Smith & Williamson

Investment outlook

A monthly round-up of global markets and trends

May 2018

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Investment outlook

Global equities have recovered from oversold levels

Global equity markets recovered from oversold levels in April. This followed two consecutive monthly declines in February and March, when stocks were rattled by a confluence of idiosyncratic factors. These included fears over greater regulation of social media (e.g. Facebook), rising geopolitical risks in the Middle East, speculation of a more hawkish Fed under new Chair Jerome Powell, and of course, President Trump's scattergun tweets ranging from trade protectionism to individual attacks on Amazon.

Market nerves have since been calmed by a combination of less volatility in US long-term interest rates and the delivery of healthy company earnings in the States. On the latter point, with many companies in the S&P 500 composite index now having reported, US Earnings Per Share (EPS) growth is up 22% from a year ago, the fastest expansion since early 2011. This is supported by a combination of tax cuts, faster economic activity and record high profit margins.

A favourable global macro backdrop for stocks

Looking forward, the global macro backdrop appears favourable for EPS growth. In its latest semi-annual outlook report, the IMF projects global real GDP growth of 3.9% in both 2018 and 2019 (the fastest rate since 2010), up from 3.8% in 2017, on the back of expansionary US fiscal policy and still accommodative monetary policy. The global expansion continues to be synchronised, with stronger growth forecast by the IMF in both developed and emerging markets, increasing the probability that the business cycle is sustained.

Crucially for markets, the typical signs of late cycle economic overheating are missing. First, there does not seem to be evidence of capacity constraints showing up in inflation. Second, a tightening in labour markets is not leading to a squeeze on company profit margins. As we discussed in our October Investment Outlook, advances in information technology have increased the size of labour supply, reducing the ability of workers to demand high wage rates. Indeed, US average hourly earnings for the bulk of workers rose at a tepid 2.4% annual clip in March, compared to an average rate of 2.2% since the job cycle recovery started back in 2010. Stable labour costs enable companies to sustain high profit margins. And third, considering the length of the business cycle, economic imbalances from over-investment or stretched consumption are not apparent. The share of consumption of durables and private investment in the US economy is 24%, below the long-term average of 25% and the previous cycle peak of nearly 28%. Equally, leverage in the banking sector looks manageable, largely because tighter regulation has forced banks to raise capital ratios. For example, major UK banks' capital strength has tripled since 2007. In short, the macro backdrop of steady output growth without the typical signs of economic overheating provides fundamental support for equity prices to rally from here.

Upcoming political challenges for Prime Minister May increases Brexit uncertainty

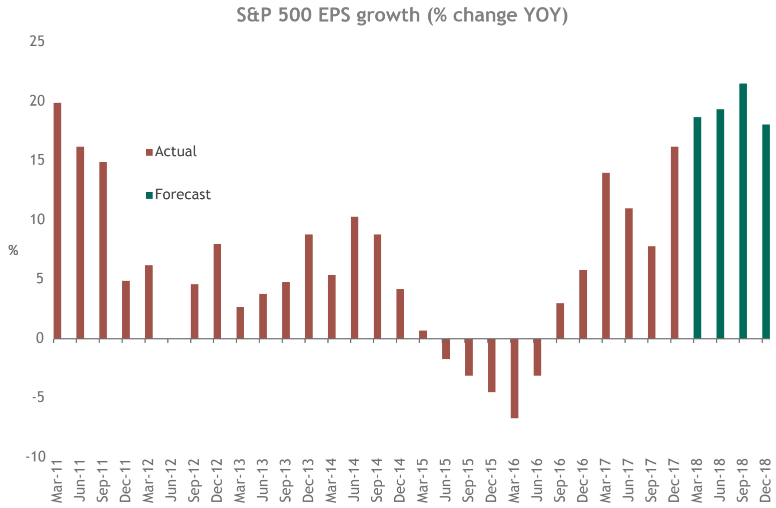
Prime Minister May needs to jump some tough political hurdles over the next couple of months. The European Council meets on the 28-29th June to assess progress on the Irish border issue, which appears dependent on whether the UK forms a new customs union with the EU - the last major risk to the negotiations. As well as leaving the single market, the government is committed to exiting the EU customs union. The House of Lords has already passed an amendment to the government's EU Withdrawal Bill to negotiate a new UK-EU customs union. The government has delayed such a vote in the House of Commons twice before, but a change of stance by the Labour party (in favour of a customs union with the EU) and greater cooperation between opposition and soft-Brexit rebel conservative MPs, adds pressure on the PM to allow a specific (and possibly binding) vote on the customs union.

Should Prime Minister May decide to include a customs union in the EU Withdrawal Bill, which is due to be voted in Parliament around October, it is likely to alienate the pro-Brexit Tory MPs, since it would make it impossible to negotiate trade deals with countries outside the EU and undermine the "global vision" of Brexit. Alternatively, should the UK leave the EU customs union, it may require "hard border" infrastructure between Northern Ireland and the Republic that could lead to the Democratic Unionist Party MPs withdrawing their support for the government. The fallout from the UK-EU customs union issue could become entangled with a leadership challenge and a possible snap general election.

