Investment outlook

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

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Investment outlook

Post-Brexit transition period extension talks with the EU are a short-term risk for sterling

Unsurprisingly, following the COVID-19 induced lockdown, the latest UK macroeconomic data has slumped. April underlying retail sales volumes (excluding fuel) registered a record decline of 18% from a year ago[1], while consumer confidence has fallen to levels last seen in 2012. The Independent Office of Budget Responsibility forecasts a near 13% real GDP decline for 2020[2]. If correct it will be biggest decline since the Great Frost of 1709, which was the coldest winter in Europe for more than 500 years.

The slump in UK (and EU) output caused by COVID-19 has overshadowed the upcoming 30 June deadline: the last straightforward opportunity to extend the post-Brexit transition period for the UK leaving the EU beyond the end of 2020 by 1 or 2 years. Given that valuable negotiation time has been lost by COVID-19 and the wide gap in the two negotiating positions, politicians do have a valid reason to extend the transition period. However, the UK government's view is that without a cliff edge the necessary compromises won't be made, so more time would not make any difference. With so much to do and the personalities involved, there is plenty of risk that the UK and the EU fail to reach an agreement in the time available. For example, fisheries policy appears to be a sticking point in current negotiations. Ultimately, the EU could well back down: there is no way to force the UK to allow European fishermen to have the same access to British waters. There may be a move in this direction. The press reported that Michel Barnier, the EU's chief negotiator, has conceded on the need to shift from the "maximalist" mandate on fisheries demanded by France, Spain, Belgium and the Netherlands.

If an agreement is not reached by the end of June, an extension can still be agreed by end-December before the current transition period runs out. However, once the June deadline passes, the legal and political obstacles to agreeing one further down the road are significantly higher. That's because it would be likely require another treaty change and therefore unanimous agreement by the other 27 member states. Post-June, any single member state could block an extension, as against the current arrangement where only agreement by the UK-EU Joint Committee (the body to oversee and monitor the Withdrawal Agreement) is required. Although decisions made by the UK-EU Joint Committee must be approved by the Governing Council (the heads of state), it is nevertheless hard for a hold-out nation to block the "consensus" of Council members. For example, France failed in its bid to take a hard-line stance on Article 50 extension in April 2019.

Sterling could be vulnerable over the coming months amid big trade and budget deficits, zero interest rates and around 30% of government debt held overseas[3]. The lack of clarity on the UK's future relationship with the EU could be a potential catalyst. Nevertheless, over the longer-term, the strong build-up of US money supply should be a negative for the USD leg of the 'cable' currency pair of the dollar against sterling. Assuming the world recovers, more of this money will pour out of the US through a widening fiscal and current account deficit. This would then increase the supply of USD in the global financial system and could well lead to a new downward leg in the greenback and a rally in GBP.

Brewing inflation risk beyond the near term

A sudden rise in inflation is a key risk for any unprepared portfolio. Currency devaluation, more local supply lines, tariffs and trade-war could all increase costs. Potentially, higher inflation could mean central banks are forced to tighten monetary policy in order to abide by their mandates. In the near term (1 to 2 year) the outlook across the post-COVID-19 globe is disinflationary which is reflected in very low government bond yields. One way to observe this is through US real GDP growth and its lead on underlying inflation. With the consensus forecasting large GDP declines, US core (ex food/energy) consumer price inflation is expected to drop from its current position of around 2% to near zero in 2021[4].

