Target Return

Managed Portfolio Service - Portfolio 4

Quarterly Update - Q2 2019

Aberdeen Standard Capital

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In brief

- Trade tensions between the US and China escalated in May, and a new front opened with the US briefly threatening to impose tariffs on Mexico.
- A number of central banks moved towards a looser policy stance – for example, the US Federal Reserve is expected to cut interest rates later this year.
- Our portfolios enjoyed a solid quarter, benefiting from the continued equity rally.
- Lower-risk fixed income assets also boosted performance, while a number of our diversifying currency and curve positions helped to protect the downside during the weakness in May.

Global overview

Our portfolios enjoyed a solid quarter, as risk assets like equites continued to rally. Lower-risk assets also produced solid gains, as global central banks turned dovish on monetary policy, and sentiment shifted towards interest rates being cut.

Equities were a significant contributor to the performance of our portfolios over the period, with US equities again the best performers. Since the start of the year, the S&P 500 Index is 18.5% higher (to end June), while the more technology-driven Nasdaq is up an astonishing 21.3%. Both UK and European indices delivered solid returns. Surprising, perhaps, given the political upheaval in the UK and the notable downturn in Germany's fortunes. Conversely, Japan and most Asia-Pacific indices suffered small losses, as sentiment on the US-China trade war see-sawed on President Trump's twitter output.

Yet there seems a discord between the recent strength of investment markets, and the more gloomy prognosis from economic data and geopolitics. Furthermore, we can question investment markets themselves. Risk-off investors have bought up sovereign debt, sending yields ever lower. But at the same time, risk-on investors have bought equities, sending many indices to year-to-date peaks. Bond markets point to lower growth, lower inflation and lower interest rates, while equity markets remain buoyant.

On the positive side, global financial conditions have remained relatively loose. The US Federal Reserve (Fed) is edging towards cutting interest rates. At the same time, US consumer confidence is close to all-time highs and unemployment is near all-time lows. Meanwhile, the European Central Bank (ECB) reiterated its stance on monetary policy recently, stating "we will use all the flexibility within our mandate to fulfil our mandate". While not quite the "whatever it takes" speech of July 2012, Mr Draghi still seems unequivocal in his role.

On the negative side, trade tensions have re-escalated. Geopolitical developments in the UK, Italy, Argentina, Turkey and Iran have also taken a less positive direction. Global manufacturing sentiment, meanwhile, hit a 6.5-year low in May. The rapid shift in the trade policy environment is perhaps the most difficult to forecast. On the US-China question, negotiations have waxed and waned between positivity and downright hostility all year. In addition, President Trump turned his ire on Mexico for a brief time, before seemingly being reassured on border-control issues. In addition, the US is still considering whether to impose tariffs on auto imports from Europe and Asia.

Our forecasts no longer incorporate a quick resolution to the US-China dispute. We do, however, envisage a greater chance of resolution regarding tariffs on Mexico. Nonetheless, Mr Trump will continue to use his twitter account and affect investor sentiment.

Along with most market analysts, we now expect the Fed to cut US interest rates twice in 2019. While on his campaign trail in 2016, President Trump commented that the previous Fed Governor should be "ashamed" of her handling of monetary policy. He accused her of artificially keeping interest rates low to boost President Obama. As such, when he assumed office, he replaced her with Jerome Powell, commenting that "he's strong, he's committed, he's smart". Fast forward eighteen months and Mr Trump is openly scathing of the Fed's policies and agitating for rate cuts. The market has already priced in such moves, which opens a 'tail wagging the dog' question. Is the Fed being pushed into policy by President Trump and the investment markets, and just how independent is it now? Furthermore, since the financial crisis of 2008, the prevailing assumption is that central bankers will come to the rescue when markets become violent. That central bankers are alive to the threats is not the issue as such. Rather, it is the complacency that this breeds among investors. Nonetheless, it is this central bank response that leads us to forecast a broadly flat and tepid global economy for the coming months.

It is worth noting that US consumer confidence is near all-time highs. The last time it hit this level was in 1998-1999. That was just before the technology crash wiped 50% off the S&P 500 over the following three years. Indeed, as one would expect, consumer confidence does tend to peak just before a market correction. Previous highs include in 2007, 1987-1988 and 1978-1979. Looking at the world's dominant equity market, the S&P 500 has added 18.5% year-to-date. This brings its annualised return over 10 years to an astonishing 14.7% per annum. Clearly, such a return is not sustainable. Indeed its 20-year annualised return, a period which encompasses the 2008 crisis, is a more sober 5.9% per annum. Surely we need some lean years to bring returns back down to their long-term average. We should also bear in mind that US earnings forecasts are decreasing, while share buybacks are increasing. One has to consider just how shaky the ground is to justify the market's return thus far in 2019.

