Heartwood
Investment Management

August 2017

Market Update

Monthly Strategy Review

Summary

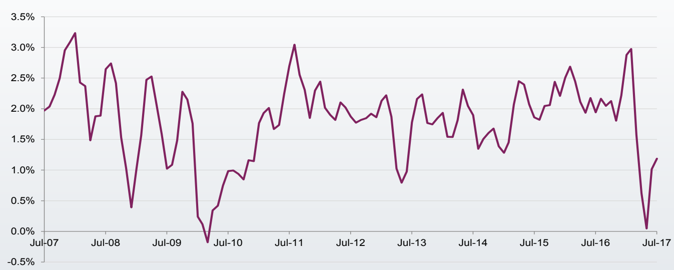
– Global growth remains stable, but is softening at the margin and we are seeing less synchronised economic performance from individual countries.

– Central banks have stepped back from their more hawkish rhetoric, but overall we believe that the direction of travel remains in favour of policy normalisation.

– While risk assets are supported by the current benign backdrop, there is a danger of complacency.

US core inflation has bounced on shorter-term measures

3m/3m annualised rate (seasonally adjusted)



Source: Bloomberg

China: GDP (YOY%)

We expect growth to slow in the second half of the year

Source: Bloomberg

Past performance is not a reliable indicator of future performance.

Economic review and outlook

Global growth remains stable, although moderating at the margin as the improvement in global manufacturing over the last year may have reached a cyclical peak. We are also seeing less synchronised economic performance, with developed economies outperforming emerging economies. Inflation data has underwhelmed, prompting a more dovish outlook among market participants. We believe there is an increasing risk that financial markets are not appropriately priced for an inflation rebound and, hence, tighter monetary policy. In particular, we note that shorter-term trends in the US suggest that inflation could be nearing a trough. Of course, central banks have also encouraged the market's more sanguine view of growth and inflation, having stepped back from their more hawkish rhetoric of mid-summer. Despite more mollient language from policymakers, we continue to believe that the direction of travel is towards policy normalisation.

US

On the growth front, there appears little to prevent the US Federal Reserve from continuing in its efforts to begin normalising policy. Economic activity in the US picked up in the second quarter - the first estimate is 2.6% quarter-on-quarter (annualised) - although the overall growth trend has perhaps been somewhat softer than many economists had expected at the start of the year. The strongest part of the US economy continues to be the labour market, with July's employment report delivering another solid reading. The US economy added 209,000 jobs and the unemployment rate fell to a 16-year low (to 4.3%), even though there was a slight rise in the labour force participation rate. In the year-to-date, monthly job gains now average 184,000, almost keeping pace with the gains seen in 2016.

However, it has to be acknowledged that inflation pressures remain tame and the lack of pipeline pressures coming through from wages and core inflation has puzzled Fed policymakers, based on their recent comments. Wage growth still remains modest by historical standards at 2.5% year-on-year and core inflation stayed at 1.7% year-on-year in July. Meanwhile, core personal consumption expenditures – the Fed's preferred inflation measure – rose slightly in June to 1.5% year-on-year. In addition to energy price declines, one-off factors, such as telecommunications prices, airfares and lodging away from home costs (i.e. hotels), have been attributed to the lower headline readings. With these influences most likely dissipating, the impact of a weaker US dollar and an eventual feed through of tight labour market conditions on wage pressures, we would expect to see inflation begin to lift higher in coming months, albeit still to moderate levels versus history. Furthermore, looking at the shorter term, core inflation has bounced on a three-month annualised basis, suggesting potentially higher year-on-year rates in a few months from now. Overall, we expect the Fed to follow through on its stated intention to reduce the balance sheet later this year, as well as increase the benchmark policy rate one more time before the end of the year, which would be in line with Fed policymakers' projections.

Europe

Eurozone growth continues at a healthy pace, with second quarter GDP growth seeing a higher revision from the initial estimate to 2.2% year-on-year. Survey data is still at elevated levels, although moderating slightly from recent highs. We also note that the eurozone composite PMI survey in July showed more individual country performance alongside a decline in the headline level, suggesting this data may have reached a cyclical peak. Furthermore, industrial production data in June disappointed expectations. Meanwhile, the labour market continues to make good progress, with the unemployment rate falling to 9.1% in June. Wage growth remains moderate but a tightening labour market should underpin domestic demand.

At its July meeting, the European Central Bank offered little guidance regarding the future policy path and any potential tapering of the current asset purchase programme. In addition, President Draghi appears to have stepped back slightly from his more 'hawkish' remarks in recent communications. Low inflation continues to concern European policymakers, despite a stronger growth picture. We are looking to the September meeting for further hints around tapering, particularly given the recent pick-up in July's core inflation reading to 1.2% year-on-year.

