Smith & Williamson

Investment outlook

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

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Investment outlook

Fed tightening and market jitters in Q4 2018

In the months leading up to autumn, markets were already volatile due to the uncertainty created by a trade spat between China and the US. Nevertheless, global equities had returned 4% (including dividends) between the end of December 2017 and the end of September 2018. Yet, when Fed Chair Powell warned that we're "a long way" from neutral on US short-term interest rates on the 3 October, global equity markets (including the US) were spooked and fell sharply. Essentially, investors had become unnerved about Powell's hawkish comments and what impact Fed tightening would have on economic growth, company profits and financial conditions.

The Fed has since taken a less hawkish stance on monetary policy. First, Mr. Powell delivered a more dovish tone in a speech at the Economic Club of New York on the 29 November compared to his 3 October comments. Second, although the Fed raised interest rates at its policy meeting in December, the Committee indicated it would take a pause on raising interest rates every quarter (the Federal Open Market Committee reduced its interest rate projections this year from three hikes to two hikes, and expects just one in 2020 to complete the cycle). And third, in the December FOMC statement, the Committee showed a modest degree of caution by stating it will "monitor global and financial developments and assess their implications for the economic outlook", which suggests that the Fed stands ready to ease policy, if required.

Even so, following the December FOMC, the US stock market index fell by 1.5% on the day, its worst decline in response to a Fed rate increase since 1994. Markets reacted negatively, as the Fed did not rule out further rate increases. Moreover, Mr. Powell said that the Fed is satisfied with its program to reduce the size of its balance sheet through quantitative tightening (QT), and had no plans to change it. Markets are concerned, as there is plenty of uncertainty in an untested QT program on autopilot and its impact on the economy. Global equities, as measured by the MSCI All Country World Index (ACWI) benchmark, fell 12.7% in the final quarter of 2018, the biggest decline in more than seven years.

However, critically for equity markets, the US dollar trade-weighted index (TWI) appears to have peaked. It would be reasonable to see a decline in the US dollar TWI (i.e. the cost of US dollar money) as an important offset to the shortage of dollar liquidity, which has precipitated stress in banks (eg, Deutsche Bank, as a globally systemically important bank) exposed to US dollar-denominated debt in emerging markets.

Market outlook for 2019

The global economy is undergoing growing pains. The fundamental growth backdrop has weakened somewhat as the Fed tightens monetary policy. US real GDP growth is slowing from around a 3% clip in 2018 to 2.6% expected by the consensus in 2019. Elsewhere, output growth in 2019 is anticipated to grow by 6.2% in China, 1.6% in the Eurozone, 1.5% in the UK and 0.9% in Japan, with all countries and regions here showing a steady deceleration from 2018.

Analysts have now taken into account the changed macro backdrop and marked down consensus earnings expectations. Equity valuations have also become less demanding; the MSCI ACWI is currently trading on 12.9 times forward earnings, which is lower than when markets last wobbled over global growth expectations in early 2016.

There are now two scenarios for the trajectory of equity markets; (i) if the decline in the US dollar (and US 10 year Treasury yields) reflects a severe downturn in US growth, or even a recession, it would likely lead to further equity downside; or (ii) if the decline in the US dollar reflects a nearing in the end of the US rate cycle, and with US growth holding up, this would provide an opportunity for equities to recover from oversold levels. We believe scenario (ii) is the more likely outcome, but risks have increased.

