Manager's Report

QUARTER TO 31 DECEMBER 2019

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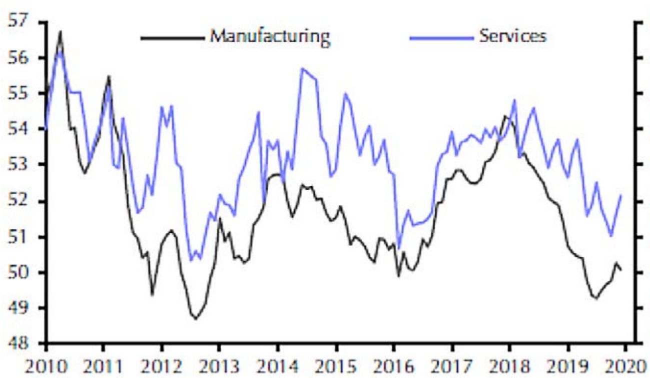
The past year has turned out surprisingly well for all major asset classes, thanks mainly to a complete policy U-Turn by the US Federal Reserve and other major Central Banks.

There were multiple risks competing for attention in news headlines. We saw the unfolding of a US-China trade war and increased tariffs, threatening tariff spats between the US and other major trading partners (Canada, Mexico, Europe), Brexit. We experienced a sharp slow-down in global trade and industrial production, with a resulting recession in global manufacturing. We witnessed increased "populism" and demonstrations in countries as diverse as Hong Kong, Chile, and France. News flow intensified about the risks and ramifications of climate change.

Notwithstanding these risks, US employment growth remained strong in spite of the manufacturing slow down. The US consumer plus a buoyant housing market, helped by three 0.25% rate cuts by the US Federal Reserve, carried the US economy to an estimated 2.3% real GDP growth for 2019 – lower than the previous year, but by no means the recession that was feared last summer.

The return of abundant global liquidity helped risky assets as well as bonds power ahead in the final quarter of the year. There was also a positive resolution to the main headline risks, as the US and China agreed to sign a "phase 1" trade deal, the UK avoided "crashing out" of the European Union, and global economic leading indicators point to a bottoming out of the manufacturing slowdown, as illustrated by the Global Purchasing Manager Index graph below.

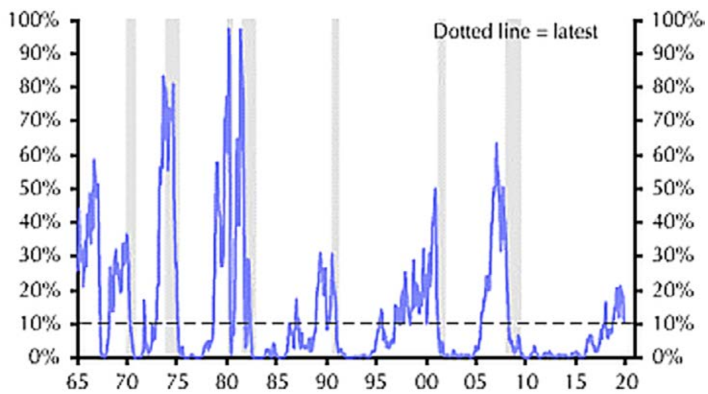
Graph 1) Global PMIs (Services and Manufacturing) seem to have bottomed



Sources: Markit, Refinitiv, Capital Economics

The risk of a recession in the US and Europe happening within the next 12 months has receded, and the widely watched "US Yield Curve" (an inversion of which usually precedes a recession) is no longer inverted, since the Fed stopped in the tracks of its previous tightening spree and cut short term rates back to 1.75%.

