Smith & Williamson

Investment outlook

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

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Investment outlook

Market volatility returns

Equity markets experienced a bout of volatility in early October from concerns about higher US bond yields. However, it could be argued that US yields have overshot underlying fundamentals and are close to peaking. First, the global manufacturing Purchasing Managers Index (PMI, a proxy of global growth) has declined for six consecutive months to its lowest level since November 2016. Interest rates have a tight relationship with the PMI, which would suggest that further upside in US yields is limited. Second, the Fed's interest rate projection for next year is roughly equal to current rate for 10-year bonds, which suggests that much of the central banks' hikes for this cycle have been discounted. And third, there is limited evidence that the US economy is overheating. Underlying US annual consumer price inflation surprised the market on the downside in September and has been slowing since peaking in July.

Moreover, the market sell-off came at a vulnerable time for stocks, as US companies are subject to a black-out period before they report their financial results for the third quarter. This meant there was a temporary reduction in company share buybacks and dividend announcements that lessened support for equity prices in October, but that should reverse in November.

Nevertheless, markets are likely to remain somewhat jittery about the uncertainty over potential regulation of big tech companies after the US midterm election next month, Italy's standoff with the EU over its public spending plans and rising energy prices once US sanctions on Iran are implemented in early November.

Looking forward, global equities are deeply oversold. Provided there is no US inflation overshoot and economic growth holds up, it would be reasonable to expect equities to track the upward trend in company earnings, which is still intact.

A long-term opportunity for China and Emerging Markets

China's Belt and Road Initiative (BRI) was officially launched on the 7 September 2013 by President Xi in Kazakhstan at the heart of the ancient Silk Road route. The BRI aims to link China with 69 countries across Asia, Europe, Africa and Oceania, and is the largest international development since the Marshall Plan rebuilt war-ravaged Europe in the 1940s. Beijing wants to use the BRI to reduce overcapacity at home and stimulate Chinese economic activity by developing demand from new markets overseas. Crucially, Chinese exports are anticipated to be invoiced in its domestic currency, the yuan. In other words, the BRI forms a key part of China's long-term plan to raise foreign demand for its domestic currency.

China is also making use of the energy market to internationalise the yuan. Back in March, the authorities launched the first-ever yuan-denominated crude oil futures contract (the so-called petro-yuan) on the Shanghai International Energy Exchange. As the world's largest net importer of crude oil, China has no shortage of countries willing to supply its energy needs. Russia and Iran have agreed to accept the petro-yuan to get around US sanctions. Ultimately, Chinese overseas trade in energy will create large pools of yuan that could potentially be reinvested into Mainland financial markets. Beijing has already made significant efforts to open up its bond and equity markets over the past few years. This has increased market liquidity and transparency to such an extent that Barclays and MSCI have begun to include Chinese bonds and equities, respectively, in their benchmarks.

Considering Beijing's long-term objective is to offer the yuan as a reserve currency alternative to the US dollar, China will be keen to show potential overseas investors' its credibility in the management of the economy. President Xi will also want to ensure officials deliver on the BRI as this is his flagship foreign policy. Finally, China may want to use the vacuum created by President Trump's seemingly isolationist foreign policy, as a strategic opportunity to show global leadership and to lessen its dependence on US commerce following increased trade tariffs applied by Washington on Chinese exports.

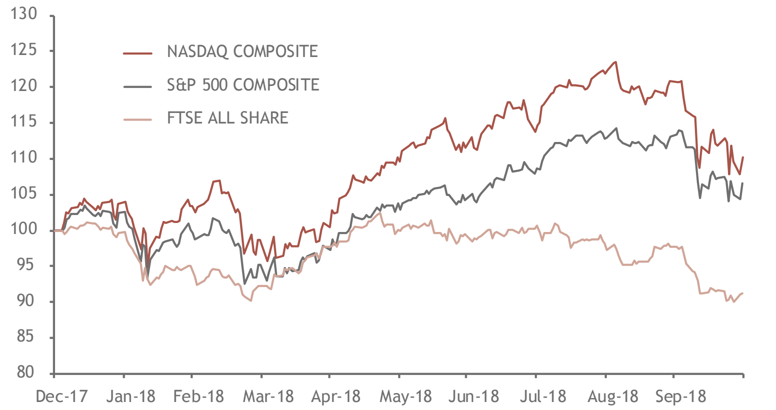
Given this intent by the Chinese government, it would be reasonable to expect Beijing's recent policy easing to feed through to faster growth, and lessen market fears of a sharp slowdown in the economy. Nevertheless, policymakers are likely to continue to maintain a tight control on murky off-balance sheet bank lending and implement policies to improve credit efficiency to lower the risk of a crisis in the financial system. At current undemanding valuations, a stabilisation in the mainland economy suggests a long-term buying opportunity for Chinese and related-emerging market financial assets is fast approaching.