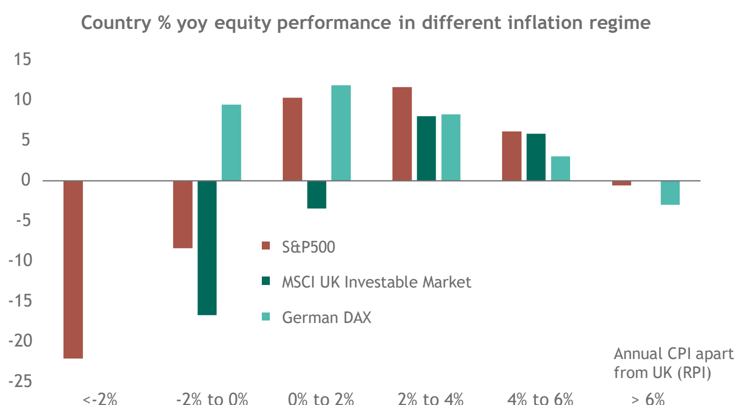
However, equity investors should not despair. From data going back to 1965, a 0-2% inflation range for each country has seen annual US S&P 500 and German DAX returns of 10.3% and 11.9% respectively[4]. For the moment, global equities are in a sweet spot of current low inflation enabling policymakers to step-up monetary and fiscal stimulus to lift markets higher. The MSCI All Country World index has already retraced more than half of its losses since the market peaked in mid-February[4].

Nevertheless, the risk of higher consumer price inflation over the medium-term (3-5 years), primarily due to policy responses to COVID-19, has increased and is a potential risk for portfolios. Essentially, more money is being directed to Main Street (consumers) over Wall Street (banks), the opposite of what happened during the Global Financial Crisis (GFC) in 2008 when funding was used to repair balance sheets of the financials. Looking forward, when consumer confidence recovers and unemployment rates decline following the lifting of lockdowns, pent-up demand could lead to higher inflation in the years ahead. To hedge against this risk, we favour inflation protected government bonds (particularly US Treasury Inflation-Protected Securities) and gold.

[1] Bloomberg, April 2020
[2] www.obr.uk, May 2020
[3] Refinitiv, as at end of May 2020
[4] Refinitiv, S&W Investment Strategy calculation, as at end of May 2020

Equities

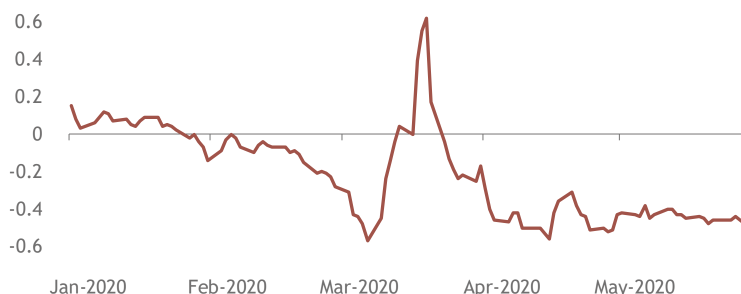
The immediate effect of the pandemic has been to reduce both the demand and supply sides of the economy. Without intervention this could have been quite deflationary, but we have seen governments around the world unveil unprecedented levels of stimulus, in terms of both monetary and fiscal policy in an effort to calm these forces. The net effect is that yields on government bonds have fallen, but not precipitously. This leads us to believe that in the short-term inflation will remain modest, similarly to the general environment we have seen since the GFC. Looking at historical performance, we see that equities, tend to perform well in times of relatively benign inflation.



Source: Refinitiv Datastream/Smith & Williamson Investment Management LLP, data as at 1 June 2020

Fixed income

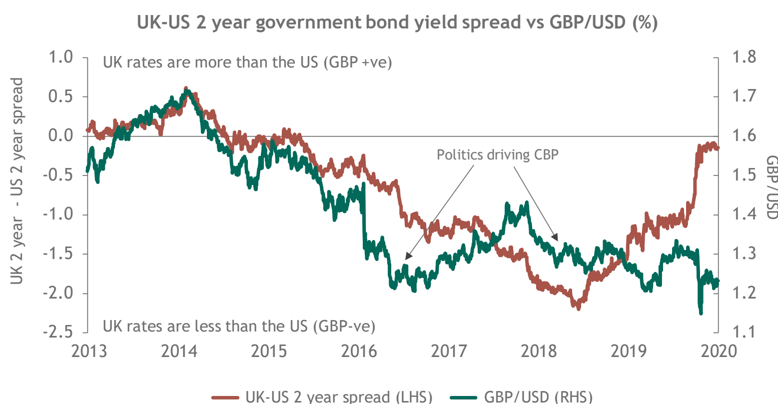
Certain government bonds like index-linked gilts in the UK and Treasury Inflation Protected Securities (TIPS) in the US provide fixed income like returns while protecting investors from the effects of inflation by linking coupon and principle repayments with a measure of national inflation. We prefer TIPS to their UK counterparts because they offer much better value: the TIPS market is offering a real (post inflation) yield of around -0.5% over the next 10 years, which compares with less than -2% for index linked gilts. With interest rates at (near) zero on both sides of the Atlantic, it is also inexpensive to hedge the currency exposure currently. TIPS offer attractive characteristics to hedge portfolios which have equity exposure allied with the ability to protect portfolios from unexpected rises in future inflation which may be the long-term result of prevailing stimulus measures.



