INVIEW

GLOBAL HOUSE VIEW & INVESTMENT PERSPECTIVES

JANUARY 2018

DISCIPLINED BY NATURE. FLEXIBLE BY DESIGN.
The icons alongside represent our investment process. Through a disciplined provision of investment policy and security selection at the global level, regional portfolio management teams have the flexiblility to construct portfolios to meet the specific requirements of our clients.

HIGHLIGHTED IN THIS PUBLICATION:

GLOBAL STRATEGIC ASSET ALLOCATION

GLOBAL SECURITY SELECTION

REGIONAL ASSET ALLOCATION

REGIONAL PORTFOLIO CONSTRUCTION

Editorial

Moz Afzal
Chief Investment Officer

Welcome to the January edition of *Inview: Global House View*. In this publication we consider significant developments in the world's markets, and discuss our key convictions and themes for the coming months.

Are we too complacent about inflation?

Inflation has been very modest across the world in recent years. Global headline inflation peaked at around 3% year-over-year in 2011 and then fell continuously to a little over 0.5% in 2016, but has since rebounded to just below 2%. Global core inflation, a measure of inflation that strips out highly volatile prices such as energy and food, followed a similar path, peaking at 2% in 2011, falling to 1% in 2016 and rising to about 1.6%.

Is there a risk that central banks and investors are underestimating the amount of inflation in the pipeline? This is certainly a possibility we should at least consider.

Since inflation is below central banks' objectives, monetary policy remains highly expansionary across the world. But monetary policy impacts inflation *with long and variable lags*, as stated by Nobel Prize winner Milton Friedman. In setting monetary policy today, central banks should rely on forecasts for 2019 and beyond. Since the financial crisis brought with it economic dislocation and deep structural economic changes, central banks may have reduced confidence in their forecasting abilities and focus perhaps too heavily on current economic conditions when setting policy. This may lead to overly exaggerated expansionary policy.

Many central banks have been embarrassed by their inability to overcome inflation that is too low. That failure may be partially due to the transmission mechanism of monetary policy having become compromised as a result of severe financial sector dislocation during the crisis. This weakness may now be a story of the past. There is certainly a risk of the transmission mechanism growing stronger as the financial sector recovers from the crisis. Developments in the euro area are a case in point. Past policy changes that central banks have written off as ineffective might well become increasingly impactful as time passes. This may ultimately lead to a much more robust rise in inflationary pressures than expected.

Central banks' collective failure to raise inflation may have encouraged them to throw caution to the wind and overdo monetary stimulus. Having undershot inflation objectives for several years despite the use of highly controversial and expansionary policies such as negative interest rates and Quantitative Easing, their credibility has been diminished. The temptation to end the current embarrassment as soon as possible by adding monetary stimulus must be strong.

Central banks may have been lulled into believing that the inflationary consequences of too expansionary a policy can be disregarded. It is now often argued that the Phillips curve – the relationship between the unemployment rate and inflation – has become much flatter over time. If true, over-used monetary stimulus will merely result in a massive boom with little inflation. That does not sound like a terrible outcome for central banks.

This has a similar impact for investors, at least in the short term. As the economy strengthens thanks to central banks' loose policies, there is scope for financial assets to gain. Equities will benefit the most as inflationary pressures creep higher starting from a low base. Only at a later stage when central banks begin to withdraw accommodation will investors have to start considering a more cautious approach to portfolio construction.

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Global Asset Allocation: Summary

Equities

- US indices continue to hit record highs. Buoyant earnings estimates and the prospect of successful tax reform have provided room for a continuation of US market success. As such we are still overweight US equities.
- While growth prospects across the eurozone are strengthening, the euro remains strong. The case for being overweight towards the US is still valid and we are not yet ready to facilitate a transition to moving overweight European equities.
- Although beginning to look more attractive from a valuation pespective, we remain underweight UK equities given the slow progress of Brexit negotiations.
- Emerging Market equities have been the strongest performers this year, with China being the shining star, ultimately providing confidence in our tactical overweight decision.

Fixed Income

- Within fixed income we are strategically overweight on all sub-asset classes with the exception of high yield (neutral) and sovereign (underweight).
- High yield spreads continue to hover around cyclical lows, although recent new issuance has caused some unease.
- Sovereign debt is still a strategic underweight for us. Markets have priced in one further Federal Reserve rate hike this year, although the pace of rate hikes in 2018 is a bit less certain.