Graph 2) Capital Economics Proprietary Recession Monitor – risk of a recession in next 12 months

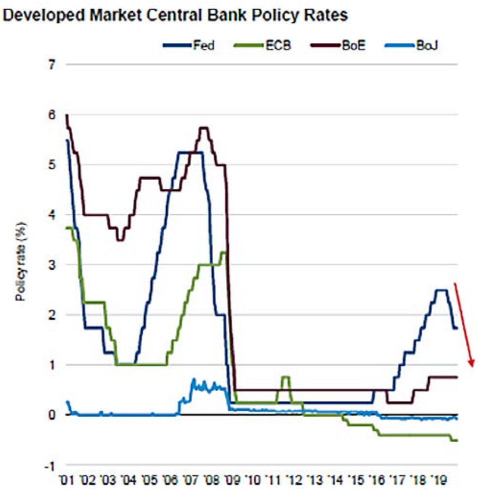


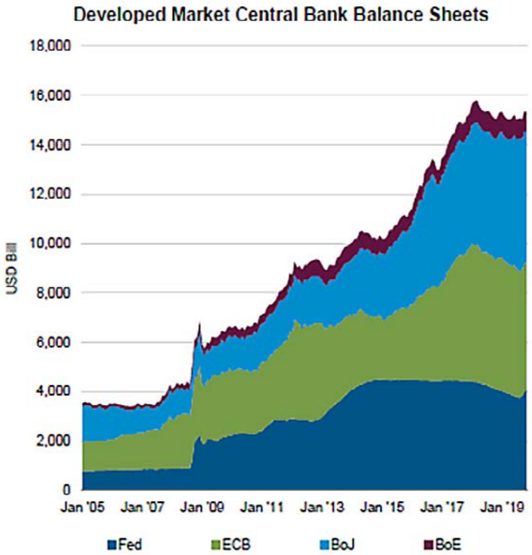
Sources: Refinitiv, Capital Economics

The current economic expansion in the US (now in its 11th year) is the longest on record. It seems likely to continue for now; we expect a modest global growth rebound backed by easy monetary policy, plus fiscal policy working in the same direction, also in China, Europe and Japan.

While cooperative Central Banks have "increased the time to recession", the possible loss once there IS a recession has probably also increased, as central banks do not have much ammunition left in their policy tool kit – rates are very low and their balance sheets are bloated.

Graph 3) Central Banks don't have many policy tools left





Source: Haver, PIMCO, as of 31 December 2019

As the Fed announced its policy U-Turn last summer we added back some equity risk to the portfolios, which has been beneficial. Where do we stand now, and how do we view this year's opportunities, and risks?

Given our base case expectation of a mild rebound in global growth, coupled with accommodative central banks and no real signs of an acceleration in inflation, we remain cautiously optimistic for this year. One caveat is valuation. Government bonds are downright expensive; the 10 year US treasury yield is, at 1.8%, the highest available in Developed Markets. In spite of a slight pick up in global government bond yields since last summer there is still a USD 11 trillion global supply of bonds carrying negative yields (down from USD 17 trillion last June, when markets were priced for a recession). In spite of the fact that global demographics (the ageing of the population) and technological advancement will probably keep inflation unusually low this coming decade, effectively paying a borrower for the "privilege" of lending them money makes little sense to us. It also means that government bonds no longer automatically fulfil their traditional role of hedging an equity portfolio in the case of an economic downturn.

In any case the risk/return profile of government bonds has become quite asymmetric, with higher downside risk should inflation surprise on the upside coupled with limited up side potential in the case of a stock market correction.

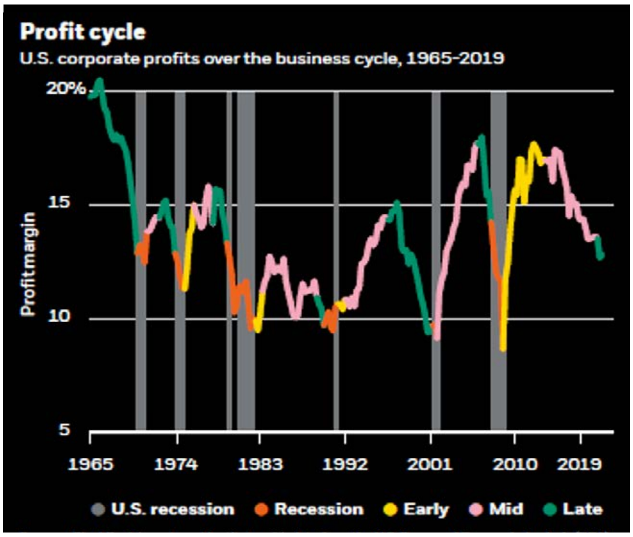
US Treasury bonds seem to be the "cleanest dirty shirt" but, at a 1.8% yield, are hardly a bargain. US Inflation linked bonds look relatively attractive; currently priced to discount only 1.7% inflation, they provide a decent hedge against an upside surprise in inflation.

