Smith & Williamson

Investment outlook

A monthly round-up of global markets and trends
February 2020

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Investment outlook

Geopolitical risks from the Middle East

The new decade started with rising geopolitical risks emanating from the Middle East. This followed a US strike that killed Major General Qassim Soleimani, the commander of the Iranian Revolutionary Guard Corps, at Baghdad airport. The Iranians retaliated with missile strikes at US airbases in Iraq, but there were no reported casualties in what seems to have been a calibrated response by Tehran to appease some anti-US support at home. Fortunately, heightened US-Iranian geopolitical tensions have not been accompanied by a dramatic rise in the crude oil price which could raise production costs and depress global economic growth. That's largely because there was no knee-jerk reaction by the Iranians to attack oil infrastructure, tankers or energy fields within the region, but such a course of action remains a possibility and a potential key risk for markets. Nevertheless, global equity markets largely ignored Middle Eastern geopolitical risks. Investors recognise that the threat to the global economy from higher crude oil prices has diminished over time, as technological adoption improve energy efficiency. Though towards the end of the month, volatility returned to equity markets on concerns that the novel coronavirus would spread from and within China to affect manufacturing supply chains and hinder economic growth.

More generally, the overriding influence on markets has been widespread central bank loosening of monetary policy through interest rate cuts and Quantitative Easing (QE, or asset purchases). In the last decade, G4 central banks (the Fed, ECB, BoJ and BOE) have seen their combined total assets rise by $10.4trn*, providing significant liquidity support for financial systems and markets to absorb geopolitical issues and major events like the coronavirus. Since September, Fed total assets have increased by nearly $400bn*, the biggest expansion of its balance sheet since the last round of QE in 2012. This was a major driver of equity markets in 2019 and the fourth quarter of last year. Though central banks are signalling that there are limits to what can be achieved by monetary policy and are calling for greater fiscal support for growth.

Cyclical upside in bond yields are capped by structural factors

In its latest economic projections (January 2020), the IMF forecasts that global real GDP will expand by 3.3% in 2020 and 3.4% in 2021, up from 2.9% in 2019. The recovery is likely to put upward pressure on bond yields, at least in the short term. However, any upside in fixed income yields is likely to be capped by the "3D" structural factors of disruption by tech, demographics and debt. We look at each factor in turn.

Disruption by tech: Back in our October 2017 Investment Outlook, we highlighted how advances in telephone technology increased the size of the labour pool to keep down wage rates, an historical driver of inflation. Other technological innovations like big data, artificial intelligence and mobility have also suppressed inflation. For instance, Amazon lowers consumer prices by using its sizeable logistics network and the internet to undercut bricks and mortar retailers. Elsewhere, Google and Uber lower company pricing power by reducing search costs and bringing existing assets into the marketplace, respectively.

Demographics: Global population growth is slowing and that will continue to exert downward pressure on domestic demand and inflation over the long term. For instance, the US population grew by 0.5% in 2019, the lowest increase since the Spanish flu influenza pandemic and tail-end of World War 1 in 1918. Across the Pond, the Europe's population is set to decline from 2021. While over in Asia, the United Nations forecasts (June 2019) that China's population will peak by the end of the decade. Japan is already facing a severe demographic headwind, with its population down by a record 512,000 people in 2019 and is forecast by the government to fall by 16m (or 13% of its population) in 25 years' time. Even after years of fiscal spending and monetary easing, it is no coincidence that Japan has struggled to lift inflation against demographic headwinds.

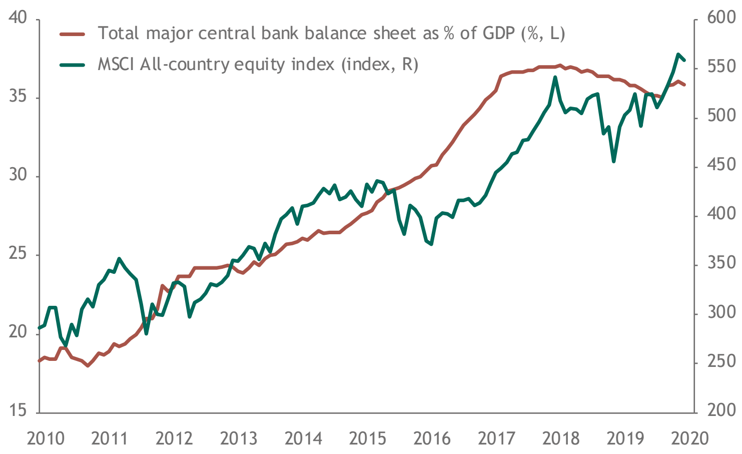
Debt: According to the International Institute of Finance (January 2020), global debt (public and private) rose $70trn to $255trn between 2010-19, as corporates issued bonds to buy back equity and governments increasingly utilised fiscal spending at low interest rates to support growth. Perversely, rising debts have correlated well with lower government bond yields in the past. That's because a leverage overhang is seen as an impediment to economic expansion, since it "borrows" from future growth. In addition, the household sector is crowded out by the public sector and this encourages a higher savings rate and less private spending to keep down inflation and bond yields.

Central banks have made it clear that they would welcome and are prepared to accept higher levels of inflation. However, as discussed, the deflationary forces of the "3Ds" offer a powerful counter-weight. In the meantime, the recent bold action by central banks have again extended the economic cycle. So we continue to like equities over bonds, as risk-adjusted returns look favourable. In terms of individual markets, we prefer non-US equities, where growth in the Rest of the World is catching up with the States and valuations are less demanding.