Alternative Investments

- No changes were made to our alternatives positioning this month.
- We are still strategically neutral on commodities, even as oil approaches the top of its range.

Currencies

- Our positioning on the dollar has not changed. We are strategically neutral and tactically overweight.
- Most economic data releases from the eurozone have pointed to a solid ongoing recovery, which in turn has added to euro strength so we are strategically neutral.
- Our only asset allocation change this month was made on the Australian dollar. We downgraded our tactical overweight on AUD to neutral, due to the macro-prudential policy undertaken by the Reserve Bank of Australia. We also took into account potential issues on the horizon with respect to excessive consumer debt.
- The yen has strengthened against the dollar for the month, benefiting from tentative signals that the Bank of Japan may at some distant point tighten monetary policy. As for our overall positioning on Asian currencies, we remain neutral.

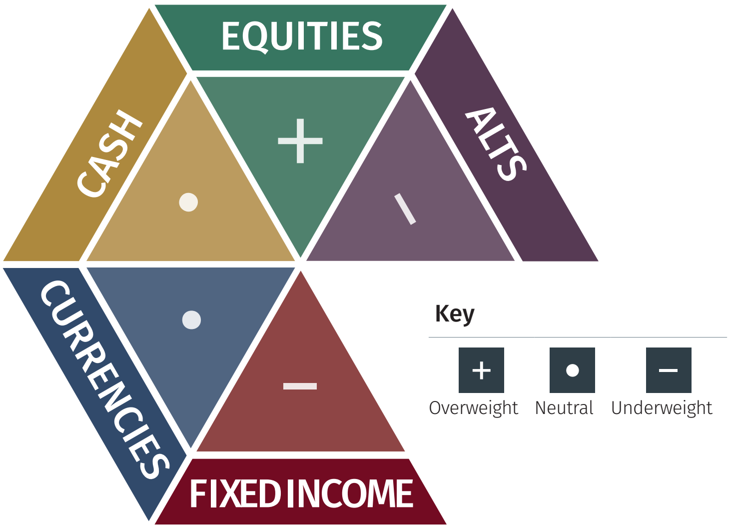
Sector allocation (✚ overweight, ▬ underweight, ● neutral)

Sector	Dec-17 Weight	Change	Jan-18 Weight
Consumer Discretionary	✚	↔	✚
Consumer Staples	▬	↔	▬
Energy	▬	↔	▬
Financials	✚	↔	✚
Healthcare	●	↔	●
Industrials	✚	↔	✚
Information Technology	✚	↔	✚
Materials	●	↔	●
Real Estate	●	↔	●
Telecoms	▬	↔	▬
Utilities	▬	↔	▬

Global Asset Allocation: 12-Month Strategic Outlook

Based on a balanced mandate, the matrix below shows our long-term house view on investment strategy.

Overall Asset Allocation Views



Asset Class Breakdown

	EQUITIES	FIXED INCOME	ALTS	CURRENCIES	CASH
+ Overweight	North America Japan E. Europe, ME & Africa Latin America	Investment Grade Corporate Convertible Preferred & Hybrid EM Local Currency	Hedge Funds Directional/ Equity -Linked		
• Neutral	Europe Switzerland Asia Pacific ex-Japan Europe Ex-UK Ex-Switzerland	High Yield Other	Hedge Funds Carry/Credit Hedge Funds Uncorrelated Commodities / Mining Equity Insurance-linked Securites Other Infrastructure	USD EUR AUD Asia Other	Money Market
– Underweight	United Kingdom	Sovereign	Property / REITS	GBP	Cash

Global Asset Allocation: 3-Month Tactical Outlook

Based on a balanced mandate, the matrix below shows our short-term house view on investment strategy.

Asset Class Breakdown

Note: The highlighted boxes indicate a difference from our 12-month strategic outlook.

	EQUITIES	FIXED INCOME	ALTS	CURRENCIES	CASH
+ Overweight	Europe Europe ex-UK ex-Switzerland Switzerland Japan Asia Pacific ex-Japan Latin America	Convertible Preferred & Hybrid	Hedge Funds Directional/ Equity -Linked Commodities / Mining Equity Other	USD Other	
• Neutral	North America	Investment Grade Corporate High Yield EM Local Currency	Hedge Funds Carry/Credit Hedge Funds Uncorrelated	AUD Asia	Money Market
− Underweight	E. Europe, ME & Africa United Kingdom	Sovereign Other	Property / REITS Insurance-linked Securities Infrastructure	EUR GBP	Cash

Equity Allocation Grid

Based on a balanced mandate, the table below provides our long-term (strategic) and short-term (tactical) house view on investment strategy.