Yield spreads on corporate bonds have moved lower again on strong risk appetite, and are attractive from a "carry" perspective but vulnerable to widening in case of an economic down turn or a risk-off event. We maintain our exposure to (managed) high yield bond funds for now, but are keeping an eye on the risks. Emerging market bonds still look relatively attractive and we maintain exposure to this asset class. As the US housing market is in very healthy shape we like mortgage backed securities in the US, and also hold an asset backed securities fund in Europe. With the European Central Bank ready to keep buying large swathes of the bond market, the risks seem low for now.

The valuation of equities remains attractive relative to bonds, but is becoming more stretched, especially in the US. The combination of the manufacturing slow down and higher wages due to a tightening labour market has caused a reduction in profit margins, which fell from a peak of 12.13% in Q3 2018 (for the S&P 500 Index) to 11.21% in Q3 2019.

Growth in operating earnings per share for the S&P 500 index was only 4.1% in 2019, so the bulk of the appreciation in stock prices has been due to the expansion of the price to earnings multiple. The average analyst expectation for S&P 500 earnings growth this year is 11%, which seems too high to us given relatively low global growth and inflation expectations and no clear catalyst for margin expansion; this growth rate is likely to be adjusted downwards as the year progresses. European and especially UK stocks are slightly better value, and certainly offer a large yield pick up over bonds, but growth rates in Europe are lower than in the US.

Graph 4) US Profit margins are declining; a typical "late cycle" phenomenon



Sources: BlackRock Investment Institute, with the data from the US Bureau of Economic Analysis (BEA), US National Bureau of Economic Research (NBER) and Refinitiv, Nov 2019. Notes: We look at profit margins during different stages of the business cycle. The classification of the stage is done via a "cluster analysis" that groups together time periods where economic series have behaved in similar ways. These are the profit margins of US corporations, in percentage points, as derived from National Income and Product Accounts data (NIPA) from the BEA.

Asian and Emerging Markets stocks have underperformed those of western, developed markets over the past few years due to a host of factor ranging from the strengthening US Dollar (usually a challenge for Emerging Markets assets) to uncertainties relating to global trade and the resulting disruption of global supply chains.

There is potential for some reprieve from both of these headwinds; the US Federal Reserve has indicated it sees absolutely no change to interest rates this year so the dollar can be expected to remain stable or even weaken a bit. Meanwhile the US and China both seem committed to maintaining a fragile truce around trade for now, although many uncertainties remain and the underlying issues are not clearly resolved (such as China's respect for intellectual property rights, its forcing of western companies to share technological and trade secrets, and unfairly, in America's view, supporting its state owned companies to gain a technological edge).

In a previous report we described our views on the current trend of "de-globalisation"; the resulting likely fragmentation of technology standards and global power centres means maintaining some equity exposure to Asian and specifically Chinese companies is probably an important part of portfolio diversification.

In the light of all the above, our global equity allocation is largely neutral at the moment.

Within equity exposure we are cognizant of the different "factors" that drive performance (such as quality, momentum, size and value). We have been quite overweight the "quality" factor in portfolios, which has helped performance as quality growth stocks have greatly outperformed the more cyclical "value" stocks in recent years. We are however aware of the fact that a) the difference in cumulative performance of growth vs value stocks is currently very high and could well revert back to the mean in due course, and b) growth stocks tend to outperform value stocks when the yield curve flattens, while a steepening yield curve tends to cause a relative revival of value stocks as improving growth and inflation (the underlying reason for the yield curve to steepen) tend to improve the relative earnings expectations of traditional "value" sectors such as Financials, Resource companies and Industrials. So while our fundamental long term investment style favours high quality, "growth" companies we will keep an especially keen eye on factor diversification this year.

The chart below plots the steepness of the US yield curve (illustrated by the 10 year minus the 2 year Treasury yield) against the relative performance of so called "Momentum" stocks to "Value" stocks. There is a clear negative correlation, where momentum stocks outshine value as the yield curve declines while value stocks relative performance snaps back when the yield curve steepens, as in late summer 2019.

