Smith & Williamson

Investment outlook

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

In this issue

Investment outlook
The US bull market continues to lift appetite for global stocks

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 US bull market continues to lift appetite for global stocks

The month of March marked the 10-year anniversary of the US equity bull market. Since 9 March 2009, when the S&P 500 benchmark index troughed at a devilish 666, US stocks have gained 16% per year, more than any major market – see the top right chart in the market highlights. From our calculations, roughly two-thirds of those annualised price gains have been driven by company earnings per share (EPS), suggesting that the market rally is fundamentally supported and can be sustained. While EPS data has been distorted by share buybacks, the impact is small. For instance, JP Morgan estimates that net buybacks have contributed to only 2% of operating EPS per year on average over the past decade.

Moreover, the underlying US economy currently does not exhibit typical signs of excesses and imbalances that could undermine the business cycle. First, US household and corporate combined savings, a measure of the difference between private sector incomes less spending, was in a 4.2% of GDP surplus versus deficits of -4.4% in Q3'00 and -2.7% in Q3'06. In other words, unlike the last two occasions, this expansion has not been driven by unsustainable credit to finance growth. Second, inflation and labour costs remain fairly muted, implying limited signs of economic overheating. And third, though corporate debt has gradually been building up, balance sheets are sufficiently healthy to absorb higher financing costs. While economists tend to look at debt to domestic GDP ratios, it may make more sense to compare debt to assets for internationally-focused companies. On that basis, the US corporate debt to asset ratio stands at 21.6%, below the historical peak of 25.6% in the 1990s and is only slightly above the historical average of 20.8%. Moreover, interest costs are contained. JPMorgan calculates that interest costs for listed US stocks currently account for an historical low 18% share of company earnings. However, one risk is that should the economy slow down, companies' access to capital markets may become restricted. We therefore continue to monitor financial conditions. Overall, it is reasonable to expect the rally in the American stock market to be extended and lift other regional markets higher.

Risks from Fed monetary tightening have been lowered

With easing financial markets conditions and the US unemployment rate reaching its lowest level since the late 1960s, there is a risk that the Fed may surprise markets and turn more hawkish on US interest rates again. Nevertheless, considering that underlying inflation remains contained and the interest rate projections from the latest Federal Open Market Committee (FOMC) meeting predicts no rate hikes this year, it appears that is a low risk probability. Most important, investors are arguably now assured that Fed Chair Powell stands behind the market, similar to previous incumbents like Ben Bernanke, Janet Yellen and Alan Greenspan. In short, this so called "Powell put" should boost investor confidence.

Rising US-Chinese geopolitical tensions over Made in China 2025 and technology competitiveness

Market volatility continues to fluctuate on whether President Trump decides to step-up import tariffs, as part of the US trade spat with China. However, with the 2020 presidential election campaign heating up, President Trump is likely to agree a deal with China to avoid a damaging trade war that could hurt his base supporters and hinder his chances of re-election.

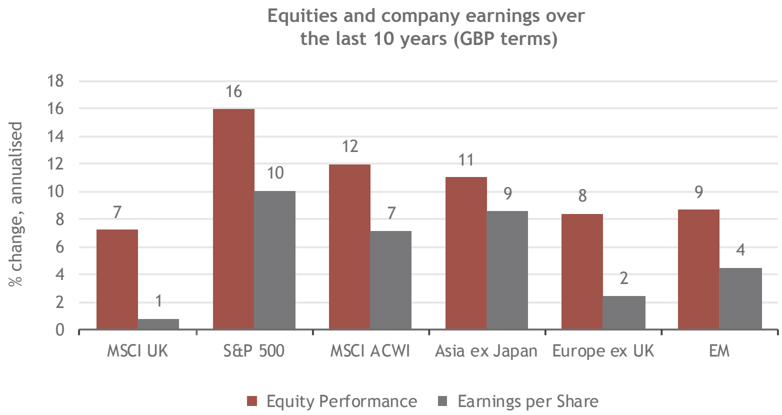
Nevertheless, geopolitical tensions between the two superpowers are simmering beneath the surface over Made in China 2025, a flagship Beijing policy to make the country's manufacturing base become more hi-tech. Currently, the specific issue that the US and China are fighting over is who has supremacy in 5G telecommunications, a key technology to handle the explosive growth in global data generation from the Internet of Things (or IoT - devices that can communicate and interact with others over the internet, such as smart traffic control sensors).

