ARTORIUS WEALTH

INVESTMENT OUTLOOK

April 2016

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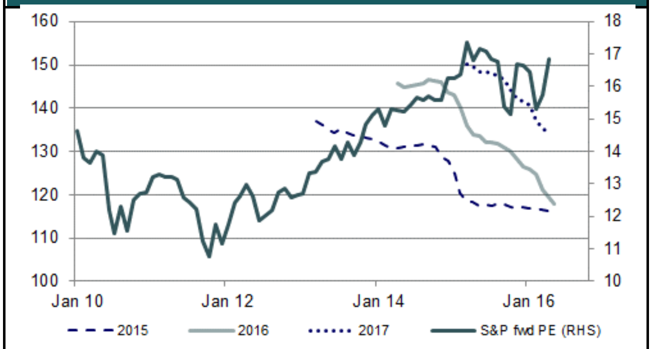
Facing back to front?

Longer days and shorter nights have led to Cherry Blossom and seen flowers bloom. With spring in the air, we question if the gloom of January was merely mid-winter blues, and whether or not the sharp rally in equity markets is justified. We hold the view that it is not, however, we must always test our assumptions.

So-called 'experts' are often left confused by the behaviour of financial markets. The recent rally in equities and other risk assets, such as commodities, is typically understood to typify an increase in risk appetite. Yet, this has coincided with moves in safe-haven assets, such as bonds, that one would expect to see in a risk-aversion environment. Without an improvement in fundamentals, i.e. profits and sales growth, increased asset values leads to a reduction in future returns for investors. A bitter-sweet reality?

The increase in the equity market has occurred whilst expectations for profits have fallen. Since the start of the year, expectations for earnings have been cut by 5% for both 2016 and 2017. In the US, this has meant that valuations are approaching cyclical highs, and with higher valuations comes increased risk and lower future returns.

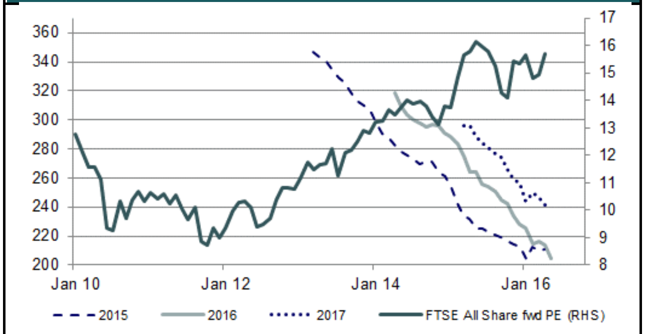
Equity prices have risen despite continued cuts in earnings expectations, leaving US equities trading elevated valuations



Source: Artorius Wealth, Thomson Reuters

The UK equity market has had a similar experience regarding falling profits expectations. This means that profits for 2016 are expected to be at the same level at the end of the year as they were in 2010.

UK equities have suffered from a sharp decline in earnings over recent years



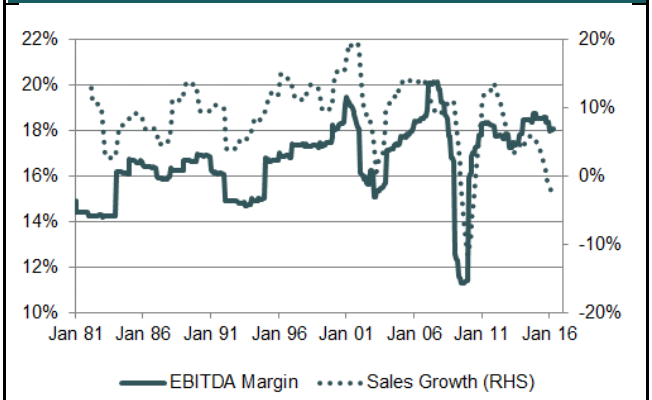
Source: Artorius Wealth, Thomson Reuters

Marginal room for error

A risk that we highlighted in October 2015 that is receiving increased commentary elsewhere is the fate of profit margins in the US. Although they have fallen slightly, the level of profit margins remains elevated, as measured by EBITDA margins (Earnings Before Interest, Tax, Depreciation and Amortisation). Whilst this is an accounting construct, consistent use of this metric provides a useful guide to profit margin in the US equity market.

