Smith & Williamson

Investment outlook

A monthly round-up of global markets and trends
December 2018

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Investment outlook

Global equities should benefit from the US mid-term elections

In the US November mid-term elections, the Democrats regained control of the House of Representatives (House), but failed to win a majority in the Senate. Arguably, this may be the best possible outcome for equities, as the risk of the Democrats winning the Senate and repealing tax cuts was removed. Moreover, the chance of the Trump administration pushing for more tax cuts through a Republican controlled Congress, which could potentially lead to an overheating economy and higher interest rates, has been lowered somewhat. Nevertheless, it should be possible to get bipartisan support in Congress for greater infrastructure spending to potentially lift US productivity growth.

Going forward, we expect long-term Treasury yields to remain range bound and for the US dollar to weaken in anticipation of the Fed not hiking rates by more than the market expects. The key beneficiaries could be those markets (e.g. emerging markets, and particularly those in Asia) that have been adversely affected by dollar appreciation this year, and are priced at fairly undemanding valuations. US stocks may also gain; the S&P 500 stock market index has been higher one year after every midterm election since 1946.

Looking at the midterms with a view to the 2020 presidential election, the results were somewhat mixed. The Republicans won the governorships of Florida and Ohio; both these states were crucial for Trump's win in 2016. If the Democrats were to send a president to the White House, they will likely need to take these swing states. On the other hand, the Republicans lost the governorships in Wisconsin, Michigan and Pennsylvania. It was not lost on some voters (e.g. soybean farmers in Wisconsin) that China had been deliberately targeting certain sectors by raising trade tariffs on imported US agricultural products. The cost of raising US import tariffs on raw materials, like steel, has also had a detrimental impact on auto manufacturing. For instance, General Motors' recent decision to shut two plants in Michigan is unlikely to be well received by traditional blue-collar Trump supporters there. The disappointing results in these Midwestern states may encourage Trump to ratchet down the US trade spat with China. Undoubtedly, the state of the economy in November 2020 and the Democrats' presidential candidate choice are likely to determine who wins the keys to the White House.

A market focus is what the mid-term election means for President Trump. Given that the Democrats now have control of the House, they will also chair House committees that can dictate the hearing schedules or launch investigations into the Trump administration. For instance, the important House Ways and Means Committee has the power to examine the president's tax filings, which Trump steadfastly refuses to release, without his permission. That could provide material for an array of investigations into Trump's finances and political connections, that could become a drag on US and global equities.

The UK-EU divorce deal has increased risks for UK financial assets

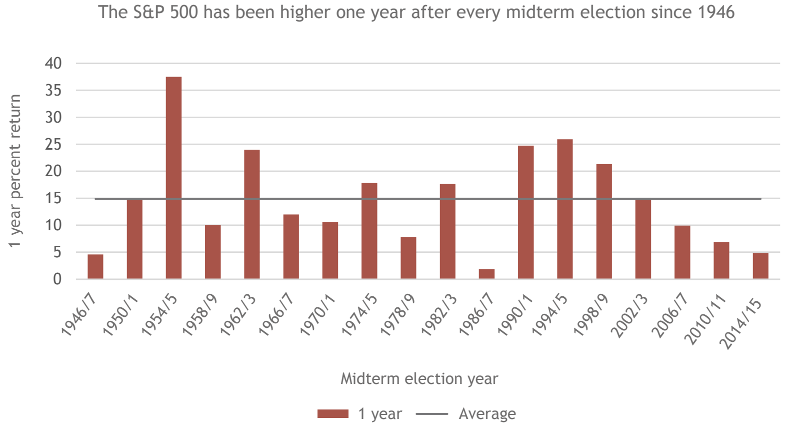
Finally, after two years of negotiations, the UK government finally agreed a Withdrawal Agreement (WA) text with the EU. The deal includes the contentious "backstop" arrangement over the Irish border issue that cannot be ended without the EU's consent. Prime Minister May now faces a battle to get the deal through parliament in December. She appears to have lost the support of the Democratic Unionist Party, which provides a majority in the House of Commons (HoC) for the government, and Eurosceptic Tories. Moreover, there is also a growing chorus of Tories demanding a confidence vote in her leadership. The possibility of the UK leaving the EU without a deal will actually increase if the PM fails to get the WA through the HoC. Looking forward, the political consequences of Brexit (and the potential of a left-wing Jeremy Corbyn government should a snap election be called) are likely to remain a drag on the performance of sterling-denominated financial assets.