Source: Refinitiv Datastream/Smith & Williamson Investment Management LLP, data as at 1 June 2020

FX and commodities

The GBP/USD exchange rate has exhibited some remarkable volatility during the recent crisis, falling from over $1.30 on the 10 March to $1.15 over the following 8 days. During that period in the market, correlations between risk assets became very high, and we saw equities falling in price at the same time as bonds and gold. The only safe haven investors wanted to own was the US dollar and sterling suffered as a result. Since then the pound recovered, and some fundamental measure suggest this strength could continue - interest rates in the US are no longer markedly higher than in the UK (incentivising investors to hold USD rather than GBP). Political developments have, however, had a strong influence on this currency pair ever since the UK's vote to leave the European Union in 2016, and with trade talks set to come to some conclusion over the rest of the year, it seems likely that it will once again become the driving force.



Source: Refinitiv Datastream/Smith & Williamson Investment Management LLP, data as at 1 June 2020

Market highlights

Market returns (Total return (%), sterling)	1 month	3 months	1 year	5 year
Equities				
MSCI All-Country World	6.5	3.4	8.0	64.1
MSCI UK	3.1	-7.7	-13.1	3.9
MSCI UK Broad	3.3	-8.3	-12.7	5.0
S&P 500	6.9	7.0	15.0	97.6
MSCI Europe ex UK	8.0	0.2	1.9	37.1
MSCI Japan	8.1	7.3	9.5	46.3
MSCI Pacific ex Japan	1.6	-8.3	-12.3	26.3
MSCI Emerging Markets	2.8	-3.8	-2.2	31.4
Bonds				
iBoxx GBP Gilts	0.0	4.8	12.9	34.1
iBoxx USD Treasuries	1.8	7.1	14.5	50.9
iBoxx GBP Corporate	0.9	-0.8	6.4	27.3
Commodities and trade-weighted FX				
Oil Brent Crude ($/barrel)	38.8	-29.9	-45.4	-44.9
Gold ($/ounce)	1.6	9.1	33.2	45.5
GBP/USD	-2.0	-3.2	-1.9	-19.0
GBP/EUR	-3.5	-4.4	-1.7	-20.1
EUR/USD	1.6	1.3	-0.2	1.5
USD/JPY	0.7	-0.1	-0.8	-13.2

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 – Federal Reserve Bank.

FX – Foreign Exchange.

GDP – Gross Domestic Product.

GFC – The global financial crisis (GFC) refers to the period of extreme stress in global financial markets and banking systems between mid 2007 and early 2009.

IMF – International Monetary Fund

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.

V Shaped Recovery – Real GDP growth trajectory,

Key macro data	Latest	2020 Consensus forecast	Spot rates	31-May	Yields (%)	31-May
UK GDP (YoY%)	-1.6	-7.80	GBP/USD	1.23	FTSE 100	4.96
UK CPI Inflation (YoY%)	0.8	0.90	GBP/EUR	1.11	FTSE 250	3.75
Bank of England Base	0.10	0.10	EUR/USD	1.11	10 Year Gilt	0.13

All values and charts as at 31 May 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.

Sources

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