Meanwhile, bond markets are, at best, pricing in a stagnant future. At worst, they are downright pessimistic. Much has been written over the last year about the increasing flatness of the US yield curve. That is, short-term borrowing rates being similar to long-term borrowing rates. In a normal environment, one would expect long-term rates to be higher. Investors would require a higher rate of return for lending longer term than shorter term. Many City scribes warned on the inverted yield curve, where short-term borrowing rates are higher than long-term borrowing rates. An inverted yield curve has almost always led to a US recession within 12-18 months.

Long periods of economic expansion invariably result in too much debt; people borrow excessively as the good times roll. This is followed by a correction and usually a recession. Consider that there is now more debt in the world than in 2007 and that a record $13 trillion of it is priced at negative yields. Non-financial US corporate debt has now exceeded previous peaks. However, buoyed by a solid global economy and accommodative central banks, default rates remain at low levels. In the current environment, it is difficult to justify a sizeable fixed income position. Late in the quarter, the five-year German bund yield hit a new record low of -0.7% (yields move inverse to prices). Indeed, Germany, France, Japan, Sweden, Netherlands, Switzerland, Spain and Portugal all have their sovereign debt trading on negative yields at the five-year maturity. It's worth remembering that it was only seven or eight years ago, when the Eurozone debt crisis was at fever pitch. Portugal had to go cap in hand to the ECB, and there were concerns that Italy and Spain would follow. Nowadays, investors are paying Portugal for lending it money over five years!

Investment Performance

After a difficult May, global equities rebounded in June to end the quarter in positive territory. Our positions in both US and UK equities were the largest contributors to performance over the period. US equities were supported by the Fed's dovishness, while the UK was boosted by sterling's weakness.

At the end of 2018, we introduced a strategy looking for the US yield curve to steepen. Steepeners have historically performed well towards the end of an interest-rate-hiking cycle. The rationale for implementing this strategy was that the Fed would cease raising rates over the next few years, and would likely begin a cutting cycle. This would, in turn, lead to the yield curve steepening. The pivot in Fed policy (becoming more dovish) occurred sooner than we initially expected, and has indeed led to the US yield curve steepening. As a result, this strategy has provided positive returns sooner than originally expected.

As the Brexit saga continues, we seem no closer to an outcome. Former US President, Lyndon B Johnson, said that the first rule of politics was that its "practitioners need to be able to count". It remains to be seen whether Boris Johnson (current favourite) or Jeremy Hunt can gather the votes necessary from Conservative party members to become the new party leader and UK prime minister. These candidates are challenging one another as to who has the most robust approach to Brexit.

This could lead to a general election before Brexit. Currently, neither candidate will rule out a hard Brexit, and this could see 'remain' leaning Conservative MPs either abstaining or voting against the government in a vote of no confidence. This political miscalculation could give the Labour party the opportunity to become the next government, which only increases the uncertainty for markets. Given the current situation, we have implemented a strategy that benefits from increased volatility in sterling. Simply put, there could easily be a sizeable move in sterling, either up or down, in most Brexit scenarios. This strategy would benefit clients if there is either a soft or hard outcome.

The performance of our currency strategies was mixed over the quarter. As sentiment turned negative in May, many of our currency positions delivered positive returns and provided the diversification that we hoped they would. This was especially so for those positions favouring the Japanese yen and US dollar. Looking forward, we are hopeful that Prime Minister Modi's re-election will enable further reforms to be implemented in India. This could lead the Indian rupee to appreciate, benefiting our rupee versus South Korean won position. Elsewhere, a strong Norwegian economy has prompted its central bank to raise rates three times in the last 12 months. This has proved beneficial to our position favouring the krone versus the euro. Of course, due to the majority of our portfolios consisting of overseas holdings, sterling's weakness over the quarter has also provided a boost.

