Smith & Williamson

# Investment outlook

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

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# Investment outlook

## Asset performance when the Fed loosens

Markets have recovered from the May equity sell-off following uncertainty caused by the US-China trade tariff spat. Fairly resilient company earnings, a point we highlighted in our May Investment Outlook, rising expectations that the US and China will resolve their trade dispute and an increased probability that the Federal Reserve loosens monetary policy has helped to lift stock markets. The Fed Futures market has priced-in three US interest rate cuts over the next year, up from one cut at the start of May, with the first loosening expected at the July Federal Open Market Committee (FOMC).

To determine whether Fed policy loosening is positive or negative for equities, we looked at data going back to the mid-1980s. We found that there were six distinctive Fed loosening cycles that could be classified as a “pause” or a “panic”. The four Fed pauses, where the central bank cut interest rates modestly (October 1987, July 1995 and September 1998) or guided on being patient in raising rates (February 2016) were in response to a slight softening in the macro data. Our analysis shows that US equities rallied on average 23% over the course of a year from the start of a Fed pause.

The two Fed panics, which led to the FOMC cutting interest rates aggressively, occurred from January 2001 (following the dotcom overvaluation stock market bubble) and from September 2007 (during the global financial crisis, when the global financial system was leveraged to the US housing market). Crucially, when the Fed began to loosen during a panic, the central bank was viewed by the market to be reactive to unfolding events, rather than proactive, and this led to a loss of investor confidence that led to a recession. From our calculations, we found that US equities fell on average by 16% over the course of a year at the start of a Fed panic.

Though there have been some weak US data points of late (e.g. non-farm payrolls and the manufacturing ISM survey), the underlying economy continues to be underpinned by healthy take-home pay and fairly buoyant corporate profit growth. It is our assessment that the Fed is set to cut rates in response to slightly weaker macro data (largely self-inflicted by President Trump’s trade protectionism agenda), rather than in reaction to an anticipated deeper economic downturn. As such, we still remain constructive on US (and global) stocks, but risks have risen lately.

### Rising chance of a no deal Brexit

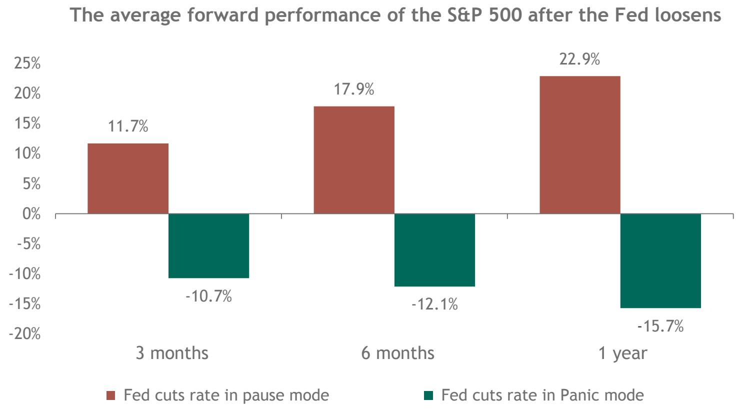
Over the past few months there has been a series of political events that together raise the chance of the UK leaving the EU without a deal. First, is the success of the Brexit party, and the rejuvenation in the Liberal Democrats (Lib Dems), which has lured disgruntled leave and remain voters away from the Conservatives (Tories) and Labour. By failing to deliver on Brexit, the Tories managed to win just 9% of the vote in the May European parliamentary election, its lowest share for a national election since the party was formed in 1834, while the Brexit party came first with a 31% share of the vote. Labour did win the Peterborough by-election with 31% of the vote, ahead of 29% for the Brexit party, but it came after a sizeable 17% swing against its last election result. Both the major parties fear that they will continue to lose voters, whether they are leavers or remainers, unless they resolve Brexit one way or another.

Assuming Tory party members elect Boris Johnson, an ardent leaver, in July as the next leader and Prime Minister, there is a risk that the government will take a more determined approach to the UK exiting the EU with or without a deal. Boris Johnson’s threat that the UK will withhold the £39bn divorce payment may make the EU less willing to agree a Brexit extension. Moreover, there is a tight timetable for the UK and EU to reach an agreement, as the next EU Council meeting is on 17-18 October, which gives very little time to negotiate before the 31 October deadline for Brexit. And logistically, the new European Commission will not be sworn in until 1 November, making negotiations problematic to organise.

Irrespective of whether or not a no deal Brexit materialises in the autumn, political uncertainty is weighing down on the UK economy. In April, real GDP grew 1.3% from a year ago, its lowest rate this year. Economic growth was led lower by the biggest decline in manufacturing production for almost 17 years, as auto producers’ scaled back production after an earlier boom in stockpiled goods before the original Brexit deadline at the end of March that has since been extended into the autumn. Nevertheless, the economy has not slipped into recession, since the service sector continues to grow and is supported by a strong labour market and rising wages. Even so, given the risk of a no deal Brexit, downside risks to sterling-related assets make the UK a less attractive investment destination on a risk-to-reward basis than opportunities overseas.

