Smith & Williamson

Investment outlook

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

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Investment outlook

The global economic backdrop favours equities over bonds

Global growth is strongly influenced by the US, the world's largest economy. The current US economic cycle is now into its ninth year, the second longest expansion since records began in 1854. However, just because the cycle is historically long it does not necessarily follow that the expansion is approaching its end. That's because the normally cyclical parts of the economy (e.g. expenditure on consumer durable goods and business fixed investment) have lagged the recovery. Indeed, the economic recovery since the Global Financial Crisis (GFC) in 2008 has been the slowest since the Second World War. Essentially, the US has swapped economic vigour for longevity.

Importantly, there are less obvious signs of imbalances in US private consumption, which accounts for 70% of the economy. The US statistics agency recently revised up its estimate of the personal savings rate to 7.2% of take-home pay from its previous estimate of 3.3% in the first quarter, largely due to significantly stronger incomes than originally thought. Much of the upward revision came from the last 18 months, and this could reflect more complete data from annual tax returns for 2017 that showed employment income was higher than expected. In short, the data shows that there is financial wherewithal to sustain consumption growth at current rates.

Separately, there are now signs that US corporates are beginning to invest more in plant and equipment. In the second quarter, annualised non-residential fixed investment expanded by a healthy 8.5%, as tax cuts and President Trump's deregulation agenda start to kick-in. Not only should that increase risk-appetite, but it should boost company earnings, as company top-line sales are raised. It is worth noting a record 84% of US S&P 500 companies beat Earnings Per Share (EPS) estimates in the second quarter financial reporting season.

Moreover, despite US monetary tightening, global real interest rates are still low and accommodative for growth. Fiscal policy is also becoming more conducive for faster economic activity. For instance, the US is implementing its largest tax cuts since the Reagan administration in the 1980s and China, the second largest economy, has recently begun to ease both fiscal and monetary policy to support its economy.

Assuming that corporates are able to sustain relatively elevated profit margins during this ongoing expansion, it would be reasonable to expect global equities to track consensus Global EPS growth expectations of around 10% on average per year for both 2019 and 2020. Based on a fairly benign inflationary environment and a gradual reduction in ultra-loose monetary policy by the major central banks (Fed, BOE and at some point in 2019, the ECB), our expectations are that equities will continue to outperform conventional bonds.

The key risks to equity markets are: i) a sharp pick-up in inflation that forces central banks to tighten policy more aggressively and stifles global growth; and ii) an escalation in trade protectionism that leads to competitive currency devaluations. Nevertheless, our central scenario is that these risks are contained.

Crunch time for sterling

The outlook for sterling will be dependent on whether the UK government is able to secure a "soft Brexit" deal with the EU or not. While Michel Barnier, the European chief negotiator for the UK's exit from the EU, has said 80% of the Withdrawal Treaty (WT) has been agreed, there are four major outstanding issues, namely; i) the Irish border question; ii) the role of the European Court of Justice in resolving disputes over the governance of the WT; iii) the link between the UK's future trading relationship with the EU and the divorce settlement; and iv) the ability to extend the WT beyond the end of 2020.

Considering the febrile political environment, it will be difficult for the British government to make the likely required concessions to deliver an agreement with the EU on the withdrawal terms. Moreover, time is running out before the EU Council Meeting (18/19 October), to agree the WT and a political declaration on the future UK-EU trading relationship.

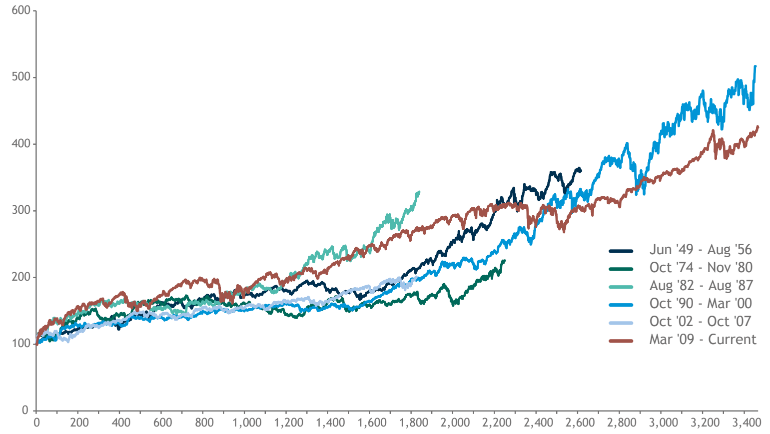
With MPs due to come back to parliament after the summer recess on the 5 September, domestic politics are once again set to influence the sterling exchange rate. Should Prime Minister May fail to unite the party at the upcoming Conservative Party Conference (30 September to 3 October), it could lead to a leadership challenge or a confidence vote in the government. The Democratic Unionist Party could also pull out of the confidence and supply agreement with the government if it feels Northern Ireland is going to be treated differently than the UK as part of a deal with the EU. That would deprive the Tories a majority in the House.

Looking forward, we see sterling as being vulnerable to downside from EU and domestic politics. This increases the need to diversify to overseas' markets from sterling-denominated assets.

Equity markets

Equities (as measured by the bellwether S&P 500) are in their longest bull run since the Second World War. This is defined as being a period of equity market growth without a 20% drawdown (the common definition of a bear market). On 22 August 2018, the rally surpassed the previous record which occurred in the run up to the tech market bubble in 2000. Commentators have expressed concern over the current concentration of the market (a large proportion of recent returns have been attributed to a handful of stocks in the technology sector), but we note that current levels of concentration are lower than in 2000. This bull market has also been relatively slow in its progress – 17.7% annualised return, compared to 21.2% for the previous record run.