For UK markets, domestic political turmoil could delay UK-EU negotiations and increase the likelihood of the UK leaving the EU in March 2019 without a deal. Moreover, with the Conservatives broadly tied with the Labour party in opinion polls, investors' fears of a left-wing Jeremy Corbyn government may continue to weigh on UK equities. We continue to prefer opportunities in overseas markets, where political risks are lower.

Equity markets

Around 50% of companies in the S&P 500 have now reported their first quarter earnings: annual EPS growth has come in ahead of previous estimates at around 22% and company guidance has, on average, increased for the remainder of 2018. In further good news, earnings growth is not forecast to peak until the third quarter of 2018.



Source: Bloomberg/Smith & Williamson

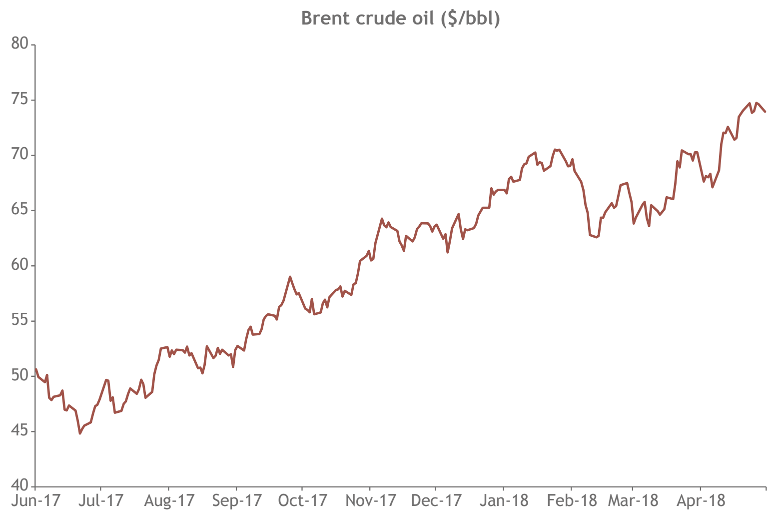
Fixed income

The UK Office for National Statistics published the annual CPI inflation rate for the period to the end of March which came in at 2.5%. This was below previous figures and economists' estimates which were both 2.7%. The following day Bank of England Governor Mark Carney suggested that financial markets should not consider a rate rise at the Bank's May meeting a certainty. They duly did, discounting the prospects from a virtual certainty back to a coin toss. Since then softer than expected UK GDP growth has made a rate rise unlikely.

Source: Bloomberg/Smith & Williamson

FX and commodities

Oil prices have increased by over 60% since their lows in June last year. This has been largely due to bouyant and synchronised global GDP growth, as well cooperation between Russia and OPEC helping to reduce a glut of supply in the market.



Source: Bloomberg/Smith & Williamson

Market highlights

Market returns (Total return (%), sterling)	1 month	3 months	1 year	5 year
Equities				
FTSE All-World	2.9	-2.1	7.8	77.5
FTSE 100	6.8	1.1	8.5	41.1
FTSE 250	4.7	1.0	6.2	66.2
S&P 500	2.2	-2.7	6.4	107.8
FTSE Europe ex UK	4.1	-2.0	7.4	63.3
Topix	2.5	0.6	13.4	69.9
FTSE Asia Pacific ex Japan	3.1	-0.8	9.6	46.5
FTSE Emerging Market	1.0	-4.6	11.5	42.2
Bonds				
UK 10-Year Gilt	-0.4	1.0	-1.2	18.4
US 10-Year Treasury	0.5	1.9	-9.1	14.3
UK Corporate BBB	0.2	-0.8	1.8	28.9
Commodities and trade-weighted FX				
Oil Brent Crude ($/barrel)	7.0	9.3	45.5	-26.2
Gold ($/ounce)	-0.8	-2.1	3.6	-10.5
TW USD	1.6	2.8	-5.8	15.6
TW GBP	-0.3	-0.5	0.1	-1.7
TW EUR	0.1	-0.1	7.7	1.5
TW YEN	-2.0	1.5	-2.0	-5.9

Glossary of terms

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

IMF – International Monetary Fund

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.

Key macro data	Latest	2018 Consensus forecast	Spot rates	30-Apr	Yields (%)	30-Apr
UK GDP (YoY%)	1.2	1.50	GBP/USD	1.38	FTSE 100	3.91
UK CPI Inflation (YoY%)	2.5	2.50	GBP/Euro	1.14	FTSE 250	2.71
Bank of England Base	0.5	0.85	Euro/USD	1.21	10 Year Gilt	1.45

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

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