Portfolio Acitivity

US President Trump's tweet towards the beginning of May led to a deterioration in the ongoing trade negotiations between the US and China. Both sides adopted more bellicose positions, and recent newsflow suggests that the two sides were not as close to an agreement as previously thought. This risks escalating, which would have consequences for the global economy, and also places greater pressure on risk markets. We have become more pessimistic about the prospects of a trade deal being agreed in the short term and have, therefore, taken steps to reposition the portfolio to reflect this outlook. We have reduced the equity exposure in regions that are most sensitive to international trade. For example, we have closed our Chinese equity position, and reduced European equities, global equity oil majors and the emerging market versus Taiwan equity strategy.

We had increased portfolio duration in May, when the US Fed signalled a shift towards a more dovish policy stance. Government bond yields have fallen quite significantly since then, boosting returns from these positions. We responded by selling into the rally – closing the US duration strategy and reducing the US real yields strategy. The ECB also signalled increasing willingness for loose monetary policy to promote growth across the region. We increased our European flattener strategy, which we expect to benefit as low short-term yields encourage investors starved of income to push further out on the yield curve. The Swedish flattener versus Canadian steepener has performed very strongly and we took profits by closing the strategy.

We opened a US inflation strategy during June, where we are positioned for US inflation expectations to rise.

If additional tariffs are imposed by the US on China (or other trade partners) then these tariffs are likely to feed through to higher prices for US consumers. On the other hand, a de-escalation of trade tensions should be positive for the growth outlook and lead to higher inflation.

We had reduced our high-yield credit exposure towards the end of April, as credit spreads had tightened to levels we deemed expensive. This reduction proved well-timed, with spreads widening as risk assets sold off in May, and we were able to add back to high yield at more attractive valuations. We believe the evolving monetary policy and global growth backdrop will encourage investors to focus on carry and yield opportunities.

Outlook

We have downgraded our global growth forecasts amid subdued economic data and increasing policy uncertainty. While we had long anticipated a slowdown in the latter half of 2019, and into 2020, we had expected a coordinated central bank response to ensure any dip would be temporary. We now no longer expect a bounce back in global growth, rather a more protracted malaise. To be clear, our base case does not suggest recession. However, it would not take much for us to review this position.

Performance

Portfolio performance is based on Aberdeen Standard Capital MPS hosted on the Standard Life WRAP platform.

Please note: portfolio constituents and performance may vary on other platforms.

The portfolio has not been available on all platforms since inception.

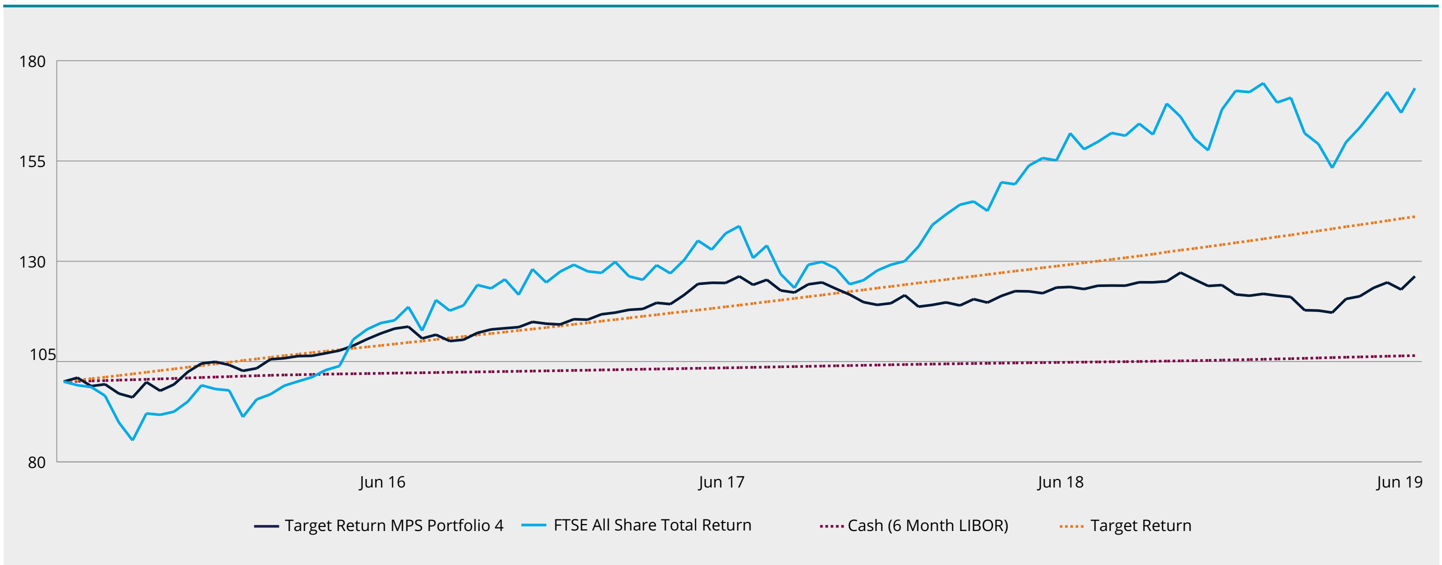
Performance figures are net of the Aberdeen Standard Capital Discretionary Management Charge. However they do not include the deduction of product and adviser specific charges. The effect of these charges would be to reduce the performance levels shown. In addition, MPS portfolios are subject to fund level annual management charges, which vary over time in line with the composition of the portfolio. Please refer to the relevant Managed Portfolio Service Annual Charges Summary for more information on charges.

