Smith & Williamson

Investment outlook

A monthly round-up of global markets and trends
February 2019

In this issue

Investment outlook
The global economy is in the middle of a soft patch

Market highlights
Equities, fixed income, and FX and commodities

Market returns
Asset class by asset class

Please read the important information section

Investment outlook

The global economy is in the middle of a soft patch

With a number of recent key indicators showing slow growth in the global economy, some have speculated that we are heading for a recession. What therefore is the prospect of recession risk to financial markets in the coming months?

As a backdrop, the IMF recently lowered its 2019 global output growth expectations to 3.5%, its second downgrade in three months and the lowest rate for three years. Sluggish growth has been captured in some recent macro data releases reported in January. For instance, US pending home sales declined nearly 10% from a year ago, the biggest contraction in 5 years, French consumer confidence fell sharply following the yellow jacket (or gilet jaunes) demonstrations, and Chinese auto sales fell 5% in 2018, the first annual decline for 30 years. The partial shutdown of the US Federal government through most of the month, and the still unresolved trade spat between the US and China, adds another layer of uncertainty to the economic outlook.

Even so, January also saw some positive developments. First, the US announced its biggest increase in payrolls for nearly a year, with another increase in average hourly earnings, and a rise in the participation rate. This broadening and deepening in the labour market should put the economy on a solid foundation. Second, US personal spending has picked up, as evidenced by online shopping sales that rose over 20% from a year ago, during the important Christmas season. Third, the Chinese central bank announced additional monetary stimulus to complement tax cuts for both Mainland consumers and businesses this year. And fourth, Fed Chair Powell gave some dovish comments, to suggest the US central bank is flexible and prepared to adjust policy tightening if required.

On balance, it is our assessment the global economy is in the middle of a soft patch, rather than heading for a hard economic landing that could entail material risk for financial markets. Provided economic growth stabilises (our base case view), equities can rally from current attractive valuations and oversold positions.

Approaching Brexit crunch time

The UK is set to leave the EU on the 29 March 2019. However, following Prime Minister May's heavy defeat over the "meaningful vote" on the government's withdrawal plan from the EU in the House of Commons in January, sterling appreciated against the US dollar, suggesting the foreign-exchange market believes the UK may not actually leave the single market at the end of March. And in what has been a pretty hectic month, the government survived a vote of no confidence tabled by the opposition Labour party, as Tory Brexiteers and the DUP, the government's confidence and supply partner, gave their support to the embattled PM. The UK is in the bizarre situation where Tory backbenchers have confidence in the government, but no confidence in its flagship Brexit-policy.

In terms of market risks, Brexit-related scenarios can really be grouped into two broad buckets. The first bucket includes the less risky options for equities (at least initially), such as an orderly Brexit or no Brexit (either through revoking Article 50 or extending Article 50).

The second bucket includes the riskier options of no deal Brexit and a possible left-wing Jeremy Corbyn-led Labour government if a snap election were called. Indeed, based on current opinion polls, Electoral Calculus, a general election predictor, predicts 280 seats for Labour, 41 for the SNP and 291 for the Conservatives in the 650-seat House if an election were to be held now. Assuming the speaker and 3 deputies do not vote, and Sinn Fein do not take up their seats in the Commons, Labour could, with the help of the SNP, form an effective working majority with 321 seats in the House.

A no deal Brexit or snap election could lead to substantial UK capital outflows. To put this risk into some perspective, Bank of International Settlements data shows the EU has cross-border claims of nearly GBP1trn on the UK, while the UK has claims of GBP572bn on the EU. Should the UK's relationship with the EU end in acrimony, under a no deal Brexit scenario, or Labour introduces higher tax rates under a new government, capital could leave the UK quite quickly. This could lead to sterling depreciation and a mark-down in UK financial asset prices.

With the clock running down, it is unclear how this deep political crisis in the UK will unfold. Both major political parties are split on which direction to go on Brexit. Though parliament is trying to wrestle with the government over how to use the available time in the House to agree a deal with the EU, the uncertainty created by Brexit is filtering through to sentiment and the real economy. For instance, with UK consumer confidence at its lowest level since mid-2013, retail sales volumes slumped in December. Given these political and economic risks, we believe that investors should be looking outside the UK for better equity returns.

