



Investment Outlook

April
2017

A monthly round-up of global markets and trends

In this issue:

Investment review

Sanguine market response to the Fed's interest rate hike and Trump reflation exuberance continues to fade

Market highlights

Equities, fixed income, and FX and commodities

Market returns

Asset class by asset class



Smith &
Williamson



Investment review

Sanguine market response to the Fed's interest rate hike and Trump reflation exuberance continues to fade

Despite a strong first quarter for global equity markets, the Donald Trump reflation exuberance has continued to fade in recent weeks. With Trump yet to complete his first 100 days in The White House, his credibility has already come into question. US equities appear to be fuelled on the hope, rather than expectation, that Trump can deliver the key fiscal stimulus measures that will lead to higher growth. There has been a notable divergence between 'soft' (survey based) and 'hard' (quantifiable) economic data, with the former ratcheting higher and the latter pointing to a notably weak first quarter GDP figure. Tighter financial conditions experienced towards the end of 2016 appear to have impacted the US economy. The next few months will be a key test for Trump and the sustainability of the reflation trade.

US equity outlook

On the positive front, there has been a relatively sanguine market response to the Federal Reserve's (Fed) largely expected interest rate hike in March. The Fed expressed their desire to proceed with caution and still expect rates to peak at just 3% during this cycle. Although this remains above current market expectations, the Fed appears to have struck the right tone between keeping policy accommodative and remaining positive on the economic outlook. Our main area of caution is US equity market valuations. Despite heightened expectations; we have seen analyst forecasts drift lower. With US equity valuations looking stretched and moving to a wide premium to the other developed markets, we will need to see earnings upgrades in the US to alleviate valuation concerns. Much appears to be priced into markets leaving scope for disappointment.

UK and Europe outlook

With Theresa May officially handing over the Brexit divorce papers to the European Union, the tone of subsequent negotiations will be the focus for markets as the year progresses. We expect very little in the way of substantive news flow in the near-term but the early conciliatory tone from both sides has been encouraging. The more immediate focus for the UK is the impact of the squeeze on real incomes. With inflation outpacing wage growth, we are already seeing signs of the UK consumption growth losing momentum. At 2%, we believe the Bank of England's 2017 GDP forecast remains too optimistic and the headwinds facing the consumer could force the bank to backtrack towards their previous forecast of 1.4%. Longer-term UK bond yields (a proxy for GDP growth) have responded to the uncertain economic outlook by moving lower. UK equity market valuations still look relatively attractive and a weak sterling continues to support earnings for the more internationally-exposed FTSE 100. But given the headwinds facing the UK consumer, we have a more cautious stance on the outlook for more domestically focussed UK companies.

Political concerns in the Eurozone have continued to subside. However the French election could still produce a scare for markets if Macron (the current clear favourite) started to lose momentum ahead of the first round vote on 23 April. It has been encouraging to see the continued improvement in Eurozone economic data and should this cyclical rebound in the economy persist; this should continue to support sentiment towards Eurozone equities which have performed well in Q1. With improving earnings estimates and attractive valuations relative to the US, we remain positive on Eurozone equities. The improving growth and inflation outlook in the Eurozone could lead to a more hawkish (or notably less dovish) stance from the European Central Bank (ECB). We still believe the ECB will maintain an accommodative stance.

Emerging markets

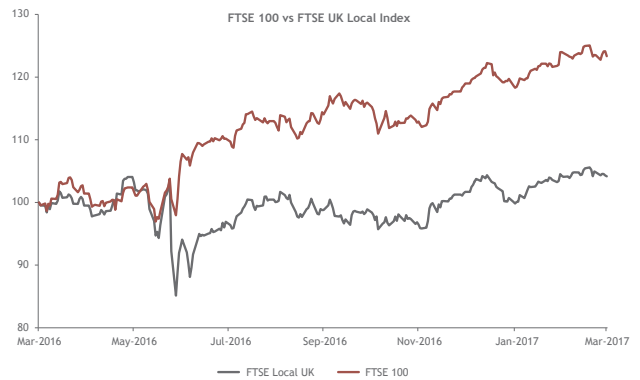
Emerging markets have been a key beneficiary of the weaker dollar and have outperformed their developed market peers year to date. Further signs of stabilisation in China have also helped buoy emerging markets. A relatively quiet and stable period for the Chinese economy has been a positive and has supported the global reflation theme. Capital outflows appear to have also stabilised in recent months but the high levels of debt in China remain a lingering concern. An inflating housing bubble and a surge in credit could force the authorities into tightening monetary policy later in the year, potentially curtailing economic activity.

Looking ahead, markets appear willing to give the Trump reflation trade the benefit of the doubt and volatility has remained at relatively low levels, however we sense patience will soon wear thin going into the second quarter. Any positive impact from what is likely to be a watered down fiscal stimulus plan could now be delayed until late 2018. With US equity valuations looking rich, we believe there is more than enough scope for a period of heightened volatility should news flow continue to disappoint. Although we remain more positive on Eurozone, Asian and emerging markets, the strong relationship between global equity market performance means it's difficult to see wider markets sustaining the rally without the US leading the way. With this in mind, we continue to see the benefits of holding a more balanced portfolio of equities, bonds and alternative assets, such as absolute return funds, to help ease volatility.

