Psigma
Investment Management

For Professional Advisers only

Psigma Asset Class Outlook

Q3 2019

The Psigma Investment Team meet quarterly to review and update their five years asset class, inflation and interest forecasts. This meeting is the central pillar of the Psigma Investment Process and the report is compiled to help you understand any key decisions we have made or will make in the foreseeable future across our client portfolios.

In This Quarter's Report

Psigma's Key Views on Financial Markets & the Global Economy

- The **first half of 2019 brought a major recovery in asset markets** after the challenges of the final quarter of 2018. All markets around the world rallied in an extraordinary period for gains, with equity markets enjoying their best start to the year since 1987.
- In direct contrast to the boom in asset markets, the **global economy suffered a period of sluggish growth**, with an obvious slowdown taking place in all of the export-focused economies of Asia and Europe. As yet, there has been no obvious sign of recovery in the mercantilist economies. Even the previously strong US economy saw growth ratchet down to a slower rate, as the global economy slumped down through the gears.
- Our view from the start of this year was that **2018 saw the peak of growth for this economic cycle and we fully expected the slowdown that we are now experiencing**. Our view was also that the global economy would see its growth rate fall back to "trend" levels of growth. However, we view the medium-term trend growth of the global economy as being below that which the wider consensus expects and believe that sustainable growth from the global economy is around 2.5% real GDP growth. We are far from convinced that equity markets have come to a similar realisation and that is a key factor behind our more conservative long-term growth assumptions.
- Our expectations for lower economic growth are built around the poor demographics we are seeing across the developed world, the **high levels of outstanding debt that exists across the world and lower levels of productivity.** There is a chance that these negative factors improve but it would have to be a historic effort, in all honesty.
- **Short term growth could reach a trough** in the coming months. There has been a combination of monetary stimulus and fiscal support that could support growth and prevent a major economic downturn.
- The **ongoing "trade wars" between the US and China, have also been an impediment to recent growth rates.** Global trade grew impressively in 2017, but with the opening salvo of a mutually-impairing trade war between the US and China having been fired, obstacles to free trade have been raised and this is undoubtedly a concern we need to monitor as we enter the second half of 2019. The market has once again become optimistic that a deal between the US and China will occur, but we are sceptical that it will be particularly impressive over the long run. **More importantly, we feel strongly that a new era of geopolitical uncertainty between the US and China has started and that this will act as a brake on global growth in the future.**
- The US Federal Reserve has carried out a major volte-face with regards to their likely future monetary policy over the last nine months. At the start of the fourth quarter of 2018, the expectation was for further rate hikes in 2019 and a continued shrinking of their "balance sheet", which had built up over the post-financial crisis years' quantitative easing policies. Now **the next move from the Fed is fully expected to be a cut, with more to follow in the coming months, and they have decided to stop their quantitative tightening process**. This has, in our view, been the major driver behind positive asset market returns in the last few months. **In all honesty, we expect the Federal Reserve to start up the printing presses again in the not-too-distant future, to help fund the growing US government fiscal deficit.**
- At least the Federal Reserve was to raise interest rates before capitulating towards easier monetary policy again; the European Central Bank might not ever be able to raise rates again. Indeed, having only recently started to stop their monetary policy measures of the last decade, the ECB have been forced to change tack and loosen policy again. This is reflective of the fact that the **European economy is suffering from a combination of bad political decisions, a lack of proper structural reform, the constraints of the single currency, low levels of economic growth and persistently low levels of confidence.** In all honesty, monetary policy is not going to be enough to change those dynamics.

Psigma's Key Views on Financial Markets & the Global Economy (Continued)

