Investment Outlook

May 2017

A monthly round-up of global markets and trends

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Smith & Williamson

Investment review

Diminishing hopes Trump will deliver fiscal stimulus package, UK stages General Election, and Emmanuel Macron front runner in French Presidential election.

Politics has continued to dominate market sentiment early in the second quarter of the year. Markets responded positively to Emmanuel Macron's strong showing in the first round of the French presidential election. Mr. Macron, a pro-EU and reformist politician is now clear favourite to defeat the anti-euro candidate, Marine Le Pen in May's second round. As Donald Trump completes his first 100 days in office, markets are continuing to question the President's ability to deliver the promised fiscal stimulus measures aimed at boosting economic growth. In the UK, Theresa May surprised both markets and many in parliament by calling a snap general election, to be held on June 8. The Prime Minister hopes to substantially increase her majority and personal authority ahead of key Brexit negotiations with the European Union this year.

Europe & UK outlook

Emmanuel Macron's success in the first round of the French presidential election substantially eased perceived political risks across the eurozone. This led to a strong "risk-on" rally in the euro and the region's equity markets led by cyclical sectors, as well as a drop in the French bond yield spread (seen as the barometer of political risk). Whilst Ms Le Pen made it through to the second round, opinion polls have consistently shown Mr Macron winning the second round by a wide margin. Support for centrist candidates in both France and Holland in March — albeit from a new party in Mr Macron's case — appears to have slowed the momentum behind the populist movement that claimed victories in the US and UK, and risked shaking the eurozone to its core. Mr Macron's policies, including lowering corporation tax and boosting public investment, are seen as market-friendly. But should he enter the Elysee Palace in May, his new En Marche! Party looks most unlikely at this stage to gain a majority in France's National Assembly elections in June. The risk here is that Mr Macron could struggle to push through economic reforms and potential economic benefits could well be diluted.

We remain encouraged by evidence that a cyclical recovery in the eurozone is, at long last, now developing. Leading indicators point to better growth in the second quarter and, against this backdrop, corporate earnings have continued to improve. However, domestically driven inflationary pressures in the region still remain subdued. Core inflation has picked up to 1.2% but still remains at historically low levels. ECB president Mario Draghi continues to resist pressure from within the Governing Council for a more rapid taper of the ECB's asset purchase programme, or an increase in the deposit rate; for now at least.

The eventful chapter in British politics continues and the UK stages a General Election on June 8. The Prime Minister is seeking to take full advantage of the Conservatives' strong lead in the polls and increase her majority in the House of Commons. Sterling rallied strongly on the announcement, perhaps on the view that Theresa May will have greater scope (and time) to reach a transitional deal with the EU and avoid a cliff-edge Brexit scenario in two years' time. Should she increase her majority, as opinion polls suggest, PM May could also reduce the influence of the hard-line Eurosceptics within the Tory ranks, increasing the chances of a 'softer', and more pragmatic Brexit. The tone of the negotiations will be a key focus for markets and is likely to continue to dictate the direction of sterling as the year progresses.

For the UK economy, a stronger (or more stable) currency could begin to feed into the Bank of England's inflation forecasts. A more stable sterling will help reduce imported inflationary pressures. Although consensus GDP figures have moved higher (1.8% for 2017), 10-year gilt yields (seen as a proxy for economic growth) have remained at low levels, reflecting the still uncertain economic outlook in the UK. Meanwhile, there is some evidence of the squeeze on disposable incomes impacting consumer spending. This remains a key headwind for the UK economy this year, and, as a result, we continue to believe the MPC will keep monetary policy accommodative.

US equity outlook

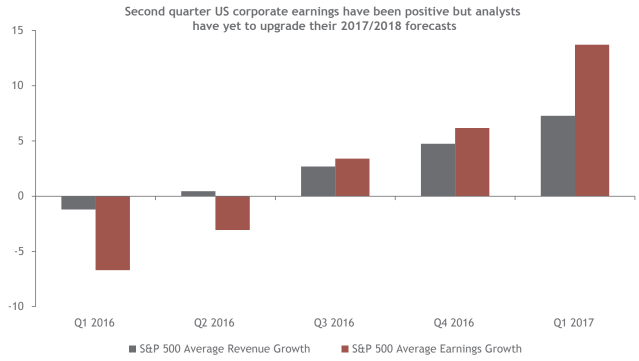
The Trump administration finally released some details of its long awaited tax reform plan on April 26, but the plans were long on ambition and short on detail. Proposals included aggressively lowering corporation tax and incentives for US companies to repatriate some of the $2.6tn held in cash overseas. Without a notable increase in the US economic growth rate, the tax cuts look likely to substantially increase the US budget deficit over the next decade. This is a highly contentious issue for a divided and fiscally hawkish congress, with the US government debt-to-GDP ratio already close to 80%. The subdued market response to the announcement perhaps reflects scepticism such aggressive tax cuts will successfully be enacted, and in a timely manner. President Trump's plan is a starting point for what is likely to be a period of protracted negotiations between his team and congress. A watered-down, and delayed, version of the tax reforms looks a more likely outcome, and any positive impact on the US economy from this could be pushed out well into 2018. Treasury Secretary Steven Mnuchin has also conceded the possibility that tax cuts may be temporary. US GDP growth in the first quarter was weak (0.7%), and with markets losing patience with Trump's ability to stimulate the economy, we may need to see a strong rebound in the second quarter data to help reignite the reflation trade.