Equity markets

The US S&P 500 stock market index fell 14% in the fourth quarter of 2018, the 25th worst quarter from data going back to the 1920s. Fourteen of those quarters were during the Great Depression and the Second World War when market volatility was elevated. Arguably, it probably makes more sense to look at the post-war period to see if history can be used as a guide to the future. From our post-war dataset, we find that the subsequent quarterly return, following a poor performance in the previous quarter, is for an average gain of 5.9%, with the market being up 90% of the time. The exception was the first quarter of 2009, when the market was still recovering from the tumult of the US-led Global Financial Crisis (GFC).

Large quarterly declines and subsequent quarterly returns for the US S&P 500

Quarter	S&P 500 return	Next quarter
Q2 1932	-39.4%	82.4%
Q3 1931	-34.5%	-16.4%
Q4 1929	-28.9%	17.2%
Q3 1974	-26.1%	7.9%
Q4 1937	-23.3%	-19.4%
Q4 1987	-23.2%	4.8%
Q4 2008	-22.6%	-11.7%
Q2 1962	-21.3%	2.8%
Q1 1938	-19.4%	36.0%
Q2 1970	-18.9%	15.8%
Q3 1946	-18.8%	2.3%
Q2 1930	-18.6%	-9.1%
Q2 1940	-18.1%	6.8%
Q3 2002	-17.6%	7.9%
Q4 1930	-17.5%	8.8%
Q1 1939	-16.4%	-1.1%

Quarter	S&P 500 return	Next quarter
Q4 1931	-16.4%	-10.0%
Q1 1933	-15.5%	86.5%
Q3 2001	-15.0%	10.3%
Q4 1941	-14.8%	-7.8%
Q3 1990	-14.5%	7.9%
Q4 1932	-14.4%	-15.5%
Q3 2011	-14.3%	11.2%
Q2 1937	-14.1%	-10.6%
Q4 2018	**-14.0%**	

Average return (all 24 Qs)	8.6%
Percent positive (of all 24 Qs)	62.5%

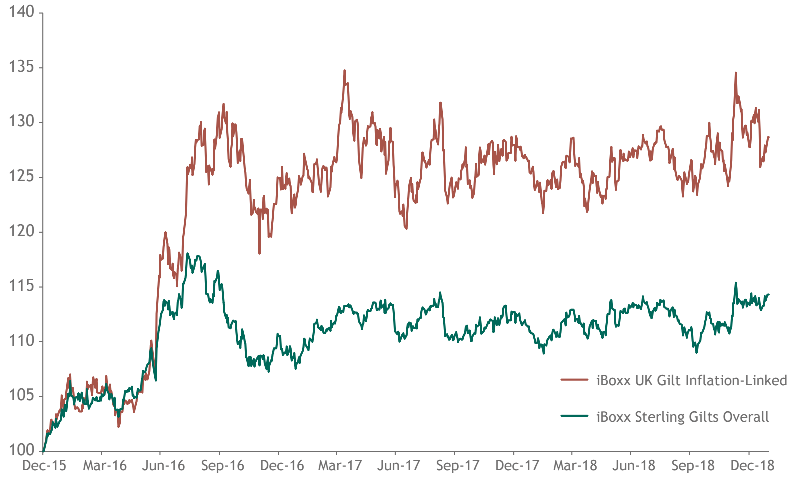
Average return post WWII	5.9%
Percent positive (post WWII)	90.0%

Source: Datastream, Smith & Williamson

Fixed income

UK index-linked gilts offer a useful hedge against Brexit related uncertainty in investment portfolios. Since the UK referendum on whether to leave the EU was held on 23rd June 2016, UK linkers have outperformed conventional gilts by 12.8%. The majority of this outperformance came in the 6 months following the vote as sterling collapsed by around 20% relative to the US dollar, as markets were concerned the UK would import inflation from abroad. Inflation subsequently did increase from its benign level of 0.5% (CPI, annual change) to a peak at over 3% at the end of 2017, and has declined back to the current level of 2.1%. Sterling has also recovered, although not back to pre-referendum levels, but index-linked gilts have retained most of their gains.

