Investment Outlook

February 2017

A monthly round-up of global markets and trends

In this issue:

Investment review

Trump's controversial first few weeks in office and Brexit developments have been the main focus for the new year

Market highlights

Equities, fixed income, and FX and commodities

Market returns

Asset class by asset class

Smith & Williamson

Investment review

Trump's controversial first few weeks in office and Brexit developments have been the main focus for the new year.

- Donald Trump's first few weeks in office have been the main focus for markets at start of 2017. The post-election exuberance has lost a little momentum but markets appear to still be giving the expected Trump economic boost the benefit of the doubt. Closer to home, Brexit is back on the radar for markets with the government likely to trigger Article 50 and officially begin divorce proceedings with the European Union (EU) in the coming months. The improving economic backdrop in the Eurozone has proven a welcome distraction for what's likely to be a challenging political period for the region in the first half of 2017. Politics are likely to remain a key focus for markets globally in the near-term. Given the potential for further twists and turns, we expect market volatility to pick up from the current low levels.
- As expected the start of Trump's Presidency has not been without controversy, but the real focus for markets is on the scale and timing of his proposed fiscal stimulus measures, aimed at boosting the US economy. Early signs have been encouraging with Trump quickly signing off on a two high profile infrastructure projects in the energy sector. But given that markets have already priced in the prospect of higher growth and inflation, and US equity market valuations have moved back to elevated levels; there is scope for disappointment if the overall scale of the fiscal stimulus underwhelms. Possibly the greatest risk is that the tax cuts do not get signed off by congress until the latter end of the year meaning they won't impact the economy until 2018. In the meantime, tighter financial conditions (a stronger dollar and higher interest rates) could act as a drag on the US economy going into the second quarter of the year. We remain cautiously optimistic that Trump can deliver policies that will lead to higher growth. However, unless we see details of his plans soon, markets could rapidly begin to lose patience.
- The economic landscape in the Eurozone has continued to look brighter in recent months. GDP growth picked up to 1.8% in 2016 and more forward-looking indicators (such as Purchasing Managers' Indices and consumer confidence surveys) are pointing to a further pick-up in activity in this year. Indeed analysts have begun to upgrade their earnings forecasts for this year in response. An improving economic climate, combined with relatively attractive equity valuations and abundance of internationally-focused companies, means we are warming to the Eurozone market. However, the region also faces a potentially disruptive election timetable including key elections in the Netherlands (March) and France (May). The latter will be of particular interest for markets if the polls show the anti-Euro Marine Le Pen is gaining traction. While we acknowledge the increasingly unpredictable nature of the political landscape, we have started the process of gradually increasing our exposure to European equities.
- In the UK, Brexit has very much been the focus at the start of the New Year. Theresa May has outlined her strategy with the government seeking a clean break from the EU as she pledged the UK would quit the single market. She has won the support of MPs in the commons and the government now looks on course to officially trigger Article 50 before the end of March. The UK government goes into Brexit negotiations with the economy on a firmer footing. The first estimate of Q4 GDP came in marginally above expectation at 0.6%, meaning growth in 2016 of 2.2%. 2017 consensus forecasts have ticked higher but growth is still expected to come in at just 1.2%. Inflationary pressures have continued to build in the UK as a result of the weaker sterling driving up the price of imports. Inflation is expected to rise to around 2.5% this year and market interest rate expectations have crept higher in recent months. However, we continue to believe the Bank of England will look through the near-term spike in inflation for the time being and keep interest rates low. Particularly with inflation likely to outpace the growth in wages, eroding disposable incomes and acting as a headwind for UK consumption in 2017.
- Having been one of the main (and surprise) beneficiaries of Trump's election victory, Japanese equities have lost momentum at the start of the year. The equity market has a strong negative correlation with the yen (as the yen weakens, the market generally moves higher) and Japanese stocks have suffered from the yen strengthening against the dollar. Although we remain generally positive on the Japanese market, the currency plays a significant role in direction of the market. As a result, much will depend on the dollar strengthening against the yen once again from here.

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

Market highlights

Equity markets

Since the start of the year the FTSE 250 has outperformed the larger (and more internationally exposed) FTSE 100. Much of this is down to signs of a more resilient UK economy and a pick-up in sterling in recent weeks. Both the FTSE 100 and 250 have seen their price-earnings ratios (a valuation measure) decline with both markets now on attractive valuations compared to the US. But clearly the UK economy is facing enormous uncertainty as the Brexit negotiations unfold and as a result we remain cautious on the more domestically-focused FTSE 250 index. Our preference remains for the FTSE 100, particularly if sterling remains within a likely trading range of around 1.20-1.27 versus the dollar. If sterling remains relatively weak we have greater faith in the earnings growth outlook for the FTSE 100 index due to the currency translation impact (over 70% of FTSE 100 revenues come from overseas). Another positive is that with a large proportion of FTSE 100 companies paying their dividends in dollars, this could provide an 'extra kicker' to the value of investment income.