- The **UK continues to stagnate under the fog created by the never-ending process of leaving the European Union.** Economic growth has dwindled, in line with the global economy, with a number of businesses putting off investment until the UK's political path becomes clearer. What happens next is still open to a range of possibilities, not least as we await a new Prime Minister. **Our sense is that there is plenty of "pent up" demand that could help the UK economy when any clarity is achieved on the Brexit situation, but sadly any "clarity" remains totally elusive.** For now, we see no rush for the Bank of England to raise interest rates.
- **China continues to be the pre-eminent driver behind the global economic cycle**, a fact that is missed by many commentators. Certainly, the fiscal and monetary support applied by the Chinese authorities in 2015 and 2016 was the biggest impulse behind the strong growth enjoyed by the global economy in 2017 and early 2018. As that impulse began to fade, the global economy stuttered and growth rates declined to the point where we are now. Therefore, the fact that the Chinese are starting to be more active with their policies now could be a positive dynamic for global growth as we move into the second half of the year. Two caveats should be noted; firstly the Chinese are not being as aggressive as they were in 2015 and secondly there will be some longer-term negative implications of this further addition to China's debt pile.
- Our asset class forecasts are predicting that **future returns from equity and fixed interest markets will be lower than they have been through history;** we believe that "realism" is appropriate at a time when asset valuations are not cheap and the economic potential of the developed world, in particular, is lower than it has been for the last 50 years.
- Our **portfolios are positioned with a "neutral with a hint of caution" stance**, with high levels of diversification and a moderate cash buffer. This helped to partially protect against the volatility of all major asset markets last year. In recent months we have been moderating our risk allocations tactically and have temporarily had more of a "risk-on" approach as we started 2019; we have subsequently reduced risk as markets have risen, **taking money more recently from bond-sensitive investments that had outperformed this year so far.** We are continuing to operate with a flexible mindset as to our next strategy moves, as we head deeper into this unpredictable year.
- Our core view has been since the start of 2018 that there is a "new regime" for the global economy and financial markets from that which we experienced between 2009 and the end of 2017 and we need to be more respectful of rising risks around volatility, valuations and liquidity, while remaining alert to any opportunities that come our way. The key advice we can have for all investors at this time is to **be very "open-minded" about one's ongoing investment strategy.**

Key Themes within Our Portfolios

Global Defensive **25% of Portfolio**	We have maintained some "reassuringly expensive" defensive equity exposure, through global multinationals with strong brands, more often than not with a tech bias. Also known as our "Nifty Fifty" theme. Fund example: **Loomis Sayles Global Growth Equity.**
Inflation Insurance **20% of Portfolio**	Finding inflation protection is hard, but we favour global and inflation-linked bonds over UK inflation linked bonds. Fund example: **Fidelity Global Inflation Linked Bond.**
EM Growth **15% of Portfolio**	Arguably one of the more exciting themes in our portfolios. We particularly like India, given the positive growth dynamics and favourable political backdrop, as well as more broadly the unloved consumer cyclicals across the region. Fund Example: **BlackRock Asian Growth Leaders.**
Yield **25% of Portfolio**	The "hunt for yield" persists in global markets. We still hold positions in asset backed securities and a specialist high yield fund to supplement our existing income selections. Fund example: **Semper Strategic Focus US High Yield**
Equity Recovery **15% of Portfolio**	Probably our "riskiest" theme, but we favour the value markets like emerging markets, Japan and to a lesser extent Europe, which should be heavily geared to any continuation of the equity market recovery. Fund example: **River & Mercantile World Recovery**.

Psigma Asset Class Forecasts – Q3 2019

Red illustrates where a forecast/scenario has decreased from last quarter and **Green** illustrates where it has increased. Please refer to the Appendix section of this report for a full description of each of Psigma's Scenarios.

Scenario	Structural Downturn	Slowdown	Growth	Strong Growth	Psigma Five Year Forecast Return	
% Chance	10	35	45	10	Q3 2019	Q2 2019
Cash	0	0	1	2	0.7	0.7
Sovereign Debt	3	1	0	0	0.7	0.6
Investment Grade	3	3	2	1	2.4	2.3
High Yield	0	1	6	7	3.8	4.0
Index Linked	2	2	1	1	1.5	2.0
Developed World Equity	0	1	7	11	4.6	4.9
Emerging Market Equity	0	1	9	13	5.7	6.1
Property	0	1	3	3	2.0	3.0
Resources	1	3	7	12	5.5	5.2
Gold	10	8	4	1	5.7	5.5
Alternatives	2	4	4	4	3.8	3.6

Psigma Inflation and Interest Rate Forecasts

%	2019	2020	2021	2022	2023	Five Year Rolling Average
Five Year Inflation Forecast	2.0	2.0	2.0	2.0	2.0	2.0
Five Year Interest Rate Forecast	0.75	1.0	1.5	1.5	1.5	1.3

Latest Asset Class Preferences (Based on a Psigma Balanced Strategy)

Red illustrates where the asset allocation has decreased from last quarter and **Green** illustrates where it has increased.

