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IQ Q3

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A Note From The CEO

The third quarter was a positive one for risk assets as global equities continued their long march higher. The FTSE100 however remained a fly in the ointment as investors grappled with the Brexit issue. Volatility in Sterling during the period was material, which distorted domestic equity market valuations for investors. Driven by strong fundamental data, the US equity market has been the stand-out performer however more recent price action shows even this is susceptible to strong reversals in risk sentiment.

Emerging markets continue to wobble, primarily as a function of escalations in the trade war instigated by the US administration earlier this year. Investors, rightly, remain cautious of some areas of the developing world, where politics meddles with monetary policy (in the case of Turkey) and IMF bailouts recur (in the case of Argentina). Fixed income markets remain a challenge as global interest rates tighten.

The immediate path for financial markets is increasingly difficult to forecast. The lengthening of the business cycle, higher mortgage rates and increasing corporate leverage should be viewed in the context of higher disposable income and multi-decade low levels of unemployment accompanied by low inflation. The balancing act may continue for some time. Our job will be to prudently judge this balance with appropriate prudence for our clients.

I would like to take this opportunity to thank you for your support and we very much look forward to continuing to work with you to achieve your financial goals.

Please do speak with your Investment Manager or Wealth Management Consultant should you wish to discuss your financial affairs.

Hugh H Titcomb
Chief Executive Officer

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Weakening growth and rising policy uncertainty undermine market outlook

Economic and Financial Market Developnments

- In the US, the final official update of GDP growth for the second quarter of 2018 showed that the economy expanded at an annual rate of 4.2% during the period. This followed a real GDP growth rate of 2.2% in the first quarter. As the official release noted, the update meant that the general picture of economic growth remains unchanged despite some movements in the underlying components. A downward revision to private inventory investment was offset by small upward revisions to most other GDP components.

- The backdrop of strong economic growth has enabled the Federal Reserve (Fed) to continue its policy of gradual interest rate rises which began in 2015. In late September the Fed raised the target rate by 0.25% to a range of 2.00%-2.25%. Importantly, a majority of Fed members also indicated that they expect a further hike in rates later this year as well as three hikes in 2019.

- Turning to the UK, recent economic reports have been mixed. On a positive note, the official estimate of GDP growth for the second quarter was left unchanged at 0.4%–a notable improvement on the performance in the first quarter, which was revised back down to 0.1%. Another positive aspect to the data was the resilience in consumer spending which was a primary driver of growth in the second quarter. However, data showed another quarterly decline in business investment by -0.7% following a fall of -0.5% in the previous three months. The weakness in business investment largely reflects ongoing Brexit uncertainty.

- Official data also showed that the UK's current account deficit widened to 3.9% of GDP in the second quarter. This was worse than forecast and raised concerns about the sustainability of the UK's current-account position. The UK has the highest deficit among the G7 and essentially depends on the willingness of foreign investors to keep financing the deficit. A major concern among economists is that Brexit makes the UK less attractive and foreign investors less willing to fund the country's deficit. In this regard, data published in August showing that overseas investors reduced their holdings of UK government bonds (Gilts) by a record £17.2 billion, was concerning.

- Clearly, Brexit is not just a UK issue. As we have noted before, for the UK and the EU, the outcome of the ongoing Brexit negotiations will have a significant bearing on the outlook for economic growth and monetary policy over the next few years. Beyond Brexit, incoming reports on the Euro-zone continue to paint a picture of muted economic outlook and ongoing political tension. Reflecting this, the European Commission's sentiment index, which incorporates data on both households and companies, recently fell to its lowest level in more than a year as the combination of Brexit uncertainty, concerns about trade wars and fears about the ramifications of the Italian budget have undermined confidence.

- Global financial market performance was mixed in September. In the developed equity markets, the best performer was Japan's Nikkei 225 index which gained 6.1%, supported by a weak Yen. At the other end of the spectrum, European stock markets, which had enjoyed strong gains earlier in the month, suffered sharp falls in the latter part of the month following the announcement of Italy's budget in late September. In the end, the German DAX index lost -0.9% for the month. Losses were more severe in the Euro-zone periphery as stock markets in Spain, Portugal and Greece declined by -0.1%, -1.5% and -5.2% respectively. The UK's FTSE 100 index gained 1.1% for the month in sterling terms. Looking over the full third quarter, gains were led by Japanese and US equity markets where the Nikkei and the S&P 500 index delivered total returns of 8.8% and 7.7% respectively. On the same basis, the UK's FTSE 100 index fell -0.7% and Germany's DAX was down -0.5%.

