Investment Outlook

March 2017

A monthly round-up of global markets and trends

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Smith & Williamson

Investment review

Pivotal month for markets as Article 50 is likely to be triggered and Trump promises "phenomenal" tax cuts

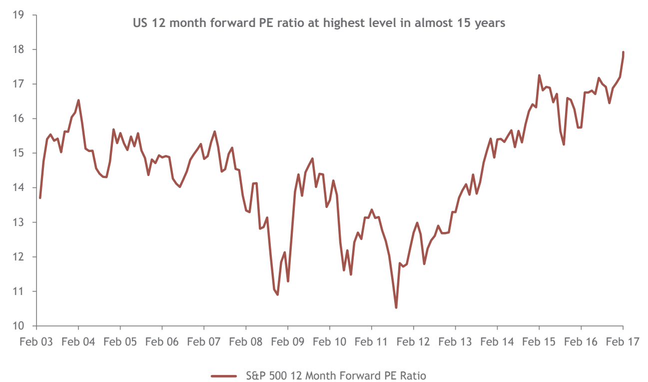
- March looks set to be a pivotal month for markets. Theresa May is likely to finally trigger Article 50 and voters go to the polls in Holland in the first of a series of significant elections in the Eurozone. There are also key central bank meetings at the European Central Bank (ECB) and Federal Reserve (Fed) that could set out the trajectory of monetary policy. However, the dominant theme for markets remains the Donald Trump reflation trade.
- Whilst Trump's new administration continue to talk the talk we have yet to see any real details on the much anticipated fiscal plans. Trump has whetted the market's appetite by stating (or invariably tweeting) about 'phenomenal' tax cuts in the weeks to come and he launched a review into easing the regulatory burden on banks. Equity markets are keeping the faith that Trump can deliver, but the message from the bond market is less optimistic. US treasury yields (which move inversely with prices) have again moved lower on signs that any positive impact on the US economy could be delayed until next year. This policy implementation risk, that tax cuts and infrastructure spending do not come through quick enough, is the key factor that could disrupt the momentum behind the Trump reflation trade and cause equity markets to pull back.
- The uncertain fiscal outlook in the US is also making the intentions of the Fed harder to read. Market interest rate expectations have risen since Trump's election victory and a more hawkish consensus amongst Fed members has left the door open for another rate increase as early as this month. The Fed are forecasting three rate hikes this year, still above market expectations. Although the labour market appears to be close to full employment, we still believe the Fed will want to see more clarity on Trump's fiscal plans before pressing ahead too aggressively this year. Whilst markets currently appear relatively relaxed about the prospect of further rate increases, the risk remains that any delay in fiscal measures, combined with tighter financial conditions (higher rates and a stronger dollar), causes the US economy to lose momentum going into the second quarter.
- The Bank of England notably revised up its 2017 GDP growth forecast in February's Inflation Report to 2% (up from 1.4% in November), well above the consensus of 1.2%. After a (possibly overly) pessimistic view of the economy the lead up to the referendum, we feel the MPC have now placed themselves under unnecessary pressure with an overly optimistic view of the UK's growth prospects. After a solid finish to 2016 we are seeing early signs of the economy losing momentum. Purchasing Managers' Indices, more forward looking sentiment indicators, are beginning to roll over and there is early evidence that the squeeze on disposable incomes is beginning to take hold on the UK consumer. Indeed, the MPC now sees more slack in the labour market than previously estimated, suggesting wage growth will remain subdued whilst inflation continues to rise. With Article 50 likely to be triggered in this month and headwinds facing the UK consumer, the hard yards are clearly ahead for the UK economy. As a result, we are beginning to see analyst earnings forecasts for more domestically-focused UK companies rolling over.
- The Eurozone economy continues to show signs of a cyclical upswing and an improvement in analyst forecasts. Like elsewhere, inflationary pressures appear to be finally building and headline CPI is finally approaching the ECB's 2% target. With the ECB due to meet this month, questions have been asked about whether the pick-up in inflation expectations will be enough to cut asset purchases further and begin the process of slowly withdrawing monetary stimulus. We don't believe this will be the case in the near-term, but markets will be focused on Mario Draghi's tone following the meeting and hints that further tapering is on the table.
- The more pressing hurdle for markets to negotiate remains politics within the Eurozone with a series of key elections on the horizon. The French yield spread (difference) over German bunds, the market's key barometer of political concern in France, fluctuated substantially in February. Concern has eased in recent weeks with polls still suggesting that the chances of the anti-euro Marine Le Pen eventually winning remain slim. We agree with this view but markets will remain sensitive to swings in the polling data over the coming months and we cannot rule out a Le Pen victory altogether given the political shocks over the last year.