Asset Class	Bandwidth %	Neutral Allocation %	Q3 2019 (1st July) %	Q2 2019 (1st April) %
Cash	0-10	2.5	5.5	4.5
Sovereign Debt	0-10	5.0	5.0	5.0
Investment Grade	5-15	7.5	15.0	15.0
High Yield	0-10	5.0	10.0	10.0
Index Linked	5-20	10.0	7.5	7.5
Developed World Equity	30-50	42.5	38.25	38.75
Emerging Market Equity	5-10	7.5	5.5	5.5
Property	0-5	2.5	0.0	0.0
Resources	0-5	2.5	1.25	1.25
Gold	0-5	2.5	2.5	2.5
Alternatives	10-15	12.5	9.5	10.0

Asset Class Preferences (Based on a Psigma Balanced Strategy)

Asset Class	Short Term View (3 Mths)	Long Term View (1Yr+)	Comments
Cash	Overweight	Underweight	In light of the increased volatility in markets and the strong rebound in risk assets so far this year, we have maintained a moderate overweight allocation to cash. We remain mindful of the deteriorating global growth outlook, increased political tensions across the globe and the elevated valuations of many assets. We are using cash allocations for defence whilst retaining a portion in case the opportunity arises to invest in better priced investments in the coming months.
Sovereign Debt	Neutral	Underweight	In the UK, inflation levels have been picking up over the past few years, largely due to the impact of weaker sterling, following the UK referendum and the subsequent impasse over the terms of any "divorce" bill. This is increasing pressure on the Bank of England to tighten policy. At the same time, economic data continues to weaken, as the "pinch" from inflation begins to impact consumer spending (c.70% of the economy) and capital investment remains subdued due to ongoing uncertainty over the position of the UK post-Brexit. This dynamic argues for looser monetary policy. This conundrum for investors is causing significant volatility in the bond market, particularly at the short end of the yield curve. At current levels, we see limited long term value in government bonds, although we remain conscious of the increased economic risks facing the UK.
Investment Grade	Neutral	Neutral	On an absolute and relative basis, corporate bonds no longer look as appealing as they once did, given the paltry yields now on offer in core government bonds. However, there remain some pockets of opportunity, particularly in the UK, where an attractive "Brexit Premium" has emerged given the uncertain outlook over the UK's political situation. We have maintained exposure to the asset class, limiting our investments to boutique managers who remain extremely nimble and focused, which we believe is vital for the months ahead.
High Yield	Neutral	Overweight	As global economic data points have started to deteriorate government bond yields have fallen aggressively, closing in on all-time lows. The more clouded growth outlook has seen volatility return to the high yield markets, most acutely seen in Q4 2018, as investors have begun reassessing the risks. However, so far this year we have seen a significant rebound in the asset class, in part caused by the duration (the rally in government bonds) as well as a tightening of spreads (the yield premium commanded by investors over and above government bond yields). This market dynamic had led to a sensational six months for the asset class, which has now more than offset the weakness seen at the end of last year. While the asset class no longer looks cheap, we do continue to believe that the asset class is well supported by low, but still positive growth, low inflation, central bank support and default rates that are expected to remain exceptionally low. Nevertheless, with the yield now of only around 4% achievable on a high-quality portfolio of bonds (after hedging costs), we have focussed our allocations on very specific credit opportunities, such as asset backed securities and small cap US high yield bonds, where the risk/return profile is much more favourable.

