Investment Outlook

July 2017

A monthly round-up of global markets and trends

In this issue:

Investment review
Volatile end to the quarter for global equities as markets rattled by mixed central bank messages

Market highlights
Equities, fixed income, and FX and commodities

Market returns
Asset class by asset class

Smith & Williamson

Investment review

Volatile end to the quarter for global equities as markets rattled by mixed central bank messages

As we move into the second half of 2017, factors influencing financial markets have continued to shift on a weekly basis. Over the second quarter, we have seen political risks in the Eurozone ease and continued evidence of a cyclical rebound in the region's economy. This has underpinned the continued strong performance of Eurozone equities. On the other hand, hopes for Donald Trump's fiscal stimulus plans providing a boost to the US economy have continued to fade. This comes when the US economy has been showing signs of losing momentum. The UK's domestic political strains are likely to continue to dominate the headlines, and have added a further layer of complexity to Brexit negotiations. Sterling is likely to remain the bellwether of political concern for investors going forward.

Towards the end of Q2, markets have been rattled by mixed messages from central banks globally. Recent speeches from Bank of England Governor Mark Carney and European Central Bank (ECB) President Mario Draghi have been interpreted by markets as a shift to a more hawkish stance; both speeches hinted that an end to the era of ultra-accommodative monetary policy could be drawing near. Bond yields (which move inversely with prices) have spiked higher in recent weeks in response to higher interest rate expectations and the possibility of a tapering of asset purchases, particularly in the Eurozone. This has caused comparison with the 'Taper Tantrum' of 2013 (where US treasury yields spiked to 3%), although we are unlikely to see moves of that magnitude. The volatility in bond markets has begun to spill over into equity markets with bond proxy sectors (those with similar characteristics to bonds such as telecoms and utilities) initially hit the hardest.

US Equity Outlook

Looking ahead to the second half of the year, despite the recent central bank commentary, we don't expect a notable shift in policy. Although the Federal Reserve (Fed) raised rates again in June, we suspect the Fed will assess the incoming data over the coming months and are unlikely to consider moving again until the end of the year. It is hard to see the Fed moving to tighten again purely on grounds of financial stability, particularly with US inflation still below target, and real growth weak. The IMF recently downgraded its 2017 US GDP growth forecast (to 2.1%), citing the diminishing prospects for fiscal stimulus this year. With expectations low, equity markets could respond positively should we see a concerted effort from the Trump administration to revive fiscal stimulus plans over the summer. However, this seems unlikely given the amount of political capital already spent attempting to (unsuccessfully) push through healthcare reforms. US equity valuations continue to look relatively stretched, something Fed Chair Yellen referred to this week, on "standard metrics" like price/earnings ratios. With the Fed looking to gradually withdraw stimulus and share buybacks, another key driver behind US equities in recent years, on the decline, corporate earnings will need to replace QE as the main driver, if share prices are to maintain current high levels.

Europe and UK Equity Outlook

The Eurozone's economic recovery remains encouraging and we remain relatively positive on the prospects for the region's equity markets. Analysts continue to upgrade corporate earnings forecasts and valuations remain relatively attractive. Despite recent efforts to stem contagion risks from Italy's troubled banking system, the health of much of the region's ailing banks remains a risk going forward. With much of the positive news in the Eurozone now priced in, looking ahead the danger is that the data undershoots higher market expectations. Moreover, should data remain positive, Mario Draghi is likely to come under further pressure to remove monetary stimulus. Focus will now be on the ECB's next meeting in September. Mr Draghi is likely to give the ECB's hawks more recognition, but a change in policy seems unlikely at this stage.

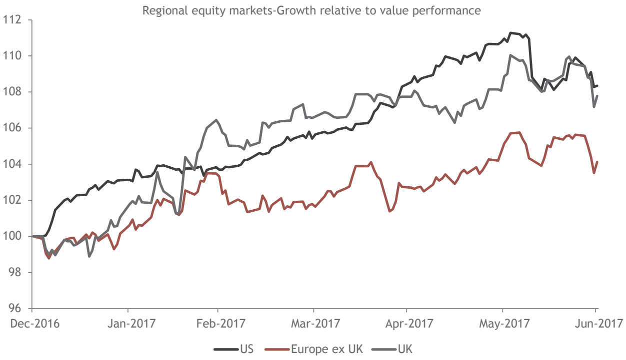
In the UK, the political uncertainty may already be weighing on corporate and consumer confidence. UK Purchasing Manager's Indices are likely to deteriorate further and feed through into lower growth forecasts. This comes when real disposable incomes are being squeezed and the household savings ratio is at a 50 year low. Against this backdrop, we are likely to see the government's zero public sector deficit target be pushed further out and some shift back towards fiscal stimulus. For the Bank of England, a shift towards a more expansionary UK fiscal policy would reduce the onus on monetary policy to prevent a recession during Brexit uncertainty. However, that does not mean an early monetary tightening would necessarily make sense. Raising base rates prematurely, when inflation is likely to peak in the third quarter, risks tipping the UK economy into recession by deepening the squeeze on household incomes and importers' margins. Given the 'stagflationary' backdrop (higher inflation and lower growth), we believe Mark Carney's dovish influence will ultimately prevail, despite some members of the MPC recently taking a hawkish turn. It seems the UK is set for an extended period of stagflation, which presents the central bank with difficult choices. With sterling likely to remain on the weaker side and given the headwinds facing the economy, we continue to favour the overseas earners of the FTSE 100 over more domestically focussed companies. Within the fixed income space, the 'stagflationary' environment favours index-linked bonds over conventional gilts. However UK index-linked bonds continue to look relatively expensive. We feel there is better value in US TIPS for those seeking some inflation protection.

