Smith & Williamson

Investment outlook

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

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Investment outlook

UK stocks are likely to continue to lag behind their global peers

Despite persistent uncertainty surrounding Brexit, UK equities have returned 34% (including dividends) since the UK electorate voted to leave the EU in the June 2016 referendum. This domestic performance looks respectable when compared against 10-year gilts, which returned 5% during the same time frame. However, UK stocks have lagged behind the 54% total return of world equities (ex-UK) in sterling terms since 23 June 2016.

Market uncertainty has increased following the publication of the government's "soft-Brexit" white paper (the so-called Chequers agreement) in July that outlines its plan on what the UK seeks to achieve in negotiating its exit from, and new partnership with, the EU. The Chequers deal has come at the cost of the cabinet resignations of both Boris Johnson and David Davis, led to the alienation of many pro-leave Tory MPs and has hardened the split in the party. Potentially, PM May could face a leadership challenge that would use up valuable time required to negotiate the UK's exit from the EU. Moreover, the EU may reject the Chequers agreement as it may be seen as "cherry picking" the four single-market freedoms of services, goods, capital and labour, which the EU regards as indivisible. The risk is the UK could leave the EU without a deal.

Tory party disharmony over Brexit is also beginning to wear thin with the public. Recent opinion polls show the Tories and Labour are tied in popular support. As we discussed in the June Investment Outlook, the threat of a market unfriendly, left-wing Jeremy Corbyn government getting into power is likely to weigh down on UK equities.

Aside from the politics, there are fundamental reasons behind the lagging performance of UK stocks. The uncertainty over the UK's future relationship with the EU begets economic uncertainty, less business investment and lower growth. In the IMF's updated economic projections, UK real GDP is expected to grow by 1.4% in 2018, versus 2.4% for all advanced economies. Even though UK firms are internationally focused (around two-thirds of FTSE 100 companies sales are derived overseas), sluggish domestic demand is evident in lower relative consensus earnings expectations when compared with the rest of the world. For example, UK Earnings Per Share (EPS) growth over the next year is forecast by the consensus to grow by 8.0%, which is less than the eurozone on 9.3%, emerging markets on 13.4% and the US on 14.1%. Unless British companies are able to deliver stronger EPS growth, it would be reasonable to expect UK equities to underperform global markets.

US deregulation provides a growth tailwind against trade protectionism fears

Throughout his presidential campaign and first year in office, President Trump has repeatedly stated that over-regulation is hampering US output growth. Trump has made cutting back on red tape a key priority and signed an executive order in early 2017 that requires federal agencies to cut two existing regulations for every new regulation they implement. There is increasing tangible evidence to show that regulation cutbacks are happening. First, the number of pages in the Federal Register (a uniform system to track public regulations and legal notices issued by federal agencies) in 2017 fell 36% to 61,950. This marks the biggest percentage decline in regulations from data going back to 1947 and surpasses a 21% fall for President Reagan's first year in office, the last president who made a significant drive to cut red tape.

Second, digging a bit deeper in a recent piece*, the Brookings Institute (BI), a century-old US think tank, found that the regulation cuts under President Trump were surprisingly broad-based. In their analysis, the BI showed that deregulation was applied by both executive agencies (under greater control of the president), as well as independent agencies, which are generally more insulated from the White House. Both executive and independent agencies also cut major rules (>$100m in annual impact on the economy) and non-major rules (<$100m) evenly across the government. In short, the regulatory cuts are genuine and not designed to help the president make political gains.

The boost to the economy from deregulation (as well as tax cuts) has helped business optimism, and particularly for small firms, where confidence is at the high end of its historical range, after picking up sharply when President Trump was elected in November 2016. Given that America's 28m small businesses create nearly two-thirds of net new private-sector jobs, rising confidence increases the probability that the business cycle can be extended. On balance, we believe the combination of deregulation, tax cuts, steady economic growth and profit margin expansion from limited wage inflation, provides plenty of equity market support to offset the headwinds coming from trade protectionism concerns, allowing global stocks to rally further.

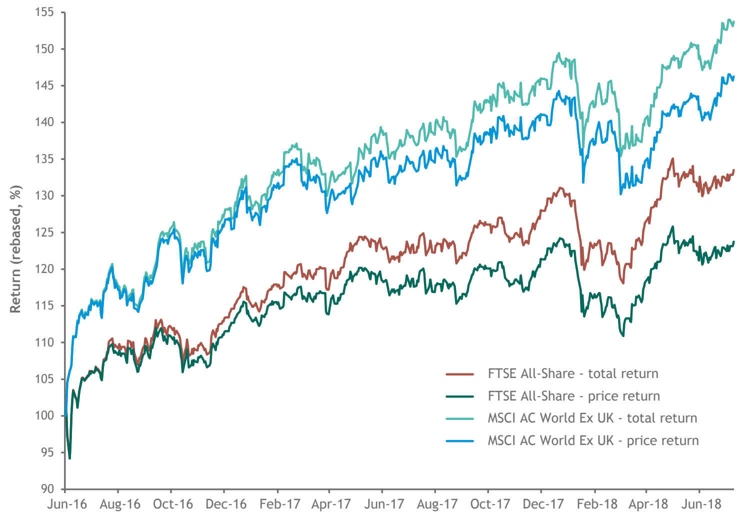
* https://www.brookings.edu/research/where-and-why-has-agency-rulemaking-declined-under-trump/

