Psigma
Investment Management

For Professional Advisers only

Psigma Asset Class Outlook

Q4 2018

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

- So far **2018 has proven to be a challenging time for most major asset markets**, with volatility higher than the relaxed environment we enjoyed in 2017. Positive returns have certainly been much harder to come by and we believe that the challenges are here to stay as we head into 2019.
- Many commentators have been surprised by the change in market behaviour, as it has come at a time when the global economy is expanding and corporate profits are expected to grow at a healthy pace in the year ahead. However, our view is that the **global outlook has become more uncertain and when this has been combined with high valuations and creeping complacency**, it has spelt trouble for investors. While we have not become outright "cautious", we recognise that the likelihood is that 2019 is likely to be a challenging year for global asset markets.
- Our forecasts from the start of the year have not changed markedly as the year has progressed. Our expectations earlier this year were that we expected a year of around trend growth from the global economy, but the chances were that **we have seen the best of the growth for this particular economic cycle**. We stressed that we needed to keep "open-minded" about any economic projections, as there remain a confluence of major factors providing a genuinely uncertain short-term future. However, we now expect a slowdown in global growth in 2019 as this economic cycle comes towards an end, before a possible recession in 2020.
- Whilst we are starting to think about an end to this business cycle, **loose fiscal policies in the US and continued "pent-up" economic demand could potentially lengthen the cycle further**. On the negative side, the positive "credit impulse" from China is starting to slow and liquidity in the global economy is tightening.
- The key factors behind the recent market oscillations have been **concerns over global trade, rising market interest rates and signs of a return of inflation**. 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 key concern we need to monitor.
- Certainly, the **greatest change to the regime has been the switch in expectations for interest rates in the developed world**. The surest thing for investors since the market bottom in 2009 has been that central bankers "had your back". Despite the fact that we still live in a world of historically low interest rates, this has now changed, with interest rates rising in the US and the UK and quantitative easing set to be stopped in Europe by the year end (as the European Central Bank itself has stated in recent months). These developments have led to bond yields rising from extremely low levels in global fixed interest markets, leading to volatile and negative returns in core bond markets so far this year.
- **Bond yields and borrowing costs have also been given added upward pressure** from the spending intentions of the US government, which has decided to pursue an extremely loose approach to its finances to spur further growth. When combined with the recent tax cuts afforded to US companies and consumers, the cost could well be extremely high to the future generations with question marks hanging over the efficiency of the spending. It could also lead to a further structural shift lower in the US dollar, although our call made at the end of Q1 2018 for better short term performance from the dollar was well timed and remains in place today, although after recent US dollar strength we are open to moderating our views once again.

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

- Another by-product of the US government's splurge could well be a further inflationary push. Certainly, **the days of disinflation and deflationary fears appear to be behind us** and inflation uncertainty has risen. This has contributed towards rising expectations for US interest rates, with the Federal Reserve (Fed) expected to raise rates one more time in December, following on from the three hikes we have seen already this year. The Fed is also suggesting that they will raise rates three times next year as well, although we are not convinced by this projection, particularly if our views for a growth slowdown prove correct.
- In the UK, the Monetary Policy Committee (MPC) raised rates in August, although we are not convinced by this decision and recognise that their own forecasting powers are not strong and they are prone to changing their minds. We are **sceptical about the merits of the MPC's change in policy** towards a moderate tightening bias, with the UK economy still lingering under a fog of uncertainty.
- In **Europe** there finally seems a commitment to bring to an end the insanely loose monetary policy that has been in place for the last few years; this is a dynamic that might have major consequences for investors and we **might start to discover what price certain assets should be without indiscriminate purchases from central banks** distorting financial markets.
- Our asset class forecasts are predicting that **future returns from equity and fixed interest markets will be lower than they have been through history**. While such returns might be perceived to be "conservative" by the perennially optimistic investment community, we believe that "realism" is appropriate at a time when asset valuations are high 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 healthy cash buffer. This should have helped partially protect against the volatility of all major asset markets so far this year, particularly in the early months of this year, although making positive returns has been challenging. We are operating with a flexible mind-set as to our next strategy moves, as we finish the last lap of 2018 and head in to a new year.
- We are alert to **take advantage of selective opportunities** as they present themselves with emerging market assets chief amongst the investments that we are reviewing for possible increases. Other investments that have performed badly could be ripe for an increase within portfolios, despite our core view that the there is a "new regime" for the global economy and financial markets and we need to be more respectful of growing volatility and rising risks, 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. 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 US Total Return.**
Equity Recovery **15% of Portfolio**	Probably our "riskiest" theme, but we favour the value markets like Japan and to a lesser extent Europe, which should be exposed to any continuation of the equity market recovery, as well as investments in the financial sector. Fund example: **River & Mercantile World Recovery**.

