Smith & Williamson

Investment outlook

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

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Investment outlook

Political risks are likely to remain a drag on relative UK equity performance

Last month Prime Minister Theresa May agreed with European leaders for a second delay in the UK's date of departure from the EU to the 31 October 2019, but with an option to leave earlier if Parliament agrees a divorce deal. This so-called "flextension" is not necessarily a solution to resolving Brexit and comes with plenty of political risk. That's because the flextension means that the UK has to participate in European Parliamentary elections on the 23-26 May. Given recent opinion polls show that the Tories lag behind Labour, and are losing votes to Pro-Leave parties, such as UKIP and Nigel Farage's newly formed Brexit party, the government is set to perform poorly. Moreover, in order to look for a solution to overcome the Brexit impasse in Parliament, PM May has opened talks with the opposition Labour leader, Jeremy Corbyn, to get cross-party support for her Withdrawal Agreement, a move that has not gone down well with Tory backbenchers and the party's membership. Yet it is far from certain that the Tories and Labour can agree a way forward on Brexit.

Party rules show that Theresa May can't be forced out until a new Tory leadership ballot is triggered in December. However, should the Tories suffer disappointing results in the European elections, and the PM continues to work with Labour on securing a Brexit deal through Parliament, it would raise pressure on Theresa May to resign. Should that happen, a transition to a more Pro-Leave PM, like former Foreign Secretary, Boris Johnson, could split the Party. Alternatively, a new PM may gamble on seeking a fresh mandate from the electorate through a snap general election to break the Brexit deadlock. That would come with huge political risk, as current opinion polls show that Labour would likely be the largest party in Parliament after an election and could possibly form a government with the SNP.

To understand what a Corbyn-government would mean for markets, it is worth looking at the last (2017) Labour party manifesto and pledges from the party conference last year. Some market sensitive policies include Labour's intension to raise corporate income tax to 26% (from 19% currently) and increase income tax for high earners. Labour also wants to increase public sector borrowing, has flirted with the idea of central bank money printing to finance government investment, as well as nationalising water, energy, postal services and the railways. More recently, a leaked letter in the Sunday Times, from Shadow Chancellor, John McDonnell, to a senior Treasury official warned that he will present an emergency budget within 10 weeks of taking power. The letter calls for civil servants to be re-schooled in economic theories and for Treasury officials to consult members of the public and trade unions in "listening exercises" around the country. For investors, the uncertainty of such left-wing policies is likely to remain a drag on UK equity relative performance to its global peers. We continue to look overseas for more favourable risk-adjusted returns.

Reasons to be cheerful over US company earnings and equities

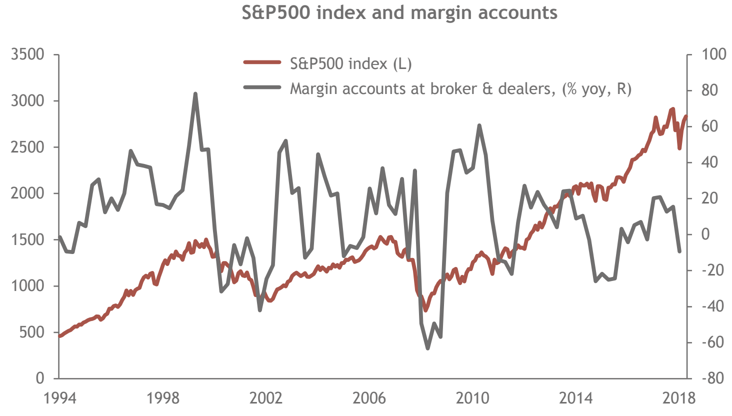
So far, US S&P companies have reported sluggish Earnings Per Share (EPS) growth of around 2% in the first quarter of 2019. Looking forward, the consensus expects EPS growth to accelerate to 9% by the fourth quarter of this year. If equities are to rally into the rest of 2019, then company earnings need to at least match market expectations. We believe the chance of companies meeting those expectations is fairly high.

First, there have been some transitory factors that negatively affected earnings in the first quarter that should dissipate as the year progresses. These include the Federal government shutdown (which is now over) and extreme cold weather. Second, the consensus estimate for 2020 earnings before tax, depreciation and amortization, an underlying measure of company profits, has accelerated to an annual rate of 8.7% from a low of 6.5% in the summer of 2018. Third, there are signs that the EPS downgrade cycle is ending. After falling sharply in the early part of 2019, the 1-month change in EPS forecasts, a more timely measure of annual EPS, is now nearly flat. And fourth, faster US economic growth provides upside to EPS growth. For instance, first quarter US annual real GDP growth came in at 3.2%, a full percentage point higher than consensus expectations.

Aside from the expected recovery in US EPS growth, the Fed also continues to give a dovish message to the market. The Fed has formally announced the intention to end balance sheet normalisation (quantitative tightening or QT) at the end of the third quarter 2019. Given that the US inflation outlook is benign, the Fed is unlikely to raise short-term interest rates this year. That has led to a decline in US government bond yields and mortgage rates. In turn this has given a boost to the important real estate sector to support overall growth and company earnings. On balance, this market and economic backdrop should enable stocks to rally further.