Key

+	•	−	▲	—	▼
Overweight	Neutral	Underweight	Upgrade	No Change	Downgrade

Sub-Asset Class	Strategic 12-month		Tactical 3-month		Sub-Asset Class Additional Guidance
	View	Change	View	Change	
North America	+	—	•	—	We are only marginally overweight US equities. We continue to be patient on the Trump tax plan and recent news seems to suggest our patience will be rewarded. The S&P 500 continues to hit 52-week highs as earnings expectations remain buoyant and bond yields subdued. As confidence in the Trump tax plan builds the S&P 500 and the Russell will continue to edge higher. When/if the tax plan passes, US growth expectations will start to edge up above trend for next year and possibly into 2019; the impact of this on US rates (and inflation) will need to be watched carefully. Recent moves in the Russell affirm our confidence in the overweight to small-caps. We continue to advocate a greater balance between growth and value. However we also note that momentum is still with growth stocks, but value stocks have economic sensitivity on their side.
Europe	•	—	+	—	We are neutral European equities and note the persistently stronger EUR is tempering valuations as well as short-term political uncertainty. The decision is quite finely balanced to increase our strategic weight to overweight - this will need to be funded from our US position, where there is better momentum on a short-term basis. Economic growth prospects for the European region continue to improve and the ECB has remained accommodative in its action. The EUR will potentially keep the ECB on the side-lines as inflation expectations remain mediocre. Any weakness in the EUR would lead to a rally in European equities and this has implications for asset allocation depending on the base currency.
Europe ex- UK ex- Switz.	•	—	+	—	We are neutral European equities and note the persistently stronger EUR is tempering valuations as well as short-term political uncertainty. The decision is quite finely balanced to increase our strategic weight to overweight - this will need to be funded from our US position, where there is better momentum on a short-term basis. Economic growth prospects for the European region continue to improve and the ECB has remained accommodative in its action. The EUR will potentially keep the ECB on the side-lines as inflation expectations remain mediocre. Any weakness in the EUR would lead to a rally in European equities and this has implications for asset allocation depending on the base currency.
United Kingdom	−	—	−	—	We remain underweight UK equities and political uncertainty has reinforced this view. Momentum in the UK economy has clearly slowed. Uncertainties around Brexit have bitten into capital expenditures and, due to recent higher inflation, also impacted real consumer incomes. Focus should remain on large-caps and export oriented companies. However, domestic names are starting to look attractive and the better quality companies can be bought, particularly if softer Brexit options come into play.

Equity Allocation Grid

Based on a balanced mandate, the table below provides our long-term (strategic) and short-term (tactical) house view on investment strategy.

Key

+	●	−	▲	–	▼
Overweight	Neutral	Underweight	Upgrade	No Change	Downgrade

Sub-Asset Class	Strategic 12-month		Tactical 3-month		Sub-Asset Class Additional Guidance
	View	Change	View	Change	
Switzerland	●	–	+	–	Swiss equities have performed better relative to the rest of Europe, principally due to stock specific impacts and more recently the weaker CHF. Valuations are improving at the large-cap end but we remain focused on the small and mid-cap sector for now.
Japan	+	–	+	–	We remain bullish on Japan on the basis of a broadening out of monetary and fiscal stimulus. The recent election result provides even more stimulus for the Japanese stock market. With global growth conditions improving and a range-bound JPY, we maintain our overweight. Relative performance is also now improving in local terms and valuations are attractive from a historical viewpoint. We continue to find lots of opportunities at the company level. The emphasis on "exporters" versus "domestics" should be balanced. Given that the JPY is in our 110-115 target zone, we are indifferent to hedging. But we are now on alert for an upside break following the election result on a further stimulus agenda.
Asia Pacific ex-Japan	●	–	+	–	Our confidence in Asian equities and our Emerging Market overweight call continues to be strong. North Asia has been the hands-down winner this year and it remains our focus within Asia. These markets are proxies for global growth and with China continuing to accelerate the overweight should remain in North Asia. Valuations are also reasonable especially in the context of accelerating earnings growth. India has been a strong performer, but valuations are now becoming a liability.
Eastern Europe, Middle East and Africa	+	–	−	–	We are tactically downgrading Eastern Europe, Middle East and Africa (EMEA) as previous oil price trends and greater political uncertainty make us a little more cautious. From a longer term perspective, we find the negative / low yield environment to be an attractive driver for equities and coupled with cheap valuations the forward-view looks attractive. This outlook should be considered as part of our wider positive view on Emerging Markets.
Latin America	+	–	+	–	Economic conditions have stabilised in Latin America and this has led to better inflation conditions and an improved growth outlook. The political scene in Brazil is uncertain - our view is that better economic conditions in the medium term will prevail. Mexico also continues to look attractive as reforms locally start to improve the market environment. Recent local elections have also been a net positive for market sentiment. In the region, broad earnings upgrades continue and if inflation is not too drastically impacted, further interest rate cuts will ensue, which is positive for Latin American equities.

