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INVESTMENT OUTLOOK

While markets held up well in the third quarter, there has been a significant sell off in October, the second correction of the year. The risk factors behind market sentiment remain much as we have documented them this year, notably the pace of Fed tightening. In broad terms, the overall economic landscape has not altered much, with the exception perhaps of a weakening in the European economy.

The Brexit discount on UK equities has not changed with continuing underperformance and Mrs May's customs partnership offer to date has been rejected by the EU. The government is talking up the prospect of agreement later in November. Meanwhile, the budget was notable for the shift to fiscal stimulus and the abandonment of a balanced budget objective as better tax revenues than expected have been used to deliver the NHS spending pledge, with the carrot of a Brexit dividend if a good deal is struck.

As a commentator once said "bull markets don't die of old age, they get killed by the Fed". Ten years on, it is no surprise that the bull run is being challenged despite the very positive corporate earnings reported in the US. We are now seeing selling of both US equities and US bonds. In recent years, this has caused the Fed to soften policy to avoid any macro weakness but now the Fed seems determined to press on. With trade wars threatening, China slowing and Trump bearing down hard on Iran,we reiterate our cautious outlook.

ECONOMY

In the US, policy rates are now up to 2.0-2.25% with another rise likely by year end and the expectation being rates well over 3% by next year .In contrast, UX base rates are only 0.75%. The US economy is growing strongly still but the Fed fears presumably that there is little spare capacity given full employment and that inflation will rise over 3%. With the mid –term elections imminent and Democrat gains expected, the President is picking fights overseas, with China and Iran the current targets. The spat with Iran could be the more dangerous in the near term if over 1mbbl/day oil exports are cut off as there is little spare production capacity in OPEC these days. Oil prices at $100/bb plusl would damage the global economy and raise inflation though of course, economies are less vulnerable than they used to be, given increased energy efficiency.

The European economy slipped back to growth of only 0.2% in Q3, half the rate expected and, not surprisingly, Italy saw zero growth. If the overall economy is really stalling, as these numbers suggest, that will present a dilemma for the ECB, as it is due to stop its policy of buying bonds at year end. It will be difficult to start contracting its balance sheet, as the Fed is now doing, if the economy is contracting. The Italian stand-off over its proposed budget deficit is concerning with Italian bond yields now around 3.5%. The unknown is the exposure of European banks to the bond market and the extent of any writedowns necessary.

In the UK, the government had a good budget, albeit somewhat political in emphasis. The shift from fiscal contraction to stimulus was equivalent to some 0.5% GNP, which helps prop up a subdued economic forecast. The deficit has reduced from some 10% of GNP to around 2% currently so a degree of belt loosening seems justified. The positive impact can of course be more than offset by Brexit in a hard landing scenario. In that event, the Chancellor has kept something back, to support the economy through tax cuts or spending increases. The BoE may also be forced to reduce interest rates as well as provide liquidity to markets. Whether the outturn is a variant of the existing customs union proposal, a Canada plus deal or a Norwegian deal, consensus forecasts all point to weaker economic activity than would otherwise be the case in the near term .With a sensible transition period, the challenges should be manageable but it is harder to say that of a disorderly exit where supply disruptions could be very damaging. Markets are not pricing that in as hopes remain for a deal.

In emerging markets, the recovery in the dollar and higher US interest rates provide a continuing threat. Brazil has elected a conservative at last which has rallied the market. China is still reporting growth numbers of 6.5%, in line with target, but the economy does seem to be slowing and the remnimbi is at a ten year low against the dollar which the US won't like. Higher tariffs are not having much impact yet though factory orders are beginning to fall off. As in previous growth pauses, the authorities are likely to intercede and already bank reserve requirements are being eased. They are however conscious of moving too far as they did in 2015 to stimulate the economy. That produced a stockmarket boom and bust which they will try to avoid this time round.

MARKETS

Equity markets suffered their worst monthly sell-off since 2013 in October. The period under review though saw a more nuanced picture, with the US and Japan producing gains but the UK, Europe and emerging markets down somewhat. In sterling terms, global equities were up some 5% in the quarter and for the year to date while the UK has flatlined.

It is more helpful perhaps to focus on these last few weeks. In 2016, US treasury bonds rallied as equities sold off as flow of funds sought security. Now bonds are weak too with 10 year yields at 3.25%. The fundamentals are not good for bonds with the Fed shrinking its balance sheet at the same time as the government is issuing bonds in record size to fund the expanding budget deficit.

Valuation models with higher discount rates put a lower value on future corporate earnings and thus equity market levels. Recent US profits growth has been an extraordinary 20% but the view is increasing that we must be at the top of the earnings cycle and valuation is certainly strained in the US. Other factors though are at work. There has been a major retreat by technology stocks, partly for non-market reasons like the privacy debate.

Former Fed chair, Janet Yellen, has been stepping up her critique of the credit markets recently, a frequent source of comment in this report. Corporate leverage in the US is now very high, partly to fund stock buybacks but also to fund takeovers. Could a credit event unnerve markets as in 2008? Certainly, loan standards are deteriorating but while credit spreads could widen out if defaults increase, the capacity of the financial system to absorb losses is much greater now than in 2008 as banks have been forced to improve their capital ratios.

With the UK, Europe and emerging markets all suffering in their different ways at present, it is hard to see how a general contagion can be avoided if the US correction does extend further. Already, some markets, like China, could be said to be in bear market territory, with falls of some 20%. The global economy does not look like it is heading for recession even though it appears to be slowing. By 2020, though, a global slowdown is quite likely as the Trump fiscal stimulus runs out of steam and escalating tariffs start to bite.

Even without Brexit, therefore, it would be wise to be cautious about prospects for markets in 2019. How much of that will be brought forward into 2018 is the current focus. All risk assets are vulnerable, including credit where spreads are in the process of starting to widen out. High yield bonds have produced returns of only 1% year to date though leveraged loans have done better.

Where does the UK gilt market go with all these divergent forces? 10 year gilt yields have stuck around the 1.3% level, so have not shared in the US retreat. A major sell-off in sterling in the event of a hard Brexit could produce that but experience suggests the safe haven argument tends to win the day in the UK. Index linked might do better in this potentially inflationary scenario

Property continues to surprise with its resilience, at least as far as commercial property is concerned. The high street remains challenged with no easy solution but elsewhere rents and capital values are holding up. With limited office developments in the pipeline and overseas buying likely to be attracted by any further sterling weakness, some areas like London offices may become even more over- priced.

ASSET ALLOCATION

Brunel implementation continues apace and will be addressed elsewhere. Allocations to pools in Secured Finance and Private Equity have been agreed. The LDI mandate remains under discussion with a case to be made for increasing the inflation hedge closer to 50%. That is one use of spare capital but given the risks addressed in this review, there is no harm in keeping some cash on the sidelines at present.

FOR FURTHER INFORMATION

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