ARTORIUS WEALTH

INVESTMENT OUTLOOK

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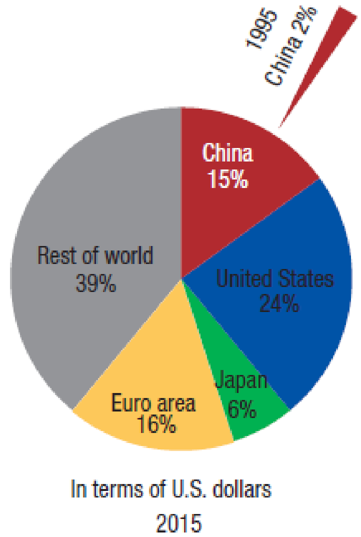
Growing a tree in the air

"Growing a tree in the air" is an analogy that paints a picture of the risks associated with economic growth based on increasing leverage. The *People's Daily* may not be everyone's source of news-flow, but the main publication of the Chinese Communist Party coined a wonderful term for the growing risks in the Chinese economy. It was written by an 'authoritative' figure (likely to be connected to the Chinese leadership).

The image captures the risks that we see after the unprecedented amount of credit pumped into the Chinese economy in the first quarter. Without roots in the *'terra firma'* of increased employment and productivity, economic growth will likely fail to be sustainable. Debt can successfully keep the game going for so long, but at some point there has to be readjustment to lower growth, and potential debt write-offs.

Chinese economy a meaningful share of the global economic pie



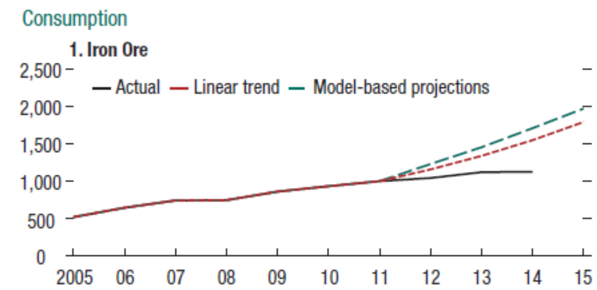
Source: Artorius Wealth, Thomson Reuters

China is a more important component of the global economy than at the turn of the 21st century, as its pace of growth has far exceeded the more mature economies, such as the UK and US. A slower pace of economic growth is now widely expected in China and if the *People's Daily* report is proved correct this is likely to result in a more subdued global economic backdrop.

It is interesting to note the article suggests that 'Chinese performance will be L-shaped for more than one or two years'. Rather than a surge in economic growth, the article suggests the pace of growth will be subdued for the next few years.

One can already observe the slower pace of growth in the consumption patterns of industrial commodities, such as iron ore. The pace and nature of Chinese growth has changed in recent years and this has caused the actual level of consumption of various commodities to undershoot trend projections based on outdated economic models. Not only has the pace of growth slowed, but as the Chinese economy has become more orientated towards the domestic economy, then demand for iron ore and steel has eased.

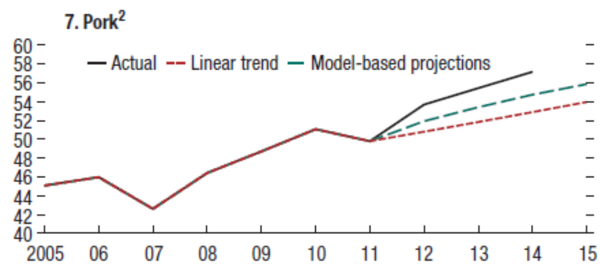
Chinese commodity consumption growth has stalled (metric tons)



Source: Artorius Wealth, IMF

However as Chinese consumers' wealth has increased they have shifted their pattern of spending. Increased levels of pork consumption and other middle-income goods has accelerated.

Chinese pork consumption growth has remained strong



Source: Artorius Wealth, IMF

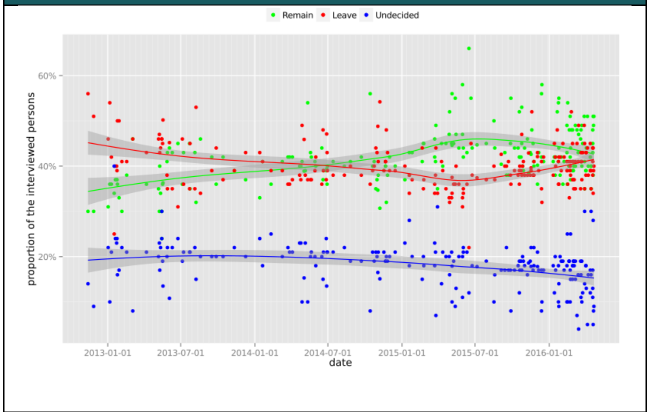
EU Referendum

The UK is faced with a ‘once-in-a-lifetime’ choice in June; to remain in or leave the European Union.

