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Investment Outlook

The global economy and indeed stock markets stabilised in Q2 after the weakness of Q1. The main driver of this has probably been the resurgence of the US economy, encouraged by the fiscal and confidence boost of President Trump's tax cuts. The escalation of protectionist rhetoric is tending in the opposite direction of course as the US administration starts to impose higher tariffs. Another threat on the horizon is the US pressure on Iran. Oil prices are rising. Any restriction of Iranian oil supplies would raise inflationary pressures.

Markets have been resilient so far to the continuing tightening of Fed monetary policy. The central bank balance sheet is contracting and short term interest rates are close to 2%. The main effect so far has been on the dollar which is strong against all currencies. While developed markets have recovered from the Q! sell-off, this has not been true of emerging markets which are challenged by a rising dollar. Higher short term interest rates also pose a longer term challenge to risk assets. Already, flows into equity and bond funds are falling this year as deposit rates become more attractive to dollar investors. This is not true for sterling investors of course, despite the first rise in base rates since the financial crisis.

This bull market in equities has almost approached the bull run of the 1990's in terms of longevity. That ended with the dot com sell off. Markets have so far shrugged off corrections like the 10% we experienced in Q1 but political risk seems high at present while US monetary tightening will gradually reduce investor confidence. That said, the global economy is in reasonable shape and corporate earnings are still supportive. Caution though should be the order of the day.

Economy

As we said in the last report, the tax cuts have probably lifted US GNP by some 1.5%. Q2 GNP growth came in at an annualised rate of 4 %, the best for four years. With profits buoyant, it would be disappointing if this did not translate into higher investment spending. The margin of spare capacity is tight at present though with unemployment around 4% and inflation approaching 3%. Some of the recent strength may reflect stockpiling abroad in anticipation of higher tariffs .The Fed has taken the federal funds rate to the 1.75-2.0% range and 2.5% looks feasible by year end, which will temper the current buoyancy. Oil prices are critical to the US inflation outlook. Brent crude is not far off $75/bbl. If US Iran sanctions extend to oil in Q4 as threatened, for example by blocking the Straits of Hormuz, then prices could move back towards %100/bbl which would not go down well with US consumers.

The UK remains stuck in a low growth gear though Q2 showed improvement over Q1 with a rise of 0.4 %, back to the average of 1.5% growth likely in the near term. The Chequers compromise proposals on Brexit with their proposal for a customs partnership have proved controversial and now we wait upon the EU response which does not look encouraging .The core of the proposals assumes goods but not services remain in the customs union subject to EU rules while in services some sort of equivalence on rules may need to be conceded for access. Business has been more vociferous of late but is now reluctantly planning for a no deal or hard Brexit outcome, the odds of which are increasing. So much uncertainty exists over both political and economic outcomes that it is hard to offer much insight into the way ahead.

The Bank of England assures us it is prepared for worst cases and that it stands behind our much recapitalised banking system. It has indeed now taken the first steps towards raising interest rates but is likely to pause before going any further down the tightening path. As ever, sterling moves with the ebb and flow of the Brexit debate. Recent weakness reflects increasing fears over a no deal outcome.

In Europe, quantitative easing is moving towards its end but Mr Draghi has indicated that rates will not rise at least until well into 2019. The economy appeared to falter earlier in the year, not helped by the protectionist noises from the US but latest data suggests growth is trending around 2% pa. Juncker's meeting with Trump appears to have calmed the protectionist noises, at least for now. In Italy, the populist government has also toned down its rhetoric and appointed a more acceptable finance minister though Italian assets remain at a discount. In Japan, the economic recovery appears to be losing traction but that may be temporary.

Emerging markets have been challenged by the rise of the dollar, the spat between the US and China and the troubles in Turkey where the currency appears to be in freefall. This is due to loss of confidence in the authorities with presidential pressure on the central bank not to raise interest rates, already at 17% but with double digit inflation. In China, apart from tariffs, the story has been one of the authorities trying to soften the recent tightening phase as they tried to rein in the credit fuelled excesses. Bank reserve requirements have been cut to ease bank lending. The risk of a hard landing in China is very unlikely but other economies are more at risk.

Markets

Our June report picked up on the recovery that took place in Q2 after the first quarter retreat. In the event, UK equities finished the first half of the year slightly positive while global equities in sterling terms were much better at 6% with Asia Pacific and emerging markets both slightly negative, Europe up 4% and the US up 9%. Sterling weakness clearly helped the returns. Growth stocks comfortably outperformed value stocks in the first six months, 10% against 4%, continuing the trend of recent years. In bonds, gilts gave a zero return and corporate bonds a negative 1.5% as spreads widened out on growing credit concerns.

July proved a good month for equities with a rise of 4% in US, UK and European shares and markets have maintained these levels in August as we write. Good economic news and strong profits growth in the US have provided a boost to sentiment. Earnings growth in the US is averaging some 20%, surprising for this late stage in the cycle. This is not matched elsewhere in the developed world but valuations are lower of course, though this partly reflects the prominence of the highly rated technology sector in the US. The divergence in rating is striking. Cyclically adjusted P/E s range from over 25 for the US to around 15 for emerging markets.

As ever in a late stage bull market, there is the dilemma between staying in for the momentum or taking a more strategic view and concluding markets cannot rise for ever. Cash is now providing decent returns for dollar investors but not elsewhere except in the most distressed emerging markets. Brexit remains a risk for UK and EU assets , tariff escalation threatens everybody while the risk of oil prices shooting upwards is not yet baked into market sentiment. Markets may have further to run but the withdrawal of central bank liquidity over the next twelve months means market shocks will not be so easily absorbed. A problem exacerbated by the reduction in market liquidity we commented on last time. Volatility is likely to increase.

Bond markets have been doing little. US ten years continue to challenge the 3% yield level but UK gilts are still trading in the 1.3-1.4% range, suggesting we are a long way from normalisation in the UK market. The same comment applies to Europe and Japan of course .Corporate bond spreads had narrowed in too far and have widened out somewhat, more in the case of high yield bonds. Default rates are still subdued but credit standards have slipped as referred to extensively last time.

UK commercial property values rose very slightly in Q2, with rental growth slowing. The contrast between a strong industrial market and a weak retail market is striking. Capital values in retail are now falling. Overall, commercial property returned 4.2% for the first half of the year, again better than expected. It is an asset class vulnerable to Brexit fears and the cycle must be near its peak now. Certainly, valuation is not very supportive.

Asset Allocation

We are in the process of transition to Brunel pooled funds for some asset classes now. This gives an opportunity to adjust asset allocation closer to the strategic guidelines agreed in committee following last year's Strategy review. Strong markets have led to overweight equity allocations against a strategy that has reduced the equity allocation so some trimming could now be done.

The LDI review has been completed . It shows a somewhat surprising jump in liabilities on a flat gilts basis using the latest valuation results which is being investigated. Our focus though has been to target the lower actuarial liability value. On that score, our inflation hedge is now a little over 40% on an acceptable leverage ratio. There is perhaps a case for allocating a little more spare cash resulting from the equity trimming to increase that hedge ratio to the 50% level. While inflation is trending down again, a hard Brexit remains a threat which would weaken sterling and push inflation back up again.

For Further Information

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