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Investment strategy

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Economic and market commentary

Given the economic and political headwinds and shocks we have experienced in the first six months of 2016, the summer could easily have been characterised by uncertainty and volatility. But in the main, global markets have been relatively quiet as investors continued to take comfort in easy money being pumped into the financial system by central banks, which has continued to underpin asset valuations.

But it is clear to most observers that central bank stimulus, and in particular the ECB's bond-buying programme, is distorting global markets. We are very mindful of what this means for global interest rates as well as the impact on pension scheme deficits, company profits and relative valuations. It's arguable now whether monetary policy is providing a positive stimulus to the economy, and a chief question is whether we are getting to the situation – particularly in the UK and Europe – where the cure is potentially more damaging than the illness.

We know that without quantitative easing, core bond yields would rise, but it is more difficult to say what would happen if there were no QE, given the heightened levels of global debt we have and the weakness and fragility of the financial system. Arguably, without central bank intervention we would be in a worse place, but that doesn't mean monetary stimulus hasn't distorted the valuation of assets.

Indeed, some of the most striking moves in recent weeks have occurred in fixed income assets, both corporate and government. We have seen European high yield bonds rallying to levels at which, in the past, has led us to cut back our exposure; while long-dated gilts have returned upwards of 30% since the UK referendum on EU membership – well in excess of equity returns. Yields have, of course, collapsed in the main.

The powerful rally in credit has led us to evaluate our position on European investment grade and high yield, but we have decided to leave our allocations unchanged. We are neutral on credit overall with a preference for high yield over investment grade, on which we are modestly negative, given we are late in the credit cycle and are seeing soft economic growth and weakening profitability.

Traditionally, late-cycle activity such as debt-funded mergers and acquisitions and share buy-backs tend to be negative for the asset class, while the ongoing march of easy money across Europe will

further lower the cost of credit. Moreover, valuations are now reasonable, whereas they appeared cheap earlier this year.

As we've seen, volatility in equity markets has been very low, despite significant risks on the horizon. Against this backdrop of collapsing volatility, we have been keeping an eye on political headwinds such as the upcoming US election and the Italian referendum, as well as other pressures, such as a rise in sterling (which would hit sterling-denominated funds) or a dollar rally (which would put pressure once again on emerging, as well as global, markets).

The banking system remains fragile, and certainly in the periphery we still need to see a significant injection of capital. Almost certainly Brexit has led to a more fragile European Union and has reduced Angela Merkel's power, which must introduce a degree of uncertainty about the outlook for the EU. All of this increases the general uncertainty that markets are feeling, which partly explains the heightened awareness and reaction to the publication of any economic data or central bank announcement.

Clearly, we are reluctant owners of equities and credit in these markets and continue to pay close attention to yield, but we have made no major changes to our asset allocation model. Our central case remains one of low growth, low inflation and low rates, and even the return of fiscal stimulus does not threaten that outlook – but we need to see fiscal stimulus nonetheless.

Reductions in interest rates can stimulate demand only if they are accompanied by effective fiscal expansion, which makes the current situation increasingly unpalatable, unless governments use the room they have been given by lower interest rates to increase their fiscal spend. Indeed, Europe has been criticised for combining an austerity drive with low rates, which violates this 'fiscal connection'.

But there are signs that fiscal could be on the horizon, in the US at least. Both presidential candidates have hinted at it in their political campaigns and there is historical precedent for candidates that have previously called for lower deficits eventually bringing through fiscal expansion. While Clinton and Trump have got different ideas for how they would implement any fiscal expansion, it is clear that increased spending on infrastructure would be part of their plans.

Figure 1: Asset allocation grid

	Strongly Dislike	Dislike	Neutral	Favour	Strongly Favour
Asset Allocation		Government I/L	Cash Credit Equity	Commodities Property	
Equity Region			EU x UK UK Pac x Japan EM US	Japan	
Global Equity Sector	Energy	Materials Utilities Telecoms Financials	Staples	Industrials Consumer Cyclicals Healthcare	Technology
Bond – FX Hedged		Japan	Germany US UK	Nordic Australia EM Local	
Credit			Corporate IG EMD	Corporate High Yield	
Commodity			Livestock Softs Energy	Base Metals Grains Precious Metals	
FX		JPY AUD EUR GBP	Nordics	USD	

Source: Columbia Threadneedle Investments, as at 20 September 2016.

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