Market highlights

Equity markets

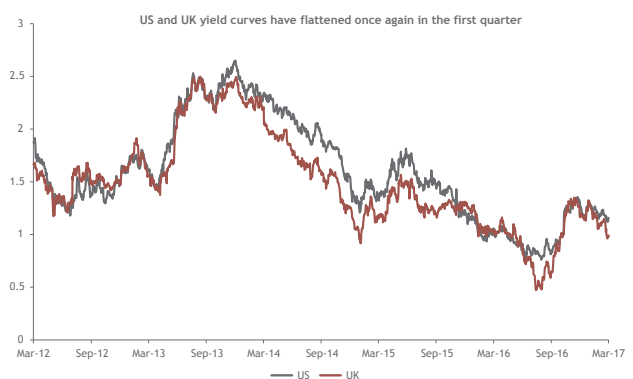
Despite a strong Q1 for global equity markets, we witnessed a notable switch by investors into more defensive sectors as the quarter progressed. This has been due to growth expectations, which picked up in the 4th quarter of 2016, beginning to ease back. The underperformance of the stock market in the UK has been more pronounced due to the notable pull back in energy sector stocks, which accounts for around 15% of the UK market. The biggest contributors to UK performance over the quarter were defensive consumer stocks including tobacco and pharmaceuticals. This could well be a reflection of the squeeze on disposable incomes starting to hit the UK consumer. This, as well as the weaker sterling has meant the FTSE local index (which is comprised of companies with over 70% of sales generated in the UK) has underperformed the more internationally exposed FTSE 100 by almost 20% since the EU referendum. We remain cautious on companies with higher exposure to UK consumer spending going forward.



Source: Thomson Reuters Datastream/Smith & Williamson

Fixed income

Bond markets have remained more sceptical over Trump's ability to deliver higher economic growth. US treasury yields have hit resistance at 2.6% and fallen back despite the Fed increasing interest rates in March, indicating investors are being cautious about stock markets. UK gilt yields have followed suit and have moved lower, a sign that the bond market is sensing a loss of economic momentum. In the US, lower yields could well be an indication that the tighter financial conditions (a stronger dollar and increase in mortgage rates) experienced in the fourth quarter, are beginning to impact the economy. Looking ahead, we suspect yields are likely to remain range bound, struggling to break out of longer term resistance levels while the timing and substance of Trump's fiscal stimulus measures remains ambiguous. Within the fixed income space we continue to prefer good quality investment grade corporate bonds where the yield spread (difference) over government bonds remain more attractive for those seeking income.



Source: Thomson Reuters Datastream/Smith & Williamson

FX and commodities

A key feature for markets over the first quarter has been the weaker dollar. The US currency has fallen 2.3% and has reflected diminishing expectations of higher growth and notably higher interest rates in the US. With the market currently pricing in a further two rate hikes in 2017, a more hawkish Fed increasing interest rates further in upcoming meetings could push the dollar higher once again. However, with growth coming in on the weaker side and Trump's ambitious fiscal plans yet to materialise, we expect the Fed to hold steady in the interim. Sterling has remained in a fairly tight range (1.21-1.25) versus the dollar since late last year and is likely to remain the market's barometer for Brexit negotiations. Although looking cheap relative to its long-term historic value, we suspect this range will remain intact until the direction of travel of negotiations becomes clearer.



Source: Bloomberg/Smith & Williamson

Glossary of terms

Market returns (Total return, sterling)	1 month	3 months	1 year
Equities			
FTSE All-World	0.8	5.8	33.1
FTSE 100	1.1	3.7	23.3
FTSE 250	1.4	5.4	15.3
S&P 500	-0.4	4.8	34.7
FTSE Europe ex UK	4.6	7.5	27.9
Topix	-0.7	4.0	33.0
FTSE Asia Pacific ex Japan	2.5	11.2	36.5
FTSE Emerging Market	1.5	8.9	35.6
Bonds			
UK 10-Year Gilt	0.1	1.8	5.7
US 10-Year Treasury	-0.5	-0.4	11.5
UK Corporate BBB	0.3	2.0	11.0
Commodities and trade-weighted FX			
Oil Brent Crude (\$/barrel)	-4.7	-7.2	31.7
Gold (\$/ounce)	-0.7	7.8	1.0
TW USD	-0.2	-2.3	4.1
TW GBP	0.1	0.2	-9.0
TW EUR	0.4	-0.4	-0.5
TW YEN	0.3	4.3	4.2

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 central bank responsible for the monetary system of the European Union (EU) and the euro currency.

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	31 March		31 March
		Consensus forecast	Spot rates	2017	
UK GDP (YoY%)	2.3	1.6	GBP/USD	1.25	FTSE 100 3.69
UK CPI Inflation (YoY%)	0.6	2.6	GBP/Euro	1.17	FTSE 250 2.64
Bank of England Base	0.25	0.25	Euro/USD	1.07	10 Year Gilt 1.07

Notes

All values as at 31 March 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
Philip Lawlor	London	020 7131 4767	philip.lawlor@smithandwilliamson.com
Christopher Bates	London	020 7131 8131	christopher.bates@smithandwilliamson.com

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