Heartwood
Investment Management

15 January 2016

Investment Insight

Weekly Insight

If you can keep your head about you...

Sharp falls in US equities, which have reverberated globally, are leading some commentators to question whether we are at the end of the bull market. The S&P 500 is down 10% from last year's high, and half of the constituents are more than 20% lower. Europe and Japan have also weakened 8-9% since the start of the year. For sterling investors, losses have been compounded by a weaker currency; sterling has fallen around 2% against both the US dollar and the euro in the year-to-date.

Investor sentiment remains nervous and is highly sensitive to data disappointments. Furthermore, there are concerns that recent financial market volatility will have wider implications for global growth. Our central case of a modest expansion remains intact, but we acknowledge there are more challenges to this view. These challenges are focused on three areas: China, oil prices and the US economy.

China

We do not believe the authorities have lost control and we expect that the most probable outcome is for a soft landing, where the economy gradually transitions to a more sustainable level of growth. Moreover, the real economy impact of the Chinese stock market's decline should be relatively contained, given that no more than 5% of household wealth is invested in domestic stocks [Source: Gavekal).

Oil

We view the unwinding of commodity prices as being driven by financial markets rather than the underlying fundamentals; if anything, the recent escalation in geopolitical risk should have supported energy prices. Oversupply is weighing on the sector, but we expect the supply/demand balance to improve later this year, which should help to support oil prices.

US economy

While US economic momentum has softened, we expect to see improvements over the course of the year. Domestic demand is healthy, which is clearly important in a service-led economy. Given the continuing improvements in employment, housing and construction sector, as well as the culmination of years of fiscal consolidation, we expect these trends to continue to underpin US economic growth.

What are the investment implications?

Overall, our cautiously positive view of the macroeconomic environment remains unchanged and we are currently not making any meaningful strategic changes to portfolios. However, we remain on a journey of ensuring portfolios adequately reflect our areas of highest conviction. That said and given where we are in the cycle, we are avoiding complex, illiquid instruments and maintaining reasonable levels of liquidity via cash and short-dated UK conventional government bonds.

Our core view remains to overweight equities, which we believe offer a better risk/reward profile on a longer-term view, and where there is more upside risk should sentiment improve. Within equities, we remain overweight in developed markets versus emerging markets, with a preference for Europe and Japan.

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