China has significant cost advantages in 5G technology. For example, China is forecast to have 430 million 5G subscribers by 2025, larger than the entire population of the US. As of last year, China had 350,000 5G-ready base stations, more than ten times as many as the US. This creates economies of scale and lowers the cost-per-user for China's 5G technology by leveraging on the world's largest population and infrastructure already in place. Given that US tech companies have capitalised on access to data to boost their market valuations, the 5G revolution provides an opportunity to utilise IoT data to disrupt the balance of power in the tech industry in favour of China over the US.

China's increasing dominance in 5G technology lies at the heart of the trade spat with the US and underscores why China has a vested interest in protecting its intellectual property. Competition in key technologies will be a source of tension between the US and China over the years ahead, and is a risk for markets.

Equity markets

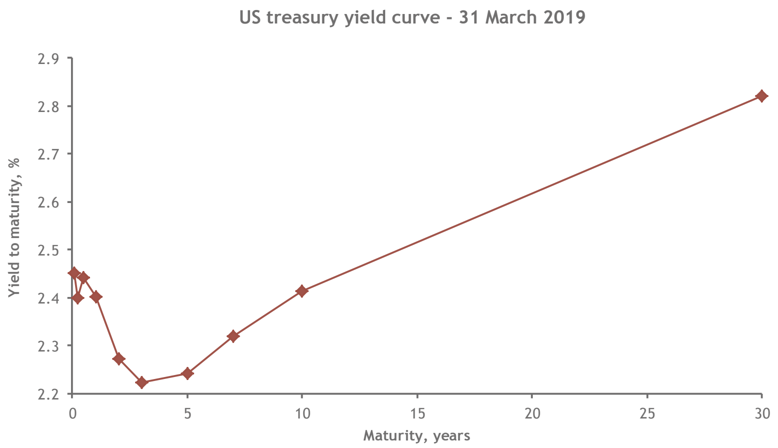
Over the last 10 years, the US has led the rest of the world in terms of performance, returning 16% on average every year, largely driven by 10% earnings per share (EPS) growth. Asia ex Japan has followed a similar pattern with earnings growth materially contributing to their performance. However, Europe ex UK has lagged global markets on 2% EPS growth, while the UK has struggled with only 7% annualised equity performance and 1% EPS growth, as uncertainty over Brexit has taken its toll.



MSCI ACWI = All Country World Index, Asia ex Japan = MSCI Asia ex Japan, Europe ex UK = MSCI Europe ex UK, EM = MSCI Emerging Markets
Source: Thomson Reuters Datastream/Smith & Williamson, data as at 28 March 2019

