Smith & Williamson

Investment outlook

A monthly round-up of global markets and trends
September 2017

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Investment review

Markets seek safety amid US-North Korea tensions

Geopolitical concerns and natural disasters in the US led to a ‘risk-off’ tone for markets as we head towards the end of the third quarter. Heightened tensions between North Korea and the US led to a spike in volatility in August, exacerbated by thin trading volumes during what is historically a quiet summer period for financial markets. Gold and US treasuries, which are traditionally known as ’safe haven’ assets, have benefitted but equity markets have remained relatively resilient, aided by modestly improving global economic growth, and subdued levels of inflation, meaning central banks appear in no rush to tighten monetary policy. As we head into the autumn, politics is likely to remain a key focus with a looming debt ceiling to be negotiated by US congress, ongoing Brexit negotiations and German parliamentary elections in late September.

Against an increasingly uncertain political backdrop in the US, the economy is showing signs of resilient, if unspectacular, levels of growth. Second quarter US GDP was revised up to 3% annualised (from 2.6%), driven by robust consumption and business investment. Corporate profits (as measured by the national income and product accounts) also rebounded in Q2 from a first quarter slump. This bodes well for further investment and hiring going forward. This is a positive for markets, with the prospects of the meaningful fiscal expansion in the US this year remaining slim. US small-cap stocks, which have been more sensitive to Donald Trump’s tax plans, have continued to underperform larger, more internationally-exposed S&P 500 so far this year. Maintaining economic momentum going into the final quarter of the year will be key with US equity valuations remaining at relatively high levels.

Despite the economy gaining some momentum recently the dollar has continued to fall. This has largely reflected weak inflation in the US which has further pushed back expectations that the Federal Reserve (Fed) will raise rates again in the near-term. Persistent dollar weakness has remained a positive driver for emerging markets which have continued to outperform their developed market peers so far this year. The Fed meets again in September; focus is likely to be on any further granularity on the plans to slowly begin reducing the size of the Fed’s $4.5tn balance sheet later this year. If communicated correctly, we suspect this is unlikely to be a disruptive event for markets.

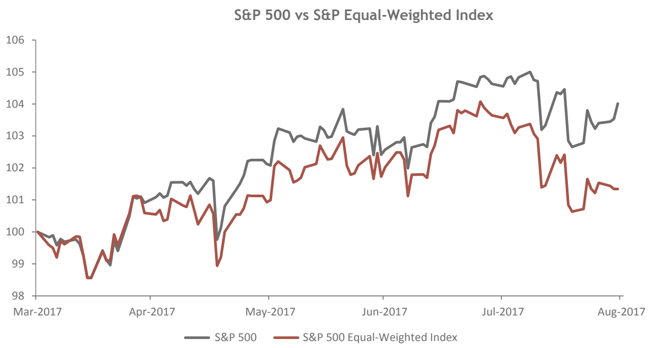
Although the economic backdrop in the Eurozone continues to look brighter, the region’s equity markets have continued to underperform their developed market peers in recent months. The euro recently tested its highest level versus the dollar since early 2015 but sterling investors in Eurozone equities have continued to enjoy gains due to the current strength of the single currency. With many of the region’s companies and economies heavily reliant on exports, further strength risks beginning to derail the Eurozone’s cyclical recovery. The euro, which has risen 7.3% on a trade-weighted basis so far this year, may also be giving the European Central Bank (ECB) food for thought ahead of its meeting in early September. Market expectations of a tapering announcement by the ECB have built this year as inflation has risen and this has been contributing to the rise in the euro along with improving economic prospects and an easing of political concerns. However we remain of the view that the ECB will proceed with caution. ECB president Mario Draghi has recently attempted to dampen expectations of a notable change in policy. With core inflation remaining weak in the region and the ECB cognisant that a hawkish message could send the euro even higher, we believe there’s enough for Mr Draghi to keep the hawkish stance at bay for now.