- September brought some respite for emerging market (EM) assets with gains of 3.7% and 3.5% in the Shanghai Composite and Bovespa respectively. Over the second quarter, both indices lost -9.1% and -14.8% respectively. EM bonds also recovered some ground following heavy losses in Q2, with a gain of 1.5% in aggregate (-9.2% for Q2 and still -1.0% in Q3) in USD terms. Elsewhere, developed market bond markets were generally weak. In aggregate, UK Gilts and US Treasuries were down -1.6% and -1.0% respectively. Corporate bonds fared little better, with GBP investment grade corporates down circa -1.0% while their USD counterparts fell by -0.3%.

INVESTMENT STRATEGY OVERVIEW

Implications for Investment Strategy

- The ongoing run of positive data in the US has fuelled a sell-off in government bonds and yields have risen markedly over the past month. Similar moves (but of less magnitude) have occurred in other developed government bond markets. This trend seems likely to persist in the weeks ahead given investors' concerns about the effect that the sustained increase in oil prices will have on inflation as well as expectations for another interest rate hike in the US in December. Elsewhere in the fixed income markets, corporate bond spreads remain historically tight and therefore offer little value from the perspective of a long term investor. On balance, we believe that it is appropriate to adopt a cautious stance on fixed income investments.

- The divergence in global equity market performance has been striking. Over the year so far (to the end of September) much of the gains in global equity markets have occurred in the US where the S&P 500 index has delivered total returns in excess of 10%. The decline in the yen boosted Japanese equities in the last quarter and year-to-date gains for the Nikkei stood at 7.7% at the end of September. However, equity market performance elsewhere has been lack lustre. In the UK, the FTSE 100 index's year-to-date total return stood at 0.9% while the German DAX was down -5.2% at the end of September. It is worth noting that the performance of the US markets has been fuelled by the tax cuts at the turn of the year which provided a sharp boost to corporate profits. The current double-digit pace of earnings growth (expected to be circa 20% in Q3) is clearly unsustainable and this will create a headwind in the months ahead. For this reason, as well as the ongoing elevated levels of political and policy uncertainty in key regions of the world, we retain a cautious outlook on equities for now and await better opportunities to add to holdings.

- In the currency markets, despite the recovery enjoyed by EM currencies in September, the path of least resistance is for further downside in the months ahead as the US Dollar will continue to enjoy policy support. Elsewhere, sterling's fate will continue to be determined by the swinging balance of probabilities on the nature of the likely outcome of ongoing UK-EU negotiations. For investors, this high degree of political sensitivity means that the best cause of action is to remain currency neutral in asset allocation decisions.

Abi Oladimeji
Chief Investment Officer

ASSET ALLOCATION

TMI ASSET ALLOCATION SCORECARD (as at 4 October 2018)

	United States	United Kingdom	Euro-Zone ex UK	Asia ex Japan	Japan	Emerging Markets
Equities (overall)	0					
Equity allocation by Region	0	0	0	0	0	0
Bonds (overall)	–					
Agency/ Supra	0	0	0	0	0	0
Corporate bonds	0/–	0/–	0/–	0/–	0/–	0/–
High Yield bonds	–	–	–	–	–	–
Govt guaranteed bonds	0	0	0	0	0	0
Index-linked bonds	0	0	0	0	0	0
Alternatives	0					
Cash	+					

The scorecard above represents our current tactical asset allocation position relative to portfolio benchmark. 0 =neutral, + =overweight, - =underweight.

Rising yields typical of late cycle economic behaviour

Bonds had a poor third quarter, with yields rising in synchronised fashion in most parts of the world.

The move upwards was led by the US, in what might be characterised as a textbook example of 'late cycle' economic behaviour.

Economic activity continues to come in strongly, with strong showings from both 'forward looking' sentiment indicators and 'lagging' indicators like employment. There have as yet been no signs of a slowdown in the wake of the monetary tightening we have seen over the past two years.

There have also been some signs of incipient inflation. US CPI inflation has risen to 2.8% year on year, while core PCE inflation has crept up to 2%, which is in line with the Federal Reserve's 2% target level.

