Investment outlook

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

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Investment outlook

The longest US economic expansion in history

Apart from Independence Day and the 50th anniversary of the moon landing, the US had another good reason to celebrate in July. The month also marked the 11th year of economic expansion and set a new record for the longest business cycle from data going back to 1854. Given the length of the current expansion, there are doubts that it can continue. However, it is worth noting that the expansion has been quite tepid; the current average annualised real GDP growth of 2.3% since 2009 is the lowest rate out of all the post-second world war recoveries. For investors, the slower pace of expansion should be seen as a positive, since it probably means that there is less likelihood of accumulated economic imbalances (e.g. rapid credit growth) to undermine the business cycle, a point we highlighted in our April Investment Outlook. Moreover, a paper released by the Federal Reserve Bank of Cleveland* in February makes the point that there is no evidence that long expansions are necessarily followed by deeper recessions.

The bottom line is that so long as the US economy is growing, corporate sales can continue to increase to provide fundamental earnings support for US (and global) equities – see the chart on the top of the next page. On top of company earnings, shareholder returns have also been boosted by nearly $5trn in equity buy-backs since the bull market started in March 2009. US equity valuations look justifiable provided global growth continues to expand, as we expect.

Bond markets are a risk for equities

Global government bonds yields continue to fall, with US, UK and German 10-year yields trading at or near record lows (see market highlights on the next page). Fixed interest rates have been dragged down by a slowdown in the global economy, which has prompted dovish messages from the US, UK and European central banks. In addition, the nomination of Christine Lagarde as the next president of the ECB also helped to lower yields. As a continuity candidate, Ms. Lagarde has strongly backed ECB President Draghi's "whatever it takes" pledge in 2012 to use unconventional monetary policy (i.e. quantitative easing) to support the euro and has recently called on central banks to adjust policies in response to concerns about global growth. We see three key risks from bonds that could spill over to equities.

First, it would be a US inflationary surprise that forces the Fed to become more hawkish on interest rates. Bond markets would likely correct and this could undermine the rally seen in equities, which have been driven this year by an expansion in valuations despite weaker earnings. For the moment, we see that risk as contained. Market inflation expectations, as derived by inflation linked securities, continue to trend down.

Second, in search of higher returns, investors have been willing to take on more risk. For instance, even though Italy has a huge public debt pile and the current Eurosceptic administration has a fractious relationship with Brussels, the Italian government was still able to issue a 50-year bond that was six times oversubscribed at a yield of 2.9%, almost a full percentage point down on late 2018. Should the Italian political relationship with the EU deteriorate, it could lead to a contagion sell-off in riskier forms of debt, including junk bonds.

And third, considering that the prices of fixed income and equities have been tightly correlated, so that both asset classes have risen this year, a sharp unwinding of extremely overbought bond positions could have a detrimental impact on equities.

As long as global growth stabilises, as we expect, this will provide a favourable backdrop for company earnings and some protection for risks in the bond market. On balance, we still remain constructive on equities over bonds as an asset class.

Rising probability of a snap UK general election

When parliament comes back from recess in early September, Boris Johnson, the new Prime Minister, will have an incentive to show a determination to leave the EU, even if it means doing so under a no deal Brexit. First, in a scenario where Brexit has been delivered, a YouGov opinion poll showed that the Tories could win a majority in the House if a snap election is called. And second, Jeremy's Corbyn's recent email to party members implies that Labour is now a second referendum and remain party, a move that could draw votes away from the EU friendly Liberal Democrats in a first past the post voting system and improve the chances of the Tories to get re-elected. The threat of a no deal Brexit could mean that the government faces a confidence vote in the autumn, with some ardent remainer Tories actually voting against the government. Considering that the government has a small working majority in the House of Commons, the probability of a snap election is high, and this risk is likely to weigh down on sterling and sterling-denominated financial assets.

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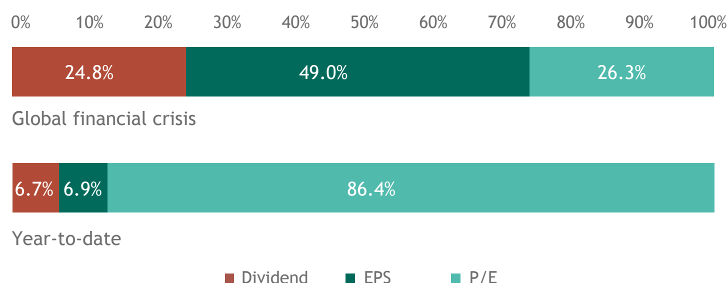
*https://www.clevelandfed.org/en/newsroom-and-events/publications/economic-commentary/2019-economic-commentaries/ec-201902-do-longer-expansions-lead-to-more-severe-recessions.aspx

Equities:

Strong fundamentals have underpinned the rally in equity markets since 2009, during the longest expansion in history for the US economy. Earnings and dividends were together responsible for nearly three quarters of the 363% total return of the S&P 500. Since the beginning of the year, equity returns have been largely comprised of increasing valuations, driven by expectations of softer monetary policy from the Federal Reserve.

