Strategic Perspective

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Investment Research

Using cash to add to our equity overweight

- This month we raised our global equity allocation, and funded that move from cash. A big part of what originally prompted the idea to buy more equities was the pullback in prices since mid-October. A lot of that reversed after this week's rally, and it now looks like equity sentiment is more or less neutral. True, the COVID backdrop has deteriorated sharply across Europe, and the US looks like it's heading down the same path. And given it's looking like the Republicans will hang on to the Senate, there is not going to be another massive COVID stimulus package, nor will there be big structural deficit spending. Therefore, the economic and profit recovery will be slower. Despite all this, we decided to put some of our cash overweight to work in equities for the following reasons:
  - We're still going to get some new US stimulus.
  - The lockdowns now will be much less economically repressive than those of the spring.
  - We'll very likely get a vaccine, with most experts thinking one will be widely available by Q2. When we do, the leisure, hospitality and travel sectors will open back up, and growth will pick up strongly. Even with poor growth over the winter, strong growth in the quarters after that should see overall above trend global economic growth over the next 12-18 months.
  - There won't be any tax increases, either for corporations or for the wealthy individuals who buy equities. For this reason, while a Republican Senate doesn't provide the immediate "sugar high" to growth, it does probably result in the best backdrop for corporate profits over a three to four-year time horizon.
  - If Biden hangs on to his lead and wins, we are not going to get the disruptive trade uncertainty that we did under Trump.
  - Bond yields are likely to remain lower for longer with a Republican Senate. Low yields on competing assets make equities the only game in town among the main asset classes during times when the economy and corporate profits are improving.

- We increased our allocation to Asia ex Japan. It's the region with the brightest cyclical and structural growth prospects, and valuations are reasonable. Its currencies are pro-cyclical, so they have a higher likelihood of rallying during periods of above trend economic growth. Relatively high Chinese bond yields at a time of low yields in developed world markets should attract foreign capital and keep domestic capital at home, pushing up the RMB in the process. The risk of a US/China trade war drops sharply if Biden hangs on to win the election.

- We increased our allocation to the US. Lower interest rates for longer are supportive of growth stocks, which the US index is loaded up with. Also, the tax hikes that would have occurred in the event of a Democratic party Blue Wave would have hit the mega cap tech names very hard. We are not going to get these now if the GOP hangs on to the Senate. If Biden becomes president, a less adversarial relationship with China is likely, which is good for US companies with a large Chinese presence.

- We added to our Europe ex UK weighting modestly. The performance of this index in common currency terms is usually a bit more cyclically levered than our other three developed market regions, which is appealing given we expect above trend economic growth in around 6-months are so. In addition, Joe Biden as US president means that a trade war with the EU would be much less likely than it would have been with four more years under Trump.

- We cut our UK equity allocation, as we remain pessimistic on UK relative performance prospects.

	Local Total return (%)			£ currency total return (%)			Valuation			Earnings	
Region	1m	3m	12m	1m	3m	12m	12m fwd P/E	12m fwd P/Sales	Equity risk premium*	12m fwd EPS growth (%)	EPS revisions balance (%)**
UK	-5.25	-7.59	-25.66	-5.25	-7.59	-25.66	13.63	1.06	7.04	18.66	-0.6%
Dev'd Europe ex UK	-5.47	-4.34	-11.56	-5.87	-4.63	-7.10	17.32	1.29	6.27	24.63	9.5%
Japan	-2.54	2.09	-4.86	-1.63	3.44	-1.36	17.41	0.92	5.72	22.65	6.3%
EMEA	-4.43	-4.98	-13.99	-4.54	-5.57	-21.34	10.82	1.54	1.34	28.25	7.0%
Lat Am	-0.70	-8.59	-16.54	-1.20	-13.32	-35.81	13.63	0.96	0.12	83.11	11.7%
Asia ex Japan	2.08	2.87	12.31	2.74	5.27	13.35	15.34	0.95	4.04	20.04	9.8%
North America	-2.70	1.16	9.20	-2.72	2.03	8.70	22.32	2.47	3.62	16.01	38.8%

*12m fwd earnings yield minus the relevant 10-year government bond yield. We use an equity market cap weighted average 10-year government bond yield for Europe ex UK (Germany, Switzerland, Sweden), Asia ex Japan (China, South Korea, Taiwan, India and Hong Kong), Latam (Brazil and Mexico) and EMEA (South Africa and Russia). ** Revisions up minus down as a percent of up plus down.