Source: Thomson Reuters Datastream/Smith & Williamson

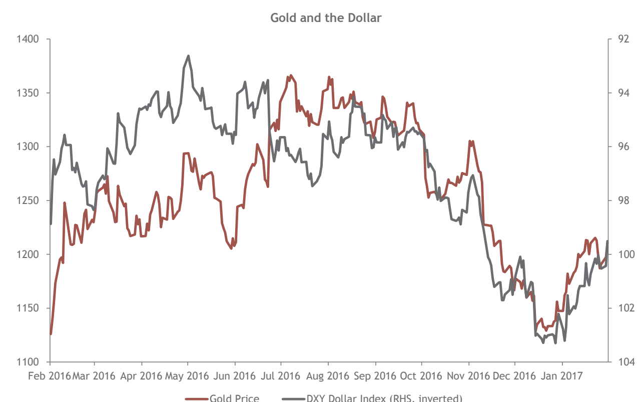
Fixed income

Bond yields (which move inversely with prices) began to fall in early January as markets grew more cautious on Donald Trump's ability to quickly return the US to higher growth and inflation. However, since Trump's inauguration, yields have once again moved higher on early announcements of infrastructure expenditure, as investors switch into equities which might benefit. With the 10-year US treasury yield currently around 2.5%, we believe 3%, the upper end of a very long-term trend, is the next key resistance level. A break above 3% could signal the end to the bull market in bonds. But with the economic outlook remaining uncertain, we believe much will need to be delivered for yields to move through this level. Within the UK fixed income space' our preference remains for good quality investment grade corporate bonds. The risk of corporate defaults remains low and the extra yield over gilts means they remain a more attractive means of gaining income.

Source: Thomson Reuters Datastream/Smith & Williamson

FX and commodities

The price of gold has gained 7% since its recent low in mid-December. The bounce has been driven by a weaker dollar and a decline in the US real yield (inflation adjusted), both of which have historically moved inversely with the price of gold. Given gold does not provide an income; the opportunity cost of holding gold becomes greater as interest rates rise. Conversely, gold has also historically been seen as a hedge (protection) against inflation. Given these qualities, as well as generally displaying a negative correlation with equities, we see the benefits of holding some gold as part of a balanced portfolio over the longer-term. Its status as a safe-haven asset means it should protect against a risk-off move (switch out of equities) should Trump's policies not deliver the expected growth in time, but also acting as a hedge against inflation should CPI figures continue on a notable upward trajectory.



Source: Bloomberg/Smith & Williamson

Glossary of terms

Market returns (Total return, sterling)	1 month	3 months	1 year
Equities			
FTSE All-World	0.9	2.8	33.9
FTSE 100	-0.6	2.7	21.4
FTSE 250	0.5	3.9	13.2
S&P 500	0.1	4.6	35.3
FTSE Europe ex UK	0.7	1.7	24.4
Topix	2.0	-0.9	31.7
FTSE Asia Pacific ex Japan	3.9	1.1	41.1
FTSE Emerging Market	2.8	-2.6	43.3
Bonds			
UK 10-Year Gilt	-1.4	-1.2	4.0
US 10-Year Treasury	-1.9	-7.2	10.1
UK Corporate BBB	-0.6	0.2	10.7
Commodities and trade-weighted FX			
Oil Brent Crude ($/barrel)	-1.0	17.9	63.7
Gold ($/ounce)	4.7	-4.9	8.4
TW USD	-3.0	1.5	-3.1
TW GBP	0.5	4.4	-11.4
TW EUR	0.1	-1.6	1.9
TW YEN	2.6	-6.6	7.9

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.

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 January 2017	Yields (%)	31 January 2017
UK GDP (YoY%)	2.3	1.2	GBP/USD	1.26	FTSE 100	3.68
UK CPI Inflation (YoY%)	0.6	2.5	GBP/Euro	1.16	FTSE 250	2.74
Bank of England Base	0.25	0.25	Euro/USD	1.08	10 Year Gilt	1.42

Notes

All values as at 31 January 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

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

Our offices: London, Belfast, Birmingham, Bristol, Cheltenham, Dublin (City and Sandyford), Glasgow, Guildford, Jersey, Salisbury and Southampton.

Smith & Williamson Investment Management LLP authorised and regulated by the Financial Conduct Authority.
Smith & Williamson International Limited Regulated by the Jersey Financial Services Commission.

We have taken great care to ensure the accuracy of this newsletter. However, the newsletter is written in general terms and you are strongly recommended to seek specific advice before taking any action based on the information it contains. No responsibility can be taken for any loss arising from action taken or refrained from on the basis of this publication.
© Smith & Williamson Holdings Limited 2017. Code 16217db.