US unemployment is now – at 3.7% - the lowest since the late 1960s, with vacancies higher than available workers. Wage inflation has been solid at a little under 3%, the strongest rate since the recession a decade ago, while the price of WTI oil is up 50% over the past year to $75 a barrel.

"Yields in other parts of the world have also risen, and the early part of October has seen the 10 year Gilt yield touch 1.7%"

The pace of expansion in Q3 may be a tad less than the 4% we saw in the second quarter, but is still likely to be over 3% - well ahead of the 2-2.5% average of the past decade.

It came as no surprise, then, that the Fed raised the target rate by 0.25% to a new range of 2% to 2.25% in September.

As a result of the above, US Treasuries lost -1.47% in total return terms over the three months. Short dated bonds performed better, with losses of -0.21%. the US Treasury market as a whole is now yielding over 3%, the highest level since before the crisis.

In recent weeks we have seen a number of benchmark US yields moving up to – on the face of it – quite attractive levels. In early October the 10 year yield pushed above the 3% level following a couple of unsuccessful attempts earlier in the year, and at the time of writing stands at 3.2%. The 5 year yield also made it through the 3% level in the first days of October, while the 2 year is hovering just below 2.9%.

Yields in other parts of the world have also risen, and the early part of October has seen the 10 year Gilt yield touch 1.7% for the first time since February, while the 10 year Bund yield has crept back over 0.5% again.

The UK economy recovered quite well in the second and third quarters after a slow, weather-related first quarter. Much as expected, in August the Bank of England put in their second rate rise of the past 12 months, increasing the base rate to 0.75% - above the 0.5% level for the first time since 2009. The decision was unanimous, though given with provisos about Brexit related uncertainty, and assuming the latter can be managed reasonably well the likelihood is for further rises next year.

Also as expected, the European Central Bank confirmed that it would cut its Asset Purchase Programme back from €30bn per month to €15bn per month, starting on October 1st. The likelihood, all things continuing well, is that the APP is cut to zero in the New Year.

The worst performing G7 nation in the period was Italy, where yields have doubled since the Spring. The 10 year yield pushed above 3.5% in late September after the coalition government which came to power in May, a combination of the left wing Five Star movement and the anti-immigration Northern League, agreed to run a 2.4% fiscal deficit – within the 3% limit imposed by the EU, but above levels EU officials wish to see given already high government debt levels in Italy.

Corporate bonds had a better quarter than government bonds this time, and outperformed - for the first quarter this year. High yield has been resilient in the face of rising yields, testimony to resilient credit quality and short duration, but participated in the early October sell-off after the ISM Services index came in at a new expansion high of 61.6.

James Penn
Senior Portfolio Manager

A real division in US and non US Equity market performance

US reported earnings continue to benefit from tax cuts.

They started to show up in numbers in Q1 2018 and earnings grew in the first and second quarters of the year by about 25%. This against a fairly pedestrian economic backdrop (positive but hardly stellar).

Without the tax tailwind, earnings in the rest of the world were positive, but not close to the US, reflecting some margin progression and some top line growth. This is one of the key reasons behind what has been a real division in US and non US equity market performance so far this year. The US S&P500 was up nearly 11% at the end of the quarter while the next best region was Japan, up just less than 2%. Europe was similar to Japan while the UK showed an anaemic sub 1% return. Fears over currency strength and global trade tensions pushed emerging markets down 7.5% with China off 12.6%. The US also continues to benefit from the strength of its tech sector. I touched on this in our Q1 commentary and do not propose to revisit but the UK's very narrow tech sector demonstrated its concentration risk. The two main quoted protagonists Microfocus and Sage have both delivered effective profits warnings, so the UK tech sector is actually down almost 17% this year.

Looking out, US earnings will continue to benefit from the tax tailwind for the rest of the year but as this falls away earnings growth will fall back meaningfully. Our current economic view supports continued rises however this growth rate decline does remove one of the pillars of US market strength. Ceteris paribus, the rest of the world will show some earnings growth, but global trade may struggle if current positions taken by the Trump administration and responded to by other nations are not eased. It is hard to be hugely bullish at this present moment in time, but with earnings growth set to continue and central banks acting slowly, the conditions do not seem in place for a sustained pull back in equity markets.

