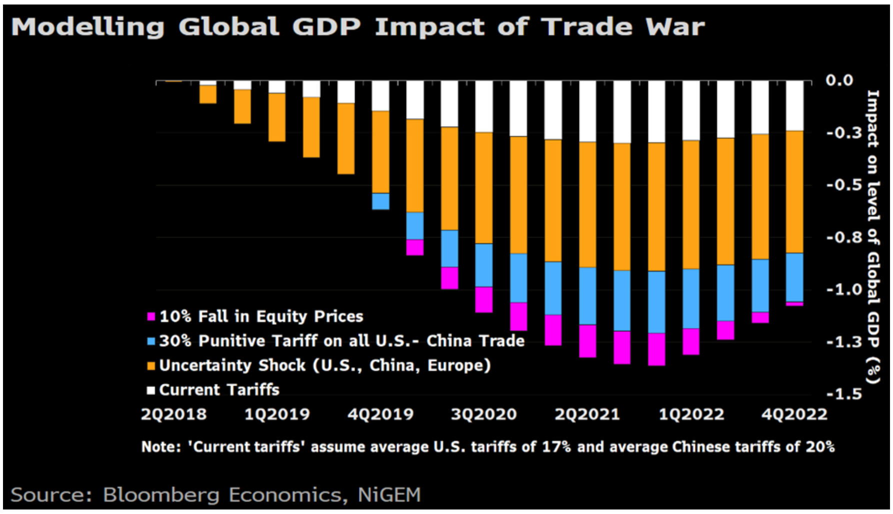
Quarterly Asset Allocation Update

November 2019

In the last few days we have seen seemingly significant progress made on perhaps the two issues that have roiled markets most in the last few years. We speak of course of the decisive victory for Prime Minister Boris Johnson and the Conservative Party in the UK election held last week, and the announcement of an initial phase of a trade agreement between the US and China. During November we had the pleasure of presenting to many investors, and whilst we acknowledged that there are always issues about which investors should be concerned, we also discussed the possibility that we could start to see the outlook improve in a number of areas. Or at the very least not see a further deterioration. For now, that does seem to be the case, and the market reaction has been very positive in the short-term.

Before we move to the discussion of these and other global and local topics, it is timely to share a concept that we have written about previously. Markets tend to be forward looking, and in aggregate what is often most important is not so much a definitive view of whether conditions are objectively good or bad, but rather whether they are getting better or worse. It has also often been observed that markets don't like uncertainty, so any moves to reduce that are generally welcomed. Less uncertainty is being reflected in recent rallies across equity, bond and currency markets following these latest developments.

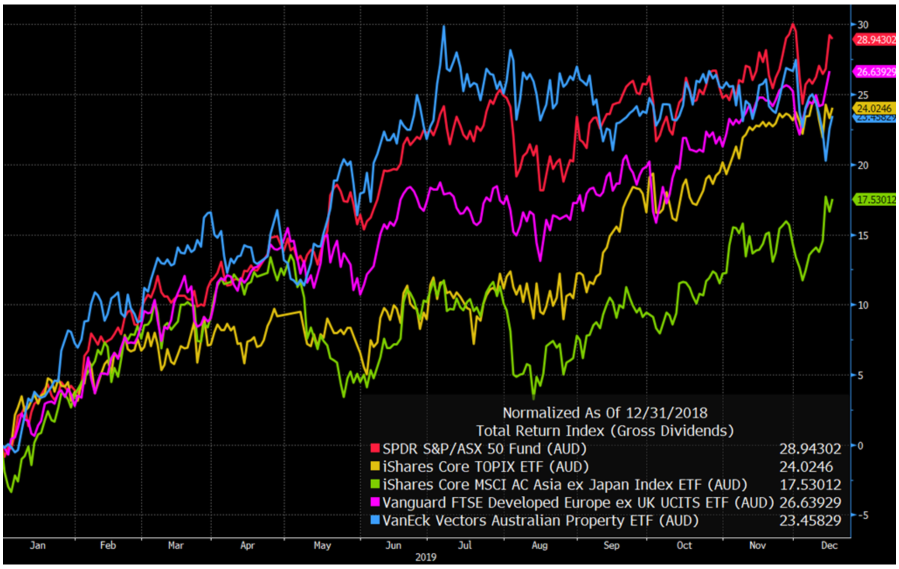


Here we share an updated version of the chart that was in the August quarterly note. As we observed then, there are real economic impacts of the trade war on global GDP (white), but a large part of the effect is uncertainty (orange), and an expectation of further tariff escalation (blue). We may actually start to see the orange, blue and pink impacts in this chart reduce, if this current progress is sustained.