Fixed Income Allocation Grid

Based on a balanced mandate, the table below provides our long-term (strategic) and short-term (tactical) house view on investment strategy.

Key

+	●	–	▲	–	▼
Overweight	Neutral	Underweight	Upgrade	No Change	Downgrade

Sub-Asset Class	Strategic 12-month		Tactical 3-month		Sub-Asset Class Additional Guidance
	View	Change	View	Change	
Sovereign	–	–	–	–	We remain strategically underweight government debt. We believe that overall duration should be underweight. Our core view is that the Federal Reserve will hike one more time this year. Inflation in Europe is forecast to pick up in the medium term although in the US we are waiting for the Trump tax plan to assess whether this will lead to a boost to inflation expectations. Curves in Europe are steeper, suggesting a pick up in inflationary expectations. The debate is focused on tapering, but timing will be dependent on a pick up in inflation expectations. However, there is no evidence of this as yet, driven in part by the stronger EUR.
Investment Grade Corporate	+	–	●	–	Corporate bonds in investment grade are attractive on a relative basis although due to the strong rally in yield spread the attractiveness is reducing. However, we do not see significant widening coming. Our focus strategically is on undervalued high quality, long-dated bonds in the IG space in the US and Emerging Markets given the marginally better valuations and fundamentals. We would strongly avoid UK corporate bonds given an uncertain growth environment.
Convertible	+	–	+	–	We confirm our overweight to convertibles. Some of the profit in corporate bonds or high yield could be allocated back into convertibles. However, we are mindful that we are overweight corporate bonds and Emerging Market fixed income, so risk management should determine the overall split.
High Yield	●	–	●	–	High yield spreads continue to bounce around cyclical lows, although new issuance recently has caused some indigestion. As a result the prospect of further capital gains is limited to individual security selection. The carry remains attractive relative to Investment Grade corporate bonds and government bonds. Last quarter we downgraded our strategic weighting to neutral, although we do not see a sell-off in the near term given the stronger global growth dynamic. On a sectorial basis, energy and asset backed car loan debt should be avoided.
Preferred & Hybrid	+	–	+	–	Preferred and Hybrid debt is closely correlated with equity markets. Given that over the last 12-months both convertible and P&H have underperformed relative to high yield, we have already increased positions to the higher risk elements of fixed income at the expense of the high performing areas. Mortgages, particularly in the US, offer diversification relative to high yield.
EM Local Currency	+	–	●	–	Growth continues to improve and this should be positive for debt spreads. We would prefer hard currency Emerging Market bonds, although selectively we like local currencies as well. On a very short-term view, we note the sensitivity to a stronger USD and rising US long term rates for EM spreads, so we could have some near-term volatility into year-end. As a result we have tactically cut our weighting to neutral after a very strong run so far this year.

Alternatives Allocation Grid

Based on a balanced mandate, the table below provides our long-term (strategic) and short-term (tactical) house view on investment strategy.