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

Market highlights

Equity markets

February witnessed a rotation in style within the UK market with more defensive sectors out performing cyclicals. Traditional bond proxy sectors (those with similar characteristics to bonds) including telecoms, utilities and pharmaceuticals have been strong performers over the last month and have rallied with gilts on signs that the UK economy is losing momentum. In the US, the S&P 500 has continued to hit all-time highs and investors appear to be continuing to give the Trump reflation trade the benefit of the doubt. Despite the record highs, analysts remain unconvinced and we have yet to see 2017 earnings forecasts upgraded. This has left US equity valuations looking expensive with the 12 month forward Price-Earnings Ratio at 17.8x-its highest level in almost 15 years. With much now priced in, the US market looks vulnerable if fiscal measures fail to deliver higher growth.



Source: Bloomberg/Smith & Williamson

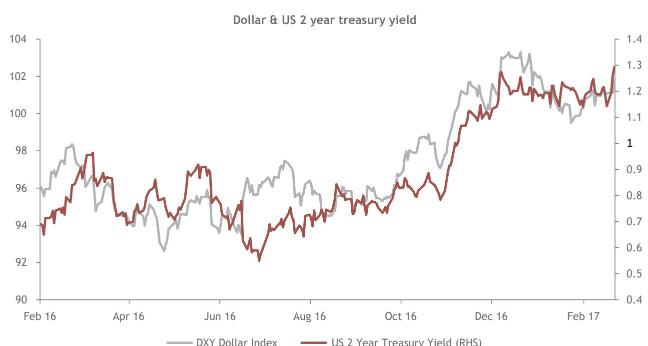
Fixed income

Over the past month, we have seen a further divergence between the US and UK 10-year bond yield. US treasuries have been trading in a tight range with bond markets yet to be convinced that Trump can deliver higher US growth. In the UK we have seen a more pronounced flattening of the yield curve, with the 10-year gilt yield (a proxy for nominal GDP growth) falling around 40 basis points in February. With the UK consumer facing headwinds, the fall in yields has largely been driven by concerns over the sustainability of the UK's recent solid economic performance. Despite the uncertain outlook for the UK, our preference remains for good quality investment grade corporate bonds over gilts. Default risk remains low, the Bank of England's asset purchases should continue to support prices and the extra yield (over gilts) remains attractive for those seeking income in an environment where low interest rates are likely to remain in the UK.

Source: Thomson Reuters Datastream/Smith & Williamson

FX and commodities

After falling at the start of the year, the dollar has staged a comeback with the trade-weighted index rising over 2% since the beginning of February. Markets have remained largely focused on Trump but more recently the outlook for US monetary policy appears to have become the dominant driver of the dollar. More hawkish commentary from key Fed members in recent weeks has led to markets ascribing a higher probability to a further rate hike in the coming months. This could possibly come as early as March. With other major central banks likely to continue to sit on their hands, further dollar strength from here is likely to be driven by signs the Fed are willing to push ahead with tightening policy further, despite the still uncertain fiscal outlook in the US.



Source: Bloomberg/Smith & Williamson

Market returns (Total return, sterling)	1 month	3 months	1 year
Equities			
FTSE All-World	4.0	8.6	37.7
FTSE 100	3.1	8.0	24.2
FTSE 250	3.5	7.4	16.2
S&P 500	5.1	8.5	40.0
FTSE Europe ex UK	2.1	9.9	27.3
Topix	2.7	7.0	36.6
FTSE Asia Pacific ex Japan	4.3	9.4	44.2
FTSE Emerging Market	4.4	9.3	46.9
Bonds			
UK 10-Year Gilt	3.2	3.5	5.0
US 10-Year Treasury	2.0	0.8	8.4
UK Corporate BBB	2.4	3.9	14.3
Commodities and trade-weighted FX			
Oil Brent Crude ($/barrel)	-1.7	10.2	51.6
Gold ($/ounce)	3.7	7.1	1.9
TW USD	0.9	-1.1	0.8
TW GBP	-0.3	-1.0	-9.5
TW EUR	-0.9	-0.5	1.5
TW YEN	1.3	1.6	2.2

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 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 Consensus forecast	Spot rates	28 February 2017	Yields (%)	28 February 2017
UK GDP (YoY%)	2.3	1.5	GBP/USD	1.24	FTSE 100	3.69
UK CPI Inflation (YoY%)	0.6	2.5	GBP/Euro	1.17	FTSE 250	2.64
Bank of England Base	0.25	0.25	Euro/USD	1.06	10 Year Gilt	1.07

Notes

All values as at 28 February 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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