Asset Class & Investment Outlook - Q4 2016

Asset/Investment Area	Income (Current Yield)	Rising Income	Long Term Real Capital Growth	Volatility	Inflation Protection	Currency Risk	Commentary
Cash	1.00%	Potentially	Slightly Negative	Very low	No	No	*UPDATE: The Bank of England has cut the UK base rate to 0.25% which has serious implications for cash investors, but we still consider a cash component to portfolios to be important at a time when markets are likely to be unsettled. In particular we are holding some tactical cash to be redeployed when equity markets are at more reasonable valuations.*
Conventional Gilt	0.72%	No	Negative	Some	No	No	*UPDATE: The 10-year benchmark gilt yield remains at less than 1% and is currently 0.72%. Monetary policy is still propping up bond prices in general for now, but markets are beginning to be unpredictable as evidenced by the global spike in bond yields in the week commencing 12 September when prices fell and yields spiked for no immediately discernible reason. Some commentators have suggested markets are losing faith in QE as bond yields fall into historically low and even negative territory. We retain our negative view based on valuation concerns and the distortions evident in markets.*
Index-Linked Gilt	-1.92%	Yes	Negative (at present)	Some	Yes	No	*UPDATE: Index-linked gilts remain overvalued and all bonds in issue have negative yields. A perception that the economic outlook might be deteriorating, an uptick in inflation as commodity prices (especially oil) have increased in the last year and revived quantitative easing operations by the Bank of England should all continue to support prices and supress yields in this asset class. There is no shortage of buyers for this debt because of the distortions created by forcing pension schemes to engage in liability matching policies. We remain negative.*
Sterling Corporate Bond (Investment Grade)	2.69%	No	Negative	Some	No	No	*UPDATE: Yields have also fallen in corporate bond markets and commentary states that trading volumes are low, indicating a lack of liquidity although issuance has picked up as the Bank of England has included corporate bonds in its new round of QE operations. There is no negative yielding Sterling corporate debt yet, but Unilver did issue a bond paying a 0% yield in July. Renowned bond manager Richard Woolnough, who runs the £15.5bn M&G Optimal Income fund, wrote an extraordinary piece in September stating that falling bond yields meant fixed-income assets had lost their advantage over cash because the low or negative income now offered by bonds was insufficient to offset the risk of capital losses. We have been stating this view for over 2 years and retain our negative view on this sector.*
Sterling Corporate Bond (High Yield)	4.80%	No	Negative	High	No	No	*UPDATE: Spreads have increased since the Referendum and higher yields are available than in other markets but we consider this market to be especially susceptible to liquidity risk and have a negative view.*
International Corporate Bond	2.09%	No	Negative	High	No	Yes	*UPDATE: European credit is supported by the ECB's quantitative easing programme, although this is constrained by the fact that bonds must yield at least -0.4% to be eligible for purchase. Issuance from major corporates is buoyant to take advantage of low interest rates and European bond markets moved into unprecedented territory when Henkel and Sanofi recently issued 2-year and 3-year debt respectively with negative yields. This is a curious situation, where companies are paid to borrow, but buyers were found for the debt as the negative yield was higher than that of 2-year Bunds. US investment grade corporate bond markets have issued $550 billion of debt this year and are offering higher yields, but remain overvalued. This debt is financing activities such as buybacks and mergers and acquisitions rather than capital expenditure and may not prove productive. It is also vulnerable to any increase in US interest rates. We do not intend to become embroiled in such extraordinary market conditions either side of the Atlantic.*
Emerging Corporate Bond	4.73%	No	Negative	Very high	No	Yes	*UPDATE: Currency is a huge influence on this debt and US dollar denominated bonds are tied in with US monetary policy. Local currency bonds require careful examination of individual currency and spread factors. Investors hunting yield levels not available in developed markets are driving up prices and ironically compressing yields in the process. We remain negative on this sector due to its volatility, poor liquidity and ongoing currency and interest rate risks.*