Longest US S&P 500 bull markets since the Second World War

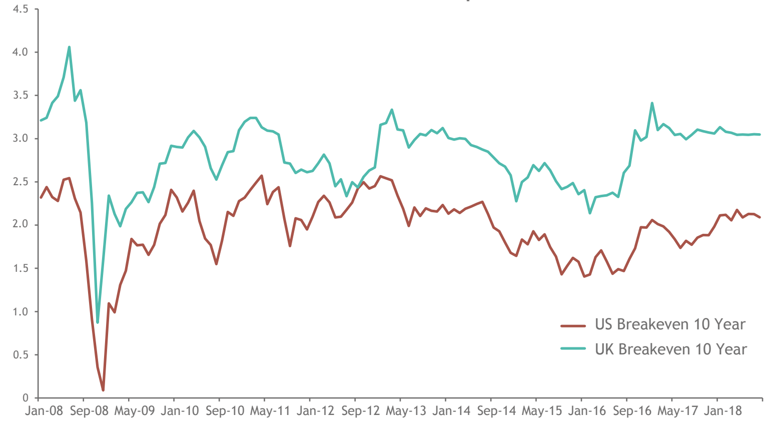


Source: Bloomberg/Smith & Williamson

Fixed income

This chart shows 'breakeven' levels of inflation for the US and the UK, which represents the expectations built into bond markets for inflation over the next 10 years. Currently these stand at 2.1% and 3.0% for the UK and US respectively. Since the Global Financial Crisis, central banks around the world have adopted extraordinary policies of Quantitative Easing, and many predicted this would lead to run-away levels of inflation. This has not yet come to pass, and market expectations remain benign. The stable inflation environment remains conducive to both equity and fixed income market performance.

UK and US inflation expectations

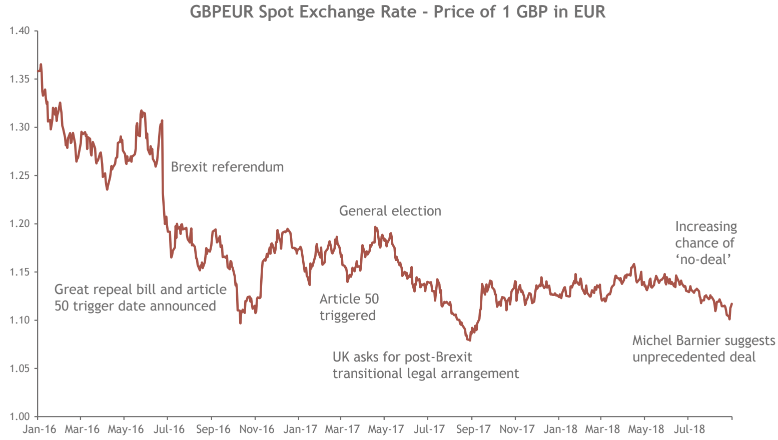


Source: Bloomberg/Smith & Williamson

FX and commodities

Since the electorate voted to leave the EU in 2016's referendum, sterling has been under pressure relative to the euro (and other currencies). Sterling has reacted strongly to news flow on the situation, falling as the likelihood of a 'hard' or 'no-deal' Brexit has risen and rallying when the chance of a 'softer' solution increased. Recently, the exchange rate has weakened as the chance of 'no-deal' has increased. We believe the risks to sterling continue to be to the downside as important dates approach in the Brexit process.

GBPEUR Spot Exchange Rate - Price of 1 GBP in EUR



Source: Bloomberg/Smith & Williamson

Market highlights

Market returns (Total return (%), sterling)	1 month	3 months	1 year	5 year
Equities				
FTSE All-World	1.7	5.7	10.9	94.2
FTSE 100	-3.3	-2.1	4.1	40.2
FTSE 250	-0.6	-0.1	7.3	61.6
S&P 500	4.2	10.3	18.6	134.5
FTSE Europe ex UK	-1.4	3.9	1.4	65.0
Topix	0.9	-0.2	7.8	83.0
FTSE Asia Pacific ex Japan	0.6	1.0	4.2	62.7
FTSE Emerging Market	-2.5	-1.6	-2.2	55.8
Bonds				
UK 10-Year Gilt	0.4	-0.2	-1.0	29.0
US 10-Year Treasury	2.1	2.6	-5.2	32.2
UK Corporate BBB	0.5	0.3	-0.5	34.1
Commodities and trade-weighted FX				
Oil Brent Crude ($/barrel)	4.3	0.0	48.5	-33.2
Gold ($/ounce)	-1.6	-7.8	-8.6	-13.9
TW USD	0.9	3.1	3.5	20.4
TW GBP	-0.8	-1.2	2.9	-3.5
TW EUR	0.5	1.7	2.0	4.1
TW YEN	1.6	2.7	1.3	-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 higher-yielding bonds.

ECB – European Central Bank.

EPS – Earnings per share is the portion of a company's profit allocated to each outstanding share of common stock.

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 Monetary Fund.

Key macro data	Latest	2018 Consensus forecast	Spot rates	31-Aug	Yields (%)	31-Aug
UK GDP (YoY%)	1.30	1.30	GBP/USD	1.30	FTSE 100	4.01
UK CPI Inflation (YoY%)	2.50	2.42	GBP/Euro	1.12	FTSE 250	2.76
Bank of England Base	0.75	0.75	Euro/USD	1.16	10 Year Gilt	1.34

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 31 August 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.

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