Performance: Target Return MPS Portfolio 4

	Performance (%) 2nd Quarter 2019	Performance (%) 3 years	Performance (%) Since Inception[1]	Volatility Since Inception (%)
Target Return MPS Portfolio 4	2.35	4.71	24.27	4.46
Target Return[2] (Cash+3.5%)	1.09	13.25	41.11	0.10
FTSE All Share TR	3.26	29.51	73.15	10.51
Cash (6 month LIBOR)	0.23	2.07	6.48	0.07

The performance figures may vary due to product specific charges and should be viewed on an indicative basis.
[1] 03/05/11 - 30/06/2019
[2] 6 month LIBOR +3.5% annualised over rolling 3 year periods (LIBOR + 4% up to 31/03/2013)
Volatility calculated using monthly returns. Any holdings referred to relate to the Aberdeen Standard Capital MPS hosted on the Standard Life WRAP platform. Differences in holdings may occur on other platforms due to fund and shareclass availability.

Performance: Target Return MPS Portfolio 4 Inception to end Q2 2019



Asset allocation: Target Return MPS Portfolio 4

Asset allocation	MPS Model Strategy 4 as at end March 2019* (%)	MPS Model Strategy 4 as at end June 2019* (%)	Change +/-
UK Government Bonds	3.7%	3.7%	0.0%
UK Corporate Bonds	1.0%	1.0%	0.0%
US Investment Grade Bonds	2.3%	2.3%	0.0%
Global High Yield Bonds	3.3%	3.3%	+0.5%
Emerging Market Debt	6.2%	6.2%	0.0%
UK Equity	14.5%	14.5%	0.0%
North American Equity	14.6%	14.6%	-0.5%
European Equity	10.2%	10.2%	0.0%
Global Equity	6.9%	6.9%	0.0%
Developed Asian Equities	1.9%	1.9%	0.0%
Japanese Equity	2.5%	2.5%	0.0%
Global Infrastructure	3.9%	3.9%	0.0%
Volatility Management[1]	28.5%	28.5%	0.0%
Cash	0.5%	0.5%	0.0%
Total	**100.0%**	**100.0%**	

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The Portfolio has not been available on all Platforms since inception.

[1] Volatility management is achieved via holdings in the Standard Life Strategic Investment Allocation Fund (SIA Fund). The SIA Fund is designed to be used as part of a strategic approach to individual client wealth objectives and should not be considered as a stand-alone investment.
The fund is designed to generate an absolute return when viewed with other assets in the client's portfolio. As a result, if other assets in the portfolio are performing well, this fund may not produce a positive return.
The SIA Fund is complemented by holdings in the Standard Life Investments Active Overlay Fund, which aims to add alternative return seeking strategies to the portfolio.
The use of derivatives in the funds may result in increased volatility in their fund price.
Due to the leveraged nature of derivatives, gains and losses can be greater than associated with traditional investment instruments.
The funds will have the ability to hold short derivative positions. This means that the funds will not necessarily follow market trends i.e. if stock markets rise the funds may not do so at the same rate, or at all.
*The data is rounded to 1dp and small variances to totals may occur. This data is based on the Aberdeen Standard Capital MPS hosted on the Standard Life WRAP platform.

The figures shown here refer to the past. Past performance is not a reliable guide to future performance. As with any investment, the value of your fund can go down as well as up and may be worth less than you invested.

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