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

Market highlights

Equity markets

First quarter US corporate earnings season is in full swing, with well over half of the S&P 500 having reported numbers. So far companies have largely beaten analyst expectations delivering revenue growth of 7.3% and earnings growth of 13.7%, at the time of writing. The headline figures have been boosted by a return to growth in both the energy and materials sector after several quarters of decline. There has also been a strong showing from technology companies, which have led the performance of the US market so far this year. The technology sector has contributed around 50% to the total return of the S&P 500 year to date. Whilst first quarter earnings have been positive, these are largely backward looking. The uncertain growth outlook in the US has meant analysts have yet to upgrade their estimates for both 2017 and 2018. Unless we see earnings move higher, US equity valuations will continue to look stretched and vulnerable to a correction.



Source: Bloomberg/Smith & Williamson

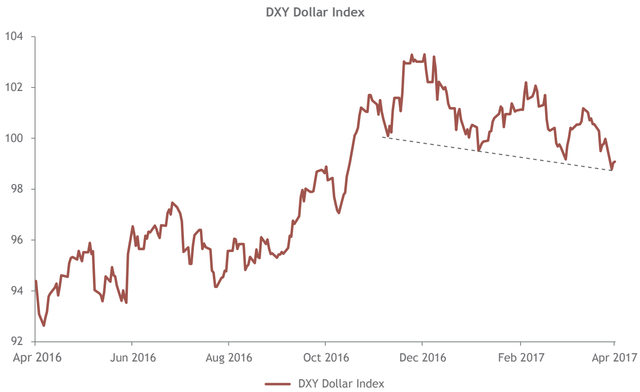
Fixed income

The French 10 year bond yield spread (difference) over German bunds fell sharply reflecting an easing of perceived political risk in Europe with Emmanuel Macron odds-on favourite to become the next French president. The broader 'risk on' move in markets in recent weeks has led to both US treasury and UK gilt yields (which move inversely with prices) moving marginally higher and we have seen a narrowing in high yield spreads. However gilt and treasury yields have remained at low levels and the bond market appears unconvinced that we are set for a return to higher levels of economic growth. Since breaking below a key support level of 2.3%, US treasury yields have struggled to recapture and or exceed this level. With Donald Trump's grand tax plans likely to be diluted and pushed out further, for yields to move higher from here we may need to see a strong rebound in US growth in the second quarter after a weak start to the year.

Source: Thomson Reuters Datastream/Smith & Williamson

FX and commodities

April witnessed further sharp moves in the currency market on the back of political events in the eurozone and the UK. The euro surged following Emmanuel Macron's strong showing the first round of the French election. Sterling rose to a 6-month high against the dollar in April following Theresa May's surprise announcement to call a snap general election. The dollar has continued to weaken and test key support levels on softer economic data and diminishing hopes that Donald Trump will deliver the necessary fiscal stimulus package to boost growth in the near-term. Sterling appears to have broken out of its 1.21-1.27 range against the dollar which began in October. Negative market sentiment towards sterling appears to have eased in the near-term and the pound could be re-establishing a higher trading range against the dollar (between 1.28-1.34), which was seen in the third quarter of 2016.



Source: Thomson Reuters Datastream/Smith & Williamson

Glossary of terms

Market returns (Total return, sterling)	1 month	3 months	1 year
Equities			
FTSE All-World	-2.0	2.2	27.9
FTSE 100	-1.3	2.9	20.0
FTSE 250	3.8	9.0	20.0
S&P 500	-2.4	2.3	33.5
FTSE Europe ex UK	1.0	7.8	28.8
Topix	-2.2	-0.2	26.9
FTSE Asia Pacific ex Japan	-2.4	4.4	35.7
FTSE Emerging Market	-1.5	4.4	34.9
Bonds			
UK 10-Year Gilt	0.5	3.8	7.8
US 10-Year Treasury	-2.6	-1.1	10.5
UK Corporate BBB	0.8	3.5	10.9
Commodities and trade-weighted FX			
Oil Brent Crude ($/barrel)	-2.0	-6.9	8.6
Gold ($/ounce)	1.7	6.0	-1.9
TW USD	-0.2	0.5	6.6
TW GBP	2.5	2.3	-8.1
TW EUR	0.6	0.1	1.1
TW YEN	-0.7	0.9	-1.1

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	30 April 2017	Yields (%)	30 April 2017
UK GDP (YoY%)	2.1	1.7	GBP/USD	1.29	FTSE 100	3.76
UK CPI Inflation (YoY%)	2.3	2.7	GBP/Euro	1.18	FTSE 250	2.65
Bank of England Base	0.25	0.25	Euro/USD	1.09	10 Year Gilt	1.08

Notes

All values as at 30 April 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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