Equity markets

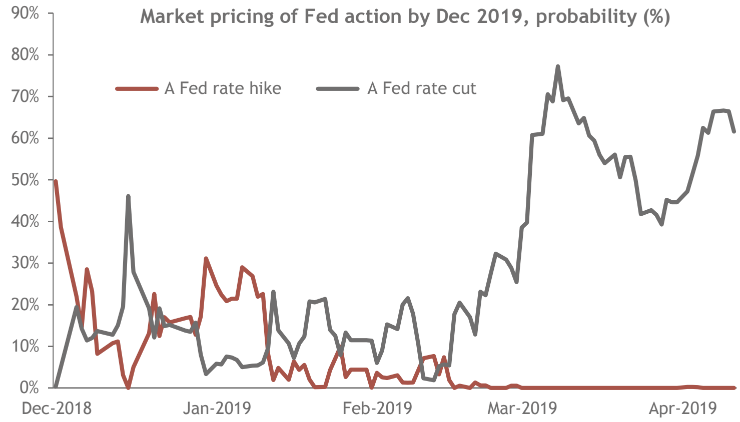
Rising use of debt in equity trading (margin accounts) has usually been a reliable sign of investor over-exuberance, and subsequently this has led to large market corrections. As the chart shows, this indeed was the case leading up to the "dot.com" and housing bubbles of the late 1990s and mid-2000s respectively. Interestingly, the strong market performance since 2014 has not coincided with rising margin account trading, which suggests that fundamentals (company earnings) have been the main driving force. As investor sentiment is not excessive, this most "unloved" equity bull market could have further room to go.



Source: Datastream, as at 30 April 2019

Fixed income

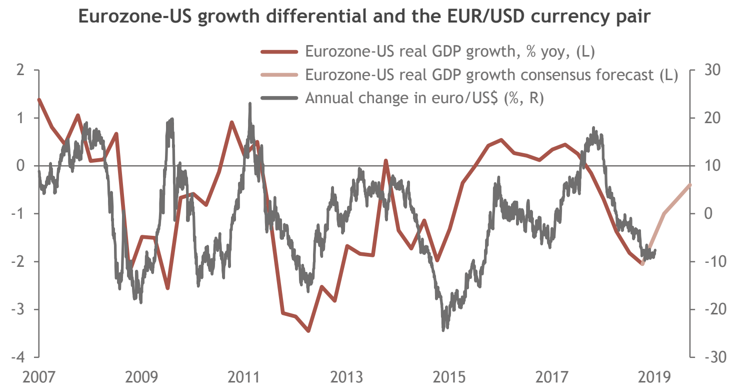
The changing monetary policy stance by the Fed has been swift, and so have market expectations of what the Fed will do by December 2019. The right-hand side chart shows that the probability of a Fed rate hike by the end of this year has gone from 50% to zero over the last 3 months, whilst the probability of a Fed rate cut has gone up from 0 to 70% over the same period. Expectations for low interest rates for longer have been a tailwind for markets.



Source: Bloomberg, as at 30 April 2019

FX and commodities

As the chart shows, Eurozone-US GDP growth differential has a good correlation with the annual change in the EUR/USD currency pair. Eurozone real GDP underperformed in the US for most of 2018 and especially in the fourth quarter, which dragged the Euro lower. However, recent incoming data suggests a Eurozone rebound is on the cards, with economists expecting the growth gap to start closing over the next few quarters. For example, Eurozone first quarter real GDP grew 1.2% year-on-year, better than consensus expectations of 1.1%. Looking ahead, the EUR is likely to have bottomed against the USD.



Source: Datastream & Bloomberg, as at 30 April 2019

Market highlights

Market returns (Total return (%), sterling)	1 month	3 months	1 year	5 year
Equities				
MSCI All-Country World	3.4	8.6	11.6	86.3
FTSE 100	2.3	8.1	3.2	33.1
FTSE 250	4.2	6.8	0.5	43.6
S&P 500	4.0	10.5	19.9	124.5
MSCI Europe ex UK	4.2	9.4	3.2	46.5
MSCI Japan	1.3	3.0	-1.6	80.1
MSCI Pacific ex Japan	1.7	7.5	9.1	56.7
MSCI Emerging Markets	2.1	4.2	0.7	60.8
Bonds				
iBoxx GBP Gilts	-1.6	0.7	3.3	29.0
iBoxx USD Treasuries	-0.7	2.0	10.6	43.9
iBoxx GBP Corporate	0.1	2.8	4.1	31.2
Commodities and trade-weighted FX				
Oil Brent Crude ($/barrel)	6.4	17.1	-2.8	-32.4
Gold ($/ounce)	-1.0	-3.0	-2.3	-0.8
GBP/USD	0.0	-0.9	-5.4	-22.8
GBP/EUR	0.2	1.5	2.0	-4.5
EUR/USD	-0.2	-2.3	-7.2	-19.2
USD/JPY	0.6	2.3	1.8	9.0

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.

EPS – Earnings per share.

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.

S&P500 – An American equity market index that consists of the largest publically traded stocks.

Key macro data	Latest	2019 Consensus forecast	Spot rates	30-Apr	Yields (%)	30-Apr
UK GDP (YoY%)	1.4	1.20	GBP/USD	1.29	FTSE 100	4.36
UK CPI Inflation (YoY%)	1.9	2.00	GBP/EUR	1.16	FTSE 250	3.15
Bank of England Base	0.75	0.90	EUR/USD	1.12	10 Year Gilt	1.18

All values and charts as at 30 April 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

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