Target Return

Managed Portfolio Service - Portfolio 3

Quarterly Update - Q1 2019

Aberdeen Standard Capital

In brief

- Global economic activity and inflation remained subdued in Q1.
- Central bankers responded by putting policy tightening on hold in some regions and loosening in others.
- Political risks have subsided but not disappeared – the US-China trade dispute has de-escalated for example.
- Financial conditions have improved and asset prices have rebounded strongly in Q1, following the sharp sell-off in Q4 2018.

Global overview

The current global economic growth environment remains subdued. Since our last outlook, our short-term activity indicators have deteriorated while global business sentiment indicators have yet to bottom.

In response to this, we are seeing policy stabilisers kick in. Central banks in developed markets have put policy tightening on hold while in China, policymakers are adding to stimulus. Finally, some of the political risks that plagued markets in 2018 have become less acute in the short term.

Central bankers have found it easier to justify their policy on account of still subdued inflation. Lower global energy prices in 2018 have depressed headline price growth, but underlying measures of inflation have also been soft. Indeed, even the US economy, which has enjoyed an unusual late-cycle fiscal stimulus, is still delivering muted inflation. This makes it easier for central bankers to delay tightening in a more uncertain economic environment.

The speed and extent of the shift in the Federal Reserve's (Fed) interest rate stance has been most remarkable. From signalling multiple further hikes, the Fed is now guiding that the next move is as likely to be up as down. In the Eurozone, the European Central Bank has pushed back its guidance on rate increases until at least 2020. The Bank of Canada has also become more 'dovish' while the Bank of England is on hold amid Brexit uncertainty. Elsewhere, the Bank of Japan's yield curve control framework is on lockdown and, in many developed markets, policy tightening is on ice.

Signs also point towards Chinese policymakers taking further steps to loosen domestic policy. They have already cut reserve requirement ratios and these will likely be lowered further. Other credit easing measures have been implemented too, although there is still a desire to constrain shadow-banking growth. Personal and corporate tax have also been cut again, adding to last year's fiscal easing.

Before November's G-20 meeting, we feared that the US would impose a 25% tariff on all imports from China by the end of Q1 2019. At the same time, intransigence in both Rome and Brussels over Italy's 2019 budget left open the potential for a more serious debt crisis. However, in both instances, brinkmanship has softened, as leaders faced the economic, political and financial consequences of their aggressive stances.

Because the underlying drivers remain in place, these political risks have most definitely not gone away. But if the current uneasy truces hold, the drag from uncertainty on growth and returns should moderate as the year progresses. This is also true of Brexit. Although we cannot rule out a catastrophic 'no-deal' scenario, our assessment is that a softer outcome remains more likely.

The combination of easing short-term political risk and the more accommodative policy stance is loosening financial conditions. Government bond yields have fallen sharply, the trade-weighted dollar has depreciated and capital flows to emerging markets have picked up. In addition, corporate credit spreads have narrowed and equity prices have rallied. It is our judgement that this loosening will have some efficacy. Indeed, in aggregate we expect global GDP growth to slow from 3.6% for 2018, to 3.2% in 2019. Thereafter, we anticipate it picking up to 3.5% in 2020. We believe that the maximum change in growth will be felt in the second half of 2019 and the first half of 2020, before moderating again.

This impulse should be most powerful in emerging market (EM) economies. Last year, they were caught in the crosshairs of US and Chinese policy tightening, slowing global trade growth and growing risks around protectionism. Relief on all these fronts, alongside other cyclical effects, will help those EM economies hit hardest in 2018. Therefore, while aggregate EM growth is expected to drop to 4.2% in 2019 (from 4.6% in 2018), we now expect it to jump back to 4.7% in 2020.

Contrary to EM economies, the developed markets' story is a little more nuanced. The open Eurozone economy will benefit most from the acceleration in global production and trade cycles that we expect. Japan will similarly enjoy a better global growth backdrop, albeit with the domestic headwind from a consumption tax hike in the autumn. Meanwhile, we expect the US to continue to slow, with the fading 2018 fiscal stimulus still dominating its growth profile.

We should emphasise that the pick-up in growth we expect over coming months is unlikely to be as powerful as 2016/17. This is because policy stimulus will be more muted and there is less spare capacity to be absorbed. Moreover, the risks to this turnaround in growth are tilted to the downside. That is, excessive borrowing in key countries and sectors could potentially constrain the growth impulse from easier financial conditions. Overarching all this remains a rather murky political environment. The starting gun has been fired on the US presidential race next year. The UK, meanwhile, remains in political paralysis over Brexit, while Europe struggles to bring together various strands of electoral discontent. As such, it is plausible that more aggressive easing from major central banks will be necessary before growth bottoms out.