Given the inaccuracy of opinion polls in the 2015 General Election, the next paragraph may be treated with as much caution (or contempt) as a briefing from an economist…

When polled, the UK public tend to register a desire to stay in the EU, although there are polls that have shown a balance towards leaving the EU, of late. The markets do not appear to be pricing in a 50:50 chance of a Leave vote.

Do I stay or do I go now? Poll-of-polls on ‘In – Out’ EU referendum



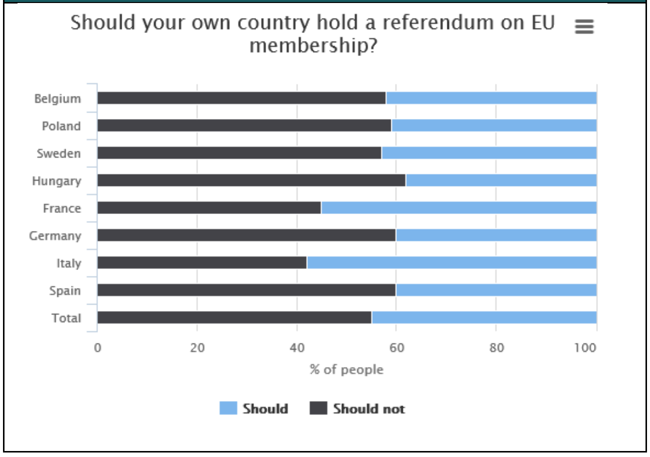
Source: Artorius Wealth, Wikipedia

Post referendum:

We suggest that whilst the vote is conducted in the UK, the result potentially has European and global implications. A Remain decision is largely discounted but removing a ‘known risk’ should result in supportive moves in sterling and broader risk assets such as equities.

A Leave decision is likely to lead to a fall in sterling, UK equities and potentially European equities in general. If a Leave decision in the UK increases the scale of voter scepticism elsewhere in Europe, especially if Greece or the Migrant Crisis remerges during the summer, then markets may have to factor in more volatile conditions in Europe. These range from Spain’s Catalan independence question through to the far-right ADF party in Germany. A Leave vote in the UK may encourage citizens to question the EU project across the continent.

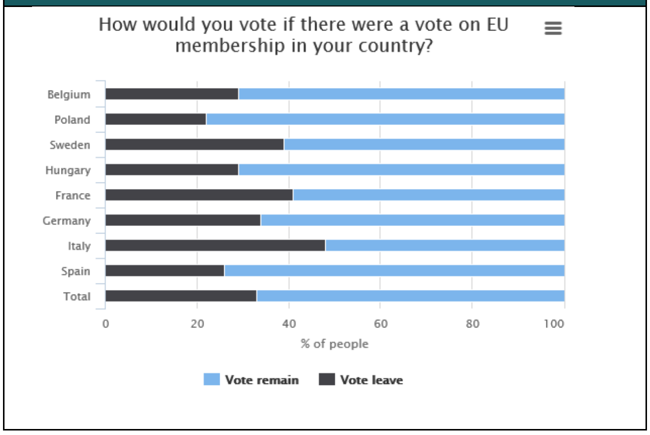
Much of the EU want their own chance to vote on EU membership



Source: Artorius Wealth, IPSOS Mori

A recent IPSOS Mori poll around Europe suggests that the UK referendum is triggering similar thoughts elsewhere. A large minority of those polled would want a similar referendum in their own country. However it is worth noting that when asked whether their own country should leave the EU, a majority voted to Remain.

But the majority of the EU want to stay together



Source: Artorius Wealth, IPSOS Mori

That the desire to stay in the EU is weakest in the likes of France, Italy, Sweden and Germany suggests that political sentiment may be overlooking popular opinion in what many would regard as core EU members. A Leave vote in the UK may result in consequences in other countries on the Continent. This may increase risk aversion towards the Euro and European risk assets in general.

Asset Allocation Views

Equities	⊖
US	⊖
UK	⊜
Europe ex UK	⊜
Japan	⊜
Pacific ex Japan	⊖
Emerging Markets	⊜

Fixed Income	⊜
Government	⊜
Investment Grade	⊜
High Yield	⊜
Emerging Market	⊜
Cash	⊕

Alternatives	⊜
UK Real Estate	⊜
Infrastructure	⊜
Private Equity	⊜

⊕ = 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. The risk of higher interest rates and tighter credit conditions, as seen in surveys, threaten the subdued economy. This is likely to impact the Small Cap which accounts most of our underweight stance.	-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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