Smith & Williamson

Investment outlook

A monthly round-up of global markets and trends
October 2017

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Investment outlook

A favourable backdrop for stocks overall

September proved to be a month where records and cycle highs were set. According to index provider MSCI, global equities rose for the 11th consecutive month, equal to the longest unbeaten run set in February 2004. In Developed Markets (DMs), the US S&P 500 and tech-heavy Nasdaq indices traded at peaks towards the end of the month. Equity performance is broadening to Emerging Markets (EMs) too, where stocks are up 25% so far this year, the best return since the post-Global Financial Crisis rally in 2009.

Behind these market performances, there is increasing evidence of a synchronised global economic recovery. For the first time in seven years, the International Monetary Fund projects that real GDP growth will accelerate in both EMs and DMs in 2017. Demand is picking up in DMs from ongoing employment gains and the wealth effect stimulus on consumption from rising asset prices. Meanwhile, EM demand growth is benefiting from Chinese structural reforms to use the market more effectively in the allocation of financial resources. Looking forward, both DMs and EMs are transitioning to self-sustaining growth. This increases the probability that the global expansion will last for longer, even if geo-political risks lurk on the Korean peninsula.

Separately, companies are becoming more profitable. The S&P 500 operating profit margin is at a record high, as major companies have been adept at keeping labour costs down. If labour fails to negotiate higher wages from corporates, profit margins are likely to remain elevated. There are structural reasons to believe that labour is unlikely to regain pricing power anytime soon. Advances in telecommunications technology enables companies to parcel out service-sector jobs to areas with high unemployment, where wage rates are typically low. Faster broadband speed allows businesses to outsource back offices from major to minor cities, or possibly overseas. Job search apps or websites such as LinkedIn, also make it easier to match job offers with applicants to reduce frictional unemployment.

The lack of labour pricing power is a global phenomenon. Take the UK and Japan, where labour markets are tightening. Even though the UK employment-to-population ratio is at all-time highs, wage growth has decelerated to just 2% year-on-year, from near 4% in 2015. In Japan, the job offer-to-applications ratio is near a 45-year peak, but average regular cash earnings are barely growing at all. The bottom-line is that an enlarged labour pool limits the pricing power of workers and enables big business to boost profit margins.

This favourable backdrop probably explains why equities have been able to shrug-off a new cycle of monetary tightening by major central banks. Starting with the US, the FOMC last month announced its intention to stop reinvesting all of the money it receives when Treasuries and mortgage-backed securities mature, but with caps added to reduce the risk of a sudden withdrawal of liquidity from the financial system. Over in Europe, the ECB is set to taper asset purchases, while the Bank of England has brought forward expectations of a rate hike. Considering that inflation is running below central bank mandates, monetary tightening is expected to be gradual.

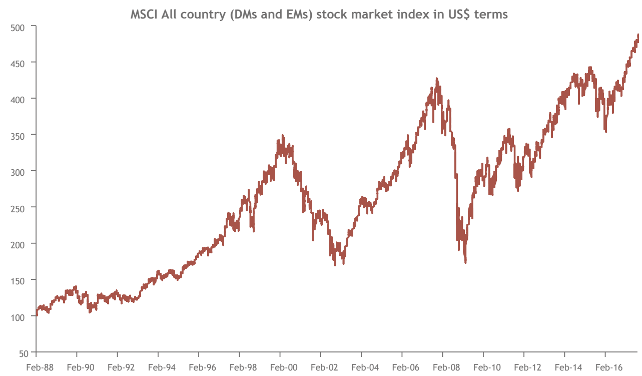
Global stocks have proved robust, in the face of political uncertainty. Although Angela Merkel secured a 4th term as German chancellor in the September federal election, it was not a great result for her party. Merkel's CDU/CSU union had its poorest showing since 1949, while its junior government coalition partner, the SPD, fared no better and said it would now go into opposition. The biggest winner was the far-right AfD party, which entered the lower house for the first time to become the third largest party in parliament. This indicates that populism remains a risk to the political establishment in Europe.

Given the seat distribution in parliament, Merkel's only realistic option to govern is to link up with both the business-friendly FDP and the Greens to form a so called "Jamaica" coalition, named after the colours of the Jamaican flag. The inclusion of the FDP in the coalition, which is strongly opposed to EU integration, runs the risk of creating uncertainty over EU support for economies in the periphery of Europe.

