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Investment update

Ready and waiting

Winter 2017

Ready to respond to changing conditions

Monetary policy shift underway

Youthquake - it's coming to you

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Overview

As we close the books for 2017 and look ahead, it is pleasing to see a broad economic improvement in several areas, particularly those which are still in receipt of continued stimulus from low interest rates and central banks' asset buying programmes.

Much of this has allowed financial markets to retain their composure and deliver another year of positive returns for investors, but it has also extended stock valuations to new highs in some areas and compressed bond yields to ever-tighter levels. Correlations between asset classes have remained high and volatility has stayed very low, and in the absence of any meaningful setback a whole range of assets continue to be wrapped in increasingly puzzling levels of complacency, something that still causes us to be wary.

As many will know, we have progressively reduced the risk within both the equity and bond components of portfolios over the last 18 months or so. This action has been against a background of a wide variety of obstacles that we have felt could cause significant upset. The issues we had in mind when reducing risk included the imminent end of quantitative easing, higher interest rates, an overheating Chinese economy, elevated asset valuations and exploding debt levels, as well as potential for significant political and geopolitical uncertainty. Some of these risks have been well managed and some may simply have dissipated somewhat, but the threats are just as valid today as they have been throughout the period in which we have trodden a more cautious path. For now, protecting hard fought gains that have built up since the end of the last financial crisis still seems more important to us than squeezing the last drop of return from an extended bull run in most financial assets. Not to have seen any meaningful market adjustment seems to us something of an oversight, and reinforces our belief that a better entry point for increasing equity risk now that the fog is beginning to lift might not be too far away.

1 January 2018

Ready to respond to changing conditions

Talk of increasing equity risk is still in our view premature, but we are poised to act when the opportunity arises and believe that our prudence and patience will be rewarded.

In the meantime, one area where some adjustment may be necessary is within the alternative investments segment of client portfolios. This area embraces a range of funds that are generally not fully correlated to stock or bond markets, and has typically included funds with quite modest return objectives. In times of very low interest rates and inflation they can deliver acceptable real returns, but with inflation picking up and volatility remaining low, some of them are already starting to find it more difficult to meet their stated objectives. Introducing some modest additional risk within this portfolio segment, whilst not being exposed to the full vagaries of stock or bond market risk, seems an appropriate step as we look to at least maintain the real value of investments to which portfolios are allocated.

Monetary policy shift underway

Although central banks have managed the shift in monetary policy very well over the last year or so, the policy risks are still valid and may ultimately trigger disruption in both equity and bond markets.

And whilst more interest rate rises in the US in 2018 are probably baked into market expectations, sentiment could easily switch towards how soon it might be before the US economy begins to overheat, and whether the current restraint from the US Federal Reserve has been a little too cautious. For now, one can fully understand central banks' hesitancy, not wishing to undo all their hard work post the financial crisis. But there is a genuine risk that they may have underestimated the power of some of their policies and been too slow to tighten policy in the face of a strengthening economy. Either way, it remains to be seen whether increasingly higher multiples of corporate profits or severely compressed bond yields can withstand a higher interest rate environment.

The new Chair of the US Federal Reserve, Jerome Powell, a Republican chosen by Donald Trump, will face a potentially tougher task ahead of him than the outgoing Janet Yellen, who was broadly aided by a steadily recovering economy with relatively few data shocks for her to deal with. Powell's background, together with an additional reshuffle amongst the committee membership, suggests that the current dovish undercurrent might be replaced by something slightly more hawkish. Despite a rise in economic activity and a return to what many would consider a point of full employment, the main restraining influence on the current committee's thinking has been inflation remaining stubbornly low. But with signs that inflation is on the move, and a potential nudge upwards from anticipated tax cuts, continuing the smooth journey towards policy normalisation may become a little more challenging for the new team at the Fed's policy-setting committee.

Youthquake - it's coming to you

Youthquake, the new official term used to describe, in tandem with social and cultural trends, the political awakening among millennial voters, remains something to monitor closely as it potentially alters the political status quo and, in time, the economic roadmap too.