Despite the on-going political uncertainty, the UK has been showing some signs of resilience. However we continue to believe the hard yards are ahead for the economy. Both household spending and business investment slumped in Q2. Indeed, record low household savings rates and elevated levels of consumer debt could further hold back consumption this year. Particularly with real wage growth remaining negative. Consensus GDP forecasts for this year and next (1.5% and 1.2%, respectively) have continued to fall. One encouraging sign has been the improving contribution to growth from net trade from the weaker sterling. The impact of sterling’s weakness on inflation also appears to be easing, with both consumer and producer price indices rolling over in recent months. The apparent lack of domestically-driven inflation should tip the balance in favour of a dovish stance amongst the Monetary Policy Committee.

Brexit negotiations appear to be moving at a glacial pace and little of substance appears to have been achieved so far. The government stance appears to be shifting towards favouring a transitional deal with the EU, although the clock is ticking and the EU’s divorce settlement first stance means the risk of a ‘cliff-edge’ Brexit remains significant. Signs of a transitional deal should be positive for sterling in the medium term. However the risk of no deal, along with a negative view on the outlook for the UK economy has continued to weigh on sterling which fell another 3% on a trade-weighted basis in August. Sterling weakness is likely to persist whilst the political uncertainty remains. This continues to favour the large overseas earners of the FTSE 100 over the more domestically-focused small caps.

Equity markets

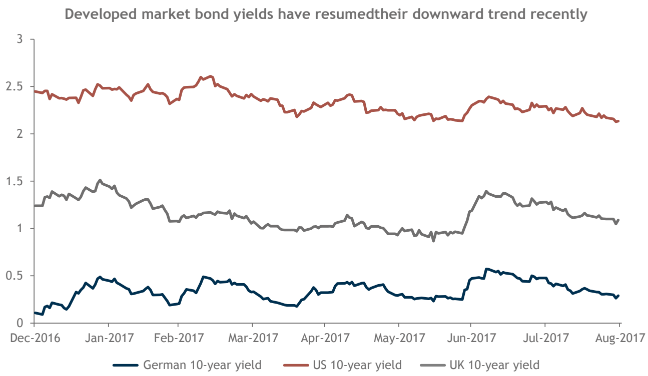
Despite a modest pull-back in August, the S&P 500 has again been approaching record high levels. More recently however, we have seen a deterioration in the breadth of the US market performance (an indicator of the overall health of the market). Recent performance in the US has once more been almost entirely driven by a small group of large-cap stocks, mainly in the technology space, which was again the top performing sector in August. This has raised question marks over the sustainability of the US market's advance, with valuations at relatively high levels. As we witnessed in August, volatility amongst tech stocks has been higher than in other areas of the market and, as a result, they look more vulnerable should we see another pull-back over the coming months.



Source: Thomson Reuters Datastream/Smith & Williamson

Fixed income

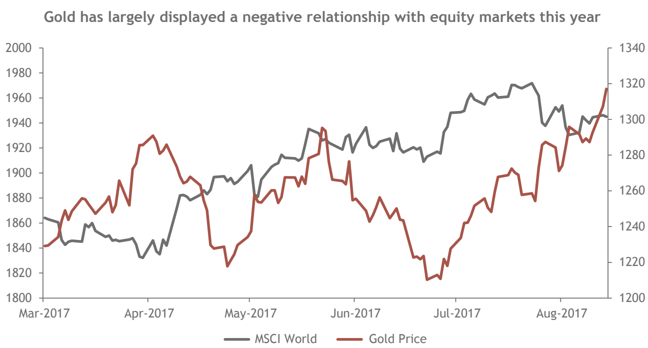
Focus for bond markets in September is likely to be on the upcoming Federal Reserve meeting (September19-20), and although a further rate increase is unlikely, after recent low inflation data, many investors are expecting further announcements on the Fed's plan to reduce the size of its balance sheet. Since this is a step into the unknown, the potential impact on the US economy remains uncertain. The market response so far has been muted, perhaps reflecting the Fed's June announcement that the maximum pace of balance sheet reduction will be relatively modest (a maximum of $900 billion over the first two years, when the programme begins). This would be a slow process, which could have limited upside risk for Treasury yields. Indeed, the final size of the Fed's balance sheet could well be over $3 trillion, versus the current $4.5 trillion, and compared with a balance sheet of less than $1 trillion at the time of the global financial crash. Market interest rate expectations have continued to be pushed out further despite a recent pick-up in US economic data and yields have remained at low levels. We continue to believe the Fed will proceed with caution, given the weak inflation numbers so far this year, and now the negative economic shock from Hurricane Harvey. This could well mean the Fed brings down its own projections for the path of rates when it releases its latest forecasts later this month.



