



ARTORIUS WEALTH

INVESTMENT OUTLOOK

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MANCHESTER



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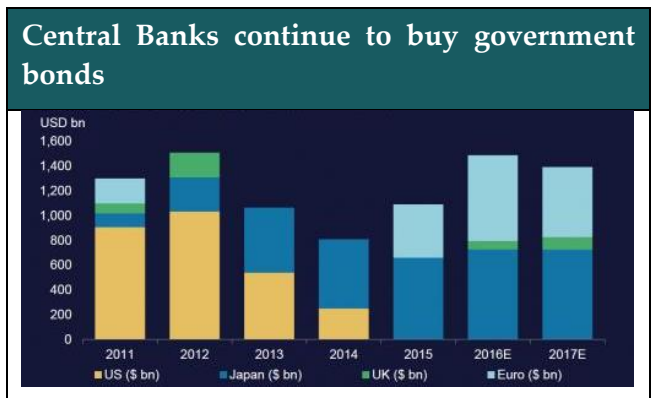
An Uncommon Market

The Olympian ideal and quest for ‘faster, higher, stronger’ may be entertaining the sports minded amongst us through August, as the Games in Rio continue. The cultured have their Festivals (Edinburgh, North Sea Jazz, Glyndebourne) to soothe and enrich their lives. Markets and policymakers are also doing their best (or worst) to entertain and enrich.

BREXIT and a failed coup in Turkey have not been lasting shocks for markets. The expectation that central banks are going to keep government bond yields ‘lower for even longer’ has driven markets higher. The S&P 500 index has recently hit an all-time high of 2183. Indices in Asia ex-Japan, Japan (TOPIX), and Europe (STOXX 600) have returned 7.5%, 5%, and 4% in 3Q.

Central Banks: Saviours of the world?

Ahead of the BREXIT vote and subsequent policy response, the concern in financial markets was that central banks had run out of ammunition. The monetary policy cupboard was empty with interest rates close to zero, negative rates creating problems for banks and quantitative easing (QE) having little or no impact on the real economy. The view was that central banks were finished. Now they are seen as saviours.



Source: Morgan Stanley Research, Artorius Wealth

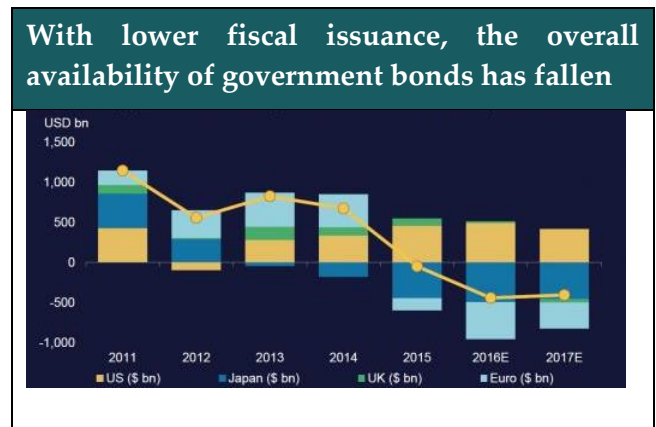
The risk is that the response from Central Banks, easing policy in Europe and the talking of tightening policy in the US, creates a stop-go investment backdrop. Injections of liquidity drive bond yields lower and equity prices higher. However once adjusted to the new level of interest rates equities then run out of steam without further impetus.

The rally in the equity market comes not because of better than expected profits growth but because of the Central Banks coming to the rescue. This is very different from an earnings-driven market where investors are balancing stronger earnings-per-share (EPS) against the potential for tighter monetary policy.

The Central Banks have been buying between \$900 billion and \$1.5 trillion worth of bonds every year. The US was the buyer of largest resort through 2011-13, but has been replaced by the European Central Bank and the Bank of Japan subsequently.

Running out of bonds to buy

As governments’ own fiscal position has improved in most countries, the Central Banks are buying more bonds than being issued by the government. As a result, the net supply of government bonds fell in 2015 in Europe and Japan, and will shrink further in 2016-17. The only issuer in size is the US government, primarily as a reflection on unresolved fiscal deficit and a Federal Reserve that has stopped buying bonds.



