Investment Outlook

June
2017

A monthly round-up of global markets and trends

Smith & Williamson

Investment review

Trump continues to make headlines as polls narrow in the UK. Will the second quarter bring stronger growth for the EU?

Despite a brief bout of politically induced volatility in May, equity markets have continued to drift higher. Markets so far have broadly shrugged off the political risks which have recently shifted from Europe to the US. Continued speculation over Donald Trump's connections with Russia has raised the possibility of an impeachment, although this looks unlikely in the near-term. Renewed political turmoil in Brazil caused a dramatic sell-off in the country's equity market and currency following corruption charges against President Michel Temer, less than a year after taking office. Political risks are likely to linger but the main focus for markets remains on the prospects for economic growth. After a weak first quarter, will any economic rebound in the US be strong enough to support equity markets at current record high levels?

US Equity Outlook

While Donald Trump is always generating headlines, market sentiment hinges on when he will deliver his much vaunted fiscal stimulus plan. Optimism that Trump can instigate aggressive tax cuts and increased infrastructure spending is starting to evaporate. A more modest set of measures therefore looks likely, although these could well be pushed out into 2018. While US equity markets remain cautiously optimistic, both the US yield curve and the dollar, two indicators sensitive to US growth prospects, have fallen back to pre-US election levels. Analysts have yet to upgrade their more forward-looking earnings forecasts, a concern when US equity valuations remain at elevated levels, and sentiment indicators (a contrarian signal) are perhaps showing heightened levels of investor complacency.

The Federal Reserve (Fed) remains confident the first quarter weakness is due to transitory factors and looks set to increase interest rates again in June. Attention has also been on the Fed's initial plans to begin reducing the size of its $4.5tn balance sheet, accumulated after almost 10 years of asset purchases in response to the Great Financial Crisis. Should this begin later in the year, it is likely to be an extremely gradual process and good communication from the Fed should avoid a repeat of 2013's 'Taper Tantrum' which saw 10 year treasury yields (which move inversely with prices) spike to over 3%. Given the still uncertain outlook for the US economy and question marks over the fiscal stimulus plans, we expect the Fed to proceed with caution.

Europe and UK Outlook

Now political risks in the eurozone have eased after the election of Emmanuel Macron in France and focus has rotated to the improving economic prospects for the region. More forward-looking indicators point to stronger growth in the second quarter and consensus GDP forecasts (currently at 1.7%) have moved higher. The improving sentiment has seen continued inflows into the region's equity markets. We remain relatively positive but with heightened expectation comes greater scope for disappointment. Financial conditions have tightened. The euro's 7.5% appreciation against the dollar since the start of the year could act as a headwind for the region's internationally exposed companies. A key risk for the eurozone is that the improved sentiment and better data causes a premature tightening of policy by European Central Bank (ECB), a move that could hamper the economic recovery in the region. Inflationary pressures remain weak but focus will be on the ECB's meeting in June for hints that a change in policy could be on the cards later this year.

The tragic events in Manchester have somewhat overshadowed the UK's general election campaign but at the time of writing (a week before the election), the polls have narrowed markedly. The Labour Party has continued to gain ground at the expense of the Conservatives, who have seen their predicted majority slashed from 134 seats just a month ago, to around 50 based on current polls. Ultimately once we get through the election, attention will again be back on the direction of travel for Brexit negotiations. Despite the recent war of words between Theresa May and Jean-Claude Juncker (President of the European Commission), we are unlikely to hear anything substantive until after the German elections in September. Sterling is likely to remain the key barometer of Brexit concern and tougher rhetoric from the EU, combined with renewed election uncertainty has meant sterling has faced resistance at 1.30 versus the dollar. The Monetary Policy Committee (MPC) nudged down its 2017 GDP forecast in May's Inflation Report but is still predicting growth of 1.9%. Given those assumptions are based on a smooth Brexit outcome, we think the risks are skewed to the downside.

Emerging Markets

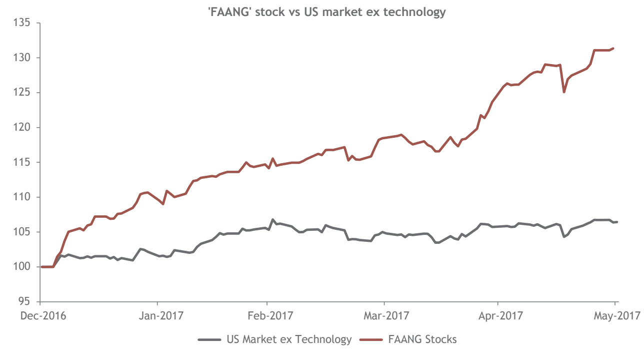
After a period out of the spotlight, China has slowly been creeping back onto the radar screen. One of the key drivers behind the reflation trade that began last year was China's improving growth, fuelled by the authorities' stimulus measures. Given the high levels of debt and unsustainably high house price inflation, the authorities have already begun to dial down stimulus measures. The squeeze on credit growth could hold back economic improvement in China. Indeed leading indicators for Chinese GDP, including money supply have begun to roll over. On the positive front, capital outflows appear to have eased and the currency has stabilised. We believe Chinese growth could well plateau as the year progresses but the risk of an outright contraction looks slim.