**For the definitions of these terms, see the glossary on the back page.*

Market highlights

Equity markets

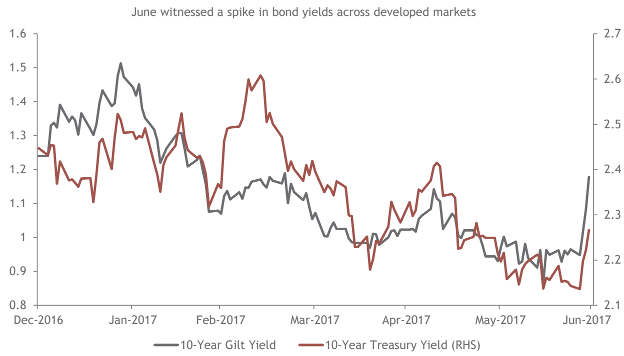
It's been a volatile end to the quarter for global equity markets after a period of relative calm. Japanese equities have been a stand-out performer over Q2 (in local currency terms). This has been aided by renewed yen weakness in recent months. The pick-up in volatility recently has hit those markets which had previously performed the most strongly this year. In the US, technology stocks have encountered more difficult conditions of late, following a period in which they were stand out performers earlier in 2017. Towards the end of the quarter, a rotation out of growth stocks into value stocks occurred, driven by the strong outperformance of financials relative to technology stocks. This in turn has been a result of rising bond yields and higher interest rate expectations (a positive for financial stocks) in recent weeks. For the FTSE 100, financials contributed almost all of the positive performance in Q2. The relationship between bond yields, and the performance of cyclical sectors (especially banks) relative to defensive, remains a key measure to watch going forward.



Source: Bloomberg/Smith & Williamson

Fixed income

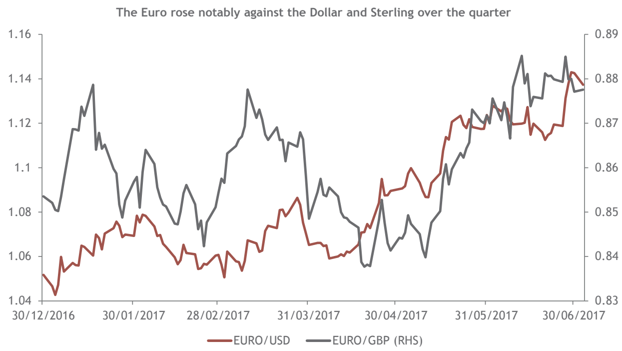
The final weeks of Q2 witnessed a notable spike in bond yields across developed markets. This seemed largely driven by a reassessment of the outlook for interest rates, after what has been perceived as a shift to a more hawkish tone from major central banks. The 10-year gilt yield has risen 25 basis points over the past few weeks, with the equivalent US treasury yield rising 15 basis points. The key question for investors is whether the recent spike is the start of a reversal of the downward trend in yields. We remain sceptical given that the economic growth outlook still remains uncertain. In the US, inflation has declined in recent months and in the UK, the continued squeeze on disposable incomes seems set to act as a drag on the economy. Economic data in the coming months will be a key focus for markets. The risk that central banks tighten policy prematurely cannot be ignored. However, after the ECB's premature move to raise interest rates in 2011, and the asymmetric risks of tightening policy excessively, we continue to believe central banks will proceed with caution, suggesting yields are likely to remain at relatively low levels.



Source: Bloomberg/Smith & Williamson

FX and commodities

Over the last quarter, a notable divergence in the performance of major currencies emerged. The dollar continued its decline on a trade-weighted basis, slipping below levels seen before the US presidential election in November. The euro has continued to strengthen driven by an improving economic backdrop, an easing of political concerns and more recently, more hawkish comments from ECB President Mario Draghi. Sterling has fallen around 4.5% versus the euro since mid-April, largely on the indecisive General Election result on 8 June. The Japanese yen has fallen over 3% over the quarter. Despite a more hawkish tone from the Fed, ECB and MPC, the Bank of Japan (BoJ) has reiterated its dovish stance and is likely to maintain its pace of asset purchases for the foreseeable future. This could mean further yen weakness going forward, particularly given the BoJ target of keeping 10-year JGB yields at zero.



Source: Bloomberg/Smith & Williamson

Market returns (Total return, sterling)	1 month	3 months	1 year
Equities			
FTSE All-World	-0.2	0.5	23.0
FTSE 100	-2.4	1.0	16.9
FTSE 250	-2.9	3.0	22.2
S&P 500	0.0	-0.8	21.3
FTSE Europe ex UK	-1.3	5.2	29.1
Topix	0.7	1.9	24.2
FTSE Asia Pacific ex Japan	1.5	0.9	28.1
FTSE Emerging Market	-0.1	0.2	24.1
Bonds			
UK 10-Year Gilt	-1.7	-0.7	-0.4
US 10-Year Treasury	-1.3	-2.8	-2.5
UK Corporate BBB	-1.0	1.2	8.2
Commodities and trade-weighted FX			
Oil Brent Crude ($/barrel)	-4.4	-9.1	-3.6
Gold ($/ounce)	-1.9	-0.3	-5.9
TW USD	-1.0	-2.9	2.2
TW GBP	-0.2	0.0	-3.9
TW EUR	1.0	4.1	4.7
TW YEN	-2.3	-3.3	-9.3

Glossary of terms

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	30-Jun	Yields (%)	30-Jun
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	1.19

Notes

All values as at 30 June 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.

For further information

Contact	Office	Direct line	Email address
Christopher Bates	London	020 7131 8131	christopher.bates@smithandwilliamson.com

Whether you are interested in accountancy, tax or investment management issues, you can register to receive our newsletters by completing the online newsletter registration form: www.smithandwilliamson.com/personal/insights/insights-registration

smithandwilliamson.com/personal/services/investment-management-private-clients