June Asset Allocation update

Our expectations for the second quarter have been broadly fulfilled as we were expecting a period of consolidation after a strong first quarter. However, although we have seen tremendous volatility in bond markets, the implied volatility of equities has remained low - which is highly unusual.

We have been positioned conservatively in bonds, carrying an underweight position and within that maintaining relatively short duration. However, whilst we remain cautious about long-term bond market prospects, we feel that present yield levels after the selloff are tactically attractive given the prevailing level of uncertainty about Greece and given the deteriorating global geopolitical backdrop. It is therefore too early to write-off government bond markets and there is every possibility that their safe haven status will provide both protection and diversification in the months ahead. At a time when the ECB’s Mario Draghi is warning us to expect more volatility going forward, government bonds can be expected to perform better in the second half of the year.

The world economy continues to heal following the worst downturn since the 1930’s but it is proving to be a long and gradual process. We are now six years into the recovery but it seems likely that it may take a decade in total to work through the excesses of the debt-fuelled subprime boom and subsequent bust. At a time when investors are searching for value in asset classes, that are in absolute terms, no longer cheap against a backdrop of modest global growth and imminence of policy normalisation, it is appropriate to take stock of what has been achieved over the last few years. Although global growth is estimated to have accelerated to 3% in the second quarter, it was following a quarter which showed the worst growth rate (1.5%) since the Great Recession. Growth forecasts over the last few years have been consistently reviewed down and the latest OECD forecast is for 1.5% this year for developed markets, improving to 2.5% in the second half.

It is unlikely to be better than this especially as companies still seem unwilling to invest, preferring to return cash to investors either through dividends or share buy-backs. Whilst this has been beneficial to share prices, it has done little for the underlying economy. The area where no progress has been made is the level of debt in the global economy. Debt accumulation prior to the 2007 crisis was huge but the fact is that debt levels now are 20% higher in GDP terms than they were then. Somewhat worryingly much of this new debt now resides in emerging markets, which was not the case then; this area is a possible source of future volatility. We have not yet been able to grow our way out of the debt overhang and the present combination of modest growth and some austerity is making escape from the mire a tortuously slow process. The longer-term possibility remains that the final solution will, in addition to growth and austerity, include some inflation and in certain areas, some defaults.

For most of the quarter, markets have been obsessed with the timing of the first US interest rate rise. As we have been repeatedly told that rises are coming but they are going to be small and gradual, it is difficult to understand why commentators are fixated with which specific month it proves to be. Given that the Fed is uncertain about the effect of raising rates on market sentiment and the underlying economy, it was always unlikely that they would be early in raising rates. They have no desire to be accused of killing the economy if there is a downturn following the interest rate rise so they will delay a rise as long as possible which has been their historical tendency. At the most recent Federal Reserve Open Market meeting Janet Yellen, (the Fed Chairwoman), once again stated that “too much attention is placed on the timing of the first increase” and what should matter most is the “entire trajectory of rates”. Whilst the meeting indicated that the rate is likely to rise before the end of the year, the Fed lowered the expected funds rate at the end of 2016 to 1.625% (from 1.875%) and at the end of 2017 to 2.875% (from 3.125%). This was a result of them having downgraded their growth forecasts for 2015 to the 1.8% to 2.0% range from the previous 2.3% to 2.7% range estimated in March. Yet again growth continues to disappoint.

The growth outlook for the UK also remains muted and the front-loaded nature of the new Government’s austerity programme is estimated by the IMF “to weigh on growth for some time”; estimates for GDP growth in 2015 are now in the region of 2.5% to 3.0% with a lower figure anticipated for 2016. So with the UK dipping temporarily into deflation during the quarter, there seems to us no chance of an interest rate rise for the foreseeable future, especially as ongoing nervousness concerning the European referendum and the concomitant fear of Scottish Independence aspirations will likely reduce investment into the UK.

Inflation has been muted, helped by falling food and oil prices. The latter has now bottomed, although the present rally appears to be running out of steam. What we believe has changed over the quarter is that the fear of deflation has diminished and there is now a growing expectation of a gradual pickup in inflation in the second half of the year. After a prolonged period of weakness, UK
Our investment views as at June 2015

Asset class positioning

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<thead>
<tr>
<th>Asset Class</th>
<th>Positioning</th>
<th>Outlook</th>
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<tbody>
<tr>
<td>Alternatives</td>
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<tr>
<td>Bonds (Govt)</td>
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<tr>
<td>Bonds (Other)</td>
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<tr>
<td>Commodities</td>
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<td>++</td>
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<tr>
<td>Equities</td>
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<td>++</td>
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<tr>
<td>Property (direct)</td>
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<tr>
<td>Cash</td>
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Equity allocation

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<tr>
<td>Sector specific</td>
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<tr>
<td>UK</td>
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Currency allocation

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<th>Outlook</th>
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</tr>
<tr>
<td>Euro</td>
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<td>++</td>
</tr>
<tr>
<td>Sterling</td>
<td>-</td>
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wages posted a 2.7% rise, the strongest annual rise since August 2011. If this can be sustained there is a distinct possibility that the inflation rate will be much closer to the Bank of England’s 2% target by the end of next year.

We reduced our exposure to equities at the June Asset Allocation meeting, taking our position from overweight previously to modestly underweight now. Whilst we retain our positive medium-term expectations for equities, the risks in the short term appear to be to the downside. We felt that investors seemed complacent concerning the Greek situation and the subsequent reaction to the Greek Government’s decision to hold a referendum following its failure to reach an agreement with its creditors suggesting that our view was correct. There will be continuing nervousness about Greece for some time. At the time of writing there is even some confusion whether or not a referendum is allowed under the constitution. Assuming it goes ahead, it is difficult to be bullish on prospects for Greece, whatever the result. A No vote is a vote for Grexit and potential chaos whilst a Yes vote would probably result in the collapse of the present government and possibly new elections. Therefore this saga is going to be a source of concern for financial markets for a while yet and this coupled with some concerns about how markets will react to the eventual rise in US interest rates, means that there is the possibility of bouts of stock market weakness over the next few months. Equity market valuations are a little stretched, especially in the US where an improvement in corporate earnings is required to provide further momentum to the rally. Given the maturity of the rally in global equities, it is very necessary to keep an open mind as to its further duration and to be very vigilant to any signs that it is running out of steam. There will be a need to be nimble through the summer months and, having raised some cash by our equity reduction we are in a good position to take advantage of any market weakness. Whilst we have some short term uncertainties, it is still too early to call an end to the rally we have enjoyed since 2009.

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