Chart 1: **Brewin Dolphin's Strategic (benchmark) and Tactical Asset Allocations**

Asset Class	WMA Conservative	BD Conservative	WMA Income	BD Income	WMA Balanced	BD Balanced	WMA Growth	BD Growth	MAPS Global Equity	BD Aggressive
Cash	5.00	5.50	5.00	5.50	5.00	5.50	2.50	3.50	2.50	2.00
Bonds	37.50	33.00	25.00	20.75	17.50	15.00	7.50	5.50	0.00	0.00
Gilts	10.00	8.75	5.00	3.75	5.00	3.50	2.50	2.00	0.00	0.00
Corporate Bonds	22.50	21.00	17.50	15.50	10.00	10.00	5.00	3.50	0.00	0.00
UK Index Linked Bonds	5.00	3.25	2.50	1.50	2.50	1.50				
Equities	32.50	37.50	52.50	57.75	62.50	67.50	77.50	82.00	97.50	98.00
UK	17.50	15.00	27.50	25.00	30.00	27.00	32.50	29.50	44.00	40.00
Overseas	15.00	22.50	25.00	32.75	32.50	40.50	45.00	52.50	53.50	58.00
North America	9.48	13.00	15.80	19.25	20.53	24.25	28.43	31.75	33.15	35.00
Dev'd Europe ex UK	2.02	3.50	3.36	5.00	4.37	5.50	6.05	7.50	7.30	8.50
Japan	1.06	1.00	1.77	2.00	2.30	2.50	3.18	3.50	4.12	4.00
Asia	2.07	3.75	3.45	5.25	4.49	6.50	6.22	8.00	7.80	9.00
Emerging	0.37	1.25	0.62	1.25	0.81	1.75	1.12	1.75	1.13	1.50
Alternatives	25.00	24.00	17.50	16.00	15.00	12.00	12.50	9.00	0.00	0.00
UK Commercial Property	5.00	3.00	5.00	2.00	5.00	2.00	5.00	1.50		
Hedge Funds	20.00		12.50		10.00		7.50			
Absolute Return		21.00		14.00		10.00		7.50		
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

All Weights as a % of total Portfolio

Source: Brewin Dolphin

Chart 2: **Brewin Dolphin's Asset class view**

	Asset Class View	Rationale
Cash	Cash	We recommend retaining a small overweight. In the current backdrop, we want to have liquidity on hand opportunistically add to positions in other asset classes in the event of corrections.
Bonds	Bonds	The 10-year Gilt yield has been broadly flat over the past month. This is interesting in light of several bond bullish developments, including the new lockdown and BoE's subsequent QE announcement, as well as what looks like to be a surprise Republican win in the US Senate race (which will hold back US fiscal stimulus, global growth and inflation). The fact remains that at current hyper low yield levels, the risks of holding Gilts are asymmetric to the downside. We suspect that rising inflation expectations will ultimately push Gilt yields moderately higher over the next 12-months. We remain underweight. Within our bond allocation, the backdrop appears to favour corporates over governments. While growth should be soft over the winter, we think there is scope for the global economy to improve on a 12-18 month view and for volatility to move lower. In this environment, credit spreads usually tighten. In addition, central banks are buying corporate bonds, and there are emergency liquidity and loan programs in place that are also supportive of the sector. Nevertheless, corporate bond yields are also very low, and the fast money has already been made. We continue recommend only neutral positions.
Equities	Global Equity	Notwithstanding the deteriorating COVID backdrop, we have boosted our equity overweight. The lockdowns now will be much less economically repressive than those of the spring, and moderate US fiscal stimulus will help. We'll very likely get a vaccine, with most experts thinking one will be widely available by Q2. When we do, the leisure, hospitality and travel sectors will open back up, and growth will pick up strongly. Even with poor growth over the winter, strong growth in the quarters after that should see overall above trend global economic growth over the next 12-18 months. Importantly, with it looking like the Republicans will retain control of the Senate, there won't be any tax increases, either for corporations or for the wealthy individuals who buy equities. For this reason, while a Republican Senate doesn't provide the immediate "sugar high" to growth, it does probably result in the best backdrop for corporate profits over a three to four-year time horizon. Meanwhile, If Biden hangs on to his lead and wins, we are not going to get the disruptive trade uncertainty that we did under Trump. Finally, bond yields are likely to remain lower for longer with a Republican Senate. Low yields on competing assets make equities the only game in town among the main asset classes during times when the economy and corporate profits are improving.
Alternatives	Absolute Return	A weighting to absolute return will provide some diversification benefits to portfolios if equities and bonds sell off together. While equity and bond prices have been negatively correlated since the late 1990s, there is the possibility they both sell off in unison under certain scenarios. Furthermore, an allocation to absolute return provides some optionality to benefit from an increase in volatility.
	UK Property	Property fundamentals on balance are mixed to poor. True, the industrial subsector is now the largest part of the REIT index, and the fundamentals for this group are OK. But this is more than offset by negative fundamentals in retail. The COVID crisis has likely created a structural break for office REITs. There is considerable uncertainty with regards to the outlook for office space demand. Against this backdrop, valuations are uninspiring. The bottom line is that it does not appear to be a great time to have much exposure to UK property. We recommend underweight positions.