*Source: Bloomberg

Equities

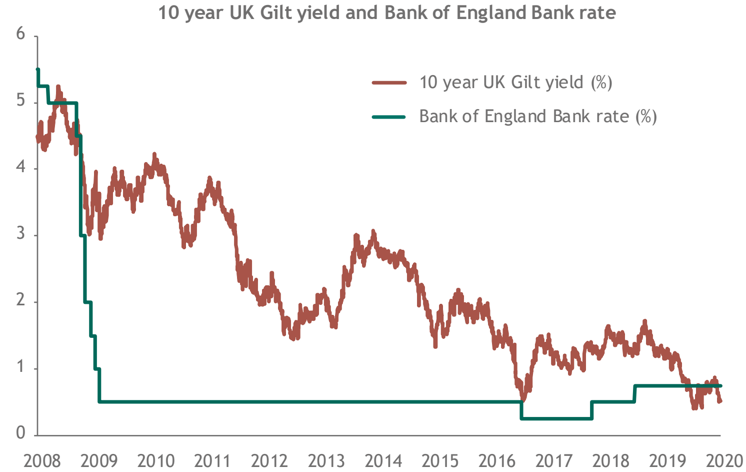
Monetary policy support by major central banks, in the form of interest rate cuts and asset purchases, prompted a rally in the MSCI world equity market in 2019. The chart on the right-hand side indeed shows a tight relationship between the two. Over the last few months, total central bank balance sheet has risen from 35% to 36% of GDP. The US Fed was the key driver, as it bought up US Treasury bills and provided money to the domestic banking system to help contain short-term interest rates.



Source: Bloomberg
Data as at 31/01/2020

Fixed income

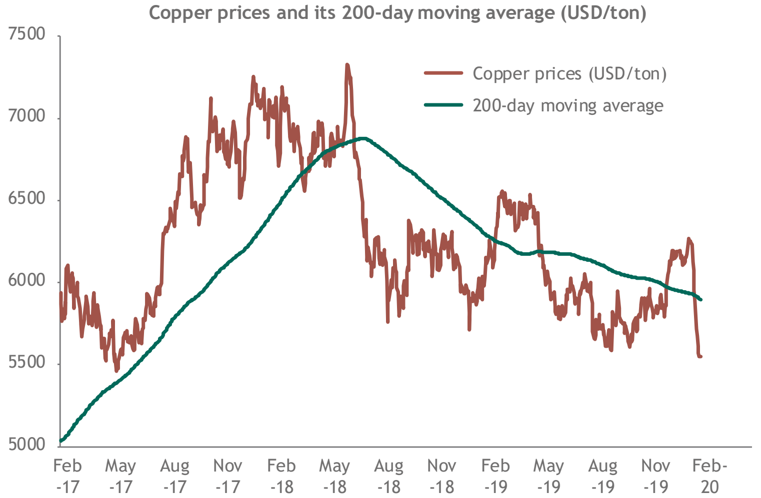
Despite weakening economic activity, and intense speculation of a rate cut, the Bank of England left the Bank rate unchanged at 0.75% (right-hand side chart) at its January monetary policy meeting (this meeting was also Governor Carney's last). The prospect for the UK economy is positive, in our view. Sentiment indicators have rebounded sharply since the general election in December. One such survey is the quarterly Deloitte CFO financial optimism survey, which recently saw its biggest increase in its 11-year history.



Source: Bloomberg
Data as at 31/01/2020

FX and commodities

Copper prices (also known as Dr. Copper) are considered by many financial analysts to be the bell-weather of global trade and more specifically demand from China. One can thus trace the sentiment in the market around the novel coronavirus by following this metal. As the virus spreads and raises concerns over economic activity, Dr. Copper have fallen for twelve consecutive days at the time of writing (31st January 2020). It has also fallen below its 200-day moving average for the first time since 6th December 2019 (see chart on right-hand side).



Source: Bloomberg/Smith & Williamson Investment Management LLP
Data as at 31/01/2020

Market highlights

Market returns (Total return (%), sterling)	1 month	3 months	1 year	5 year
Equities				
MSCI All-Country World	-0.6	3.1	16.4	76.1
FTSE 100	-3.4	1.1	9.4	32.3
FTSE 250	-3.3	6.2	16.4	48.9
S&P 500	0.5	4.8	21.4	104.1
MSCI Europe ex UK	-1.6	0.9	15.6	53.5
MSCI Japan	-0.9	-0.6	11.4	61.9
MSCI Pacific ex Japan	-1.2	-0.8	8.5	48.7
MSCI Emerging Markets	-4.2	0.5	4.0	44.5
Bonds				
iBoxx GBP Gilts	3.9	1.4	10.0	20.8
iBoxx USD Treasuries	3.2	-0.4	8.6	27.9
iBoxx GBP Corporate	2.8	2.8	11.9	25.6
Commodities and trade-weighted FX				
Oil Brent Crude ($/barrel)	-12.2	-3.3	-6.5	21.2
Gold ($/ounce)	4.4	5.1	20.0	24.6
GBP/USD	-0.5	1.9	0.2	-12.2
GBP/EUR	0.8	2.6	3.8	-10.6
EUR/USD	-1.3	-0.7	-3.4	-1.8
USD/JPY	-0.3	0.3	-0.4	-7.7

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.

GDP – Gross Domestic Product.

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	2020 Consensus forecast	Spot rates	31-Jan	Yields (%)	31-Jan
UK GDP (YoY%)	1.1	1.10	GBP/USD	1.32	FTSE 100	4.51
UK CPI Inflation (YoY%)	1.3	1.70	GBP/EUR	1.19	FTSE 250	3.12
Bank of England Base	0.75	0.70	EUR/USD	1.11	10 Year Gilt	0.52

All values and charts as at 31 January 2020. 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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Our offices: London, Belfast, Birmingham, Bristol, Cheltenham, Dublin (City and Sandyford), Glasgow, Guildford, Jersey, Salisbury and Southampton.