A GLOBALLY DIVERSE RECOVERY CONTINUES

Although global growth is likely to be slightly lower in 2019 than 2018 - which was boosted by strong US growth - it is still likely to be around the post-financial crisis average. In Developed Markets (DM), the US and UK with record low unemployment, are growing at a sustainable rate. For the UK, Brexit continues to be the main concern; whereas in the US, how long this recovery continues and how it will end remains a quandary.

The Eurozone saw a difficult end to 2018, with Germany and Italy contracting in the third quarter. We see this as a temporary wobble, with Eurozone employment growing steadily but with some way to go before triggering aggressive wage inflation. Japan is still trying to achieve consistent long-term inflation to address once and for all its deflationary issues. Emerging Markets (EM) on the whole are benefiting from long-term structural reform progress, favourable demographics, and generally, a well prepared monetary and fiscal toolkit ahead of any downturn.

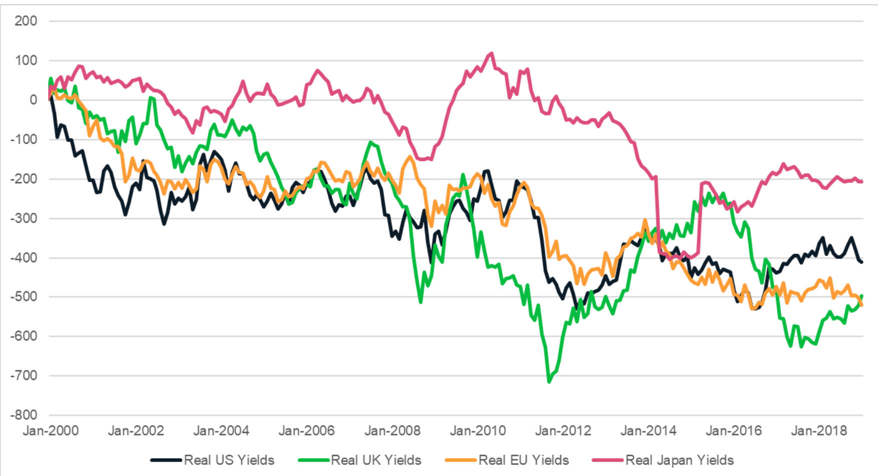
Our base case remains continued positive growth momentum, more volatility than the unnatural lows of recent memory but Q4 of 2018 set the bar quite high.

EQUITIES OVER BONDS (FOR NOW)

Most major global equities' valuations are below their long run averages, apart from the US where they are above. Even without the distortion of Quantitative Easing (QE), this would make a strong case for equities over bonds given where yields currently sit. Bond yields are likely to drift higher, with this move more pronounced outside of the US where the hiking cycle (barring an inflation shock) has 2-3 hikes max to go, and the UK, where Brexit based uncertainty has supported Gilts and where higher rates would likely attract purchases by pension funds and insurers. Government bond market distortion is especially marked in Europe and Japan where QE has only recently ended or is likely to persist for sometime. The near universal drift from QE to QT (Quantitative Tightening) will, in our opinion, weigh on bonds more than equities, as bonds suffer more when interest rates go up and money supply tightens.

We believe that concerns about growth are overdone and that earnings expectations, especially outside of the USA, are pricing in an overly depressing outlook. We may reconsider our allocation to bonds if we see rates meaningfully fall, which is unlikely without a severe growth or deflationary shock. Alternatives continue to provide some useful diversification in our investment plans and additional yield.

REAL INTEREST RATES STILL SUPPORTIVE FOR GROWTH



CUMULATIVE CHANGE IN REAL INTEREST RATES (BPS) SINCE 31/12/1999

TOP RISKS

Rapid wage growth

Global employment growth and easy credit, not higher wages, has boosted real consumer spending. A rush of wage inflation could trigger more aggressive monetary tightening, hitting Bonds and Equities.

Rising political turmoil

Current political unrest seems to have minimal global macroeconomic impact outside of localised pain-pockets. The US' focus has shifted from NAFTA and the EU to China where equities look oversold. France and Italy remain points of concern.

Brexit

The Brexit process remains the UK's key unknown, but we see little global impact. The outcome set is so wide; from a "no deal" to a complete reversal, giving UK assets a high uncertainty premium.

Hyperactive Fed

Concerns about tighter Federal Reserve Monetary Policy have weighed particularly heavily on EM assets. The EM growth outlook remains positive and structurally, most countries are well equipped to cope with a gradual QE to QT shift.

Oil

An escalation of Middle East unrest could drive oil prices significantly higher, which would likely only be positive for energy equities.