Psigma Asset Class Forecasts – Q4 2018

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	Depression	Mild Recession	Moderate Growth	Strong Recovery	Psigma Five Year Forecast Return	
% Chance	5	30	50	15	Q4 2018	Q3 2018
Cash	0	0	1	2	0.8	0.8
Sovereign Debt	4	3	1	0	1.6	1.3
Investment Grade	4	4	3	1	3.1	2.8
High Yield	0	2	6	7	4.7	4.4
Index Linked	3	3	3	1	2.7	1.8
Developed World Equity	0	1	7	11	5.5	4.8
Emerging Market Equity	0	1	10	14	7.4	6.8
Property	0	3	6	5	4.7	4.7
Resources	0	2	5	10	4.6	4.6
Gold	10	8	4	1	5.1	5.1
Alternatives	2	3	5	6	4.4	4.4

Psigma Inflation and Interest Rate Forecasts (Proprietary)

%	2018	2019	2020	2021	2022	Five Year Rolling Average
Five Year Inflation Forecast	2.5	2.0	2.0	2.0	2.0	2.1
Five Year Interest Rate Forecast	0.75	1.0	1.5	2.0	2.0	1.6

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 %	Q4 2018 (1st October) %	Q3 2018 (1st July) %
Cash	0-10	2.5	3.75	5.0
Sovereign Debt	0-10	5.0	5.0	6.5
Investment Grade	5-15	7.5	15.0	13.5
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	39.0	39.0
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	0.0
Gold	0-5	2.5	2.5	2.5
Alternatives	10-15	12.5	10.5	10.5

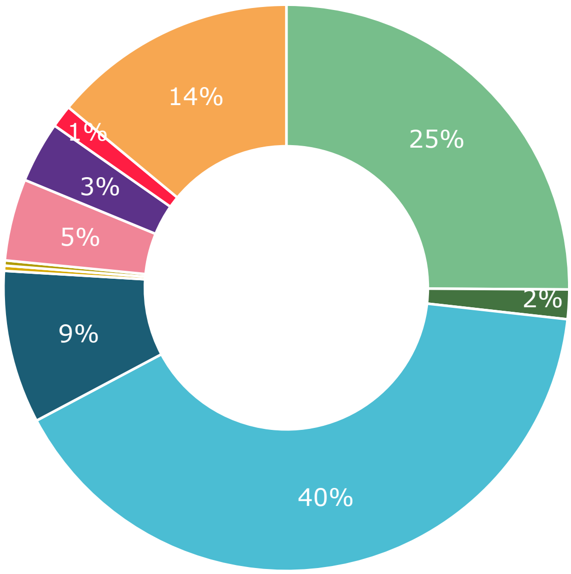
Asset Class Preferences (Based on a Psigma Balanced Strategy)