The oil price has crept back up to the mid $80s and reflects a return to discipline from OPEC and Saudi Arabia as the attempt to crush US shale oil production failed in the face of extraordinary resilience and ingenuity from those producers. Domestic political pressure resulting from the severe fall in OPEC government revenues certainly also played a part.

Last quarter I talked a little about our policy on voting shares and you may be interested to know that we were part of the investor group that voted against Unilever's proposed re-domicile to the Netherlands. We believed that the proposal was of limited corporate benefit to Unilever and would cause rather more inconvenience and cost to sterling based shareholders. As you are probably aware, Unilever management have shelved their plans, though I am not sure we were the deciding factor!

I cannot add anything to Brexit commentary here. Negotiations appear chaotic and the parliamentary process for agreeing any deal more so. Parties and some politicians appear to be exploiting the situation for narrow reasons and for such an important issue, I find this somewhat dispiriting. Nevertheless, always the optimist, it is often darkest before the dawn and I hope that my next missive in early 2019 will be set against some concrete and agreed proposals. Fingers crossed.

Andrew Herberts ASIP
Head of Private Investment Management (UK)

Why invest in Alternative assets?

From time to time it is worth revisiting the rationale for investing in alternative assets.

Equity markets have had a phenomenal run during recent years when we consider the economic backdrop over this period.

One could argue that the rise has been largely predicated on the easy monetary policies pursued by central banks. These policies have also kept bonds in a bull market such that both equity and fixed income markets have rallied substantially over this period. This has created a positive environment for absolute return generation within traditional balanced portfolios. However we are beginning to see signals that this benign state of affairs is coming to an end.

The danger is that, as the correlation between traditional assets has increased, this increased alignment may continue to be in evidence if this trend is reversed. Even if traditional markets are well supported it is reasonable to surmise that they face greater headwinds today than they have done in recent history.

Therefore we believe there is a compelling argument for the addition of alternative asset exposure within a traditional balanced portfolio. However it is equally important to recognise that certain alternative investments have a poor reputation, and in many cases this is justified.

During the financial crisis in 2008 allocations which were meant to provide an element of protection to a balanced portfolio against falling markets failed to deliver this. Many hedge fund assets in particular also suffered from issues of liquidity and this resulted in an erosion of investor confidence in the sector which has been persistent.

Reputations have been further damaged by excessive fees which, in some cases, have been compounded by poor returns. Regardless, the cumulative effect of the above has been to turn some investors off alternative investments entirely.

What we would argue is that it is important, and indeed necessary, to disaggregate the term ‘alternative investments’ into the various and wide ranging sectors it encompasses. There is a clear distinction between allocating to alternative assets as a diversifying tool within a portfolio and allocating as a hedge. Our approach is designed to address these past concerns and to deliver both real diversification and absolute returns.

Our approach to alternatives investing is to create strategies that provide investors with exposure to a range of sectors that exhibit low correlation to traditional assets whilst offering the potential for returns derived from differing market sectors outside of vanilla equities and bonds.

In terms of our approach to identifying opportunities for investment, we principally look for strategies which have supportive macro drivers and strong support from sector fundamentals. We therefore look to take positions in strategies which we have confidence can deliver positive performance over a cycle.

We believe there is a compelling argument for the addition of alternative exposure within a traditional balanced portfolio. This addition, when structured and managed appropriately, can serve to be beneficial from both a return generative and risk diversifying perspective. In our view a portfolio with an alternative investment allocation within it will be better positioned to achieve its return objectives than one without.

Mark McKenzie
Head of Alternatives Research

The World Trade Organisation (WTO) Option

After the European Union's (EU) rejection of the "Chequers Plan" in Salzburg and Prime Minister Theresa May's insistence that "no deal is better than a bad deal", by the end of September the UK and EU looked no closer to reaching a Brexit agreement. The latest impasse in talks raises the possibility of a "no deal" Brexit, in which case the UK would immediately begin trading with the EU and the rest of the world under WTO rules post the 29th of March 2019.

The Benefits

One of the biggest criticisms of the Chequers proposal is that the UK would not have an independent trade policy. Under the Chequers plan, the UK would seek free movement of goods but not services. Under this proposal UK goods would be bound by the rules and red tape set by the EU. But more importantly, the UK would have no input to what these rules are, so in effect becoming a rule-taker to the EU. This puts constraints on the UK's ability to strike free trade deals with countries outside of Europe, including the US, as it has an inability to change standards and regulations on goods.

