ARTORIUS WEALTH

INVESTMENT OUTLOOK

July 2016

MANCHESTER • LONDON • ZURICH

BREXIT reality

The outcome of the UK Referendum shocked political and market commentators alike, and caused the felling of shibboleths and spilling of much ink. In our belief that a good BREXIT is possible, we were impressed by the swift actions of the Bank of England to reduce the constraints on the banks to increase lending. An alternative fiscal path may be plotted by the new Chancellor, and sterling's fall, down over 10% against the US dollar and Euro since the Referendum, may enable the UK to undergo a virtuous although probably uncomfortable economic rebalancing.

We continue to think that sterling will have further to fall, primarily due to the nature of the current account deficit that indicates the UK economy is uncompetitive with its trading partners.

Whilst negotiations with the EU are likely to bring difficult political choices, we note reports that the USA would like to start talks around the UK having a bilateral trade pact. This is significant for the US as well as the UK, as the UK represents 25% of US exports to the EU. This may signal that a good BREXIT outcome is possible.

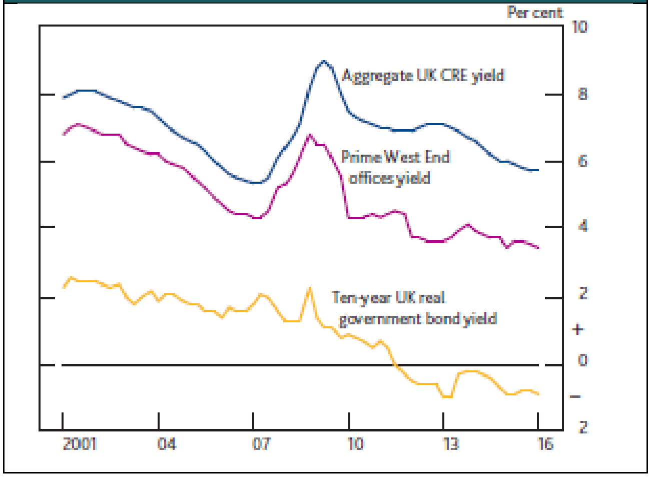
UK Real Estate

An asset class we invest in on behalf of UK clients is the UK real estate sector. It historically has generated solid returns and provides powerful diversification for a bond/equity portfolio. It is a sector which is faces a challenging period. Post-BREXIT referendum, funds invested in the UK real estate are facing outflows. For an investment based on long-term illiquid assets, sharp increases in selling by investors seeking to redeem their funds has triggered some funds in the sector to delay investors from exiting funds, temporarily. A similar issue was faced by US high-yield bond funds in 2015, which resolved itself relatively quickly.

For the UK real estate sector, recent investor selling comes after a period when the asset class has performed well. Underpinned by a strong UK economy and rising property values, investors have enjoyed robust returns; c15% per annum over the past 3 years.

Valuations have increased in part due to Central Banks (Bank of England, Federal Reserve, European Central Bank and Bank of Japan) buying other 'safe-haven' assets including government bonds. Central Bank bond buying has driven bond prices up and yields down. As bond yields have fallen, so other asset classes have seen their yields fall, and prices rise, in sympathy as investors have 'reached for yield'.

Yields have fallen across most asset classes as Central Banks have bought bonds



Source: Bank of England, Artorius Wealth

Real estate valuations are relatively full in comparison to its own history, with yields sub-6%%. When compared to the very low yields available elsewhere, the asset class appears to hold income attractions. Historically however sub 6% yields have typically signalled a period of low or even negative returns for the sector.

Investors face the choice of investing in an asset class that appears unattractive in comparison to its own valuation history but one that remains relatively attractive to other asset classes.

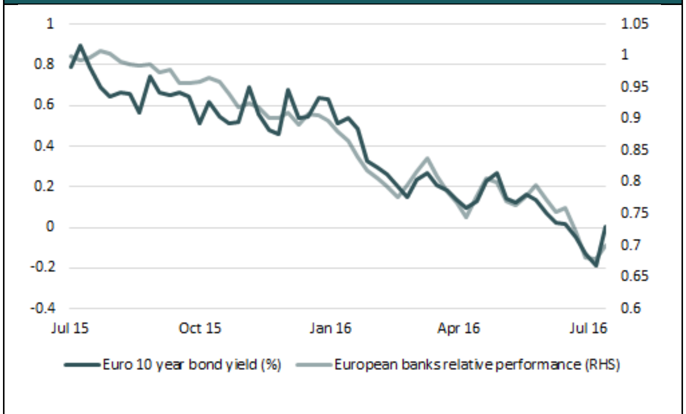
We continue to monitor the UK real estate sector both in terms of further downside risk, if the wheels fall off the UK economy or reversal of Central Bank asset purchases; judged to be unlikely in either case; but also for opportunistically, investing for long term investors seeking to add an income generating asset class that diversifies away from capital market instruments such as equities and bonds.