Key

+	●	–	▲	–	▼
Overweight	Neutral	Underweight	Upgrade	No Change	Downgrade

Sub-Asset Class	Strategic 12-month		Tactical 3-month		Sub-Asset Class Additional Guidance
	View	Change	View	Change	
Hedge: Directional / Equity-linked	+	–	+	–	We prefer equity managers with strong stock picking skills, which should benefit from less intra-market correlation. Low Net and MN managers' returns are more alpha related and hence we favour them. In the Special Situations space, we prefer hard to soft catalyst strategies.
Hedge: Carry / Credit	●	–	●	–	Stricter regulation coupled with less activity from dealers is creating a new market liquidity paradigm. As such, the risk seems to be quite high in the L/S Credit space, whereas some illiquidity premium can still be captured in the securitization segment of that market. Distressed could become more attractive and volatility-sensitive strategies should do better.
Hedge: Uncorrelated	●	–	●	–	Macro divergences along with a pickup in volatility due to the increased political risk the world may face should create a fertile ground for Trading Strategies. However, manager selection will be a key factor to generate performance as we expect higher discrepancies across fund returns especially on the discretionary side. We still have a preference for systematic approaches.
Commodities / Mining Equity	●	–	+	–	We are still strategically neutral on commodities. With cyclical inflationary pressures building and demand for commodities increasing it makes sense to reflect a more tactical positive bias, particularly in industrial commodities. To be clear, we do not include gold mining in this cyclically positive view, and favour industrial commodity companies. Oil is approaching the top of its range which will spark additional supply, particularly in WTI. Gold is generally inversely correlated to a strong US dollar, so we are wary holding the precious metal other than for diversification purposes or risk mitigation.
Property / REITS	–	–	–	–	Last quarter we downgraded REITS (Real Estate Investment Trusts) to strategically negative. We believe that concerns remain regarding the impact of Federal Reserve rate hikes on the sector and this will put pressure on REITS. We note the problematic consumer malls area as well. UK / London real estate should be avoided, as prices have not fallen enough to reflect uncertainty. Illiquidity in UK real estate funds remains, and is reminiscent of the first wave of illiquidity that came during the Bear Stearns funds crisis early on in the last financial crisis. Clearly not to the same extent but often these instances rhyme.
Insurance-linked Securities	●	–	–	–	We are neutral on insurance-linked securities. Despite, the recent spate of hurricanes the catastrophe market is still looking fully valued.
Other	●	–	+	–	Long volatility structured products should be considered to hedge short-term spikes in volatility. The recent lull in volatility has created such an opportunity. Any move is still likely to be cyclical rather than structural.
Infrastructure	●	–	–	–	We downgrade further infrastructure investments due to a renewal of rising US and European interest rate trends and the extraordinarily high valuations. Longer term we do find infrastructure attractive as we believe infrastructure and non-correlated yield is attractive. However, it is important to 'liquidity adjust' (to adjust for and manage liquidity appropriately).

Currency and Cash Allocation Grids

Based on a balanced mandate, the table below provides our long-term (strategic) and short-term (tactical) house view on investment strategy.

Key

+	•	–	▲	–	▼
Overweight	Neutral	Underweight	Upgrade	No Change	Downgrade

Sub-Asset Class	Strategic 12-month		Tactical 3-month		Sub-Asset Class Additional Guidance
	View	Change	View	Change	
USD	•	–	+	–	The USD has been weaker as a result of the lack of progress from Trump on growth initiatives and more recently the debate around the Federal Reserve leadership. A resumption of interest rate hikes, stimulative tax cuts from Trump and improvements in global growth are positive for the US dollar. However, we recognise strategically that the US dollar is further along its rate hike cycle than its peers.
EUR	•	–	–	–	We are strategically neutral on the EUR given the stronger data from Europe and resiliency to heightened political risks. However, we feel the recent rally has been too far too fast, especially in the context of "no change" in fundamentals. Given the stronger EUR, we think that Draghi will be more cautious on tapering and will prefer to address the issue only when he has to. We note also inflationary pressures are not yet visible. So a dovish outlook relative to a quiet Federal Reserve will bring the EUR back into its longer term range.
GBP	–	–	–	–	The GBP has picked up as a result of a more hawkish MPC. However, with our inflation models starting to turn lower, we are still inclined to stay with our short GBP call. Any move by the MPC we would see as a potential policy mistake, especially given the uncertainties of Brexit. We also note the unusual UK current account deficit as another fundamental reason to be cautious.
AUD	•	–	•	▼	We previously had a more positive view on AUD, as a result of the more positive commodity cycle. However, macro-prudential policy by the RBA is having an impact on the AUD, and there are some potential issues on the horizon with respect to excessive consumer debt.
Asia	•	–	•	–	We expected the Japanese yen (JPY) to remain range bound. We will look for any strength below 110 to go short and a move towards 120 to go long. The Japanese election result extends the pro-growth and inflation agenda. We may need to assess the top end of the range after the election. Ranges may well be contained for the time being. We remain neutral on the Chinese renminbi (CNH / CNY) which is trading in line with its "float range" against the USD. We like IDR as a long-term structural bullish story on Indonesia.
Other	•	–	+	–	The CHF against the EUR has been trading with a weaker bias, as benign macro and political conditions take hold. We do not, at the moment see this trend reversing.

