MJ HUDSON Allenbridge

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Alan Saunders, MJ Hudson Allenbridge
alan.saunders@mjhudson.com

INVESTMENT OUTLOOK

The strong recovery in markets in the first quarter continued into the second and extended into July. August has seen something of a correction, similar to that experienced in May as concerns over trade conflict and a hard Brexit get resurrected. As of end July, global equities were up some 21% in sterling terms, helped by sterling weakness of course so the recovery from last year's market setback has been significant.

As we reported last time, the main catalyst for this had been the move by the US Federal Reserve to start cutting interest rates again after last year's policy tightening. To some extent, this has been forced on the Fed by President Trump ratcheting up the trade war with China, which is weakening the economy through lower exports.

The global economic scene has a more sombre feel to it now than a few months ago with pronounced weakening in Europe and the UK in particular. This is reflected in the extraordinary global fall in government bond yields, which normally suggests heightened risk awareness. In the UK, for example, 10 year gilt yields have fallen to 0.45%, from 1.1% in the last report. This is not just Brexit-related but reflects rising talk of deflation or secular stagnation, a combination of low growth and low inflation..

ECONOMY

There is no doubt that the global economy is slowing and in Germany the slowdown is alarming with the economy close to reporting two consecutive quarters of negative growth, ie recession. The UK reported a bad Q2 [a fall of 0.2%] after the first quarter bounce and the outlook is for weaker growth while the US is slowing from 3% to 2%, at a quarterly rate. At the same time, inflation is levelling off at or below the 2% policy target of most central banks, despite the cyclical recovery of recent years. There is growing concern that central banks, with the exception of the Fed, may have run out of weapons to stimulate economies should they move into recession with interest rates so low and QE perhaps exhausted as a policy option.

This sober assessment leads to the prolonged deflation fear or Japanification as it is sometimes called, to reflect the last twenty years of disinflationary low growth in Japan. That is why perhaps German 10 year bond yields are at -0.7% .Mr Draghi of the ECB has promised a major stimulus again in September but there is wide scepticism towards cutting interest rates any further into negative territory. What Germany really needs is a fiscal stimulus. It is the only major economy to run a budget surplus and could easily afford a 2/3% fiscal boost.

President Trump is lashing out at everybody now and central bankers are in his aim. He regards Mr Draghi as a currency manipulator like China because the policy of cutting rates had weakened the euro against the dollar. Mr Powell of the Fed is also regarded as an enemy because he is not cutting interest rates quickly enough. So far this year, the Fed has cut by 0.25% but two more cuts are expected by the markets .This greater flexibility means that the US should avoid recession though much will depend on how much further the trade war escalates.

Finally, the UK, still faced with great uncertainty over Brexit. Renewed concern over a no deal outcome has led to a fall in recent weeks of some 3% in the pound, now down to 1.21 against the dollar from 1.30 a year ago and 1.10 against the euro, The new cabinet has a new programme which will be expansionary through public spending increases and reverse the fiscal tightening of recent years. As this has taken the budget deficit down to 1% GNP, a stimulus of some 2% is feasible, though whether more will be necessary to offset the effects of a hard landing is uncertain. Should a no deal be the end game, much of the downside will come from dislocation on the supply side so a demand stimulus may not help so much. That would also apply to any monetary stimulus from the BoE An agreement with the EU with its transition arrangements would of course be far preferable.. Either way, the economic outlook is not good for the next twelve months at least.

MARKETS

While markets are once again preoccupied with economic and political risk, they shrugged these concerns aside in Q2 with a rise of some 3% in UK equities and 6% in global equities, on a sterling basis , led by Europe and the US with emerging markets trailing, notably China as concern continues about the strength of the economy. Fixed interest produced more modest returns though corporate bond spreads narrowed again. In August, government bonds are likely to have outperformed equities as bond yields fell.

Have markets peaked? Last quarter, we spoke of a relief rally as the Fed rode to the rescue yet again but cautioned that the bull market was some ten years old. Moreover, the business cycle, at least in the US, was very extended and corporate earnings growth has slowed right down. Market valuations are full if not excessive but do assume earnings growth will continue. It is true that consensus forecasts point to recovery in profits next year but that is based on a very shallow slowdown in economic growth. Given the concerns listed above, this may prove too optimistic an assumption and earnings could disappoint. Already, companies are cutting dividends while new issues on stock markets are not proving very successful. Against that, companies have plenty of cash and renewed takeover activity could take markets higher.

The UK has been the laggard throughout the Brexit saga, even though the big FTSE 100 stocks with their high overseas earnings benefit from sterling weakness. If a deal is agreed with the EU, there will be a rally in the market, led by domestic stocks and gilts will probably sell off. It is worth noting in passing that UK companies with DB pension schemes are yet again facing a rise in pension fund deficit as a result of lower gilt yields. At present, though, a no deal outcome seems the more likely. UK property may benefit from overseas buying but seems fully priced on any normal valuation basis.

Equities could drift along at these levels for some time while these issues move towards resolution. Resumption of talks between US and China would be seen as positive as would another rate cut by the Fed or a resumption of support by the ECB. The longer term issues of high debt levels, which are no longer inflated away or the possibility of protracted deflation are not yet concerns for equities though perhaps are reflected in bond yields. Given the balance of risks, a cautious approach still seems appropriate.

ASSET ALLOCATION

The portfolio is broadly in line with the strategic benchmark set by the committee after the 2016 valuation. In particular, equities have been reduced and a greater weighting has been allocated to overseas equities, where roughly half the currency exposure has been hedged back to sterling. This currency hedge has had an opportunity cost because of sterling weakness over the period .The cash weighting of 2-3% also impacts performance when markets are rising while the inflation hedge can also cost when inflation is falling. Every insurance policy however comes with a price and these positions are designed to reduce risk and volatility in the portfolio.

As stated in the last report, the actuarial valuation will produce a new discount rate which in turn will determine the size of the pension fund deficit. The employer contributions and the length of the recovery period agreed on will in turn determine the rate of return required from the portfolio. That may lead to a debate about the investment strategy and whether more or less risk needs to be taken to meet the target.

RFOR FURTHER INFORMATION

For further information, please contact Alan Saunders on 020 7079 1000 or at alan.saunders@mjhudson.com.