UK

UK data remains mixed, with the PMI manufacturing survey seeing a small rise versus softer activity in services. Second quarter GDP was 0.3% quarter-on-quarter (or 1.7% year-on-year), confirming the UK economy's underperformance relative to its developed market peers. The UK consumer continues to remain vulnerable to a squeeze in real incomes, with the British Retail Consortium's retail sales measure falling to 1.4% year-on-year in July versus 2.0% year-on-year in June. Food sales accounted for most of July's increase on account of higher prices, implying that the underlying consumption trend remains weak. All that said, labour market conditions continue to tighten – the unemployment rate in the three months to June fell to 4.4% - and inflation pressures are easing, which should provide some relief to UK consumers.

With the Bank of England reducing its growth forecast for this year and with only two members of the Monetary Policy Committee voting for an interest rate rise, the market's expectations of an imminent policy hike have been reduced. A more dovish assessment of near-term policy has also been prompted by lower than expected inflation in July, which remained unchanged from the previous month at 2.6% year-on-year. Nonetheless, UK policymakers continue to be cautious about the medium-term outlook, highlighting the risk of a faster pace of tightening than currently implied by gilt yields. We expect that any tightening will be implemented through macro-prudential measures – for example, imposing stricter standards on lending – rather than adjusting the Bank of England's base rate.

Asia

Chinese GDP growth for the second quarter surprised to the upside at 6.9% year-on-year, implying that this year's growth rate is on course to exceed the official target of 6.5% year-on-year. Therefore, it would not be surprising to see economic momentum slow in the second half of the year and July's activity data point to some moderation, most likely a result of previous tightening measures. Annual growth rates slowed for industrial production, retail sales and fixed asset investment data. July's trade report also came in below expectations for both exports and imports (in US dollar terms), with the latter affected by lower demand for commodities. Price trends remain stable: producer prices were unchanged in July at 5.5% year-on-year and consumer prices slightly decelerated to 1.4% year-on-year.

Second quarter growth in Japan came in strongly at 4.0% quarter-on-quarter (annualised) and 2.0% year-on-year. Much of the strength was attributed to private demand, which is encouraging despite persistently weak wage growth. It also noteworthy that while consumer prices remain very low, producer prices saw their fastest rise since November 2013 - July's reading was 2.6% year-on-year and 0.3% on the month - which was due to yen weakness and the legacy effects of higher energy prices. The Bank of Japan is likely to maintain its current policy of controlling the yield curve until inflation reaches the target.

VIX index: Implied volatility levels of the S&P 500

Volatility has started to rise from very low levels

Source: Bloomberg

Past performance is not a reliable indicator of future performance.

US dollar index

A weaker trend this year, but potentially oversold?

Source: Bloomberg

Market Outlook

Our view of a slight softening in global economic momentum in the second half of the year remains unchanged, alongside our expectation of moderately rising inflation trends over coming months. Central banks are likely to continue on (or begin) their journey of normalising monetary policy, which we believe is a scenario that financial markets are not yet fully pricing. Risk appetite remains reasonably buoyant and market volatility very low, albeit there has been a moderate increase more recently on geopolitical concerns. We are mindful that the current benign fundamental backdrop of moderate growth, low interest rates and low inflation is leading to a certain amount of complacency in markets. Our concern is that any deterioration in the growth/inflation story could prompt profit-taking and challenge this more sanguine view of the world. We continue to believe that monetary policy remains a key trigger for caution, notwithstanding that central banks have stepped back from their hawkish signals provided in recent weeks. In our view, the risk/reward dynamic of risk assets is not as favourable compared with the start of the year and we believe it is appropriate to stay with our risk reduction plan. This will be focused on UK property, given potential liquidity issues in the event of any sell-off. Overall, we are taking a measured approach in reducing risk and maintaining flexibility to re-calibrate portfolios in either direction should economic and market conditions change.