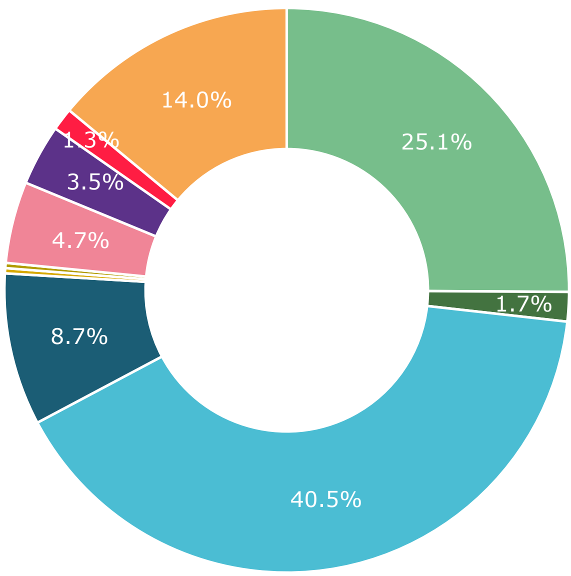
Asset Class Preferences (Based on a Psigma Balanced Strategy)

Asset Class	Asset Class	Long Term View (1Yr+)	Comments
Index Linked	Neutral	Neutral	We continue to maintain our positions in index-linked bonds. Inflation remains fairly subdued at the moment, largely due to some sizable disinflationary pulses that are keeping inflation low. However, we do ultimately believe that inflation will return, once some of the current overhangs are lifted. We believe inflation linked bond prices have reflected this conflicting dynamic, exhibiting a significant amount of volatility in recent years. Where we do have exposure, we have opted to focus on strategies that isolate the "breakeven" or "pure inflation" element of an index-linked bond. Following the weakness in sterling over the last few years, a consequence of Brexit, we have rotated our "unhedged" exposure into "hedged" exposure, preferring to take no further currency risk at this time.
Developed World Equity	Neutral	Neutral	We have a broad split between "quality" and "value" areas of the equity market. "Quality" has performed exceptionally well over the previous few years, with tech, in particular, continuing to lead the market higher and now looks quite expensive and potentially vulnerable to a shift in sentiment, as was seen in Q4 2018. However, we are very conscious of the defensive characteristics of many of these dependable growth companies. On the other hand, "value" areas of the market have performed poorly over the last few years. The disconnect between "value" and "quality/growth" is now as large as it has been since 1999 and we are attracted by the cheap valuations and further recovery potential, should we see a resolution to some the major issues overhanging markets. We continue to remain very keen on Japan as a value play and because of specific "corporate change" opportunities.
Emerging Market Equity	Neutral	Overweight	We remain conscious of the potential headwinds for the emerging world caused by increased geopolitical tensions, as President Trump follows through on his protectionist policies on trade, and as the US dollar remains strong, albeit showing signs of stabilisation. However, on balance, we remain positive on the long term growth prospects of the emerging markets and strongly encouraged by attractive valuations, particularly relative to developed peers. Emerging markets have seen huge outflows in recent years, as sentiment has turned sour. We believe we could now be approaching a point where we should consider adding to our positions, particularly in light of the recent more accommodative stance of the Federal Reserve.
Property	Underweight	Underweight	Commercial property looks fair value and our stance remains underweight. Historically, our exposure has been limited to global REITs, which we expected to do well in a low yield environment. Given the inherent linkage to conventional government bonds ("bond proxies"), and after the rise in valuations in March of 2017, we opted to sell our remaining positions, having taken profits several times previously. We continue to avoid UK commercial property funds, which remain illiquid and have been plagued with negative pricing swings (mid to bid). The Brexit referendum result in the UK and subsequent impasse on divorce terms has also seen a moderate mark-to-market impact on NAVs. Furthermore, UK property remains incredibly vulnerable to any further deterioration in economic fundamentals.