Graph 5) The US Yield Curve vs relative performance of "Momentum" and "Value" stocks

Source: Bloomberg LLP

Further risks we need to take into account when fine tuning our strategy this year are on the downside (or "left tail") as well as the upside ("right tail").

- The US Elections this year could cause some stock market volatility. It is still unclear who will be the Democratic nominee. Candidates Warren and Sanders are seen as potentially having a large impact on the stock market in general (a reversal of the Trump tax cuts would mean a one off 15% reduction in US corporate profits) as well as on the regulation of specific sectors, such as the Financial or Healthcare sector, or the potential breakup of Big Tech monopolies. Most of the resulting market volatility will be due to sentiment as fundamentally, the powers of a Democratic President to push through large policy changes while the Senate remains in Republican hands are limited.

- Geopolitical risk globally remains elevated and at much higher levels than was seen in previous decades (see Graph 6 below). The killing of an Iranian general on Iraqi soil in the first weeks of this year intensified the risk of conflict in the Middle East and resulted in an increased oil price. Again, fundamentally the US economy would be much less effected by a high oil price than in the past, due to its ability to ramp up shale production when the oil price increases. But the potential headline risk and hit to sentiment could definitely cause some market turmoil.

- Meanwhile the UK still needs to agree new trade terms with the EU, China and the US are likely to remain locked in a battle for global technological leadership, and Hong Kong and Taiwan are clearly not planning to quietly give up their democratic freedoms.

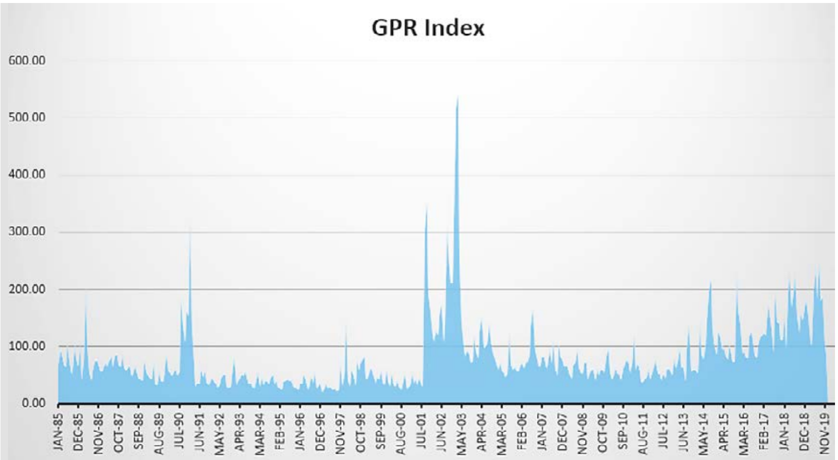
• The now very prolonged period of very low interest rates has helped to exacerbate the wealth gap, globally, as asset values have risen more than wages, with a resulting rise in "populism" and protests.

• The increasing focus on climate change and its risks is rapidly changing the way institutional investors invest and discount future risks to asset prices. The resulting shift in investment flows offers up new risks as well as new opportunities. Blackrock, one of the world's largest asset owners, recently announced in a letter to clients and CEO's that "sustainability" will from now on form the cornerstone of its investment strategies.

• Many industries are facing massive disruption from technological advancement and changing consumer attitudes, and identifying tomorrow's corporate winners and losers is a challenging task.

• To the "right tail" side of the equation, or upside risks, we can see the potential for a liquidity-induced "melt up" of stock markets (which would in fact be a negative scenario ultimately as these melt ups are usually followed by large corrections), a higher than expected bounce back of growth, perhaps on the back of increased fiscal spending, and upside surprises in inflation.

Graph 6) Global Geo-Political Risk index is structurally higher than in previous decades



Source: https://www2.bc.edu/matteo-iacoviello/gpr.htm

All in all, we believe this year will undoubtedly throw up the usual share of challenges and surprises, but the base case for the underlying economic dynamics (continued growth coupled with low inflation, continued central bank support and ample global liquidity) warrant a continued balanced exposure to risk assets with a carefully diversified approach.

As always, please do not hesitate to contact us if you have any questions or comments, about the contents of this report or your portfolio in general.

Portfolio Management Team ISGAM AG

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