Profit margins tend to follow the economic cycle. As sales growth slows, margins fall. In addition, there is evidence that wage growth has started to pick up in the US economy, which further erodes profitability.

US profit margins may fall from elevated levels as sales growth remains low



Source: Artorius Wealth, Thomson Reuters

Sales growth and profit margins are likely to continue to drift down without a sharp pick-up in economic growth. This will lead to further reductions in profit expectations.

Rallying on Yellen's dovish wings

With mixed signs on the state of US economy, and inflation drifting higher even before the impact of the recent oil price rise feeds through, some US interest rate policymakers have started to become more vocal in advocating a rate increase in June 2016.

The hawkish tone of some policymakers is in contrast with Federal Reserve Chair Janet Yellen's dovish statements suggesting interest rates remaining low. The dovish positioning by Janet Yellen was a contributory factor in both the rally in US equities and the weakness in the US Dollar in recent weeks. If other Federal Reserve policymakers continue to publically disagree with the dovish stance of Chair Yellen, we suggest that the market may retrace some of the rally that floated higher on the dovish wings of Yellen.

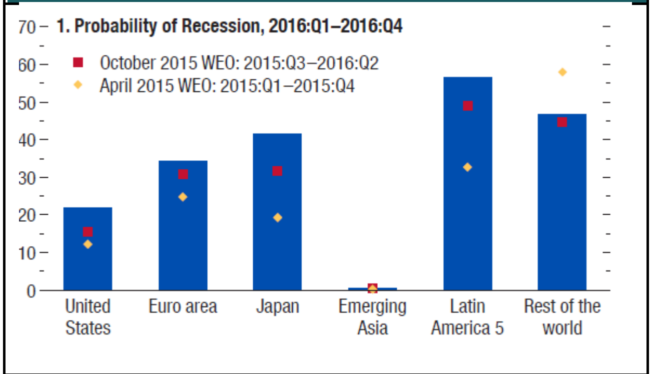
'On alert, not alarm'

The economic backdrop is summarised by the IMF's *World Economic Outlook* released on 12 April. It predicts a slight acceleration in global GDP growth this year, from 3.1 to 3.2 percent, followed by 3.5 percent growth in 2017. Their projections, however, continue to be increasingly pessimistic over time.

The IMF calculate probabilities of a recession. Analysis based on the IMF's Global Projection Model suggests an increase in the probability of a recession in major advanced economies over a four-quarter horizon compared to the probabilities computed in April and October 2015.

The new probability reflects an increased in the perception that traditional policy tools have become sterile, although when did QE become traditional, and increase in financial market volatility.

IMF calculated probability of recession has risen in most regions in recent months



Source: Artorius Wealth, IMF

We are not presently in a crisis. As IMF Managing Director Christine Lagarde has put it, the IMF's state is one of alert, not alarm. We think that this is a wise statement and we have positioned accordingly by holding higher levels of liquidity for clients that we would do in normal times. Combined with elevated valuations we believe that the subdued expected returns of equity markets and continued economic risks justifies caution in asset selection and portfolio management.

Portfolio positioning

As a result of the elevated valuation backdrop, the concerns over corporate profitability and lacklustre economic growth we remain underweight equities and will take the opportunity presented by the market rally since mid-February to de-risk the portfolio further.

Asset Allocation Views

Equities	⊖ (Negative)
US	Negative
UK	Neutral
Europe ex UK	Neutral
Japan	Neutral
Pacific ex Japan	Negative
Emerging Markets	Neutral

Fixed Income	Neutral
Government	Neutral
Investment Grade	Neutral
High Yield	Neutral
Emerging Market	Neutral
Cash	Positive

Alternatives	Neutral
UK Real Estate	Neutral
Infrastructure	Neutral
Private Equity	Neutral

= Positive view

= Negative view

= Neutral

Source: Artorius Wealth

Our Tactical Asset Allocation (TAA) tilts to the SAA to reflect our shorter-term cyclical views. Actual client portfolios will vary according to mandate, benchmark, risk profile and the availability of individual asset classes in different regions.

