Asset Allocation Debrief

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Investment Research

- Much of our investment thesis has played out well so far this year.
- Developed market economies are neatly positioned on our investment clock framework, and look to be further boosted by the current deflationary trend.
- Following the ECB's announcement last month of QE, long term inflation expectations have picked up in Europe. Whilst the committee questions the role of QE in this, we acknowledge the scope for Europe to surprise positively given the pessimistic sentiment that still prevails.
- The potential for interest rate rises in the US was also discussed following comments from Fed Chair Janet Yellen. The US remains the most likely candidate to exit ultra-accommodative policy measures first, with a June lift-off date still a possibility. This has the potential to disrupt the equity market, which now provides limited valuation support.
- The committee decided to reduce the overweight allocation to US equities, in order to fund an increased allocation to Fixed Interest and Absolute Return.

Economic Growth	2014	2015	2016
US	2.4	3.1	2.8
UK	2.6	2.6	2.4
Eurozone	0.9	1.2	1.6
Japan	0.2	1.0	1.4
Asia	6.3	6.1	6.1
China	7.4	7.0	6.7
India	5.4	7.4	7.7
Latin America	0.8	1.0	2.5
Brazil	0.1	-0.2	1.5
EMEA	1.7	-0.2	2.1
Russia	0.5	-4.0	0.5

Inflation	2014	2015	2016
US	1.6	0.5	2.2
UK	1.5	0.5	1.7
Eurozone	0.4	-0.1	1.2
Japan	2.7	1.0	1.3
Asia	2.8	2.5	3.0
China	2.0	1.6	2.4
India	6.4	6.5	5.8
Latin America	5.1	10.0	9.2
Brazil	6.3	7.0	5.8
EMEA	5.9	7.7	5.4
Russia	7.8	13.8	7.0

Central Bank Rate	2014	2015
US	0.3	0.9
UK	0.5	0.7
Eurozone	0.1	0.1
Japan	0.1	0.1
BRICs		
Brazil	5.6	5.1
Russia	8.0	7.2
India	8.0	8.2
China	11.6	12.7

Source: Datastream/Brewin Dolphin
All figures represent year on year change in percentage terms

The developed world remains in a sweet spot from an investment perspective, with low inflation and slowly recovering economic growth. The recent trend of falling inflation, driven primarily by the declining oil price, has only enhanced this position. Within our investment clock framework, countries have been moving anti-clockwise recently, potentially extending the duration of the next growth phase.

The risk to this thesis is that the positive input-shock deflation turns into a secular deflationary spiral. In this scenario, deflationary expectations can become entrenched and cause consumption to be postponed. Monetary policy becomes ineffective, as interest rates reach their zero bound and central banks can no longer incentivise spending over saving. In this environment the investment clock is entirely the wrong framework for our analysis.

However, we do not believe this is the current environment. We still believe the deflationary impulse caused by the oil price decline is in aggregate positive for global growth. Benefits of the lower input prices accrue to consumers and non-energy related businesses alike. It would appear the benefits have not yet been reflected in an improvement in retail sales, however, with additional disposable income likely to have been used to pay down unsecured debt. Consumers will be assessing the longevity of these benefits before committing to a change in their spending patterns. Once entrenched, this should result in a more tangible improvement in the economic data.

The diverging paths of monetary policies in the US and Eurozone evolved further during February. The US, a long term and profitable Overweight for the Committee, is at a more advanced stage of its economic recovery. In Janet Yellen's Humphrey Hawkins Testimony, she successfully removed the forward guidance for US interest rates. This did not in itself change our expectations for the timing or speed of future rate rises. What is clear is that the Federal Reserve would like to raise rates sooner rather than later, and we believe the strength of the economy will justify this later in the year. The US equity market now offers limited valuation support should rates move earlier or faster than we expect. Given this, the Committee took the decision to reduce the Overweight exposure marginally.

Conversely, Europe is closer to the beginning of its monetary experiment following January's announcement from the ECB of their QE programme. Underlying economic conditions across the region improved over February. Importantly, long term inflationary expectations (the 5y5y forward rate) increased, bucking the deflationary tendencies that have prevailed in the Eurozone recently. Given that the declining 5y5y forward rate was a major reason for starting QE, it is worth contemplating the implications of this improvement and the possibility for a premature withdrawal of the policy measure. Whilst it is far too early to deduce that inflationary expectations have inflected, the committee does not believe markets would react too negatively if QE is removed early. Mario Draghi has now demonstrated that he is both willing and able to implement a policy of such strength within the fragmented political landscape of the Eurozone. When this policy is eventually removed, the fact it can be forced through when required will support Mr Draghi's words with a bit more substance in future statements.