ASSET CLASS	OUTLOOK	RATIONALE
EQUITIES		
UK	=	Valuations remain low despite UK equities' large overseas component (around 70% for FTSE-100 and around 50% for FTSE-250). Negative sentiment around the Brexit process continues to weigh on investor appetite. The index is more diversified than before the financial crisis, but the FTSE retains a large commodity and financials exposure both sectors tend to be procyclical. Should the Brexit process be smoother than expected then a rapid rise in sentiment could support UK equities.
US	−	US valuations remain stretched versus other developed markets. At the same time the US 10-year interest rate is well above the S&P500 div yield. The tax cut-fuelled economic acceleration appears largely behind us. A key concern is as the economic cycle continues and wages rise greater pressure on valuations than expected is seen.
Europe ex UK	+	Growth remains above trend, employment and inflation are drifting higher without being threatening and monetary support is only being very gradually withdrawn. Fundamentals remain positive for Eurozone stocks and low valuations point to a good margin of safety even if conditions decline. Politics (Italy, France and Germany) remains a key threat. A US and China trade war would likely impact Europe but the EU and US have agreed to work together (for now).
Japan	+	Japanese equity valuations remain attractive in absolute and relative terms. A key pillar of this view is the continuation of Abe-nomics providing fiscal and monetary support, which is accompanied by solid corporate fundamentals and continued reform. A key risk is that the global recovery falters lifting JPY and delivers a double punch to the Nikkei's important exporter segment.
Emerging Markets	+	This economic cycle EM equity performance has lagged DM. Fairly steady aggregate EM growth hides the vastly contrasting performances. China's reform policies, especially those aimed at increasing domestic consumption, remain supportive for regional growth. India could benefit from its reform agenda, which may bring elections forward from the planned Q2-2019 date. Our core scenario remains a tough US initial negotiation position before moderation. Quicker Fed rate hikes would weigh on EM markets, while slower hikes from weaker US growth would also be a worry.
Asia Pacific ex Japan	+	Attractive valuations (strong expected returns) are complimented by a high dividend yield and still historically low P/Es. The key risks remain a trade war, slowdown in global growth or stronger USD/higher yields hitting corporate refinancing.
FIXED INCOME		
Government bonds		
UK	=	Gilts have benefited from continued Brexit uncertainty. Despite low yields, pension and insurance firms remain buyers. The main risk is weak growth coupled with sustained inflation driven by sterling weakness. The UK offers unique diversification properties due to idiosyncratic factors (Brexit).
US	=	Barring a growth or inflation shock, the Fed is expected to normalise rates as planned. Similarly a slower hiking cycle would see a double positive for bonds as it would reflect a weaker US economic outlook. Inflation risks have recently increased in the US but remain around trend levels. The main risk is that labour market tightness finally drives wage inflation higher, demanding higher rates.
Europe ex UK	−	ECB government bonds are dramatically overvalued due to QE. The end of ECB QE is likely to see yields drift higher, albeit slowly, although this process has longer to run than the US or UK.
Japan	−	Japan bonds offer little income and remain severely distorted due to the BoJ Yield Curve Control program. While the BoJ might alter this program there's little expectation for significant near to medium term change. Equities are the attractive way to capture Japan's economic improvement.
Emerging Market	+	EM government bonds continue to offer a strong yield premium above DM alternatives. Similarly, their currencies appear to be structurally undervalued offering a compounding supportive factor. Comparisons with the 1998 EM crash are overdone, with external debt, FX reserves and CA balances significantly firmer. The main risk is an unexpected acceleration by the Fed, especially to a higher terminal rate.
Corporate Credit		
US	=	Corporate spreads have widened somewhat, understandable given the likely late stage of the US business cycle and still loose monetary policy (outside the US). The opportunity for yield pick-up remains attractive against current recession risks.
UK	=	The BoE's bond buying program had distorted the market but although spreads have widened since the start of 2018 making these bonds more appealing. Low default rates and international diversification of UK companies leave us more optimistic than the market but still cautious enough to be neutral.
Europe ex UK	−	The ECB's bond buying program has left this market unattractive. Despite low default rates tight spreads make these bonds uncompelling.
Japan	−	Similar to Japanese government bonds these are unattractive. We prefer equity exposure.
ALTERNATIVES & THEMATIC		
Commodities	=	Commodities saw a strong run since mid-2016, however concerns about global growth have seen a volatile recent period. Oil's outlook remains uncertain given the nimbleness of shale oil although a growth surge could lift prices. Importantly, as interest rates rise the lack of yield also hurts commodities, although they typically perform well in the late cycle as demand heats up.
Global Real Estate	+	Globally real estate remains appealing given constrained supply and modest leverage compared to prior cycles. Rents remain linked to GDP and inflation offering a float rate equivalent with capital growth. It also provides diversification against equities and bonds except in a severe economic drop.
Private Equity	=	Public market valuations remain high which increases competition in the private market. This is combined with a record level of assets (indicated by fund raising data) chasing those opportunities.
Gender Equality	+	Academic research has shown that companies with greater diversity show strong long-term productivity, return on equity and dividend growth.