Despite all this, equity markets have enjoyed a V-shaped recovery from the savage sell-off late last year. Indeed, equities enjoyed the best start to a year in almost 30 years. This appears to be a rerun of the 'bad news is good news' mentality of investors, whereby their focus turns to central bank policy response. That is, that interest rate rises will be postponed, monetary policy will be relaxed and there may be another round of quantitative easing. But, after more than a decade of central banks riding to the rescue, we believe investors have become overly relaxed. They may be in for a rude awakening when the medicine is withheld.

Fund manager views on how the global economy will develop over the coming year are near their gloomiest since 2008. As a result, many have trimmed their exposure to US stocks to the lowest point in nine months. Over a third of managers believe the S&P 500 Index has already passed its peak. Yet, some large investment houses argue that the US expansion may well continue for another two decades. They contend that persistent low inflation and low interest rates will continue to support the secular bull run. And why not? US employment is so high that people are coming back into the workforce. Furthermore, there is no evidence that bull markets die of old age – Australia recently enjoyed 27 years of continued expansion.

Much has been written on how the US market continues to look expensive compared with its global peers. However, we should take account that the US is home to the vast majority of high-growth tech stocks. The UK and Europe, on the other hand, are more slanted towards financials and industrials. We should also note that the US banking sector has endured most of its pain and restructuring. The same cannot be said for Europe. Meanwhile, US growth this year remains healthy but modest. Compare this with Europe, where a sickly, stagnant and potentially deflationary outlook seems more probable.

Strategies & Performance

Global equity markets climbed a 'wall of worry' over the quarter, reclaiming most of their losses from late 2018. While economic data and geopolitics were broadly negative, investors focused on the response of central banks. In the US, the Fed changed its guidance from 'gradual' rate rises towards a more 'patient' approach. Investors have therefore revised down their expectations; from three rate rises in 2019 towards a 50-50 possibility of a cut by the end of the year. Meanwhile, Bank of England policy remains hamstrung by ongoing Brexit uncertainty. With inflation at 1.9%, the Bank can afford to sit on its hands.

Obviously, the European economy has its own economic and Brexit concerns. However, with inflation at 1.4%, interest rate rises seem a long way off. The bottom line is that we remain in a 'lower for longer' environment as the era of cheap debt continues.

The first quarter of 2019 was a mirror-image of the last quarter of 2018. Therefore, it is unsurprising that those positions that worked in our favour in late 2018 hampered us in 2019, and vice-versa.

We maintain a relative risk-on slant to our portfolios, with our typical equity allocation between 30% and 40%. Over the quarter, US equities were the standout performers among the major indices, followed by the UK and Europe. Japan took the bottom spot. It is pleasing to note that the performance of the indices mirrored our own favoured equity positions.

Our largest position in the portfolios is US equities, where the most significant performance driver was the Fed's softening tone. The US economy seems largely in good health and we expect positive news regarding the US-China trade talks. Elsewhere, we favour UK equities, where valuations appear to have priced in an overly negative Brexit deal. With the market currently providing a dividend yield over 4%, we believe we are being suitably compensated while negotiations continue. Furthermore, we have recently increased our exposure to Chinese equities, which should be buoyed by policy response. Chinese equities have climbed to their highest level in a year, recovering from their own slump in 2018.

Within fixed interest, we have trimmed our holdings in high-yield bonds where spreads over sovereign debt are at unappealing levels. Instead, we recycled these proceeds into investment-grade debt. Our position in US inflation-protected Treasuries performed strongly, as interest rates fell in response to the change in guidance from the Fed. We also benefited from our position in European interest rates which we initiated during January. Elsewhere, we favour select emerging market strategies such as Mexican government debt which have and should continue to benefit from political and economic reform.

Lastly, our collection of currency strategies performed largely as expected given the risk-on mood in the market. Two of our more defensive strategies involve taking a positive view on the Japanese yen versus the Canadian dollar and the Australian dollar. Both strategies delivered negative performance over the quarter. Conversely, we benefited from our more recently implemented strategy favouring the Norwegian krone over the euro. Norway's economy is supported by the rising oil price. After falling from $85 a barrel in October 2018, crude oil has risen almost 30% so far this year. This prompted Norway's central bank to raise interest rates on the back of an economy that is expanding at a 'solid pace'. It also maintained its stance for another interest rate increase later in 2019.

Outlook

In summary, Q1 2019 performance is pleasing and we have benefited from the structural changes we have made since August 2018. They protected the portfolios during the savage market downturn in the last four months of 2018. Equally, these changes have helped our portfolios participate more during the market recovery since the start of this year. We realise, however, that our clients have endured a trying time of late and that we still have much more work to do.