Asset Class	Short Term View (3 Mths)	Long Term View (1Yr+)	Comments
Cash	Overweight	Underweight	Despite the recent pullback in "risk assets", we have maintained a moderate overweight allocation to cash, given the increased political tensions across the globe and the elevated valuations of many assets. We are using cash allocations for defence and holding back for more attractive opportunities that may present themselves. Volatility has returned in recent months and we remain vigilant of any meaningful shift in sentiment. However, we envisage that we will be committing further capital in the coming months.
Sovereign Debt	Neutral	Underweight	In the UK, inflation levels have been picking up over the last 18 months, largely due to the impact of weaker sterling following the UK referendum. This is increasing pressure on the Bank of England to tighten policy, at the same time that economic data appears to be softening, as the "pinch" from inflation begins to impact consumer spending (c.70% of the economy), arguing for looser monetary policy. This dynamic is causing significant volatility in the bond market, particularly at the short end of the yield curve. At current levels, we still see limited long term value in government bonds, although we remain conscious of the increased economic risks facing the UK. We have maintained a reduced exposure to UK Gilts in recent months.
Investment Grade	Neutral	Neutral	On an absolute and relative basis, corporate bonds now no longer look as attractive as they once did, given the higher yields of government bonds. However, there remain some pockets of opportunity. We have maintained exposure, limiting our investments to boutique managers who remain extremely nimble, which we believe is vital for the months ahead.
High Yield	Neutral	Overweight	After the rally in high yield credit markets and the recent shift in conventional government bonds, we believe that valuations now look fairly expensive. However, we continue to believe that the asset class is well supported by low but positive growth, low inflation, central bank support (despite US rate hike expectations increasing) and default rates that are expected to remain exceptionally low. Nevertheless, with the yield now of only around 5% 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.
Index Linked	Neutral	Neutral	We continue to hold our existing positions in index linked bonds. Although inflationary pressures appear to be building, there are a number of remaining disinflationary pulses that are keeping inflation subdued by comparison to history. Index linked bond prices have reflected this dynamic, exhibiting a significant amount of volatility throughout 2017 and 2018. 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. We also continue to favour global short duration "linkers" as we believe the disinflationary pressures are more structural in nature. 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.

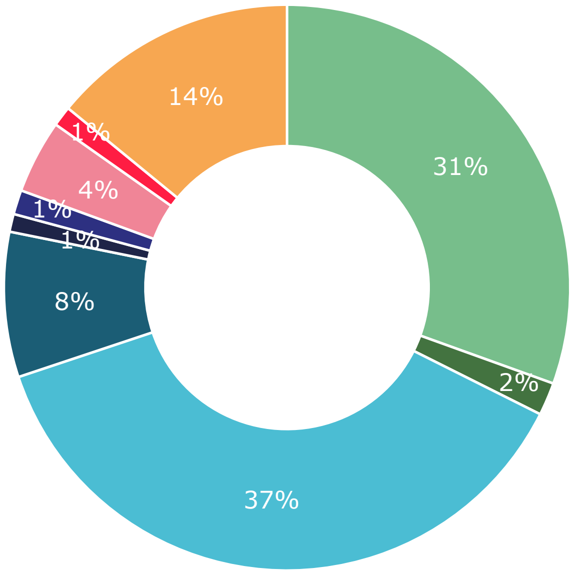
Developed World Equity	Neutral	Neutral	We have a broad split between "quality" and "value" areas of the equity market. Quality" has performed exceptionally well over the previous few years, with tech in particular continuing to lead the market higher and now looks quite expensive and potentially vulnerable to a shift in sentiment. However, we are very conscious of the defensive characteristics of 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 growth is now as large as it has been since 1999 and we are attracted by the cheap valuations and further recovery potential. 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 continues to strengthen. However, on balance, we remain positive on the long term growth prospects of EMs and strongly encouraged by the inexpensive valuations, particularly relative to developed peers. EM assets have suffered huge outflows in recent months, as sentiment has turned sour rapidly. We believe we are approaching a point where we should consider adding to our positions. Our preferred markets remain North Asia, where we see exceptional value over the longer term, although we are conscious of the valuation opportunity in more traditional EMs at the current juncture.
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. However, this is an area we are looking very closely at again, as part of our 'open minded' approach, particularly given the underlying shift higher in bond yields. We do 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 has also seen a moderate mark-to-market impact on NAVs. Furthermore, UK property remains incredibly vulnerable to any deterioration in economic fundamentals.
Resources	Neutral	Neutral	Commodities look fairly attractive as a late cycle investment, benefiting from economic expansion and higher inflation. In the short term, commodities have been buoyed by a synchronised global economic recovery, as well as the prospect of the refocusing stimulatory measures away from monetary easing (QE) to fiscal spending (infrastructure spending). However, over the medium term concerns over developed world policy tightening (the end of QE) and any escalation in the slowdown in emerging markets could continue to provide a headwind for the asset class.
Gold	Neutral	Neutral	We continue to be relatively positive on gold as a long term investment. Recent political events herald an uncertain economic future, pointing towards a potentially positive backdrop for the yellow metal. Sentiment shifted meaningfully over 2017, with gold rallying through a number of key technical levels (to the upside) before consolidating recent gains. We continue to believe that gold acts as both a long term inflation and deflation hedge for portfolios, as well as 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 also a 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