Casualties from lower bond yields

The Central Bank buying of bonds through Quantitative Easing has, as noted above, driven bond yields down. Whilst on the face of it this has reduced the cost of borrowing to the real economy, the finance sector is struggling to cope.

A bleak example of this is the low share prices of the European banks. Once the crown jewels of many countries these companies are structurally challenged in the face of low bond yields.

Lower bond yields are pushing European banks share prices down



Source: Bloomberg, Artorius Wealth

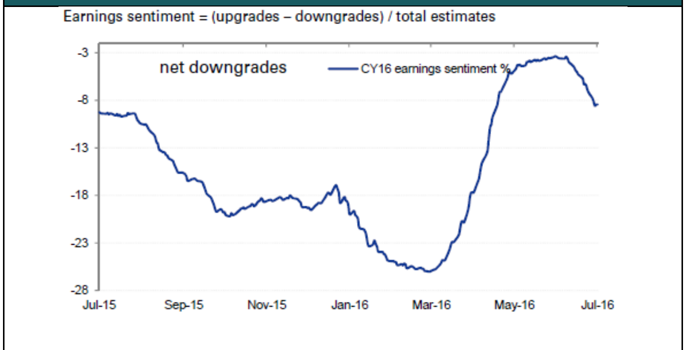
Low bond yields are a challenge to traditional banking models because a source of profitability has been the difference between the funding cost of a bank and the asset yield. Historically banks could access funds at a lower rate than they would lend at, the spread being the Net Interest Margin. Record-low sovereign bond yields could cost European banks as much as 20 per cent of their earnings over the coming years, according to research from UBS.

The challenge for policy makers is that the years of deriding the finance sector means that structuring a solution that aids the economy without appearing to be a banker bailout may be tricky. Or the economy will need to continue to evolve to enable alternative sources of finance and banks will become less dominant.

Weak global profits backdrop

Away from the issue of BREXIT, and the uncertainty that it is likely to introduce for the UK and wider European economy, expectations for global profits appear to be suffering downgrades. The pace of cuts to profit expectations has accelerated in recent weeks. In our view the low growth and low inflation backdrop of the global economy is challenging companies in their desire to generate profits.

Estimates of global profits are starting to be cut … again



Source: Goldman Sachs, Artorius Wealth

Elevating asset prices

Despite the increased uncertainty from BREXIT, cuts in expectations around profitability and elevated valuations, we are struck by the continued rise in asset prices. The fall in sterling has benefitted investors diversified out of sterling through holding global rather than UK equities. Bonds have risen robustly as a both Central Bank actions and low growth have combined to drive bond prices higher.

Total return for sterling investors in 2016

	April - June 2016	2016
FTSE All Share	5.2%	4.3%
Global Equities	8.9%	12.7%
UK government bonds	6.4%	11.4%

Source: Bloomberg, Artorius Wealth

Maintaining a cautious stance on equities appears prudent given the uncertainty around the economy and earnings, balanced off by being fully exposed to bond markets as low inflation and Central Bank action combine to keep yields low.

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 2015. The risk of tighter credit conditions, threaten the subdued economy; especially Small Cap which accounts for most of the underweight view	-7%
UK -3 -2 -1 **0** 1 2 3	7%	Post the BREXIT referendum we have switched our long standing exposure towards domestic FTSE 250 to FTSE 100 which is likely to benefit from the fall in sterling, as the larger companies have most of their profits derived from overseas.	-
Europe ex UK -3 -2 -1 **0** 1 2 3	7%	We believe that the ECB's commitment to its asset-purchase programme will remain supportive of 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 conditions 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 access 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%	UK real estate may struggle in the face of BREXIT. It is a sector that offers both long-term opportunities, but near term risk depending on policy and investor response. However, for longer term investors, the income generation should prove resilient.	-
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 term (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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