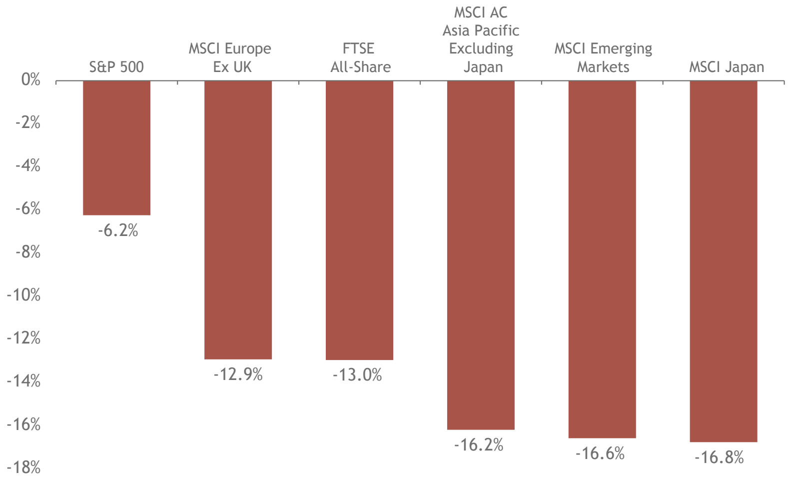
Market tail risks

There are a number of dates in 2019 that could potentially be catalysts for market tail risks that lead to greater risk aversion. These include; i) 1 March: the US will decide on whether to raise tariffs to 25% from 10% on $200bn of Chinese imports; ii) 29 March: the UK is due to leave the EU. A no deal Brexit could lead to a severe dislocation in both the UK and European economy, as well as in financial markets, and also lead to a snap election in the UK that potentially delivers a left-wing Jeremy Corbyn government. iii) 23-26 May: European Parliamentary elections will be held on these dates. A populist backlash could help anti-EU parties gain ground in European parliament and influence the direction of reform in the union. iv) Mid-summer: Around this time US Congress must raise the US debt ceiling limit to avoid a default on US government debt.

Equity markets

On a global basis, equities had their worst year since 2011. Emerging market and Asian equities were the first to suffer as the Fed's tightening of monetary policy caused the dollar to strengthen relative to other currencies. Developed markets continued to rally, particularly powered by the "FAANGs" (Facebook, Amazon, Apple, Netflix & Google) until the end of September, when hawkish comments by Federal Reserve Chairman Jerome Powell caused a sharp turnaround in sentiment. US equities outperformed global peers over the year thanks to the strong performance over the first three quarters.

Equity indices 2018 performance (price return, local currency)

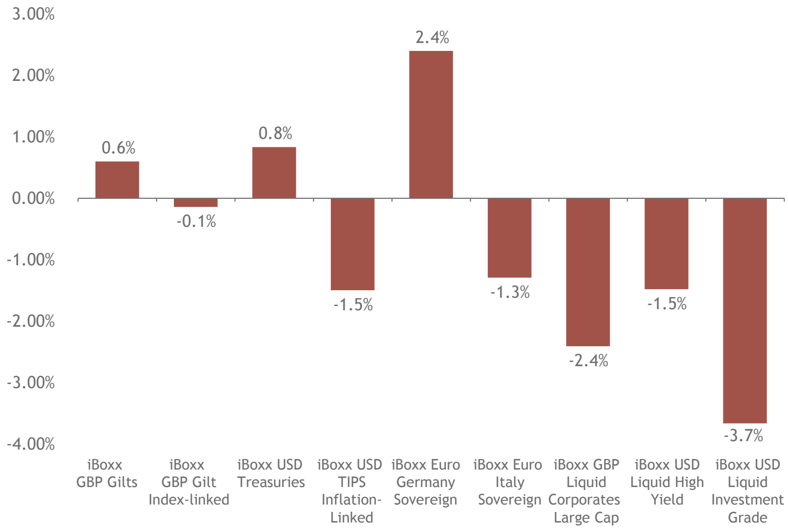


Source: Bloomberg/Smith & Williamson

Fixed income

The performance of fixed income asset classes has been more mixed. Conventional gilts and US treasuries have outperformed their inflation-adjusted counterparts. The best performance came from German government bonds which benefitted from safe haven status compared to bonds issued by the Italian government, which clashed with the European Commission over its proposed budget deficit. Corporate bonds have suffered because the yield spread over those of safer sovereign bonds has increased, reflecting a deterioration of the quality of issuance and weaker covenants protecting investors.

