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INVESTMENT NEWS

Active Asset & Factor Update

We recommend reading these notes in conjunction with our commentary on the Investment & Economic Outlook.

A Timely Reminder

The golden rule of asset allocation is to work out the efficient frontier for an agreed risk profile and then stick to it. Asset Allocation represents between 80% and 95% of the total return a portfolio will produce so messing with the standard approach can have a significant effect on returns.

We have for many years “added value” by suggesting a change of emphasis where we feel there is a long term argument for or against a sector. Whilst we have been successful in this approach, any meddling will inevitably carry the risk we get it wrong and our client’s portfolios will underperform.

Exchange Rates

With our equity weightings being heavily international, it is worth noting that many of the funds we use are denominated in different currencies. Most are not hedged, meaning that returns will be affected by changes in the exchange between the UK and whatever the foreign currency is (usually US Dollars).

UK Equities

The current high valuations for equities shows the UK at comparatively good value. Against this however we have the unique roulette of the BREXIT negotiations.

The BREXIT effect (as threatened by the pro-European forecasts) hasn’t been anywhere near as bad as predicted. Devaluation has helped enormously but did raise inflation and reduce real incomes. Since 2008 we have had 7 or 8 years of falling real income (2009 to 2015), yesterday inflation was 2.4% for the year. Productivity is very low in the UK but this isn’t a UK only problem, Germany had a very similar fall in productivity over the same period post 2008. The UK's trade with Europe was 55% in 1980 and is now 40%.

Looking ahead, we are cautious about all equities. Our UK proportions within the equity asset allocation are however being restored due to the comparative better value.

US Equities

Are now deemed expensive. Trump has done well for the American economy with almost full employment however the budget deficit debt to GDP is the highest ever due to tax cuts and increased spending. This leads to a danger of inflation and interest rate rises

European Equities (Excluding UK)

A recent economist's presentation was very critical of the Euro as being a failed concept kept going by political will. The imbalance within the Euro between northern and southern Europe look greater than ever. Interestingly, the European share of global GDP has fallen by 50% since the EU started in 1980.

Debt is still increasing in the Eurozone. There has been some recovery since 2008 however Italy in particular looks like a big problem. At the extreme, this could lead to them leaving the Euro and applying a 'haircut' to debt. The new government in Italy could well be the death knell to the EU as they have to do something about their debt crisis.

China

China's economy is moving from emerging to established rates of growth. From the heady annual growth rates of 10% plus we now see 6% pa, with some economists predicting growth rates of 3% or less ongoing. This would prevent China from surpassing the USA as the world's biggest economy. A slowdown is however not seen as a sign of imminent collapse in the highly managed Chinese economy.

Japan

Like the USA, Japan's stock markets look expensive.

Emerging Markets

Our faith in emerging markets has paid-off in the last two years. We have been taking profits at annual reviews, however for new clients we remain positive emerging markets with allocations between 5% and 10% dependent upon risk preferences.

Factor Considerations

With our concerns over the market in late 2017 through to the recent falls, we have been switching funds into value and minimum volatility stock. It has to be said, these have underperformed this far with momentum stock prevailing.

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Global Growth

In 2018, earnings growth is forecast to continue its positive trajectory with analysts expecting the global economy to continue growing at its fastest pace in seven years. Furthermore, 90% of markets are now growing above trend.

Sector Considerations

Many clients will now hold healthcare specific collectives as well as the new automation and robotics index fund. The reasoning here is that these are growth sectors in their own rights which should perform well in most markets.

Gold

Rising market uncertainty should further support gold prices higher and reflect positively on the share price of precious metals miners.

We have been hedging into a physical gold ETF rather than a precious metal funds which invest in the mining of same. This is (in our view) a lower risk hedge however it will not perform as well as a the geared producers, should markets rise significantly. To date, gold has been static which reflects the fact that markets have been buoyant.

Fixed Interest

If equities are expensive then bonds are hideously expensive. The current 10 year GILT yield in the UK is 1.4%. That wouldn't even beat inflation.

Commercial Property

We have been diversifying our commercial property recommendations, reducing the larger funds towards smaller funds, investing in different sectors of the market and allocating towards different lease types.

We continue to believe that long term commercial property is a valid income investment even if capital growth is limited. When we consider the alternative income providers of fixed interest and cash we believe our approach remains reasonable.

Summary

Pretty well every asset class looks expensive but bonds and equities are particularly high. Momentum and Euphoria could well continue to push returns for another 2 to 3 years but it is inevitable that there will be a selloff in asset prices.

Our view is to remain invested but to look to an increase in cash and other defensive measures.