### Equities:

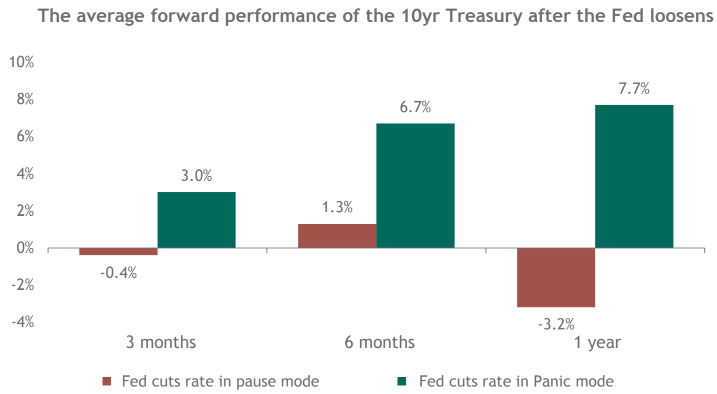
This chart shows the average performance of the S&P 500 following a loosening of monetary policy by the Fed. Our analysis shows that the S&P 500 tends to rally after the Fed cuts interest rates in a pause move in order to extend the economic cycle. In particular, it has risen on average by 22.9% in the 12 months following the first rate cut. On the other hand, the equity market tends to decline after the Fed cuts rates in a panic move, which usually occurs when the economy is already in a recessionary environment.




*Source: Bloomberg, data as at 30/06/2019*

### Fixed income:

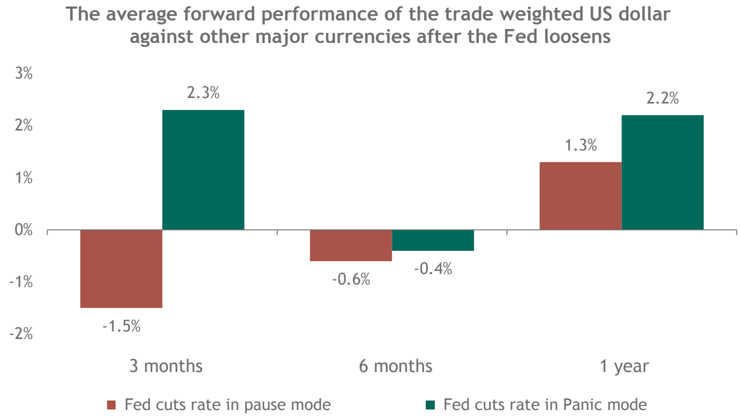
Similar to the analysis above, the chart opposite shows the performance of the 10-year US Treasury after the Fed loosens monetary policy. In contrast to equities, 10-year government bonds tend to do well in a "panic", largely due to the safety nature of this asset class, and less so in a "pause".




*Source: Bloomberg, data as at 30/06/2019*

### Forex:

Interestingly, the performance of the trade-weighted US dollar against other major currencies has been rather mixed. This is because economic conditions and other central bank actions in the rest of the world also matter. As a recent example, the Fed has signalled its willingness to change monetary policy stance over the last few months, but a decline in the US dollar has failed to take hold. This is probably due to weakness in other currencies, such as the euro, over political concerns.




*Source: Bloomberg, data as at 30/06/2019*

# Market highlights

| Market returns (Total return (%), sterling) | 1 month | 3 months | 1 year | 5 year |
|---|---|---|---|---|
| **Equities** | | | | |
| MSCI All-Country World | 5.6 | 6.3 | 10.3 | 86.1 |
| FTSE 100 | 4.0 | 3.3 | 1.6 | 34.3 |
| FTSE 250 | 2.9 | 2.9 | -3.8 | 41.9 |
| S&P 500 | 6.0 | 6.8 | 14.5 | 123.5 |
| MSCI Europe ex UK | 6.4 | 9.0 | 8.2 | 53.9 |
| MSCI Japan | 2.8 | 3.5 | -0.2 | 70.0 |
| MSCI Pacific ex Japan | 5.3 | 7.7 | 12.2 | 64.8 |
| MSCI Emerging Markets | 5.3 | 3.1 | 5.4 | 54.7 |
| **Bonds** | | | | |
| iBoxx GBP Gilts | 0.2 | 1.4 | 5.2 | 32.5 |
| iBoxx USD Treasuries | 0.4 | 5.5 | 11.6 | 53.5 |
| iBoxx GBP Corporate | 1.6 | 2.3 | 6.8 | 32.8 |
| **Commodities and trade-weighted FX** | | | | |
| Oil Brent Crude ($/barrel) | 3.0 | -2.5 | -15.8 | -40.7 |
| Gold ($/ounce) | 8.6 | 9.0 | 12.9 | 7.2 |
| GBP/USD | 1.0 | -2.3 | -3.6 | -25.6 |
| GBP/EUR | -1.2 | -3.7 | -1.2 | -10.5 |
| EUR/USD | 2.2 | 1.4 | -2.5 | -16.8 |
| USD/JPY | -0.8 | -2.7 | -2.7 | 6.4 |

## 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.

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

**Monetary policy** – Actions of a central bank or other agencies that determine the size and rate of growth of the money supply which will affect interest rates.

| Key macro data | Latest | 2019 Consensus forecast | Spot rates | 30-Jun | Yields (%) | 30-Jun |
|---|---|---|---|---|---|---|
| UK GDP (YoY%) | 1.8 | 1.30 | GBP/USD | 1.27 | FTSE 100 | 4.34 |
| UK CPI Inflation (YoY%) | 2.0 | 1.90 | GBP/EUR | 1.12 | FTSE 250 | 3.17 |
| Bank of England Base | 0.75 | 0.80 | EUR/USD | 1.14 | 10 Year Gilt | 0.84 |

All values and charts as at 30 June 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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