Asset/Investment Area	Income (Current Yield)	Rising Income	Long Term Real Capital Growth	Volatility	Inflation Protection	Currency Risk	Commentary
UK Equity (Equity Income)	3.87%	Yes	Yes	High	Yes, med term	No	*UPDATE: The latest Capita UK Dividends Monitor report indicates that UK dividends are likely to be assisted by the currency translation benefits that UK multinational companies are receiving due to Sterling weakness. Our recent meetings and calls with a number of leading UK Equity fund managers including Neil Woodford, Mark Barnett and Adrian Frost has once again emphasised the need for selective stock picking to retain a mix of companies with sustainable dividends combined with those with the potential for dividend and capital growth. Equity Income yields continue to look attractive compared to bonds and property and equities retain their liquidity even if they are quite fully valued. We retain our selectively positive view on this sector for long term investment.*
UK Equity (Other)	3.31%	Yes	Yes	High	Yes, med term	No	*UPDATE: The Referendum result has created business uncertainty, but economic data has remained firm so far. In the short term movements in Sterling will determine the relative attractiveness of domestically or overseas exposed companies but there continue to be a selection of domestically focused companies with strong fundamentals and growth potential that can be identified by talented active managers. We remain neutral whilst the details of Britain's exit from the European Union are determined.*
Global (Equity Income)	2.83%	Yes	Yes	High	Yes, med term	Yes	*UPDATE: We remain focused on funds investing in high quality companies that are likely to sustain profit margins and deliver returns through the economic cycle and which offer growing and sustainable dividends. Currency translation effects have assisted performance since the Referendum due to the weakness of Sterling. We retain a positive view on a long term basis but have taken some profits at the margins based on the high valuations of many equity markets and the fact that this has been based on the liquidity created by quantitative easing rather than improvement in fundamentals.*
European Equity	2.37%	Yes	Yes	High	Yes, med term	Yes - €	*UPDATE: European markets are exposed to political uncertainty following the UK EU Referendum, whilst the broad UK situation is known even as the details are worked out. We continue to focus on global leading businesses that happen to be based and listed in Europe or on growth companies that play in a niche area with barriers to entry. Our carefully selected fund choices have substantial non-Eurozone exposure and are orientated towards the stronger performing economies on the continent.*
North American Equity	1.30%	Yes	Yes	High	Yes, med term	Yes - $	*UPDATE: Cyclically adjusted valuations remain high at 27X Price/Earnings despite lower earnings expectations. Profit momentum has slowed at the market level due to the stronger US dollar and currency effects on international earnings. Wage increases may stoke inflation. Political risk is also evident in the run up to the presidential election. We therefore remain slightly negative.*
Asia ex Japan Equity	1.58%	Mixed	Yes	Very high	Yes, med term	Yes	*UPDATE: China is committed to shifting its economy from resources to services and continues to experience slower growth in consequence. It also has large scale debt following non-productive infrastructure development and it remains to be seen how this will be resolved. A recent BIS report confirmed that shifts in the Chinese exchange rate and stock market have a statistically significant impact on regional counterparts, so the situation in China has broad implications for the entire region. We remain very selective, with investments concentrated in defensive funds. Income is rising in some markets but it is important to assess the sustainability of dividends.*
Japan Equity	1.27%	Mixed	Yes	High	Yes, med term	Yes - ¥	*UPDATE: Aggressive monetary policy featuring negative interest rates and large scale quantitative easing has failed to combat deflation or to have noticeable effects on the real economy. In Yen terms Japanese equities have not performed well in the year to date. On the positive side we also note the change in attitudes towards paying dividends by companies, with a 15% increase in dividend payments in 2015 and a similar increase anticipated this year. On the other hand a number of leading companies such as Sony, Panasonic, Toshiba and Hitachi have actually cut dividends so we are monitoring the situation to see how stable dividends are and whether the dividend increases have longevity or are merely a reaction to extraordinary monetary policy. At present we retain a negative view on having dedicated exposure to this market.*