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

Market highlights

Equity markets

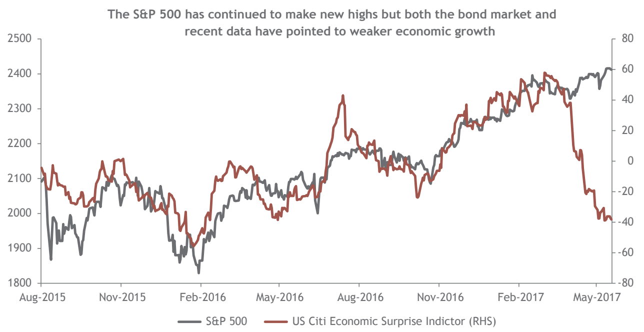
May witnessed a strong outperformance from the FTSE 100 relative to its developed market peers. More recently UK market performance has again become relatively concentrated with the top 10 stocks in terms of market weight (such as HSBC, BATS, Shell) producing around 70% of the positive return. Over the past month we have also seen a divergence in style between the UK and US. In the UK, we have again seen a shift back into more defensive sectors following a period of cyclical outperformance in April. By contrast in the US, cyclicals have continued to outperform, driven almost entirely by the technology sector. The so-called 'FAANG' stocks (Facebook, Amazon, Apple, Netflix and Google), with the addition of Microsoft, have seen their combined market value now exceed that of the entire FTSE 100. Comparisons are being made with the tech bubble of the late 1990s and whether the momentum behind these stocks is sustainable. We suspect that with the economic growth outlook remaining uncertain, in the near-term investors could continue to pay up for these stocks with better growth prospects. But we would be wary of committing too much at these high levels.



Source: Thomson Reuters Datastream/Smith & Williamson

Fixed income

UK Gilt yields (which move inversely with prices) have once again fallen, with the 10 year yield dropping back below 1% for the first time this year. Despite UK Purchasing Managers' Indices (PMIs) suggesting a better second quarter, the bond market is still pointing to a lower growth outlook for the UK economy. Brexit uncertainly could well be continuing to weigh on yields and the recent move in gilts could well be part of broader downward pressure on yields elsewhere, particularly the US. This has been driven by a continued fall in inflation expectations and ongoing doubts that Donald Trump can deliver on his fiscal stimulus plan. Indeed, directionally the relationship between UK gilts and US treasuries has remained strong. For yields to break higher from here we will need to see evidence of a strong rebound in the second quarter. Both gilt and treasury yields will remain sensitive to the key incoming data over the next few months.



Source: Thomson Reuters Datastream/Smith & Williamson

FX and commodities

The price of oil has been volatile in recent months, hitting a low of $48 in mid-May before rallying over 10% the on news OPEC is to extend its lower levels of production for another nine months. The agreement was triggered by renewed concerns over global excess supply causing the downward pressure on prices in recent months. US shale producers have also continued to increase output and inventory levels remain high. The fall back towards $50 a barrel in the past week suggests the market had been looking for a bigger statement of intent and deeper cuts from OPEC, with the nine month extension unlikely to materially narrow the gap between supply and demand in the near-term. Oil is likely to remain volatile but range-bound. With OPEC low on credibility we will ultimately need to see evidence of higher levels of demand and inventory levels falling for prices to break back above the highs seen early this year.

Source: Thomson Reuters Datastream/Smith & Williamson

Market returns (Total return, sterling)	1 month	3 months	1 year
Equities			
FTSE All-World	2.5	1.5	33.3
FTSE 100	4.9	4.7	25.5
FTSE 250	2.2	7.5	19.5
S&P 500	1.6	-1.1	32.4
FTSE Europe ex UK	5.5	11.4	35.8
Topix	3.4	0.5	31.3
FTSE Asia Pacific ex Japan	1.9	2.0	40.6
FTSE Emerging Market	1.8	1.8	41.5
Bonds			
UK 10-Year Gilt	0.5	1.1	6.8
US 10-Year Treasury	1.1	-2.1	11.2
UK Corporate BBB	1.5	2.6	11.5
Commodities and trade-weighted FX			
Oil Brent Crude ($/barrel)	-3.0	-9.4	-0.1
Gold ($/ounce)	0.0	0.9	4.4
TW USD	-1.6	-2.0	1.5
TW GBP	-2.2	0.3	-11.5
TW EUR	2.5	3.6	4.7
TW YEN	-0.3	-0.8	0.8

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	31 May 2017	Yields (%)	31 May 2017
UK GDP (YoY%)	2.0	1.6	GBP/USD	1.29	FTSE 100	3.69
UK CPI Inflation (YoY%)	2.7	2.7	GBP/Euro	1.15	FTSE 250	2.64
Bank of England Base	0.25	0.25	Euro/USD	1.12	10 Year Gilt	0.97

Notes

All values as at 31 May 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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