Heartwood
Investment Management

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Investment Insight

Weekly Insight

An eventful quarter has closed, but what to expect next?

Though we had expected more volatility for financial markets over the course of 2016, like most investors we had not expected such steep equity and credit market falls in the first month of the year. Worries about China's slowdown and its impact on the global economy, further sharp declines in commodity prices and a significant widening of corporate credit spreads all contributed to negative sentiment. Risk appetite then bounced back from mid-February and since then emerging market (EM) equities and currencies have outperformed, US corporate spreads have compressed and oil prices have rebounded strongly.

Sterling's weakness has boosted returns from overseas assets

Global equity markets have now recovered a significant amount of their year-to-date losses. Sterling-based investors have been further helped by the broad-based weakness of the UK currency. In sterling terms, all major equity markets delivered positive returns in the first quarter, with the exception of Japan – but even in this market returns in sterling were 8% stronger. Within EM equities, Brazil was the standout performer, returning 15% in local currency and 32% in sterling terms.

Recession fears were always overdone; the picture of moderate global growth remains intact

We expect risk assets to remain supported in the near term, given the stabilisation in commodity prices, an improved tone to corporate credit and central bank policy support. Private consumption in developed economies remains firm, underpinned by relatively strong labour market conditions, low inflation and real disposable income gains. We have also been more reassured of late by signs that the downturn in global manufacturing is finding a trough, particularly in developed economies. We continue to believe that the broad picture of moderate global growth remains intact.

Central bank policy responses will be increasingly challenged

Nonetheless, we are cognisant of rising market risks as the year progresses. We cannot ignore the fact that central banks will be increasingly challenged in their policy responses, whether for those in Europe and Japan burrowing deeper into negative interest rate territory or others, such as the Federal Reserve, which should probably be normalising policy, given a firming trend in US core inflation, but which is wary of external risks. Risks of central bank policy missteps and the US inflation outlook are both factors that we expect to receive the market's attention later this year.

In consequence, we are maintaining our short duration position in developed sovereign bond markets, as yields remain at historically low levels. Furthermore, we do not consider that corporate credit spreads are yet wide enough for us to invest in the broader market, though there are select areas of value.

Brexit will test UK markets this summer

We also have, of course, the upcoming referendum on the UK's membership of the European Union, which is likely to provide a further test to markets this summer. If the UK votes to leave the EU, then we would expect a further period of weakness in the UK currency and asset markets, at least in the short term. If the UK votes to remain, we are likely to see an immediate relief rally, although longer-term performance will be determined by the fundamentals once more.

Maintaining a barbell approach: overweight equities and cash

Despite these possible headwinds, we still believe that in the current global economic environment of moderate growth, equities offer the best potential risk-adjusted returns over the medium term. Therefore, while for the time being we are remaining overweight in the asset class, we are holding reasonable levels of cash to counterbalance this position. We believe that this barbell approach is the most effective way of eking out real returns while being ready for attractive entry points in the future.

Michael Stanes
Investment Director

Risk Warnings:
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