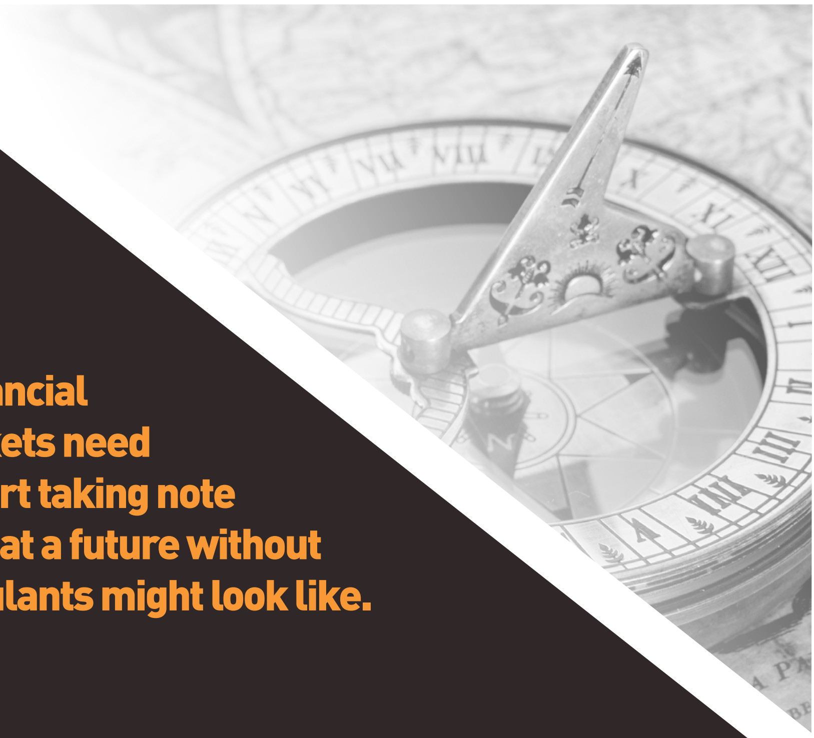
Political change can, of course, be just what economies need to galvanise them into action. Time will tell whether this turns out to be for the better or worse, but so far financial markets seem to be giving the US administration the benefit of the doubt.

From a political perspective, youthquake is largely a European affair so far; it is beginning to have greater influence on Europe's economic landscape, and in turn is likely to play a greater role in directing financial markets than it does today. The political cauldron is simmering on both sides of the Channel, but it is towards the UK, which arguably needs more political stability than anywhere else whilst it negotiates its exit from the European Union, where the attention for financial markets probably should be focused. In its current fragile state, it would not take much for a minor UK political upset or misdemeanour to become the catalyst that sparks a much bigger hiatus in UK politics and loss of confidence. Without any such political stability, fully valued stock and bond markets as well as the pound could come under some intense pressure.

Our positioning

Except for what we can now see were relatively moderate setbacks in 2011 and 2015, markets have barely drawn breath since 2009, having become increasingly addicted to the equivalence of performance-enhancing drugs dished out freely by global policymakers.

It is still unclear whether the market junkies will go cold turkey or wean themselves off in a more measured fashion, but either way financial markets need to start taking note of what a future without stimulants might look like. It is possible that in 2018 financial markets will continue to grind slowly upwards, blind to the real possibility that the improved economic conditions that we are currently witnessing are about as good as it gets. There is therefore a real danger that markets forget that this optimism has already been priced in. This could make the inevitable adjustment, when it comes, that more difficult for those investors who have failed to take appropriate action beforehand. Many market participants currently will be viewing market volatility as an enemy that has hopefully disappeared. One thing we remain confident of is that it has not. Rather than fearing it, we believe we are well positioned to take advantage of it.



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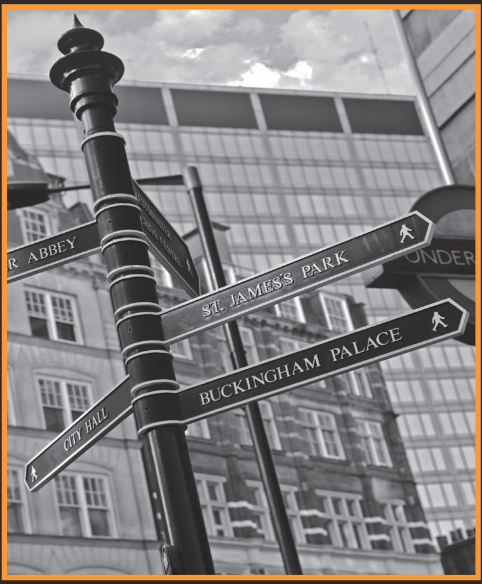

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