Smith & Williamson

Investment outlook

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

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Investment outlook

Declining UK growth expectations and ongoing political uncertainty

The Bank of England (BOE) left interest rates unchanged at its monetary policy meeting in February. Arguably, the more important development came in the accompanying BOE Inflation Report (IR), where 2019 UK real GDP growth was revised down to 1.2% from 1.7% on the back of slowing global trade, uncertainty from Brexit and lower than anticipated productivity gains. Even this low forecast looks optimistic; the UK economy grew just 0.7% at an annualised pace in the fourth quarter of 2018, with real business investment down for the fourth consecutive quarter, the longest uninterrupted downturn since the Global Financial Crisis in 2008. Less investment will make it more difficult for the UK economy to raise productivity and reach its long-term growth potential.

One factor that will influence the near-term UK economic outlook is the nature of the EU withdrawal. While the path for Brexit is uncertain, at least there is evidence that firms are making preparations for a potential no-deal Brexit to minimise supply-side disruptions. First, according to the latest UK purchasing manager's index, manufacturers are stockpiling goods (and particularly in the clothing, chemical, plastics, and food and beverage sectors) at their fastest rate since records began 27 years ago. Second, the BOE's IR disclosed that Agents of the Bank, who surveyed approximately 200 business contacts, found that around half of respondents had started implementing contingency plans for a "no deal, no transition Brexit". And third, on the EU side, Brussels announced a package of contingency proposals in December, including measures to keep planes flying between the UK and Europe and scrapped its initial plan to limit quotas for road haulage permits to just 5% of existing UK-EU traffic to avoid trade flow bottlenecks.

Nevertheless, despite the gloomy economic outlook and Brexit uncertainty, the BOE believes spare capacity in the economy remains limited and forecasts inflation running above 2% in 2020 and 2021. As such, the BOE maintains a conditional tightening bias and expects to raise interest rates once over the next three years. For investors, the UK Gilt market looked through the BOE's inflation projections; 10-year yields have declined to their lowest rate for over a year, while equities ignored the bleak economic outlook and rallied, as global markets recovered from oversold positions. Looking forward, the UK stock market remains vulnerable to political risks (e.g. Brexit and a potential left-wing Jeremy Corbyn government).

Political and economic risks coming from Italy

The EU's increasingly fractious relationship with Italy is a source of uncertainty for the euro and regional markets. Politically, an extraordinary diplomatic row has deepened between Italy and France, after Italian Deputy Prime Minister Luigi Di Maio met with French leaders of the populist 'gilet jaunes' movement near Paris in February. Relations between France and Italy were already tense since the populist Five Star Movement (FSM) formed a government with the right-wing Lega party in June 2018. However, the unscheduled visit of Di Maio, the FSM leader, led to France recalling their ambassador from Italy, the first time that has happened since the Second World War. Di Maio seems to be drumming up populist support at home following disappointing results by his party in regional elections in Abruzzo and Sardinia.

Not to be outdone by FSM, leaders in the Lega have proposed a bill that could potentially allow Italy's parliament to seize the central bank's gold reserves (worth around €91bn). This has led to speculation that the government could use the gold to fund a spending program to fulfil spending promises. It does appear that Italy's political leaders are gearing up for a snap general election, and possibly before the European parliamentary elections on the 23-26 May.

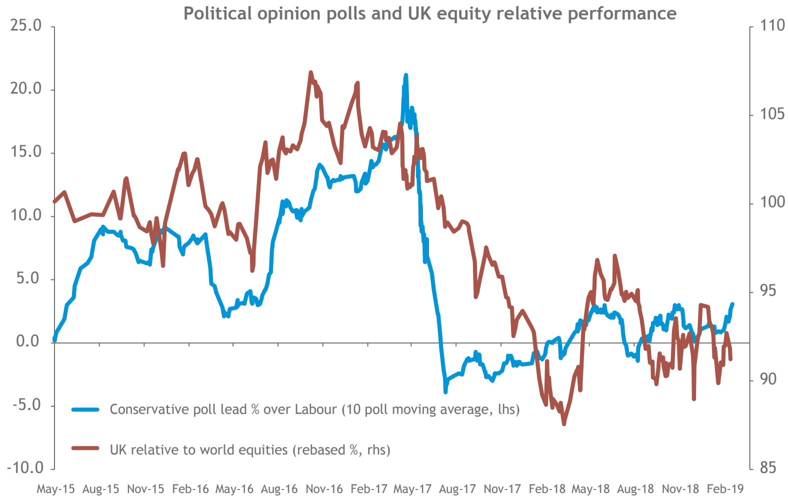
Economically, Italy slipped into recession in the second half of 2018. The country is weighed down by public debt worth over 130% of GDP, has unfavourable demographics and an ailing banking system that needs to be recapitalised. In short, European equities continue to face political and economic risks coming from Italy.

Kicking the US-China trade protectionism risk can down the road

As highlighted in the January Investment Outlook, trade protectionism is a key market tail risk. However, President Trump has since tweeted that he will delay scheduled trade tariffs (originally planned for the 1st March) on US imports from China, due to progress made in trade negotiations. Instead, Trump is likely to maintain existing tariffs and up the pressure on China to honour its commitments to purchase more US goods and make progress on resolving Washington's concerns related to state-aid subsidies, market access, forced technology transfers and intellectual property rights. Trade protectionism remains a risk for markets, but with the 2020 US presidential elections looming in the horizon, and with President Trump keen to deliver a political "win" to his electorate, this market concern has probably eased somewhat, at least in the near term.