One further point is important, and it is one we have made in both the most recent commentaries and client presentations, and that is that returns don't arrive in a uniform manner. When we share our long-term forecasts later in this commentary, we show the average annual expected return for each asset class over the ten-year forecast period, though there can be wide variance around that number from year to year. The nature of risky asset classes is that

they are volatile, and that bumpy ride requires patience and provides rewards with larger long-term returns than safe assets generally provide. There are periods such as the first half of 2019 where markets rally strongly, periods of consolidation where markets can trade sideways for many months at a time as has been the case more recently, and of course periods where markets retreat.

Pleasingly, as shown here, the total return numbers for 2019 (YTD) are very strong and much better than we forecast at the start of the year. However, we take the opportunity that such strong performance provides to remind investors that there will be further challenging times ahead, and that we should not expect such strong returns to continue indefinitely. As we have often said, all else being equal, higher prices today will generally mean lower returns in the future.



In the remaining space we will make a brief comment on the major economies and markets, leaving a fuller reflection on 2019 and a consideration of the year ahead for the December commentary which will be published in the first half of January.

United Kingdom

We continue to cast our eye over the UK forecast in our model, though for now remain comfortable with not having exposure to this market in International Equities. We agree that it appears almost certain the Brexit deal will pass the new parliament and that it will be completed ahead of the 31 January deadline. However, in a very real sense there remains much work to be done. Specifically, there will be just eleven months during which to reach a new trade agreement between the UK and the EU. To say there is some skepticism about this being achieved would be an understatement, some even referring to it as an "an absurdly narrow window through which to settle a pact of this complexity."[1]

The same article noted: "Virtually no one on the European side thinks it is possible to agree to a meaningful trade deal that quickly — meaning either Johnson will have to break a campaign promise by asking to extend the transition, or Britain and the E.U. could wind up with the same type of sudden break at the end of 2020 that Parliament until now refused to allow." It seems reasonable to expect that there will be some bumps along the path to full Brexit, and that as a result there is no need to rush any consideration of adding UK exposure to portfolios.

Europe

Economic data in Europe continues to be quite mixed, and that applies particularly to contraction in the manufacturing sector compared with a services sector that is faring better. In the region's largest economy, there have been some more encouraging signs that 2020 will start to see some German economic momentum building. At the very least, it does look to be another instance of the outlook reaching an inflection point, with leading data indicating a bottoming out and gradual improvement in measures that track business expectations and output. For context, Germany narrowly avoided a technical recession when it recorded +0.1% growth in the September quarter, and whilst the economy is expected to continue to grow, the rate of expansion is not expected to accelerate in the near future. As we have noted previously, Germany has been especially hard hit by the disruption to global trade given a comparatively high share of its economy is export focused, so the easing of uncertainty in that area implies further improvements in confidence and in time sustained economic growth.

United States and China

In the economic data released in November there was definitely cause for encouragement with regard to the outlook for the Chinese economy. Industrial production and retail sales both handily beat the consensus expectations, whilst investment activity and the unemployment rate were in line with estimates. Whilst the phase one trade deal is of course a welcome development, there are several analyses that suggest China has in fact not so much won, but perhaps lost least in the process.

A New York Times article is headlined "China's Hard-Liners Win A Round in Trump's Trade Deal - A year and a half into the trade war, China seems to have a winning strategy: Stay tough and let the Trump administration negotiate with itself."[2] The article goes on to note that "In October, trade negotiators reached another tentative deal without tariff rollbacks, only for hard-liners in Beijing to again demand revisions and a removal of tariffs. People close to China's economic policymaking process say that as the trade talks progressed this past week, the mood among Chinese officials gradually shifted from deeply worried to cautious and finally, by late in the week, jubilant and even incredulous that the hard-liners' goals had been achieved."

It should be noted that the White House are also saying this deal represents a victory for America. Since the beginning President Trump has pointed to a trade deficit with China as his primary motivation and the basis for his claims that China was stealing from America. Economist Paul Krugman points out that despite the protracted trade wars that the trade deficit has only grown wider under this administration.

"First and foremost, Trump wanted to slash the U.S. trade deficit. Economists more or less unanimously consider this the wrong objective, but in Trump's mind countries win when they sell more than they buy, and nobody is going to convince him otherwise. So it's remarkable to note that the trade deficit has risen, not fallen, on Trump's watch, from $544 billion in 2016 to $691 billion in the year ending in October."[3]

Current expectations have been upgraded for the growth rate of the Chinese economy, particularly given a solid rebound in credit growth data. Where some analysts had thought a sub 6% growth rate would be recorded, most now assume it will be at least 6% when the Q4 data is released. By contrast, the United

States will likely grow at best at around one-third that rate, with some current estimates indicating there may in fact be substantially slower growth. Our valuation shows that we continue to see the US as Overpriced and we remain comfortable with exposure to China through the Asia-Pacific investment.

Kind regards,
Asset Allocation and Investment Committee