Fixed income 2018 performance (total return, local currency)



Source: Bloomberg/Smith & Williamson

FX and commodities

The European single currency is now at about the same level, relative to the US dollar, as it was at its debut on financial markets in January 1999. It has been an eventful journey, as the exchange rate moved according to the collective fortunes of the continent. After its debut the currency devalued by nearly 25% before the paper currency came into existence in January 2002. A rally of over 80% followed as the European Central Bank (ECB) tightened monetary policy in the run up to the global financial crisis. Since then, volatility in the currency increased as recession hit Europe, closely followed by the European debt crisis. Supportive policy responses proved a catalyst for rallies along the way. Most recently the focus has been on the ECB's QE program, which has just been brought to a close.

20 years of the euro

Source: Bloomberg/Smith & Williamson

Market highlights

Market returns (Total return (%), sterling)	1 month	3 months	1 year	5 year
Equities				
FTSE All-World	-6.8	-10.5	-3.4	64.9
FTSE 100	-3.5	-9.6	-8.7	20.9
FTSE 250	-5.1	-13.3	-13.3	25.6
S&P 500	-8.9	-11.5	1.6	95.5
MSCI Europe ex UK	-4.7	-10.9	-9.1	34.5
MSCI Japan	-6.5	-12.2	-7.1	53.7
MSCI Pacific ex Japan	-1.7	-5.7	-4.6	45.2
MSCI Emerging Markets	-2.4	-5.2	-8.9	43.8
UK 10-Year Gilt	0.9	3.2	2.0	33.2
US 10-Year Treasury	3.5	7.1	6.1	49.9
UK Corporate BBB	0.9	-0.5	-2.4	29.5
Commodities and trade-weighted FX				
Oil Brent Crude ($/barrel)	-9.6	-35.8	-20.2	-52.3
Gold ($/ounce)	5.1	7.5	-1.7	6.1
TW USD	-0.1	1.6	4.7	22.9
TW GBP	-2.0	-1.9	-1.4	-8.1
TW EUR	0.1	-1.8	1.0	1.0
TW YEN	0.7	0.5	4.5	5.2

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.

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.

IMF – International Monitory Fund.

Key macro data	Latest	2019 Consensus forecast	Spot rates	31-Dec	Yields (%)	31-Dec
UK GDP (YoY%)	1.50	1.50	GBP/USD	1.28	FTSE 100	4.68
UK CPI Inflation (YoY%)	2.30	2.10	GBP/Euro	1.11	FTSE 250	3.39
Bank of England Base	0.75	1.15	Euro/USD	1.14	10 Year Gilt	1.27

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

Contact	Office	Direct line	Email address
Daniel Casali	London	020 7131 8985	daniel.casali@smithandwilliamson.com
David Goebel	London	020 7131 8908	david.goebel@smithandwilliamson.com
Sam Pham	London	020 7131 8352	sam.pham@smithandwilliamson.com

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Notes

All values and charts as at 31 December 2018. Total returns in sterling. Sources: *FTSE, Thomson Reuters Datastream, Bloomberg FTSE International Limited* (FTSE) London Stock Exchange Group plc and its group undertakings (collectively, the "LSE Group"). © LSE Group 2018. FTSE Russell is a trading name of certain of the LSE Group companies. "FTSE®" is a trade mark of the relevant LSE Group companies and is used by any other LSE Group company under license. All rights in the FTSE Russell indexes or data vest in the relevant LSE Group company which owns the index or the data. Neither LSE Group nor its licensors accept any liability for any errors or omissions in the indexes or data and no party may rely on any indexes or data contained in this communication. No further distribution of data from the LSE Group is permitted without the relevant LSE Group company's express written consent. The LSE Group does not promote, sponsor or endorse the content of this communication.

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