Falling crude energy prices do not necessarily imply a slump in global growth

Brent crude oil prices are down 28% from a peak of \$86/b at the start of October. Much of the reason for this decline can be traced back to speculators reducing risk following the recent equity sell-off by cutting their positons in crude oil future contracts on commodity exchanges. The energy market is also concerned with over-supply after the US appeared to have watered down its sanctions on Iranian crude oil exports by introducing waivers for its major customers. However, the crude oil demand side of the equation appears relatively healthy, backed up by global growth of around 3% forecast by the IMF for next year. Although the US is tightening monetary policy, the real Fed funds rate is around zero and unlikely to be a drag on the economy. Moreover, US and Chinese fiscal policy is accommodative for growth. In short, the decline in the crude oil price largely reflects an oversupply, rather than concerns about global growth, which could unsettle equity markets.

Equity markets

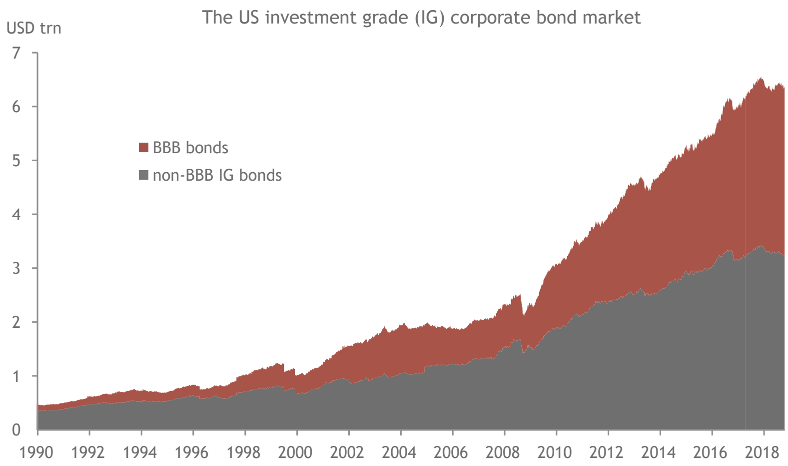
The S&P500 has increased by an average of 15% over the year following every mid-term election since 1946. The outcome of the 2018 mid-term election is expected to be positive for equities. In addition, Fed Chair Jerome Powell has hinted at the possibility of a more gradual pace of interest rate hikes. He has stated that the current levels of interest rates are "very close" to levels that allow the economy to operate on sustainable growth path.



Source: Bloomberg/Smith & Williamson

Fixed income

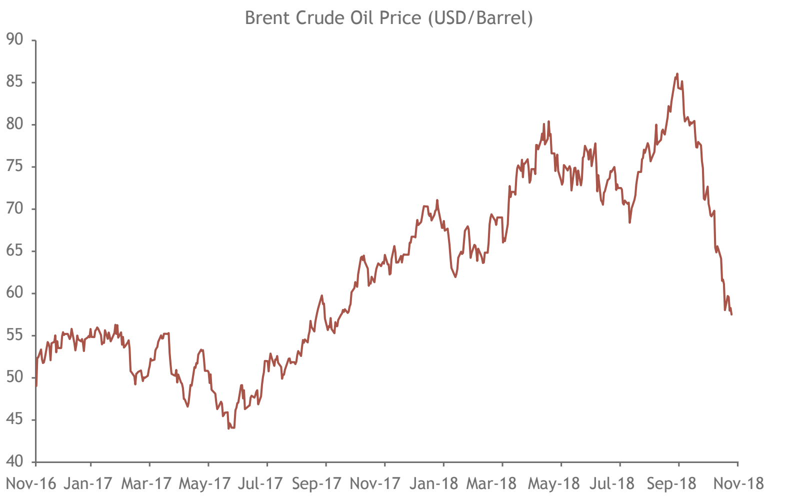
Recent weeks have seen a sell-off in the US corporate bond markets, in both the investment grade and high yield segments. Following the global financial crisis, strong investor demand for assets with higher yields have allowed companies to raise debt cheaply, and do so with less strict covenants than previously. As a result, the quality of corporate bonds in issue has generally fallen. To illustrate, the chart opposite shows that the market for US investment grade corporate bonds with triple BBB rating, which is more risky and only one rating level above high yield, has ballooned to more than USD3trn.



