silver fund and the Vontobel TwentyFour Absolute Return Credit fund selected for the portfolios are domiciled outside the United Kingdom and may not be covered in the UK by the Financial Services Compensation Scheme (FSCS). You may however be covered by the local investor compensation scheme in the relevant domiciled country. The Jupiter Gold and Silver fund and The Manager are authorized in Ireland and regulated by the Central Bank of Ireland. The Vontobel TwentyFour Absolute Return Credit fund and The Manager are authorized in Luxemburg and regulated by the Commission de Surveillance du Secteur Financier (CSSF).

Appendix Three
New Funds
Liontrust Special Situations: 0.82% Ongoing Charge to the Fund (OCF) plus transactional costs of 0.01%. An approximate initial bid/offer pricing spread of 0.90% is paid on purchase.
TB Evenlode Global Income: 0.85% Ongoing Charge to the Fund (OCF) plus transactional costs of 0.07%.
M&G UK Inflation Linked Corporate Bond: 0.42%* Ongoing Charge to the Fund (OCF) plus transactional costs of 0.19%**.
*(Aegon is*0.45%* and 0.19%**).*
L&G Global Inflation Linked Bond Index: 0.27%* Ongoing Charge to the Fund (OCF) plus transactional costs of 0.03%**.
(Fidelity Fund Network is 0.25% and 0.03%**).*
Vontobel TwentyFour Absolute Return Credit: 0.54% Ongoing Charge to the Fund (OCF) plus transactional costs of 0.06%.
Jupiter Gold and Silver: 1.06%* Ongoing Charge to the Fund (OCF) plus transactional costs of 0.07%**.
(Quilter is 0.97% and 0.07%**).*
Threadneedle UK Equity Income: 0.75%* Ongoing Charge to the Fund (OCF) plus transactional costs of 0.06%**.
(Fidelity Funds Network is 0.82% and 0.07%** and Aegon 0.82%* and 0.06%**).*

Existing Funds being replaced
Vanguard FTSE Developed World Ex-UK: 0.14%* Ongoing Charge to the Fund (OCF) plus transactional costs of 0.02%**.
(Fidelity Funds Network is 0.15% and 0.02%**).*
Allianz Strategic Bond: 0.63%* Ongoing Charge to the Fund (OCF) plus transactional costs of 0.32%**.
(Fidelity Funds Network is 0.65% and 0.32%**).*
L&G UK 100 Index Trust: 0.11%* Ongoing Charge to the Fund (OCF) minus transactional costs of 0.17%**.
*(Fidelity Funds Network is 0.11%*and 0.15%**).*
M&G Emerging Market Bond: 0.69%* Ongoing Charge to the Fund (OCF) plus transactional costs of 0.40%**.
(Fidelity Funds Network is 0.73% and 0.41%** and Aegon 0.70%* and 0.40%**).*
ASI Global Inflation Linked Bond: 0.55%* Ongoing Charge to the Fund (OCF) plus transactional costs of 0.13%**.
(Fidelity Funds Network is 0.35% and 0.14%**).*

All charges and costs above are across our main platforms of Quilter, Fidelity FundsNetwork and Aegon.

Important information
This document is solely for information purposes and is not intended to be and should not be construed as investment advice. Whilst considerable care has been taken to ensure the information contained within this commentary is accurate and up-to-date, no warranty is given as to the accuracy or completeness of any information and no liability is accepted for any errors or omissions in such information or any action taken on the basis of this information. The opinions expressed are made in good faith but are subject to change without notice. The value of investments and any yields quoted can go down as well as up and you can get back less than you originally invested. Past performance is not an indication of future performance. HFS Milbourne Financial Services Ltd. Authorized and Regulated by the Financial Conduct Authority. (registration number is 125051).