ASSET CLASS OVERVIEW

Equity	SAA	Commentary	TAA
US: -3 **-2** -1 0 1 2 3	22%	We increased our negative stance on US equities from 'slight' to 'moderate' in early December. From a valuation perspective the US equity market appears fully valued and earnings revisions are weak. The risk of higher interest rates and tighter credit conditions, as seen in surveys, threaten the subdued economy.	-7%
UK: -3 -2 -1 **0** 1 2 3	7%	We prefer mid-caps, implemented through exposure to the FTSE 250 Index, as they avoid the dominance of the commodity related companies found in the FTSE 100 index.	-
Europe ex UK: -3 -2 -1 **0** 1 2 3	7%	We are of the opinion that the ECB's commitment to its asset-purchase programme will remain intact and continue to support the region's recovery.	-
Japan: -3 -2 -1 **0** 1 2 3	0%	Following the Yen's depreciation, the earnings growth of Japan has been robust but challenges remain longer term (i.e. demographics)	-
Pacific ex Japan: -3 **-2** -1 0 1 2 3	5%	We have become more concerned over the Asian equity universe. An economic slowdown in China and collapse in commodity prices weighs heavily. Growth risks and monetary policy tightening in the US cause us to reduce exposure in clients' portfolios	-2.5%
Emerging Markets: -3 -2 -1 **0** 1 2 3	5%	Whilst China weighs on the universe the use of an active fund manager gives clients' portfolios to relatively undervalued asset class	-
Global: -3 -2 -1 **0** 1 2 3	3%	In contrast to our regional asset allocation we have a global equity theme of water. As the global population grows, water resources are stretched and companies in water industry should benefit from increased expenditure.	-

Fixed Income	SAA	Commentary	TAA
Cash -3 -2 -1 0 1 **2** 3	0%	We opt for cash in the face of unattractive opportunities, in other asset classes. Long term we look to deploy cash holdings in higher return generating assets, but in times of turbulence cash offers a safe haven.	+9.5%
Government -3 -2 -1 **0** 1 2 3	14%	We remain neutral on government bonds overall, as the inflation outlook appears subdued in the near-term. The prospect of further bond buying from the ECB is likely to keep bund yields low, which in turn should prevent yields in other markets rising too far too soon.	-
Investment Grade -3 -2 -1 **0** 1 2 3	9%	In the UK and Europe there has been a modest increase in credit spreads in 2016, but returns remain attractive in most scenarios relative to government bond markets.	-
High Yield -3 -2 -1 **0** 1 2 3	4%	High yield markets in the UK and Euro area are shielded to date from the US high yield bond market.	-
Emerging Market -3 -2 -1 **0** 1 2 3	3%	We believe that valuations are attractive and sufficient to outweigh the potential volatility caused by the Fed's rate rises.	-

Alternatives	SAA	Commentary	TAA
UK Real Estate -3 -2 -1 **0** 1 2 3	10%	Yields and rental growth of 3% should also make a useful contribution to robust total return in 2016. Valuations appear stretched in absolute terms limiting long-term returns.	-
Infrastructure -3 -2 -1 **0** 1 2 3	5%	Valuations remain full, with limited scope for disappointment, but cash flow generation is drawing fund flows.	-
Private Equity -3 -2 -1 **0** 1 2 3	6%	The asset class most correlated to the economy, in terms of risk. PE houses are expected to deliver positive returns until the economy slows markedly or credit costs rise to curtail private market activity.	-

Source: Artorius Wealth

Key: The numbers reflect a quantitative description of our tactical positions relative to the strategic benchmarks. Our Strategic Asset Allocation (SAA) solutions offer a blend of assets that over a medium terms (5-7 years) will, in our view, provided the optimal mix of returns and risk at a given level of risk tolerance. Our Tactical Asset Allocation (TAA) tilts to the SAA reflect our shorter-term cyclical views. The SAA and TAA positions reflect a medium risk sterling on-shore based client portfolio. Views are subject to change and implementation in portfolios will reflect specific client requirements.

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Past performance is not a guarantee of future performance and investors may not get back the amount originally invested. Investing involves risk, including possible loss of principal.

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