Sub-Asset Class	Strategic 12-month		Tactical 3-month		Sub-Asset Class Additional Guidance
	View	Change	View	Change	
Money market	•	–	•	–	We are neutral on money market instruments. We prefer floating rate notes and commercial paper.
Cash	–	–	–	–	Cash levels should remain low.

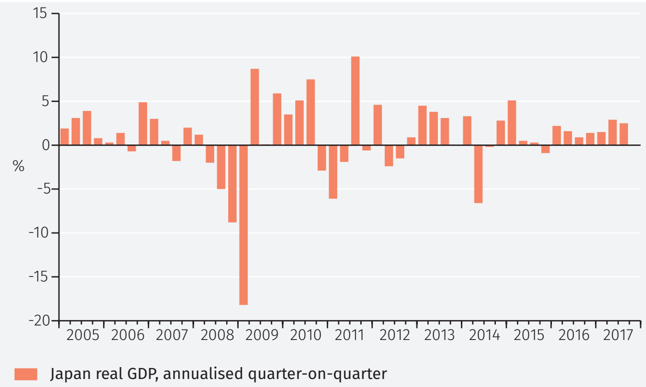
Macro Summary

The global economy continues to power on. Composite PMIs have flattened out recently but remain at an elevated level, indicating robust levels of activity. For example, US PMI data remains close to multi-year highs and global economic data has generally continued to beat expectations, as evidenced by extended economic surprises.

Donald Trump is now one step closer to the first legislative victory of his presidency. Both chambers of the US legislature have passed their own versions of a tax reform bill, the first overhaul of the US tax code in a generation. At the core of the bill is a proposed drastic corporate tax cut, with more modest reductions for individual taxpayers. While generally supportive, the political environment has also sparked some uncertainty after reports surfaced that former National Security Advisor Michael Flynn had pled guilty to misleading the FBI and was cooperating in the Mueller investigation.

Against a background of continued solid US job gains and gently rising prices, the Federal Reserve hiked rates in December, as expected. This was the third hike this year and the fifth since the tightening cycle started in December 2015. It was also Yellen's last planned press conference which she used as an opportunity to confirm the FOMC's intended gradual path of raising interest rates. New Fed Chair Jay Powell takes charge from next February and is not expected to change significantly the future of monetary policy in the US, with a continuation of the current gentle tightening strategy widely anticipated. Currently the market expects another two or three rate hikes in 2018.

1. Japan GDP



Source: Bloomberg as at 15 December 2017.

The increase in global inflation of the last 12 months largely reflects currency moves and commodity price rises. Those inflation impulses have now faded in most parts of the world. Eurozone inflation has on balance been a bit weaker than expected and ECB President Draghi recently noted that "domestic price pressures remain muted overall and have yet to show convincing signs of a sustained uptrend". The UK remains the exception, as inflation has crept higher. However, even in the UK the expectation is that inflation will decline into the year end and first part of next year.

The ECB is therefore expected to continue to adopt an accommodative monetary stance while the outlook for the BoE is less certain. The BoE has hiked once this year and indicated that it expects to hike further – albeit at a slow pace – over the next few years. Recent progress on Brexit negotiations should reduce economic uncertainty while Chancellor Hammond's Autumn Budget was marginally stimulative. Nonetheless, the combination of higher than expected inflation, surprisingly robust indicators of current economic activity and the potential for future Brexit disruption means that the BoE is the central bank for which there is the most policy uncertainty

The Japanese economy has recorded seven consecutive quarters of economic growth through September and is looking increasingly robust (see Figure 1). December's preliminary Nikkei-Markit manufacturing PMI climbed to 54.2 from 53.6 in November, the highest for several years, and the headline indicator from the Tankan survey of business confidence rose to an 11 year high. BoJ Governor Kuroda has indicated that the Japanese central bank may make changes to its yield-curve control program when inflation reaches the 2% target although we do not expect that to occur for a long time. In the meantime the BoJ remains committed to overshooting the 2% inflation target suggesting continued very easy monetary policy.

Justifying its price-rebound, oil market fundamentals have improved. An OPEC-NOPEC deal to extend output cuts beyond March 2018 suggests the market will remain well supported. The threat of price disruption from US shale has lessened somewhat although should the price rise significantly this will eventually encourage more shale exploration and production.

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Source information

The source for data used in this publication is Bloomberg, as at 18 December 2017, unless otherwise stated.