Fixed income

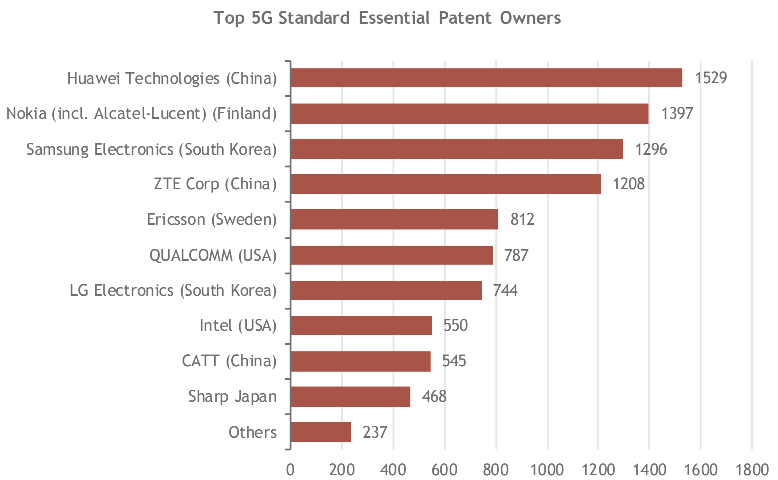
On the 22 March, the yield on a short-term 3-month US treasury bill rose above the yield on 10 year treasury bonds for the first time since the Global Financial Crisis. This occurrence has historically proven to be a good predictor of US recessions – it happened before each of the last seven. Markets reacted nervously to the development, but there are several reasons why the end of the equity bull market may not be imminent. Firstly, our own analysis indicates that the yield curve inverts on average 7 months before the US equity market peaks, and sometimes a lot longer (it was 21 months during the previous downturn in 2007-08). Secondly, the 10 to 30 year part of the curve remains upward sloping (it has been flatter before previous recessions) – a position which is consistent with long term economic growth.



Source: Thomson Reuters Datastream

FX and commodities

The US has good reason to fear that it is falling behind China in the race to set the global standard for 5G technology. According to the data-analytics firm IPlytics, Chinese companies, like Huawei, now own 36% of global 5G standard-essential patents versus 14% for US peers (i.e. Qualcomm and Intel). Should China set the global standard for 5G technology, this could in turn lead to a revenue stream derived from its patents, irrespective of whether some countries block out Huawei from their 5G rollouts. This tense relationship could influence the US dollar and the Chinese renminbi over the coming years.



Source: IPlyics, Smith & Williamson, data as at February 2019

Market highlights

Market returns (Total return (%), sterling)	1 month	3 months	1 year	5 year
Equities				
MSCI All-Country World	3.4	9.8	11.1	79.7
FTSE 100	3.3	9.5	7.7	34.1
FTSE 250	-0.1	9.8	1.0	34.5
S&P 500	4.1	11.1	17.9	114.7
MSCI Europe ex UK	2.7	8.2	3.1	41.2
MSCI Japan	2.8	4.4	-0.4	70.9
MSCI Pacific ex Japan	3.0	9.7	12.7	55.7
MSCI Emerging Markets	3.0	7.5	0.1	56.1
Bonds				
iBoxx GBP Gilts	3.4	3.5	3.9	32.1
iBoxx USD Treasuries	4.1	0.2	12.5	44.1
iBoxx GBP Corporate	2.5	4.8	4.1	32.8
Commodities and trade-weighted FX				
Oil Brent Crude ($/barrel)	3.8	29.0	-2.2	-36.1
Gold ($/ounce)	-1.5	1.1	-2.1	0.5
TW USD	0.3	-1.4	6.3	20.0
TW GBP	1.4	3.8	1.4	-6.0
TW EUR	-0.4	-1.6	-1.9	-2.2
TW YEN	-0.5	-0.1	0.6	3.1

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.

GDP – Gross Domestic Product

IMF – International Monetary Fund.

Key macro data	Latest	2019 Consensus forecast	Spot rates	31-Mar	Yields (%)	31-Mar
UK GDP (YoY%)	1.4	1.30	GBP/USD		FTSE 100	
UK CPI Inflation (YoY%)	1.9	2.00	GBP/Euro	1.16	FTSE 250	3.19
Bank of England Base	0.75	0.95	Euro/USD	1.12	10 Year Gilt	1.00

All values and charts as at 31 March 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.

For further information

Contact	Direct line	Email address	Contact	Direct line	Email address
Daniel Casali	020 7131 8985	daniel.casali@smithandwilliamson.com	Sam Pham	020 7131 8352	sam.pham@smithandwilliamson.com
David Goebel	020 7131 8908	david.goebel@smithandwilliamson.com	Sarah Giarrusso	020 7131 4218	sarah.giarrusso@smithandwilliamson.com

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