Equity markets

Since the UK's Brexit referendum, the FTSE All-Share index has produced a total return of 33.5%, 23.7% of which has been price appreciation with the remaining 9.8% attributable to dividend reinvestment.

Global (excluding UK) equities have outperformed the UK by about 20% in total return terms. Of their 53.7% total return, 7.5% came from dividends.

Equity returns since the UK referendum on EU membership (sterling terms)



Thomson Reuters Datastream/Smith & Williamson

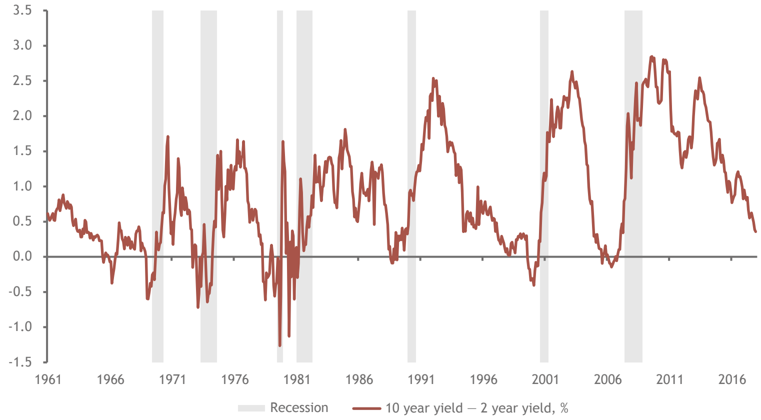
Fixed income

The slope of the 10 year – 2 year US yield curve has historically been a good predictor of economic downturns, with 7 of the past 8 yield curve inversions preceding recessions.

Such an inversion occurs when the interest rate on a government bond which matures in 2 years is greater than that which matures in 10 years. Investors would normally demand higher returns for longer investment periods to compensate for the increased interest rate and inflation uncertainty, but when this is reversed it can be considered an indication of poor expectations for future economic growth.

Although the slope has flattened over the last few years, currently at 30bps, it remains some distance from becoming inverted.

Slope of US yield curve



Source: Thomson Reuters Datastream/Smith & Williamson

FX and commodities

Beijing has allowed the Renminbi to weaken relative to the US Dollar in response to President Trump ratchetting up his protectionist agenda. This has the effect of reducing the impact of the newly levied tariffs on Chinese goods and services, which could lead to further tariffs and an escalating situation.

Chinese Renminbi / US Dollar exchange rate

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	3.7	7.7	12.1	83.3
FTSE 100	1.5	4.1	9.4	41.5
FTSE 250	0.4	3.6	8.4	60.3
S&P 500	4.4	12.2	16.8	114.1
FTSE Europe ex UK	5.1	4.4	5.8	61.1
Topix	0.9	1.5	9.8	74.2
FTSE Asia Pacific ex Japan	2.9	2.2	6.2	58.6
FTSE Emerging Market	4.1	0.7	5.7	52.2
Bonds				
UK 10-Year Gilt	-0.2	1.1	0.5	26.0
US 10-Year Treasury	-0.1	5.0	-3.2	25.6
UK Corporate BBB	0.4	-0.3	0.2	32.5
Commodities and trade-weighted FX				
Oil Brent Crude ($/barrel)	-6.3	-0.8	41.9	-31.1
Gold ($/ounce)	-2.3	-6.9	-3.7	-6.7
TW USD	0.0	2.5	2.0	17.3
TW GBP	-0.5	-2.0	1.1	-1.7
TW EUR	0.0	-1.5	0.4	-1.8
TW YEN	0.0	0.3	0.6	-5.0

Glossary of terms

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

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.

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

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.

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

IMF – International Monetary Fund

Key macro data	Latest	2018 Consensus forecast	Spot rates	31-Jul	Yields (%)	31-Jul
UK GDP (YoY%)	1.20	1.30	GBP/USD	1.31	FTSE 100	3.79
UK CPI Inflation (YoY%)	2.40	2.50	GBP/Euro	1.12	FTSE 250	2.71
Bank of England Base	0.75	0.75	Euro/USD	1.17	10 Year Gilt	1.37

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 July 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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