Source: Morgan Stanley Research, Artorius Wealth

As net supply has fallen, other investors seeking to buy government bonds will face higher prices to reflect the supply and demand imbalance, and yields will continue to remain low. The evidence from previous periods of Central Bank bond buying, is that it has had limited economic impact, with most effect taking place in the capital markets by boosting asset prices.

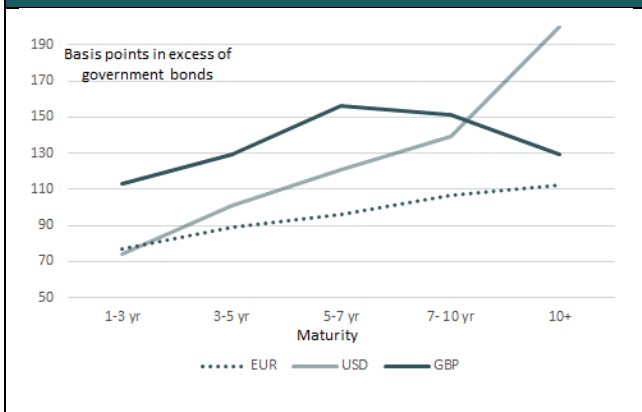


Irrationally but explicable conditions

As John Maynard Keynes once remarked ‘markets can remain irrational for longer than you can remain solvent’ so betting against the continuing irrationality (even if well meaning) of the Central Banks can be a painful and costly activity.

However, that does not make the recent rally irrational. Low rates may not help the economy, but they can certainly drive asset prices by intensifying the search for yield. For those investors seeking to pick up extra yield compared to the government bond market, we show the extra yield available to investors in the relevant investment grade bond market. Every little helps, and reflects the opportunity that we have seen and acted upon with clients’ discretionary portfolios.

Higher yields are available for fixed income investors in the Investment Grade Non-Financials universe



Source: Bloomberg, Artorius Wealth

Are equities running a bond risk?

The fall in bond yields is the primary driver of the rally in equity markets. The elevated bond market reflected in low bond yields is also finding expression in the valuations and behaviour in the equity markets.

Valuations are elevated and mean that a sell-off in bond markets (unlikely given the Central Bank support) will have an immediate negative effect on equity markets, in our view. As a result, we are cautious towards developed market equities. This doesn’t preclude buying for clients where they are putting new assets to work.

The outcome of being fully invested in bonds markets and slightly underweight equities has served clients well to date in 2016, as has the diversification away from sterling. These are trends that we envisage will continue into the later part of 2016, but we remain vigilant for potential changes to this backdrop.

An area of the global economy that has stabilised has been the Emerging Markets. As interest rates have fallen, and developed market investors have diversified into Emerging market equities and bonds, these asset prices are signalling that deflation concerns of the winter of 2015 are past. We remain fully weighted to these areas for clients with the expectation that they offer higher sustainable returns for a long term investor than developed markets.



ASSET ALLOCATION VIEWS

Equities	⊖	Fixed Income	⊖	Alternatives	⊖
US	⊖	Government	⊖	UK Real Estate	⊖
UK	⊖	Investment Grade	⊕	Infrastructure	⊖
Europe ex UK	⊖	High Yield	⊖	Private Equity	⊖
Japan	⊖	Emerging Market	⊖	⊕ = Positive view	
Pacific ex Japan	⊖	Cash	⊕	⊖ = Negative view	
Emerging Markets	⊖			⊖ = Neutral	

Source: Artorius Wealth

Our Tactical Asset Allocation (TAA) tilt verses the Strategic Asset Allocation (SAA) reflect our shorter-term 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 have turned negative on government bonds post the recent BREXIT inspired rally. Government bond yields have fallen as policy support has been priced in.	-7%
Investment Grade -3 -2 -1 0 1 2 3	9%	In the UK and Euro bond markets a new buyer of last resort (the respective Central Banks) will keep yields lower for longer. The yield pick-up and slight reduction in volatility makes it a compelling place to invest proceeds in comparison with the underlying government bond market.	+7%
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) tilt verses the Strategic Asset Allocation (SAA) reflect our shorter-term views. Actual client portfolios will vary according to mandate, benchmark, risk profile and the availability of individual asset classes in different regions. 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.



IMPORTANT INFORMATION

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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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