Source: Thomson Reuters Datastream/Smith & Williamson

FX and commodities

Gold has come back into favour amongst investors in recent months and has risen to its highest level in nearly a year. The 10% rise in the last few months has been driven by several factors. Gold has maintained its inverse (negative) relationship with US real yields and the dollar, both of which have continued to fall in recent months. In recent weeks, gold has benefitted from a move into safe haven assets on heightened geopolitical tensions in North Korea. Indeed, gold has generally displayed a negative correlation with global equity markets this year. As a result, although gold provides no income we continue to see the diversification benefits of holding non-correlated assets within a portfolio, such as gold, to protect against bouts of volatility in equity markets, as seen in August.



Source: Thomson Reuters Datastream/Smith & Williamson

Market highlights

Glossary of terms

Market returns (Total return, sterling)	1 month	3 months	1 year
Equities			
FTSE All-World	2.8	3.9	19.7
FTSE 100	1.6	0.0	14.0
FTSE 250	0.4	-0.2	14.9
S&P 500	2.6	3.2	18.1
FTSE Europe ex UK	2.8	3.4	26.0
Topix	2.7	4.0	18.7
FTSE Asia Pacific ex Japan	2.6	6.3	22.7
FTSE Emerging Market	5.4	9.9	24.9
Bonds			
UK 10-Year Gilt	2.0	0.8	-1.5
US 10-Year Treasury	4.2	1.6	-0.8
UK Corporate BBB	1.2	1.0	1.9
Commodities and trade-weighted FX			
Oil Brent Crude ($/barrel)	-0.3	4.6	11.6
Gold ($/ounce)	3.7	3.8	0.6
TW USD	-0.1	-3.8	-1.4
TW GBP	-3.0	-3.8	-5.3
TW EUR	1.3	4.4	6.8
TW YEN	0.3	-1.8	-8.1

CPI – The Consumer Price Indexes (CPI) program produces monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services.

ECB – European Central Bank, the Euro area's central bank which sets key interest rates and monetary policy.

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

FOMC – Federal Open Market Committee is the monetary policymaking body of the Federal Reserve System.

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.

MPC – Monetary Policy Committee. The Bank of England's interest rate and monetary policy setting committee.

QE – Quantitative Easing. An unconventional monetary policy in which a central bank purchases assets (mainly government securities) from the market in order to lower interest rates and increase the money supply. This, in turn, encourages financial institutions to lend to the wider economy.

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.

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.

Key macro data	Latest	2017 Consensus forecast	Spot rates	31-Aug	Yields (%)	31-Aug
UK GDP (YoY%)	2.0	1.6	GBP/USD	1.30	FTSE 100	3.69
UK CPI Inflation (YoY%)	2.7	2.7	GBP/Euro	1.14	FTSE 250	2.64
Bank of England Base	0.25	0.25	Euro/USD	1.14	10 Year Gilt	1.28

Notes

All values as at 31 August 2017. Total returns in sterling. Sources: *FTSE, Thomson Reuters Datastream, Bloomberg FTSE International Limited* (FTSE) © FTSE 2017. FTSE® is a trade mark of the London Stock Exchange Group companies and is used by FTSE International Limited under licence. All rights in the FTSE indices and/or FTSE ratings vest in FTSE and/or its licensors. Neither FTSE nor its licensors accept any liability for any errors or omissions in the FTSE indices and/or FTSE ratings or underlying data. No further distribution of FTSE Data is permitted without FTSE's express written consent.

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