If the UK moves to WTO rules, it would no longer be in the EU's custom union and be tied to its common tariffs and trade policies. Proponents of free trade often state that the EU has too many protectionist and regulatory policies in place that restrict competition. Outside of these restrictions, the UK could lower tariffs with the rest of the world and reduce regulation, boosting competition which in theory leads to efficiency and productivity gains.

The freedom to set your own trade policy would be the biggest benefit of reverting to WTO rules. The argument follows that an individual country like the UK could have more success at striking free trade agreements than negotiating as a collective under the EU. Seeking membership of existing free trade agreements such as the Trans-Pacific Partnership is often used as an example of one of the benefits of being outside the EU.

Should the UK move to operate under WTO rules, they would save money by paying significantly lower contributions to the EU budget. Under the current terms of the divorce agreement, the UK government has agreed to pay £39bn by way of a divorce settlement. However, under the principles of Brexit negotiations that "Nothing is agreed until everything is agreed" the UK would not be liable for the agreed £39bn, but, Chancellor, Phillip Hammond, advises that some form of divorce settlement would still be payable.

Lastly, one of the big fears of leaving the EU without a Brexit deal is that the EU may look to make an example of the UK and punish it through restrictive trade policies. However, WTO rules provide some protection to the UK. The WTO's Most Favoured Nation principles means that each WTO member has to be treated equally, which effectively prevents the EU from discriminating against the UK. That is unless the EU wants to change its trade policies with all other WTO members, which would make it susceptible to retaliatory measures.

The Disadvantages

One of the biggest disadvantages of WTO rules is that it does not allow a frictionless border in Ireland. Any agreement between the UK and the EU that does not involve remaining in the single market and customs union will mean checks on goods are required at the border. The highly contentious and politically sensitive nature of this issue would cause several headaches for current and future UK governments.

If the UK is unable to lower tariffs or eliminate them altogether with the EU through a new trade deal, additional tariffs as instructed by WTO rules will increase the costs of goods for UK business and households. Often, Brexiteers quote that the average EU tariff on non-agriculture goods is low and below 3%. And in the event of a no-deal Brexit, Sterling would likely decline to offset tariffs. Whilst potentially true, it neglects the fact that the average tariff level distorts major outliers. For instance, tariffs on car parts are as high as 10% and taxed each time a part crosses the border, which given the fact some parts can cross the border numerous times during the production process can significantly increase costs. The agriculture sector in the UK would be particularly badly hit, with tariffs as high as 35% for some dairy products.

The other key disadvantage of WTO rules is non-tariff barriers. In the absence of any mutual recognition agreement, border checks between the UK and the EU would have to be more detailed and more stringent making it costlier for businesses to move goods across the border.

Furthermore, no one knows the extent to which business will have to implement their contingency Brexit plans in the event of a no-deal Brexit. A number of businesses have made threats that if the UK and EU are unable to reach a free trade deal, then they will relocate and move jobs outside of the UK. If this was to happen, it would damage the short-term investment outlook for the UK economy and materially weaken the long-term growth profile of the country.

Lastly, one of the key stated benefits of moving to WTO rules is the freedom it would give the UK to negotiate free trade deals. However, this point fails to take into account the fact that these trade deals take significant time and resources to complete, often several years. This means the benefits from these are likely to be years away, and in the short-term, the uncertainty could outweigh the positives.

Conclusion

From our perspective, it does seem clear that no political party wants to see a Brexit outcome that adopts WTO rules, implying that it is sub-optimal relative to other policies. Indeed, if WTO rules provided the framework for the best possible outcome for an economy, then other countries would not dedicate significant time and resources to negotiating new trade agreements. The recent case in point would be the EU and Canada who have spent seven years negotiating the EU-Canada Comprehensive Economic and Trade Agreement.

We continue to believe that there is no one clear solution to entirely protecting portfolios against binary political events and we do not manage the portfolio with one specific political outcome in mind. Nevertheless, we believe that managing a broad, diversified portfolio of assets remains the best line of defence against both political and economic shocks. Our portfolios are global in nature and in our opinion, events in the US and China matter as much to portfolio performance as the outcome of Brexit negotiations.

Looking ahead, our outlook for the global economy remains broadly unchanged. Global growth looks on a relatively stable footing and the risks of a recession within the next 12 months look relatively low.

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