However, the region's equity markets are still threatened by the possibility for the new Greek government to engineer a "Grexit" from the Eurozone. After a longer than expected game of chicken, the European Parliament eventually agreed to extend the terms on the Greek bailout for a further four months. Despite this, negotiations between the Troika and Greek government on the structure of the necessary reforms are ongoing, and will no doubt lead to bouts of market volatility. However, the thesis of the Committee remains that the mutualistic benefits of Greece retaining their membership should be enough to preserve the status quo. The Committee acknowledge the scope for European equities to surprise on the upside given the exceptionally depressed expectations that prevail, nevertheless, the political risks deter us from increasing the Overweight allocation at this point.

Countries	P/E	Yield
US	17.9	2.0
UK	16.1	3.9
Europe ex UK	16.7	3.1
Japan	16.7	1.8
Asia ex Japan	12.6	2.7
Emerging Market	16.3	3.0
China	10.2	3.1
India	19.7	1.4
Latin America	13.2	3.4
Brazil	11.0	4.4
Eastern Europe	7.2	4.5
Russia	6.2	4.4

Source: Datastream/MSCI
Yield figures are in percentage terms

Political uncertainty is also elevated in the UK, where the upcoming election in May remains too close to call. The Committee spent time discussing the likely ramifications of a negative outcome. In our opinion, this would cause a slight devaluation of sterling, but have very little effect on the Gilt market. The area that could potentially be of concern is the effect it would have on FDI flows, particularly from China, which remain exceptionally strong at present. Given this level of uncertainty, the Committee felt our current neutral exposure is appropriate.

Finally, we have long held an underweight position in bonds, especially Gilts, primarily based on valuations. Whilst optically these assets still appear expensive, the structural demand from institutions and the weight of purchases from Central Banks means yields can easily contract further from here. Perversely, lower yields can actually increase demand for these assets, as more are required to meet the same liabilities. Following last month's sell off, the Committee took the opportunity to slightly reduce the Underweight we hold to Gilts, given these delicate balance of risks. The exposure to Absolute Return was also increased slightly to provide uncorrelated returns.

Chart 1: Brewin Dolphin's Tactical Asset Allocations relative to their respective benchmarks

Asset Class	WMA Conservative	BD Conservative	WMA Income	BD Income	WMA Balanced	BD Balanced	WMA Growth	BD Growth	Bespoke Global Equity	BD Aggressive
Cash	5.0	3.0	5.0	3.0	5.0	3.5	2.5	2.0	5.0	2.0
Bonds	45.0	43.5	32.5	28.0	17.5	14.5	7.5	5.0	0.0	0.0
Gilts	45.0	34.0	32.5	22.0	17.5	9.5	7.5	0.0	0.0	0.0
Corporate Bonds (O/B)	0.0	9.5	0.0	6.0	0.0	5.0	0.0	5.0	0.0	0.0
Equities	30.0	32.0	52.5	56.0	67.5	72.5	77.5	83.0	95.0	98.0
UK	19.0	19.0	35.0	35.0	37.5	37.5	40.0	40.0	65.0	65.0
Overseas	11.0	13.0	17.5	21.0	30.0	35.0	37.5	43.0	30.0	33.0
North America	6.3	7.5	10.0	12.0	17.1	19.0	21.3	23.5	17.1	19.0
Dev'd Europe ex UK	1.8	2.5	2.8	3.5	4.9	6.5	6.1	8.0	4.9	5.5
Japan	1.0	1.0	1.5	2.5	2.6	4.0	3.3	5.0	2.6	3.5
Asia	1.4	1.5	2.2	2.5	3.8	4.5	4.7	5.5	3.8	4.0
Adv Emerging	0.5	0.5	0.8	0.5	1.4	1.0	1.7	1.0	1.4	1.0
Emerging	0.1		0.2		0.3		0.4		0.3	
Alternatives	20.0	21.5	10.0	13.0	10.0	9.5	12.5	10.0	0.0	0.0
Hedge Funds	15.0	0.0	5.0	0.0	5.0	0.0	7.5	0.0	0.0	0.0
UK Commercial Property	5.0	5.0	5.0	4.5	5.0	4.0	5.0	1.5	0.0	0.0
Absolute Return (O/B)		16.5		8.5		5.5		8.5		
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Brewin Dolphin

All weights as % of total portfolio

Important Notes:

Main source of information: Datastream and Brewin Dolphin