- **Equities:** Emerging market (EM) indices were particularly strong in July, boosted by the weak US dollar. US, UK and Asian indices have also put in respectable return. We are retaining our overweight in European equities for now, but we are more cautious about this market given very strong currency moves. Conversely, the weakness of the US dollar is a boost to the corporate sector, so we are happy to run our existing US equity weight (but still preferring a more targeted approach). We remain concerned about economic slowdown in the UK and broader policy backdrop (Bank of England, Brexit and domestic politics). We would not repatriate to the UK, nor would we increase domestic versus overseas UK equities right now. Elsewhere, we are comfortable with retaining our overweight positions in Japanese and EM equities.
- **Bonds:** A less hawkish backdrop drove global bond yields lower in July. Rate expectations remain dovish and look most vulnerable to a re- pricing in the US and Europe. Therefore, our caution towards maintaining a short duration position remains intact. Break-even rates (the difference between nominal fixed-rate bonds and the inflation-adjusted yield on an inflation-linked bond) are falling in the UK, but are recovering to some degree in the US and Europe, which is consistent with the fundamental backdrop. Credit spreads have been supported by the ‘goldilocks growth’ backdrop, and in some areas are back to or close to the tights in 2014.
- **Property:** We have marginally reduced our UK property allocation further, comprising part of our risk reduction plan, as well as to address issues around investment trust premiums and liquidity withdrawal, given the maturity of the current cycle. We also believe an underweight stance is appropriate in light of UK political uncertainties. While activity has slowed and there are questions about rent sustainability, our regional bias and reasonable discounts on certain instruments will provide some protection in the event that market yields move higher. At this stage, there is no appetite to add overseas exposure.
- **Commodities:** Markets were resilient in July, continuing the gains that began in mid- June. Negative news about oil inventories has faded, although demand remains sluggish. We believe there is limited room for oil prices to go much higher from here, especially given rising output in Libya and with the end of OPEC supply cuts coming in the first quarter of 2018. Industrial metals have performed well, although this appears to be supply-driven rather than due to rising demand. Meanwhile, precious metals have been helped by US dollar weakness and lower real yields - factors which we think are unlikely to persist. We retain our underweight allocation in commodities, although we are maintaining our exposure to gold for portfolio diversification.
- **Hedge funds:** While we have held a limited allocation to hedge funds in recent years on concerns around performance, we believe that increasing monetary policy divergence should create more opportunities in this sector going forward. Our preference remains for macro/CTA strategies, but we are also taking a more positive view on equity hedge strategies given the greater likelihood of increased stock dispersion (i.e. between winners and losers).
- **Cash:** We have reasonable levels of liquidity across our portfolios both in cash and short-dated bonds, which we will invest as and when we see specific opportunities. Market volatility remains low – a situation that we believe is unlikely to persist as we move into the second half of the year.

Asset class returns as at 31 July 2017 (in GBP)

Asset Class	Index	Historic Returns							
		1 Mth	3 Mths	6 Mths	1 Yr	2 Yrs	3 Yrs	4 Yrs	5 Yrs
Equity - UK	MSCI UK	1.1%	3.3%	6.3%	14.0%	19.0%	21.8%	28.3%	56.2%
Equity - US	MSCI North America	0.6%	2.3%	4.2%	16.7%	43.7%	69.7%	78.8%	129.0%
Equity - Japan	MSCI Japan	0.5%	4.3%	3.4%	15.4%	31.3%	54.2%	52.4%	98.7%
Equity - Europe ex UK	MSCI Europe ex UK	1.6%	5.7%	13.7%	24.2%	32.7%	46.2%	52.4%	108.1%
Equity - Pacific ex Japan	MSCI Pacific ex JP	2.8%	3.5%	6.9%	17.5%	39.5%	34.2%	44.0%	62.0%
Equity - Emerging Markets	MSCI EM	4.5%	8.3%	13.8%	26.2%	47.8%	39.0%	44.4%	52.7%
Bonds - Conventional Government	Merrill Lynch UK Gilts	0.3%	-1.3%	2.4%	-2.7%	11.5%	22.6%	25.9%	21.2%
Bonds - Inflation Linked Government	Merrill Lynch UK Gilts, Inflation-Linked	-1.3%	-5.9%	-1.9%	3.9%	18.4%	37.5%	43.5%	48.0%
Bonds - Corporate Credit	Merrill Lynch Sterling Corporate Master	0.8%	0.8%	4.4%	2.5%	15.4%	24.2%	31.6%	38.9%
Commercial Property	IPD All Property & FactSet UK Real Estate Invest Trust Index	1.8%	1.5%	9.4%	6.2%	-2.0%	13.1%	40.7%	56.5%
Commodities	GSCI Index	3.0%	-0.9%	-9.1%	6.0%	-3.1%	-39.9%	-46.2%	-44.1%
Hedge Funds - Equity Long/Short	CSFB/Tremont Hd Fd Long/Short Eq	-0.1%	1.3%	5.0%	6.4%	1.0%	10.2%	21.8%	40.3%
Hedge Funds - Global Macro	CSFB/Tremont Hd Fd Global Macro	-0.1%	-1.4%	-1.6%	2.7%	-2.0%	4.3%	8.4%	13.0%
Hedge Funds - Multi-Strategy	CSFB/Tremont Hd Fd Multi-Strategy	-0.1%	1.2%	3.9%	7.3%	8.9%	17.3%	28.4%	42.0%
Cash	1 Month LIBOR	0.0%	0.1%	0.1%	0.3%	0.8%	1.3%	1.8%	2.3%

Source: FactSet

Please note that the returns given for the hedge fund and property indices are estimates, because of the delayed release of the monthly index values. The value of any investment and the income from it is not guaranteed and can fall as well as rise, so that you may not get back the amount originally invested. Past performance is not a reliable indicator of future performance.

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