S&P500, decomposition of cumulative total return since global financial crisis (Q1 2009) and year-to-date



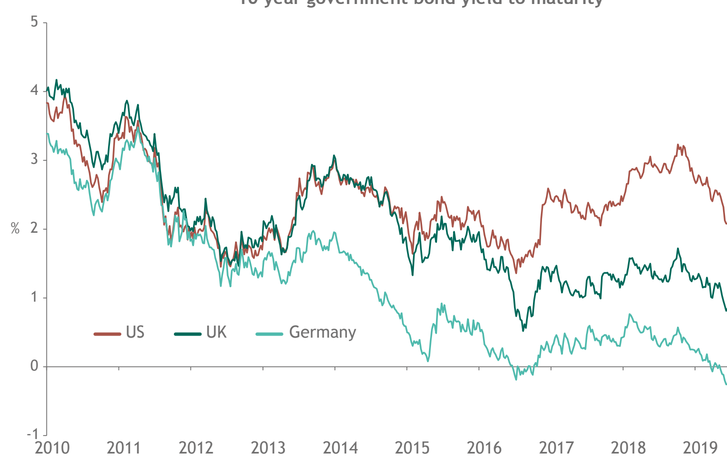
Source: Bloomberg/Smith & Williamson, Data as at 31/07/2019

Fixed income:

The long market cycle has been supported by expansionary monetary policy all over the world, as can be seen from falling government bond yields in the US, the UK and Germany. Of the three, the Federal Reserve is the only central bank to have significantly tightened monetary policy over the period. It initially raised rates in December 2015 and continued to do so until December 2018. At the Federal Reserve's latest meeting at the end of July, it decided to cut interest rates by 0.25%, the first time it has done so since the global financial crisis.

Whether this cut is 'one and done' or the start of a longer monetary easing remains to be seen, but for now at least, most major central banks have a bias toward easing and global government bond yields continue their downward trajectory.

10 year government bond yield to maturity



Source: Bloomberg/Smith & Williamson, Data as at 31/07/2019

FX:

The beginning of Boris Johnson's premiership in the UK has been marked by a decline in the value of sterling. Since gaining office, the new PM's stance on leaving the EU on the 31 October has seemingly not softened from the 'do or die, come what may' mantra he adopted during his leadership campaign. The GBP/USD exchange rate has fallen to levels it reached in late 2016, following the referendum result, as investors price in the higher chance of a 'no-deal' exit from the block.

USD to GBP Exchange Rate

Source: Datastream/Smith & Williamson, Data as at 31/07/2019

Market highlights

Market returns (Total return (%), sterling)	1 month	3 months	1 year	5 year
Equities				
MSCI All-Country World	4.3	7.2	10.9	93.9
FTSE 100	2.2	3.2	2.3	37.5
FTSE 250	1.3	0.0	-3.0	45.6
S&P 500	5.4	8.3	15.7	135.9
MSCI Europe ex UK	1.9	6.5	5.0	62.9
MSCI Japan	4.1	6.3	2.8	73.7
MSCI Pacific ex Japan	3.2	9.3	12.9	61.9
MSCI Emerging Markets	2.8	3.8	5.2	53.9
Bonds				
iBoxx GBP Gilts	2.2	5.3	7.9	33.9
iBoxx USD Treasuries	3.8	10.3	15.8	57.6
iBoxx GBP Corporate	2.3	4.5	8.9	35.1
Commodities and trade-weighted FX				
Oil Brent Crude ($/barrel)	-3.2	-11.2	-13.1	-38.2
Gold ($/ounce)	1.1	11.3	16.8	11.0
GBP/USD	-3.8	-6.1	-6.7	-27.5
GBP/EUR	-1.6	-5.5	-1.9	-12.8
EUR/USD	-2.2	-0.7	-4.8	-16.8
USD/JPY	0.8	-2.5	-3.0	5.6

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.

ECB – The European Central Bank (ECB) is the central bank responsible for monetary policy of those European Union (EU) member countries which have adopted the euro currency.

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	31-Jul	Yields (%)	31-Jul
UK GDP (YoY%)	1.8	1.30	GBP/USD	1.22	FTSE 100	4.25
UK CPI Inflation (YoY%)	2.0	1.90	GBP/EUR	1.10	FTSE 250	3.15
Bank of England Base	0.75	0.75	EUR/USD	1.11	10 Year Gilt	0.61

All values and charts as at 31 July 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.

Sources

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