Index-linked relative to convention gilts since the referendum (rebased, TR, GBP)

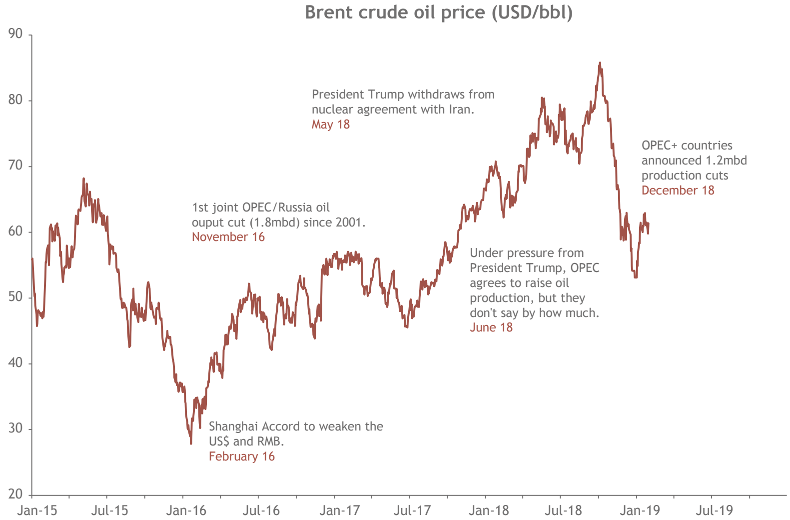


Source: Bloomberg/Smith & Williamson

FX and commodities

After peaking last year at over $85/b on the 4th October, just one day after Fed Chair's Powell's hawkish comments, the crude oil price then went on to fall nearly 40% to the end of 2018. Even the oil production cuts announced on the 6th December, by OPEC and Russia, did little to stop the decline in the price of energy, during this highly volatile period. However, the Brent crude oil price has since picked up from its low at the end of last year. Provided global growth holds up, which is our base case view, and supply is reduced, it would be reasonable to expect the oil price to pick-up further or at least stabilise from here.

Brent crude oil price (USD/bbl)



Source: Bloomberg/Smith & Williamson

Market highlights

Market returns (Total return (%), sterling)	1 month	3 months	1 year	5 year
Equities				
MSCI All-Country World	4.5	-1.0	0.6	77.7
FTSE 100	3.6	-1.6	-3.5	29.8
FTSE 250	7.1	-0.6	-5.0	36.6
S&P 500	4.6	-2.6	5.6	110.1
MSCI Europe ex UK	3.0	-2.3	-7.4	42.7
MSCI Japan	2.7	-3.4	-4.1	63.0
MSCI Pacific ex Japan	3.8	5.1	0.2	58.3
MSCI Emerging Markets	5.3	7.2	-6.9	60.6
Bonds				
iBoxx GBP Gilts	1.1	2.2	3.9	29.3
iBoxx USD Treasuries	-2.4	0.8	11.1	38.5
iBoxx GBP Corporate	2.0	1.4	0.5	29.7
Commodities and trade-weighted FX				
Oil Brent Crude ($/barrel)	17.2	-17.8	-9.3	-42.3
Gold ($/ounce)	3.2	8.8	-1.4	6.4
TW USD	-1.6	-0.7	5.4	19.8
TW GBP	1.1	-1.2	-0.9	-8.2
TW EUR	-0.7	-1.4	-0.4	0.3
TW YEN	2.0	2.4	6.8	7.1

Glossary of terms

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.

Equities – A stock or any other security representing an ownership interest.

Fed – The Federal Reserve. The central banking system of the US. Sets key interest rates and monetary policy.

IMF – International Monitory Fund.

SNP – Scottish National Party

CPI – Consumer Price Index. Measures changes in the price level of market basket of consumer goods and services purchased by households.

OPEC – Organization of Petroleum Exporting Countries. A union of oil producing countries that regulate the amount of oil each country is able to produce.

Key macro data	Latest	2019 Consensus forecast	Spot rates	31-Jan	Yields (%)	31-Jan
UK GDP (YoY%)	1.5	1.50	GBP/USD	1.31	FTSE 100	4.53
UK CPI Inflation (YoY%)	2.1	2.10	GBP/Euro	1.15	FTSE 250	3.19
Bank of England Base	0.75	1.10	Euro/USD	1.15	10 Year Gilt	1.23

All values and charts as at 31 January 2019. Total returns in sterling.
Returns are shown on a total return (TR) basis i.e. including dividends reinvested (unless otherwise stated).
Net return (NR) is total return including dividends reinvested after the deduction of withholding tax.

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.

For further information

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