Moreover, China's efforts to internationalise the yuan comes at a time when there are growing risks over the major currencies of the US (from expanding public debt), the euro (i.e. Italy's populist government backtracking against EU fiscal policies), UK (Brexit/a potential left-wing government) and Japan (ongoing quantitative easing and unfavourable demographics). A more stable yuan and the Chinese equity market could offer investors a way to diversify portfolio returns over the long-term.

Equity markets

October has been a tough month for equity markets with all major indices nursing losses. One of the larger fallers has been the tech-heavy NASDAQ which was down 7.1% in the month. US technology shares had been the darlings of 2018 until the end of September, but higher treasury yields force investors to reduce the present value of their future earnings. Year-to-date though, the NASDAQ remains ahead of the more industrially-diversified S&P 500 by almost 4% in GBP terms. Politics remain the main obstacle for UK shares, where the FTSE All-Share Index is down 7.5% in 2018.

Equity market indices (rebased to 100 = end-2017, GBP)

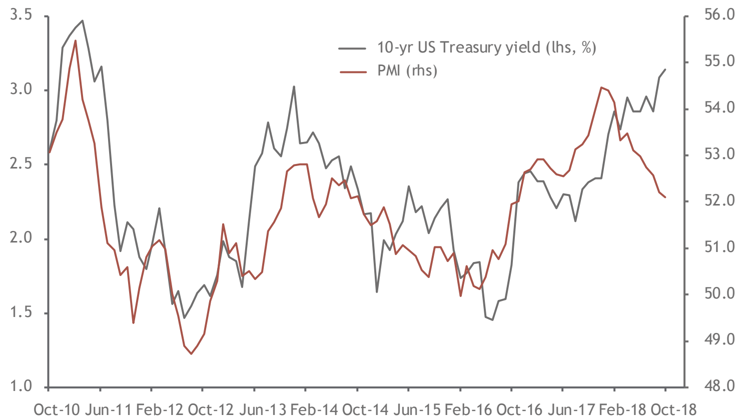


Source: Thomson Reuters Datastream/Smith & Williamson

Fixed income

The 10-year US treasury yield has historically had a close relationship with the JP Morgan Global Manufacturing PMI. Over the last 8 years, the correlation has been 77%. This relationship has not been so close this year – as the PMI has retreated from its end of 2017 high, the yield on a 10 year treasury bond has continued to increase. This, along with relatively modest expectations for future interest rate increases by the Federal Reserve leads us to believe that treasury bond yields are more likely to fall than rise from here.

Treasury Yields and Global Manufacturing Purchasing Managers Index



Source: Bloomberg/Smith & Williamson

FX and commodities

All major currencies have depreciated against the US dollar recently, driven by divergence in central bank policy. The Federal Reserve continues to raise rates while their counterparts in Japan, Europe and the UK have seen expectations for their tightening cycles pushed back. Brexit and the potential for a left-wing UK government remain a headwind in Britain, while stubbornly low growth and inflation are stumbling blocks for both the European Central Bank and the Bank of Japan.

Currencies vs the US dollar (rebased to 100=end-2017)

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	-5.6	-3.8	3.8	74.3
FTSE 100	-4.9	-6.9	-0.9	28.3
FTSE 250	-6.7	-8.7	-4.0	39.7
S&P 500	-4.9	-0.7	11.6	115.1
FTSE Europe ex UK	-6.1	-7.9	-5.6	41.4
Topix	-7.0	-3.6	-0.4	67.1
FTSE Asia Pacific ex Japan	-8.6	-8.3	-5.4	39.0
FTSE Emerging Market	-5.6	-8.8	-7.1	34.8
Bonds				
UK 10-Year Gilt	1.4	0.7	1.7	26.9
US 10-Year Treasury	1.9	1.6	-1.0	33.8
UK Corporate BBB	0.3	-0.2	-0.1	28.7
Commodities and trade-weighted FX				
Oil Brent Crude ($/barrel)	-8.6	1.7	23.9	-30.6
Gold ($/ounce)	2.0	-0.5	-4.3	-8.2
TW USD	0.7	1.8	3.6	22.9
TW GBP	0.5	0.9	2.2	-3.9
TW EUR	-1.1	0.4	2.2	3.2
TW YEN	0.1	0.7	3.3	-0.6

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.

CPI - Consumer Price Index. A measure of inflation for the typical consumer based on a weighted average price of a basket of goods and services. As such it is often used to assess change in the cost of living.

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.

Fiscal Policy - The use of government policy on revenue collection (taxes) and expenditure (spending) to influence the economy in terms of demand, employment, inflation and growth.

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.

Key macro data	Latest	2018 Consensus forecast	Spot rates	31-Oct	Yields (%)	31-Oct
UK GDP (YoY%)	1.2	1.30	GBP/USD	1.28	FTSE 100	4.25
UK CPI Inflation (YoY%)	2.4	2.50	GBP/Euro	1.13	FTSE 250	3.05
Bank of England Base	0.75	0.75	Euro/USD	1.13	10 Year Gilt	1.44

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

Our offices: London, Belfast, Birmingham, Bristol, Cheltenham, Dublin (City and Sandyford), Glasgow, Guildford, Jersey, Salisbury and Southampton.