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.

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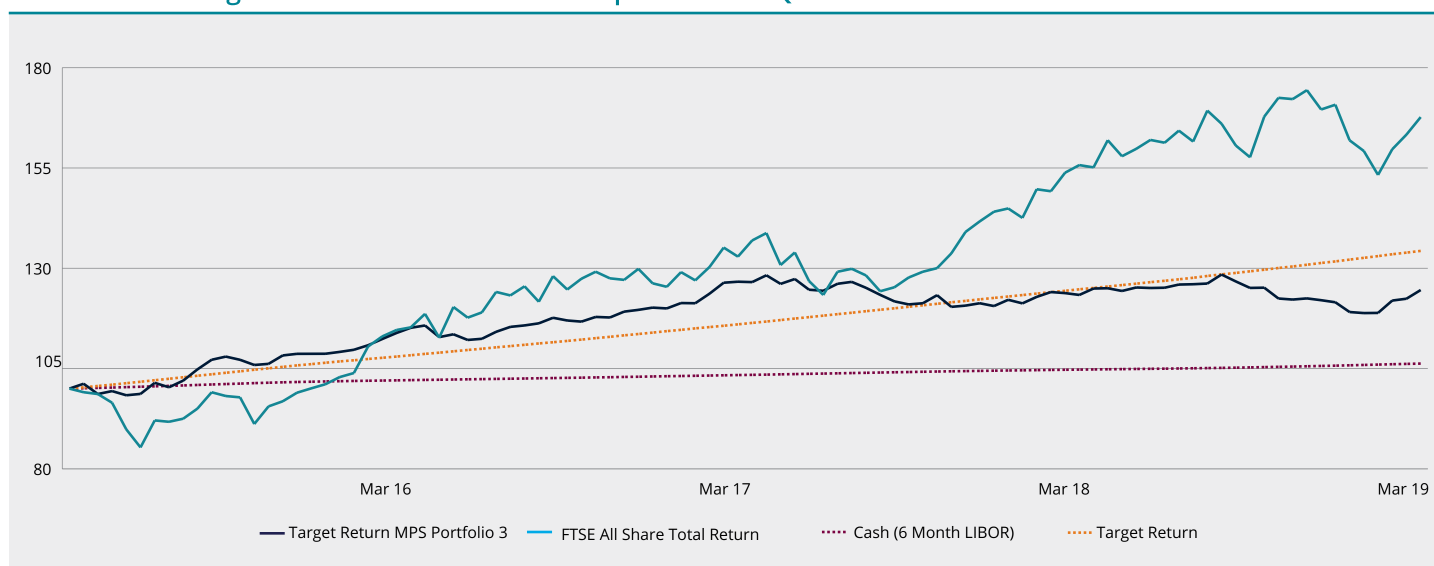
Performance: Target Return MPS Portfolio 3

	Performance (%) 1st Quarter 2019	Performance (%) 3 years	Performance (%) Since Inception[1]	Volatility Since Inception (%)
Target Return MPS Portfolio 3	4.81	2.97	24.58	4.04
Target Return[2] (Cash+3%)	0.97	11.56	34.33	0.09
FTSE All Share TR	9.41	31.32	67.69	10.52
Cash (6 month LIBOR)	0.24	2.02	6.24	0.07

The performance figures may vary due to product specific charges and should be viewed on an indicative basis.
[1] 03/05/11 - 31/03/2019
[2] 6 month LIBOR +3% annualised over rolling 3 year periods
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 3 Inception to end Q1 2019



Asset allocation: Target Return MPS Portfolio 3

Asset allocation	MPS Model Strategy 3 as at end December 2018* (%)	MPS Model Strategy 3 as at end March 2018* (%)	Change +/-
UK Government Bonds	5.6%	5.6%	0.0%
UK Corporate Bonds	5.0%	5.0%	0.0%
Short Duration UK Corporate Bonds	4.3%	4.3%	0.0%
US Investment Grade Bonds	2.5%	2.5%	0.0%
Global High Yield	2.5%	2.5%	0.0%
Emerging Market Debt	5.0%	5.0%	0.0%
UK Equity	12.3%	12.3%	0.0%
North American Equity	10.0%	10.0%	0.0%
European Equity	9.7%	9.7%	0.0%
Global Equity	7.5%	7.5%	0.0%
Developed Asian Equities	0.9%	0.9%	0.0%
Japanese Equity	1.3%	1.3%	0.0%
Global REITs	1.9%	1.9%	0.0%
Global Infrastructure	5.0%	5.0%	0.0%
Volatility Management[1]	25.9%	25.9%	0.0%
Cash	0.5%	0.5%	0.0%
Total	**100%**	**100%**	

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[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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