The German election also has potential implications for Brexit. While David Davis and Michel Barnier are negotiating deal options, they are getting no firm guidance from Berlin on which direction to pursue and are unlikely to receive any until a German government is established. Coalition talks may be difficult again this time around, as a Jamaica coalition combination has never been tried in federal government. A delay would have implications for Brexit, since it would shorten the time available to finalise a deal on the UK's divorce and transition from the EU. It remains to be seen how European leaders will respond to UK PM May's recent speech on Brexit in Florence. Considering that the UK is in the uniquely difficult position of having the widest current account deficit and lowest real yields out of the world's major economies, it will be difficult for sterling to rally far, even if market expectations for higher UK interest rates in November have intensified.

Equity markets

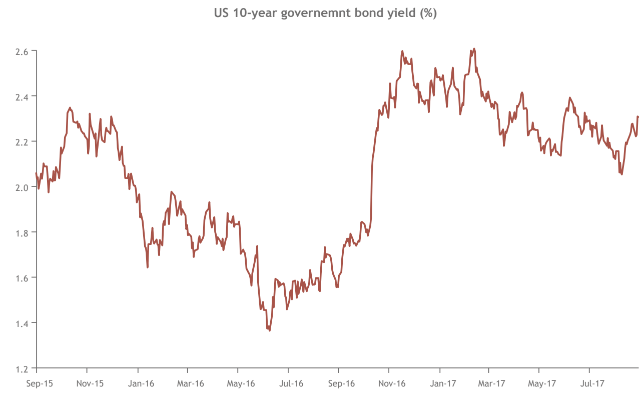
The MSCI All Country (includes DMs and EMs) stock market index reached a new high in September. So far this year it is up 15%, driven by double-digit gains in both DMs and EMs. Looking further back, the MSCI All Country index is up 181% from its previous cycle low in March 2009, when central banks actively became involved in propping up the market through QE. The current rally compares to a 152% rise from trough-to-peak during the last stock market cycle between October 2002 and October 2007.



Source: Thomson Reuters Datastream/Smith & Williamson

Fixed income

The US 10-year government bond yield is currently trading at around 2.3%, which is below its peak this year of 2.6%. Bond yields have been anchored down by lower-than-anticipated inflation in 2017, as well as less certainty that President Trump can pass a tax reform and fiscal stimulus package through Congress. On the latter point, Republican leaders unveiled a new tax blueprint towards the end of September. If bond yields are to rise further from here, the market will need to see signs that the probability of a tax package passing Congress looks likely.



Source: Thomson Reuters Datastream/Smith & Williamson

FX and commodities

The gold price has remained in a fairly stable range over the past few years, but it could potentially rise further from here. That's because China is increasing efforts to offer oil exporting countries Renminbi (the Chinese currency)-denominated contracts for oil that can be converted into gold. Recently, the Shanghai Futures Exchange and its subsidiary Shanghai International Energy Exchange completed some preparatory tests in order to list Renminbi crude oil futures. Renminbi-backed oil and gold futures would allow oil exporters to bypass benchmarks that are denominated in US dollars. Considering that Renminbi oil contracts would be paid in gold, it could appeal to energy producers that are subject to US sanctions, such as Russia and Iran, and increase demand for gold.

Source: Thomson Reuters Datastream/Smith & Williamson

Market highlights

Glossary of terms

Market returns (Total return, sterling)	1 month	3 months	1 year
Equities			
FTSE All-World	-0.9	1.8	15.6
FTSE 100	0.6	1.3	10.9
FTSE 250	2.1	3.5	14.3
S&P 500	-0.4	1.4	15.7
FTSE Europe ex UK	-0.5	3.1	22.9
Topix	-1.5	0.7	11.2
FTSE Asia Pacific ex Japan	-3.4	-0.7	13.1
FTSE Emerging Market	-3.8	4.3	15.3
Bonds			
UK 10-Year Gilt	-3.1	-0.4	-3.6
US 10-Year Treasury	-4.8	-2.8	-7.4
UK Corporate BBB	-1.8	0.3	1.1
Commodities and trade-weighted FX			
Oil Brent Crude ($/barrel)	10.1	20.4	17.6
Gold ($/ounce)	-2.4	3.2	-2.9
TW USD	1.4	-2.3	0.0
TW GBP	5.0	1.1	0.8
TW EUR	-1.6	2.0	5.1
TW YEN	-3.0	-1.4	-11.5

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 Euro area's central bank which sets key interest rates and monetary policy.

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	30-Sep	Yields (%)	30-Sep
UK GDP (YoY%)	1.7	1.5	GBP/USD	1.34	FTSE 100	3.69
UK CPI Inflation (YoY%)	2.6	2.7	GBP/Euro	1.13	FTSE 250	2.64
Bank of England Base	0.25	0.25	Euro/USD	1.18	10 Year Gilt	1.40

Notes

All values and charts as at 30 September 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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