



Central banks in the US and the UK appear to be moving closer to another round of quantitative easing, which has boosted risk assets. The irony in the rally is that this additional support would not have been forthcoming were the recovery more secure. High levels of uncertainty continue to highlight the importance of tactical asset allocation in portfolio construction and the attraction of strategies which have a greater likelihood of delivering repeatable performance.

Economic outlook

Recent data has confirmed that the steepest part of the recovery is behind us and we expect a moderation in the pace of G4 growth going forward. A relapse into outright recession is unlikely barring additional shocks to the economy, but the risks around this forecast are not symmetrical.

This is a factor which is now recognised by policy makers on both sides of the Atlantic. Recent falls in core inflation in the US, the impact of fiscal tightening in the UK and stubbornly high unemployment in both countries

combine to provide the economic rationale for new monetary stimulus. The fragilities in and between the economy, the weak financing position of governments and the instability of the banking system provide additional weight to the case for more action.

Accordingly, financial markets have begun to price in further unconventional monetary policy measures, or quantitative easing, in both countries, although the strength of the Q3 UK GDP numbers have pushed back expectations of a move by the Bank of England into 2011.

In mainland Europe, the ECB is less likely to add further unconventional monetary stimulus. The back-stop facilities already put in place should be sufficient to prevent another meltdown of confidence in the southern European countries. Perceptions of the outlook for Europe have improved in recent months, although the pace of recovery remains pedestrian, jobs growth is limited. Importantly, however, the ECB does not view employment as part of its remit, leaving the issue to be managed through structural reforms in member states.

In the developing world activity remains robust and policy makers are largely being successful in charting a path between avoiding overheating in key parts of their economies but maintaining rapid growth. We view the recent tightening in Chinese lending standards in this regard.

Chart 1: Prospective QE has pushed equity markets higher



Source: Insight Investment.

Absolute valuations

Policy makers are effectively signalling that the global cost of capital will remain low for a long time and this recognition has spurred a search for yield and higher returning assets to the benefit of both equities and corporate bonds.

However, the moderation in growth we are witnessing has historically presented a headwind for stocks, as it is suggestive of a deceleration in profit growth ahead.

Yields on government bonds are already low by historical standards, but with large amounts of spare capacity in the economy, inflation looks set to remain low for some time yet. With policy makers intent on getting the yield curve flatter we expect government bonds to retain some attraction – not least since they have proven themselves to be one of the few diversifiers in times of stress.

On our analysis, no asset class appears particularly compelling from a valuation standpoint so we have a tactical approach to asset allocation.

Risk appetite

Risk appetite remains fragile given the uncertainty surrounding the path of the recovery in a post-credit crisis world. Nonetheless, we have seen a marked improvement in risky asset performance since the second quarter sell-off.

Consequences of QE:

As expectations of additional quantitative easing (QE) from the Fed have built, three trends have been evident. Firstly, uncertainty over the future of inflation is causing a high demand for hedges against tail risk of inflationary and deflationary shocks should central banks either succeed or fail in their attempts to reflate. Secondly, government yields of short to medium-term duration have been pushed lower in anticipation of official support and in turn, these low rates are causing a yield grab further along curves and in credit. Thirdly, given that additional stimulus reflects the fragility of the recovery in the western world, investors are increasing having a preference for assets in emerging markets given their strong endogenous growth drivers.

Falling government bond yields explain part of the rebound. They reflect an easing of fears surrounding the sustainability of sovereign balance sheets – for example in southern Europe – and also a recognition that further monetary policy support – in the guise of additional quantitative easing (QE) – is likely.

The irony in the recent risk asset rally is that this additional support would not have been forthcoming were the recovery more secure.

Given this uncertainty, ‘real money’ investors have moved to broadly neutral top level asset allocations having been overweight equities and underweight bonds earlier in the year. By contrast, speculative investors have been more momentum driven, and appear to have

shifted to long positions in both equities and bonds.

Sentiment & positioning

With the outlook highly uncertain, we currently believe that it is inappropriate to be running large directional positions and, in the absence of compelling valuation signals, are adopting a tactical approach to asset allocation.

In fixed income we have had a bias to be either long or neutral duration depending on market positioning and see selected opportunities in the periphery of Europe. We also have a slight bias for credit spread duration.

Foreign exchange positions are set up for a mid-cycle slowdown, not a recession. We have a bias towards short dollar positioning.

Our multi-asset portfolios are well balanced. Our equity exposure is biased towards areas where growth drivers are more evident, such as Asia. Our bond exposure is slightly tilted to short-dated credit over government bonds. Our opportunistic exposures tend to be focused on investments that have a higher ‘certainty of return’ and offer the scope for income generation.

Chart 2: Prospective QE has pushed bond yields lower



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