Source: Bloomberg/Smith & Williamson

FX and commodities

Falls in the price of oil have been driven by a reduction in long positions in the futures market, along with concerns about over-supply following a loosening of sanction conditions imposed by the US on Iran. We are optimistic that the demand side of the equation remains robust with global growth forecast at 3% by the IMF for next year. The Organisation of Petroleum Exporting Countries (OPEC) is due to meet in December in Vienna, where oil production cuts to stabilise prices will be high on the agenda. Continued cooperation between Russia and Saudi Arabia on this matter will cause prices to rebound.



Source: Thomson Reuters Datastream/Smith & Williamson

Market highlights

Market returns (Total return (%), sterling)	1 month	3 months	1 year	5 year
Equities				
FTSE All-World	1.7	-3.8	5.5	78.1
FTSE 100	-1.6	-5.3	-0.7	27.3
FTSE 250	-2.1	-10.1	-4.9	36.7
S&P 500	2.2	-2.6	12.8	117.5
MSCI Europe ex UK	-0.5	-7.0	-4.3	42.4
MSCI Japan	0.5	-3.4	0.1	63.9
MSCI Pacific ex Japan	3.1	-5.0	0.8	44.4
MSCI Emerging Markets	4.3	-3.6	-3.2	43.6
UK 10-Year Gilt	0.9	1.1	2.4	29.4
US 10-Year Treasury	1.5	1.1	2.7	40.5
UK Corporate BBB	-1.7	-2.3	-1.9	27.5
Commodities and trade-weighted FX				
Oil Brent Crude ($/barrel)	-22.4	-24.4	-7.9	-47.2
Gold ($/ounce)	0.3	1.4	-4.7	-2.7
TW USD	1.0	2.0	4.5	23.2
TW GBP	-0.4	1.3	1.4	-5.2
TW EUR	-0.8	-0.9	1.2	2.4
TW YEN	-0.3	-1.1	3.0	0.9

Glossary of terms

Bonds – the relationship between price and yield. Yield is the return you get on a bond. When the price of a bond changes prior to maturity due to supply and demand pressures, so does its yield. When the price of a bond goes up due to demand, the yield goes down to compensate. This is so the bond's fixed rate of return (coupon) remains relatively constant – and vice versa. A bond's price and its yield are inversely related. A key factor which influences a bond is the prevailing interest rate. When interest rates rise, the prices of bonds fall, thereby raising yields. This is because the older bonds are sold in order to buy new higheryielding bonds.

Equities – A stock or any other security representing an ownership interest.

Fed – The Federal Reserve. The central banking system of the US. Sets key interest rates and monetary policy.

GDP – Gross Domestic Product. The monetary value of all the finished goods and services produced within a country's borders in a specific time period. This includes all of private and public consumption, government expenditure, investments and net exports.

IMF – International Monitory Fund.

Key macro data	Latest	2018 Consensus forecast	Spot rates	30-Nov	Yields (%)	30-Nov
UK GDP (YoY%)	1.5	1.30	GBP/USD	1.28	FTSE 100	4.37
UK CPI Inflation (YoY%)	2.4	2.50	GBP/Euro	1.13	FTSE 250	3.16
Bank of England Base	0.75	0.75	Euro/USD	1.13	10 Year Gilt	1.36

Important information

Please remember the value of investments and the income from them can fall as well as rise and investors may not receive back the original amount invested. Past performance is not a guide to future performance.

For further information

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Notes

All values and charts as at 30 November 2018. Total returns in sterling. Sources: *FTSE, Thomson Reuters Datastream, Bloomberg FTSE International Limited* (FTSE) London Stock Exchange Group plc and its group undertakings (collectively, the "LSE Group"). © LSE Group 2018. FTSE Russell is a trading name of certain of the LSE Group companies. "FTSE®" is a trade mark of the relevant LSE Group companies and is used by any other LSE Group company under license. All rights in the FTSE Russell indexes or data vest in the relevant LSE Group company which owns the index or the data. Neither LSE Group nor its licensors accept any liability for any errors or omissions in the indexes or data and no party may rely on any indexes or data contained in this communication. No further distribution of data from the LSE Group is permitted without the relevant LSE Group company's express written consent. The LSE Group does not promote, sponsor or endorse the content of this communication.