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Asset Allocation Update

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Have we turned a corner amid ugly markets?

Over recent months we have been noisily worrying about a variety of asset market headwinds. The course of US monetary policy and trade policy; tensions between the European Commission and the Italian governing coalition over a final budget; as well as what to make of the multiple twists and turns in the Brexit roadmap all have scope to change investor returns in a meaningful way over the medium term.

Without these headwinds the underlying economic outlook appears constructive, with slowing but above-trend growth and high single-digit earnings growth. Furthermore, risk premia are far from skinny across equities and bond and property markets. But absent headwinds, the outlook will always look fair. Meanwhile markets have turned increasingly ugly.

While market momentum has been starkly negative and fresh headlines have hit investors from all directions, it is worth pointing out that the developments in a number of these areas of concern have shifted to a more positive tack. In France, President Macron's backtrack over domestic structural reform and move to fiscal accommodation in the face of street protests is not something that markets seeking a more nimble French employment market might celebrate. But it does provide a better environment for Italian budgetary negotiators to find middle ground with the EC, and as such reduces the likelihood of a repeat of the European sovereign debt crisis.

The arrest of Huawei's CFO in Canada does represent a threat to fragile Sino-American relations, but it has been accompanied by talks and followed by positive signals from both countries directed at de-escalating the trade stand-off. The US economy still looks to be operating close to – or above – full capacity, setting the stage for further interest rate rises on the part of the Federal Reserve. But the peak economic growth rate was probably in the second quarter of 2018; and deceleration, together with a fading fiscal stimulus and tightening financial conditions (higher credit spreads, higher bond yields, lower equity prices), reduces the urgency on the part of the Fed and gives them scope to pause.

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Positioning

Despite these headwinds continuing to dominate the headlines, we believe – whisper it – that things have actually improved at the margin. Uncomfortable as it has felt, we have moved to increase multi-asset portfolios' exposure to Asian equity markets where asset prices discount poor outcomes, and we feel more comfortable that the risk premia we are being offered for European assets is attractively priced.

Sadly, the decline in uncertainty has not been universal across our four headwinds. Brexit remains as uncertain as ever, with the volume dial relating to UK political news seemingly stuck at 11. If the UK falls out of the European Union without a transition agreement, the prospect for further steep currency depreciation is very real. But such is the level of uncertainty being priced into markets that just avoiding this bad outcome would likely deliver potentially meaningful currency strength.

We have taken the approach of seeking to desensitise client portfolios to Brexit-induced swings in value, lacking an edge in calling the outcome. Undoubtedly the end point will appear blindingly obvious in retrospect, but gambling client funds on an area of low conviction is not a sustainable investment approach.

Asset allocation snapshot

	Dislike	Neutral	Favour	Strongly Favour
Asset Allocation	Government I/L	Cash Credit	Equity Property Commodity	
Equity Region		UK EM US	Pac ex-Jpn EU ex-UK	Japan
Global Equity Sector	Real Estate Materials Utilities Telco	Financials Industrials Consumer Cyclicals Energy Staples	Health Technology	
Bond – FX Hedged	Japan	Germany US UK	Nordic Australia EM Local	
Credit		Corporate IG EMD Corporate HY		
Commodity	Precious Metals	Livestock Softs Grains	Base Metals Energy	
FX	USD	GBP JPY AUD	Euro Nordics	

Source: Columbia Threadneedle Investments, as at 14 December 2018.