Asset/Investment Area	Income (Current Yield)	Rising Income	Long Term Real Capital Growth	Volatility	Inflation Protection	Currency Risk	Commentary
Emerging Market Equity	2.15%	Mixed	Yes	Very high	Yes, med term	Yes	*UPDATE: The performance of emerging markets has improved this year, albeit from a low base. Whilst we recognise the rising share of telecoms, technology, consumer and healthcare companies within the leading stock markets in this group (which remains very eclectic), we also note that many areas are still tied to commodities and more cyclical investments. We continue to prefer to have very minor direct exposure to this area through the few robust stocks that our carefully selected global fund managers have included in their portfolios. Analysis reveals there is sufficient indirect exposure through the revenues of the leading multinational companies in our global and UK funds which will allow us to capture the long term structural growth and rising affluence of many of these countries.*
UK Commercial Property	2.74%	Yes	Yes	Cyclical	Yes	No	*UPDATE: The Referendum had an immediate impact upon UK property funds with a number having to suspend redemptions. Most also moved to "fair value" pricing (which reduced the value of holdings) following large scale sales of units. In total £35 billion of investor's assets were frozen in suspended funds. Many now plan to reopen in October, and some are removing the fair value adjustments. But others could remain closed for 6-8 months such as the Aviva Property fund. This is the second time property funds have had to be suspended in recent memory, with many closing during the 2007-08 financial crisis and the recent situation vindicates our long standing liquidity concerns regarding these funds, which we do not believe are suited to daily trading. We also note that yields are at best comparable to equity income funds and often not as good once all taxes and charges are taken into account. We therefore retain our negative view on this sector.*
Listed Infrastructure	2.08%	Yes	Yes	High	Yes, med term	Yes	*UPDATE: The asset class has delivered downside protection in choppy markets and continues to have attractions such as barriers to entry, pricing power and predictable cash flows. The investable universe is still expanding due to privatisation and sales from conglomerates and private equity. Valuations remain quite high and are further increasing on hopes of fiscal stimulus encompassing infrastructure projects in major developed markets. Additionally, yields are not impressive compared to UK and Global Equity Income funds leading us to retain our neutral view. It is also worth noting that a number of our carefully selected UK and Global Equity Income funds have small allocations to individual infrastructure stocks and it is now a moot point whether a dedicated allocation to this sector is necessary.*
Commodities	0.00%	No	Yes	Extreme	Yes, med term	Yes	*Various factors influence individual commodity prices including relative currency levels, Chinese demand, Middle East tensions and climatic conditions. Gold prices have risen substantially in the year to date, in part because low and zero interest rates have reduced the opportunity cost for holding gold. Prices are now above $1,330, but they remain below their peak of $1,895 in 2011 and we remain cautious because the price has proven so volatile over the long term. Overall we retain our negative view on commodities based on their volatility and the difficulties of obtaining exposure to them with limited physical ETFs available and with a negative house view on synthetic ETF strategies.*

Notes:

Terms positive and negative represent our current tactical allocation adjustments to an established and well diversified portfolio. No base asset allocation stipulated.

The yield to maturity figure for various fixed income ETFs has been used as a proxy for yields within most sectors.
This metric is calculated by aggregating the yield statistics for each of the securities that make up a bond ETF and is, therefore, reflective of yields within the market.
Yield figures have been compiled as follows:
Conventional Gilt - UK 10-year benchmark gilt yield
Index-Linked Gilt - Average yield for UK Index-Linked Stock 22 November 2027, 22 March 2029 and 22 July 2030.
UK Corporate Bond (Investment Grade) - Yield on Vanguard Investment Grade Bond Index fund
UK Corporate Bond (High Yield) - Average yield of funds in IA Sterling High Yield sector.
International Corporate Bond - Yield on PowerShares International Corporate Bond ETF
Emerging Corporate Bond - Yield on iShares JPM $ Emerging Markets Bond ETF
UK Commercial Property - Average of the Yield on Aviva Property Trust, Aberdeen Property Trust, M&G Property Portfolio, Henderson UK Property, F&C UK Property and L&G UK Property Trust
Infrastructure - Average of yield on First State Global Listed Infrastructure, CF Canlife Global Infrastructure and CF Macquarie Global Infrastructure
UK Equity Income - 110% of the FTSE All-Share yield
UK Equity (Other) - Yield on Vanguard FTSE UK All-Share Index
Global (Equity Income)- 110% of the FTSE All-World yield
European Equity - Yield on Vanguard FTSE Developed Europe ex-UK (Benchmark: FTSE Developed Europe ex-UK Index)
North American Equity - Yield on Vanguard US Equity Index Fund (Benchmark: S&P Total Market Index)

Asia Ex Japan Equity - Average yield of funds within the Asia Pacific Excluding Japan IA sector
Japan Equity - Yield on Vanguard Japan Stock Index (Benchmark: MSCI Japan Index)
Emerging Market Equity - Yield on Vanguard Emerging Markets Stock Index (Benchmark: MSCI Emerging Markets Index)
Commodities - TR/Jefferies CRB Index

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