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, 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 tax reform. 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 the recent run, high valuations and high retail ownership.
UK	Underweight	Neutral	We remain marginally underweight the UK, given the overhang of the 2016 Brexit vote, given that it will be some time before the full ramifications are known. Sterling weakness in recent years has seen exporters do well, which could continue, although sterling appears to have found a floor and now probably looks about fair value. The UK remains very unpopular and under-owned and we continue to re-evaluate our exposure.
Europe	Neutral	Underweight	We are increasingly cautious on Europe. Fundamentals at both a country and company level remain challenged with recent data showing 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".

Region	Short Term View (3 Mths)	Long Term View (1 Yr +)	Comment
Japan	Overweight	Overweight	Our exposure is balanced between export companies and domestic cyclicals, which should benefit from the on-going policy actions of Japan's authorities and a return of positive sentiment and synchronised 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.
Emerging Markets	Neutral	Overweight	Recent concerns have centred on the normalisation of interest rates in the US, the associated strength in the US dollar and growing global trade tensions. 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. Given the rapid deterioration in sentiment to the region in recent months, 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 Q3 2018

+	-
Growth Equities: Another strong quarter from the Tech sector helped equity markets higher. Our best performing assets were global growth funds.	**Emerging Market Assets:** Emerging market investments were hit hard during the quarter as fears over a global trade war and a rising dollar hit sentiment.
Healthcare: An overweight to the sector boosted returns as investors returned to the theme after a period of weakness.	**Chinese Equities:** Stock markets in China fell in to a "bear market" in the summer months and our EM funds were overweight in Chinese equities.
Credit Funds: Our global corporate and consumer credit funds posted decent gains despite the rising interest rate environment.	**Protective Instruments:** In a period of strong gains for the US equity market any form of defensive investment proved to be a laggard.
Japanese Equities: Our Japanese equity managers had a great quarter, with our "corporate change" fund selection outperforming strongly.	**Value Equities:** The divergence between value and growth areas of the equity market widened further. In our view an "inflection point" is likely in the months ahead, given the differential in valuations that now exist.

Latest Key Portfolio Trades

Buy	**Lazard Commodities**
	Physical commodities are an excellent late cycle investment, as they capture and reflect real economic growth very effectively

In July we added the Lazard Commodity fund to client portfolios. We believe physical commodities are an excellent late cycle investment, as they capture and reflect real economic growth very effectively. We foresee inflationary pressures being one of the consequences of the late-stage growth, buoyant labour markets and trade tariffs. Commodities have proved this is a positive environment for them – benefiting from increased demand and price rises.

We have chosen the experienced Lazard team as they have a long-term track record of delivering superior performance with their innovative approach; the managers have scope to own stocks as well as owning hard physical commodities (accessed through futures). Their weighting between the two depends on where the team see the best value at any given time.

Appendix - Psigma's Current Four Scenarios

- **Depression**
- 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

- **Mild Recession**
- 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

- **Moderate 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 Recovery**
- 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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