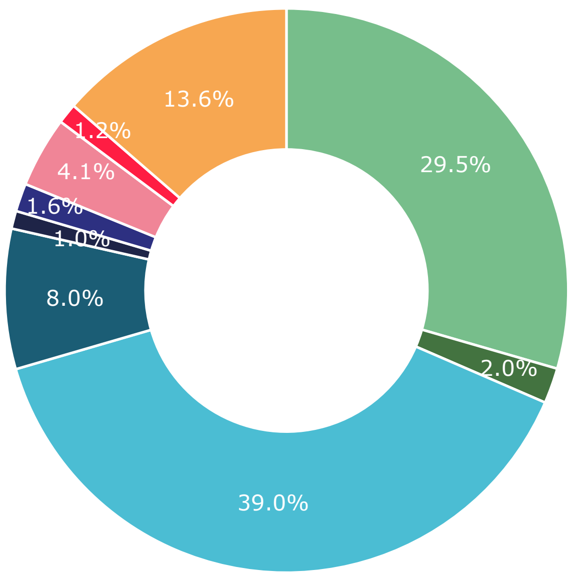
Asset Class	Asset Class	Long Term View (1Yr+)	Comments
Resources	Neutral	Neutral	Commodities look fairly attractive, given starting valuations and recent price performance. Historically, commodities have proven to be good late-cycle investments, benefiting from economic expansion and higher inflation. In recent times, commodities have been hindered by escalating trade tensions/protectionism, synchronised global economic slowdown and developed world policy tightening (end of QE), leading to broad-based US dollar strength. Several of these headwinds look to now be fading, and the prospect of the refocusing stimulatory measures away from monetary easing (QE) to fiscal spending (infrastructure spending) could be a further positive driver for the asset class.
Gold	Neutral	Neutral	We remain relatively positive on gold as a long-term investment. Recent political events paint an uncertain economic future, pointing towards a potentially positive backdrop for the yellow metal. Sentiment appears to have shifted positively in recent months, with gold rallying through a number of key technical levels (to the upside). We continue to believe that gold acts as both a long term inflation and deflation hedge for portfolios, as well as offering protection against global politics. Gold equities continue to trade at a very significant discount to gold bullion relative to history and this is where we are currently focussing our allocation.
Alternatives	Neutral	Neutral	We have maintained our focus on managers with a short and diversified bias, given the uncertain backdrop. Our expectation is that volatility is likely to remain high for the foreseeable future. We continue to use our alternatives weighting to try and add further diversification in an investment environment of high correlations.

Current Regional Equity Allocations (Based on a Psigma Balanced Strategy)

Psigma Balanced Total Regional Exposure



Psigma Composite Total Global Equity Index*



*Our Psigma benchmark is 42.1% DW ex UK, 42.1% UK and 15.8% EM & updated on a quarterly basis.

North America | Latin America | UK | Europe DM | Europe EM | Africa & Middle East | Japan Hedged | Japan Unhedged | Australasia | Asia

Current Regional Equity Allocations (Based on a Psigma Balanced Strategy)

Region	Short Term View (3 Mths)	Long Term View (1 Yr +)	Comment
North America	Underweight	Neutral	We remain somewhat cautious on US equities, given their relative outperformance over the past few years. Despite the recent wobble in Q4 2018, valuations still look expensive, particularly in certain sectors, both in an absolute sense and relative to other regions. The recent strength of the US dollar is also likely to provide a headwind to corporate profits in the short term, which may offset the immediate benefits of the recent tax reforms. Where we have maintained exposure, we continue to favour companies exposed to domestic growth and those benefitting from positive earnings revisions and momentum, such as healthcare and consumer-related stocks. We remain slightly cautious on the "FANG" stocks, given their run in recent years, high valuations and high retail ownership.
UK	Underweight	Neutral	We remain fairly neutral on the UK, although beginning to turn slightly more positive. We are acutely aware that it will be some time before the full ramifications of the 2016 Brexit vote are known, particularly given the ongoing political deadlock in Westminster. At the current juncture, we are still lacking a clear timeline, or indeed an obvious direction of travel. This huge level of uncertainty has led to the UK being extremely unpopular and under-owned, especially on the international stage. However, despite the uncertainty, we do now feel that valuations are starting to look attractive, particularly on a relative basis, as investors increasingly begin pricing in an extremely negative outcome. All else being equal, an unfavourable outcome (hard Brexit), would likely see further sterling weakness, as we have seen in recent years, which should see exporters continue to do well. A more favourable outcome (soft Brexit), would likely see sterling strength and more domestic sensitive names do well. Given the current lack of clarity, we feel that a high quality, balanced and blended approach continues to be the most appropriate.
Europe	Neutral	Underweight	We are increasingly cautious on Europe. Fundamentals at both a country and company level remain challenged with recent data further confirms signs of deterioration. We also remain concerned about the political contagion effect from "Brexit" and the recent elevated levels of terrorism and political pressure on migration policies, which is likely to indirectly impact trade and tourism across the region. Our exposure remains balanced, operating a barbell approach of cheap "value" and more defensive "quality".
Japan	Overweight	Overweight	Our exposure is balanced between export companies and domestic cyclical companies, which should benefit from the on-going policy actions of Japan's authorities a return of positive sentiment and any signs of a pickup in global growth. In 2015 we added a second Japanese fund, focussing on corporate governance, capitalising on the monumental shift in focus in favour of shareholders over corporate management in Japan. Our currency exposure is now balanced, with 50% hedged and 50% unhedged.

