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Increasing our defensive positioning

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Over the past week developments in the US-China trade dispute have deteriorated materially. On 1 August, the US declared negotiations with China were progressing too slowly and announced the impost of new tariffs at 10%. These would be applied to the remaining $300 billion of imports from China that are not already being tariffed at 25% from 1 September.

A few days later on 5 August China took a retaliatory stance, allowing its currency to weaken noticeably through key levels and to decade lows against the US dollar. It also halted the purchase of US farm products (in conflict with US demands for a rapid increase in purchases) and threatened to impose its own tariffs on US goods.

Improvement in manufacturing and trade activity remains elusive

Recent data has shown some improvement as the world economy exited a relatively weak Q2 for growth, with improving data in the US jobs market and housing—as well as ongoing domestic stimulus helping to boost China's retail sales and industrial activity. However, elsewhere data has remained weaker, with European and UK PMIs reversing much of their recent gains and emerging market data showing little upward momentum. Moreover, as we discussed in the August edition of Core Offerings, *How expensive are equity markets?*, some improvement in manufacturing and trade activity was likely to be critical to the ability of the world economy to stabilise over the rest of this year. To date, this improvement remains elusive. In addition, with 75% of the US reporting season complete, the slowdown in earnings over the past year has continued (though growth remains modestly positive).

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We still believe the underlying fundamentals for the global economy remain solid, reflecting tight global jobs markets, low inflation and very low interest rates. However, we are judging that recent developments portend further escalation in the US-China trade dispute that has the potential to weigh on global business investment and sentiment. This would increase the risk that the global economy may fail to stabilise over the rest of this year, with global trade and industrial activity potentially weakening further from here.

This judgement is not without risk. However, with equity markets on the expensive side of fair (as discussed in our recent Core Offerings), and central banks likely to be easing policy further, we believe a more defensive portfolio stance is warranted over the coming six months. While falling bond yields continue to provide equities with valuation support, the recent rapid change in the US-China trade dispute has left a dark cloud over the earnings outlook.

In particular, we are moving from neutral to underweight equities overall (-3 from 0), tilting underweight Europe (-1 from 0) and emerging markets (-1 from +1), staying underweight the UK and remaining neutral in the US and Australia. On the likelihood of further easing from central banks, we are reducing our underweight in high-grade international and domestic bonds (-1 from -2), while remaining neutral global and overweight domestic credit. We have further increased our defensive positioning, increasing our tilt to cash (+2 from 0) and are maintaining a strong overweight to alternatives (+3 to +2).

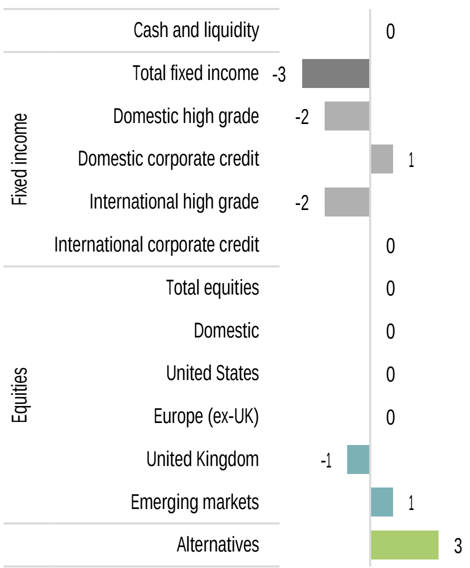
We are now moderately overweight fixed income to equities

Overall, key aspects of the portfolio are now moderately overweight fixed income (-1) relative to equities (-3) balanced by a defensive position in cash and alternatives (+4 together).

Within equities, we are relatively overweight US and Australia (which would likely be defensive markets in a trade dispute and where there have recently been better growth prospects) against all other equity markets. Within fixed income, we are overweight credit (+1, domestic) relative to high-grade government bonds (-2).

The most significant risk to this positioning is that the US and China quickly resolve their current trade dispute, delivering a sharp rally in equity markets to new levels. However, the risks of a more damaging US-China trade war have increased and, with China choosing to openly retaliate against the US (signalling a relatively new confrontational stance) ahead of any material improvement in global industrial trade and production, there now appears a more material risk that equity markets may 'give back' a significant share of their 17% rally in H1 2019 over the coming months. Uncertainty around the rising risk of a hard UK Brexit add to this concern. Further ahead, we are looking for signs of improving global growth, some resolution or de-escalation in the US-China trade dispute, as well as progress around Brexit to engage a more positive portfolio position.

Previous tactical asset allocations



New tactical asset allocations