Chart 3: **Brewin Dolphin's Equity Allocation by Region**

Equity Allocation by Region	
UK Equities	EU future relationship negotiations are going down to the wire. We suspect Boris Johnson may sign off on a last-minute compromise, as he did last autumn in the lead up to the withdrawal agreement. A deal combined with general dollar weakness on the back of a pick-up in global investor risk appetite over the next 12 months would likely push the pound higher, which is positive for UK relative performance in currency unhedged terms. But a stronger pound will likely not be enough for UK equity markets to outperform. For that to occur, we need to see the sectors that the UK has exposure to start to improve. It is not clear we have reached that point. We therefore continue to underweight UK equities relative to the global equity benchmark.
US Equities	Lower interest rates for longer are supportive of growth stocks, which the US index is loaded up with. Also, the tax hikes that would have occurred in the event of a Democratic party Blue Wave would have hit the mega cap tech names very hard. We are not going to get these now if the GOP hangs on to the Senate. If Biden becomes president, a less adversarial relationship with China is likely, which is good for US companies with a large Chinese presence. Finally, it's not clear that tech has lost its growth edge versus the overall market.
Europe ex UK Equities	Risk/reward for Europe ex UK seems more attractive than other regional value style plays like the UK. The performance of this index in common currency terms is usually more cyclically levered than our other three developed market regions (the US, Japan and the UK). We think it's good to have this cyclical exposure given that the market will start to look ahead to above trend economic growth in around 6-months are so. We also like the region given there is more room for regional cohesion to support convergence between the periphery and the core. In addition, a Biden presidency is not going to wage a trade war with the EU, which would have been a risk under Trump.
Japan Equities	Japan continues to perform very defensively, outperforming when the global equity market declines and vice versa. We are bullish global equities on a 12-month view and therefore struggle to get excited about Japan's prospects. True, Japanese equities should hold up well if equities experience a choppy next couple months, as we expect. However, once global equities start rallying anew, we suspect Japan would struggle to keep up.
Asia ex Japan Equities	Asia ex Japan is the region with the brightest cyclical and structural growth prospects, and valuations are reasonable. Its currencies are pro-cyclical, so they have a higher likelihood of rallying during periods of above trend economic growth. Relatively high Chinese bond yields at a time of low yields in developed world markets should attract foreign capital and keep domestic capital at home, pushing up the RMB in the process. The risk of a US/China trade war drops sharply if Biden hangs on to win the election.
Emerging Markets ex Asia	We maintain a small overweight to EM ex Asia. Risks are high, but we're being compensated to take risk as valuation multiples are very undemanding. Ultimately, a weaker dollar and stronger commodity prices will be required to drive EM ex Asia equity outperformance. We see this happening on a 12-month view. We therefore advise retaining a small overweight, but patience over the next few months will be required.

Important Notes:

Main source of information: Datastream and Brewin Dolphin