Region	Short Term View (3 Mths)	Long Term View (1 Yr +)	Comment
Emerging Markets	Neutral	Overweight	Recent concerns about EM have centred on the normalisation of interest rates in the US, the associated strength in the US dollar and growing global trade tensions. While we are conscious of these headwinds, we do feel that they are now moderating. We continue to focus specifically on the "higher quality" regions, whilst avoiding those that are perceived to be "lower quality" - those heavily reliant on commodity exports. At the current juncture, we like both emerging market debt and emerging equities. We continue to favour India, where we believe that there is a positive sea change afoot under the direction of Prime Minister Narendra Modi, who recently secured a second term. Given the rapid deterioration in sentiment to EM assets in recent years, we continue to re-evaluate our position, with a view to adding to our exposure over the coming months.
Asia	Neutral	Overweight	We are now balanced across the market cap spectrum in Asia but remain heavily exposed to the growing Asian middle-class consumer. At the current time, we still believe that North Asian valuations look more attractive relative to ASEAN peers.

Positive and Negative Contributors from Q2 2019

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Gold Equities: Gold mining companies performed extremely well, having previously been unloved, as the gold bullion price rallied on expectations for looser monetary policy and rising geopolitical tensions. We took profits in our position.	**Protection & Cash:** In a quarter where central bankers did all they could to force investors to buy assets, anything that was negatively positioned and the allocation we held in cash held back overall returns. After a poor month for global assets in May we reduced our position in protective funds, but our cash weighting has crept up as we have taken profits across risk assets that we believe have become expensive.
Infrastructure Equities: Buoyed by the same factors as gold equities, we trimmed our position in infrastructure on the back of strong performance. Such assets have become expensive and are vulnerable to a change in market behaviour, particularly rising bond yields.	**Predictable Fixed Interest:** Investors simply needed to either take as much credit or as much duration risk as possible during the last three months. Our approach of owning predictable and short duration corporate credit instruments produced excellent positive and risk adjusted returns, but it was a time to take more risk. We are confident in our positions and very worried about the wider fixed interest markets.
Global Growth Companies: Growth stocks once again put in a strong quarter of performance with technology and consumer discretionary companies, leading the charge. Our positions in US equities and a global growth manager stole the "yellow jersey" for the quarter.	**Healthcare:** After a strong year in 2018, healthcare companies fell out of favour and suffered relative underperformance to the wider equity market. We shouldn't be churlish as healthcare equities still generated a positive and healthy return and look well set to perform strongly in the uncertain world ahead.
Japanese Active Funds: Our call to be overweight Japanese equities counted against our portfolios, but our active managers generated high degrees of outperformance due to good stock-picking. Active funds broadly did well across the world; long may that continue.	

Appendix - Psigma's Current Four Scenarios

- **Structural Downturn**
- A potential repeat of the 2008/2009 financial crisis or the 1930's Great Depression
- Flight to safety, investors holding cash, with demand for gold and other traditional safe haven assets such as US Treasuries, Swiss Franc and the US dollar

- **Slowdown**
- The global economy does not grow or has negligible economic growth in the next five years
- Central banks reignite the huge stimulus efforts to avert the full Depression scenario, with investors holding safe haven assets over risky assets

- **Growth**
- Continued low growth globally with higher levels of volatility across financial markets and all asset classes. Investors seek yield, through high quality equities and corporate bonds

- **Strong Growth**
- Eurozone issues are resolved, Chinese and US growth accelerates, global unemployment falls.
- Investor confidence returns, with return of risk appetite into cyclical equities, commodities, EM currencies and global financial shares/credits.

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