Equity markets

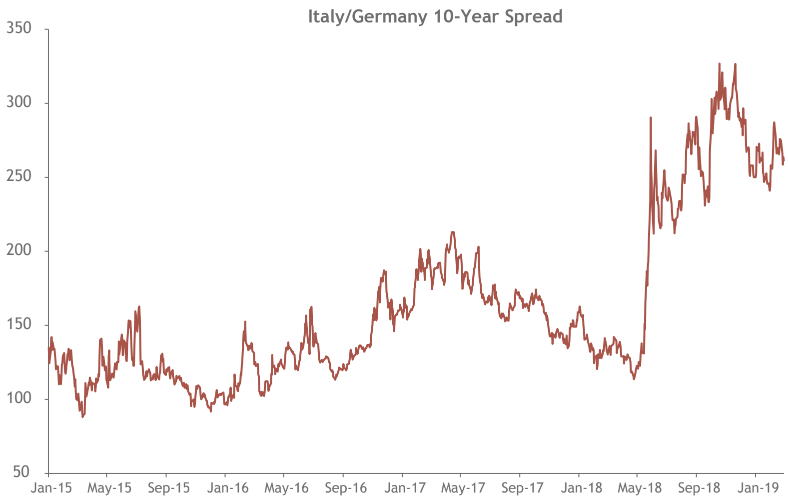
The prospect of a far-left Labour government under Jeremy Corbyn has been a significant driver of the performance of UK equities relative to their global peers. UK equities started to underperform, as investors fretted over Labour policies including nationalisation of utility companies and enforced employee share ownership. On the 18th February, 8 MPs resigned from the Labour party to stand in an 'Independent Group' and were subsequently joined by 3 MPs from the Tory benches. The breakaway group could prove to strengthen the position of the Conservative party in a subsequent general election, as they draw votes away from the Labour party.



Most recent polling data: 23 February 2019
Source: Wikipedia, Thomson Reuters Datastream, Smith & Williamson

Fixed income

The spread between Italian bond yields and their German equivalents has increased significantly in May last year as the newly elected coalition government clashed with the EU over their budget proposals which broke European fiscal sustainability rules. Since then the spread has proved an interesting gauge of the Italian fiscal situation, with Italian bonds yielding 3.25% more than German bonds at the high point in the spread in October. Interestingly, Italy is the second largest debtor in the euro denominated sovereign bond market, behind France, making up around 23% of the market.



Data as at 28 February 2019
Source: Bloomberg/Smith & Williamson

FX and commodities

Following escalation of the trade war and imposition of tariffs by both the US and China in 2018, the Renminbi weakened, which lessened the impact of tariffs on Chinese exports. Recently, talks between President Trump and President Xi Jinping and their respective trade delegations have been productive - the latest round of tariff increases has been delayed for the second time. These developments serve to reduce the tail risk to the world economy posed by the trade war escalating further.

Data as at 28 February 2019
Source: Bloomberg/Smith & Williamson

Market highlights

Market returns (Total return (%), sterling)	1 month	3 months	1 year	5 year
Equities				
MSCI All-Country World	1.6	-1.1	3.3	75.5
FTSE 100	2.3	2.3	2.2	26.4
FTSE 250	2.6	4.2	0.2	31.3
S&P 500	2.1	-2.7	8.4	109.1
MSCI Europe ex UK	2.2	0.3	-2.8	38.4
MSCI Japan	-1.1	-5.0	-6.8	65.2
MSCI Pacific ex Japan	2.6	4.7	3.0	55.6
MSCI Emerging Markets	-0.9	1.9	-6.3	57.1
Bonds				
iBoxx GBP Gilts	-0.9	2.5	2.6	27.9
iBoxx USD Treasuries	-1.4	-1.5	7.3	38.4
iBoxx GBP Corporate	0.2	3.4	1.9	29.3
Commodities and trade-weighted FX				
Oil Brent Crude ($/barrel)	6.0	12.4	0.5	-39.6
Gold ($/ounce)	-0.5	7.9	-0.3	-0.8
TW USD	-0.1	-1.8	6.2	19.5
TW GBP	1.2	0.3	0.2	-7.4
TW EUR	-0.6	-1.2	-1.3	-0.8
TW YEN	-1.6	1.1	3.0	3.5

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

IMF – International Monetary Fund.

Key macro data	Latest	2019 Consensus forecast	Spot rates	28-Feb	Yields (%)	28-Feb
UK GDP (YoY%)	1.3	1.40	GBP/USD	1.33	FTSE 100	4.54
UK CPI Inflation (YoY%)	1.8	2.00	GBP/Euro	1.17	FTSE 250	3.11
Bank of England Base	0.75	1.00	Euro/USD	1.14	10 Year Gilt	1.31

All values and charts as at 28 February 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.
Source: Thomson Reuters Datastream and Bloomberg

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.

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