REPORT PREPARED FOR

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INVESTMENT OUTLOOK

The first quarter of 2019 staged a strong recovery in markets which reversed the sell-off of Q4 2018. As at end April, global equities were up some 13% year to date in sterling terms, with the UK not far behind, despite all the background noise over Brexit. The decision by the Federal Reserve to pause its monetary tightening has been key to this better tone as markets relax about the risks of recession.

There is no doubt that global growth is slowing if not at a rate to suggest falling output levels, though Europe is still a risk. Trade tension is back with the US and China escalating tariffs in a manner which must damage world trade. Oil prices are also rising with Brent up to $70/bbl as the US takes on Iran again, a situation which may also escalate..

Geopolitical issues rarely trouble markets, perhaps complacently. The current US president is engaged in challenging the post-war consensus over the use of multilateral institutions to foster global trade and growth in favour of an America first policy. Together with the rise of political populism, manifest in the European elections, this challenges many of the presumptions on which equity markets and risk assets are priced. Rising geopolitical risk combined with late cycle economics and fully priced assets suggest further recovery from current levels might be hard to achieve. We should remain cautious.

ECONOMY

The Fed "pivot" in January was confirmed in March , ie that rates would be kept on hold and, further, that balance sheet reduction would end in September .With the stimulus of the tax cuts now exhausted and inflation remaining subdued at 2%, it is possible even to contemplate a rate cut at some stage, though not for some time. Many have argued that the inverted yield curve in the US is a harbinger of recession but there is not much economic support for that at present, given current economic data.

In the UK, GNP recovered in Q1 though that has been ascribed in part to inventory build in anticipation of a hard Brexit. While deadlines for Brexit have been pushed back to end October, we are no nearer an outcome and now face the prospect of a new PM. There was a lot of discussion about a customs union in the cross-party talks though they came to nothing. The proposals on the table exclude services which count for almost half UK exports. While we could therefore pursue trade deals in services, if we entered into a customs union, they are very hard to negotiate Now, following the European election, , no-deal Brexit is back on the table, which would be unwelcome to markets. Meanwhile, the Chancellor's latest budget shows how strong the fiscal position now is, with the public sector deficit down to 1% of GNP, from 10% in 2009. This suggests scope to offset any damage to the economy caused by a hard Brexit, should that remain a risk. At the same time, the BoE is clearly not pressing ahead with the promised rate increases.

Germany too produced a positive Q1 after two quarters teetering on the edge of recession. However, all is not right, with manufacturing orders down as the auto industry still suffers from the slowdown in China and elsewhere. Italy remains a challenge with the populist government threatening to overturn the rule book and push the fiscal deficit over 3% GNP. The tension between North and South in Europe over burden sharing is not going to disappear. The latest issue is the German push to appoint the Bundesbank president Wiedmann to replace Draghi at the ECB. This is challenging as Wiedmann has consistently opposed the policy of QE in Europe.

Elsewhere, Japan is still benefitting from the BoJ remaining accommodating but remains in low growth mode. China is reporting weakening output levels and sales so it is possible the authorities will turn on the stimulus again, earlier than they would wish as they attempt to reduce the excessive leverage of the economy. The latest round of US tariff increases comes therefore at a bad time. In emerging markets more broadly, political risk seems to be reducing – with Modi reelected recently in India - and currency volatility diminishing as the dollar stabilises so domestic economies could begin to pick up. Even so, countries like Brazil and South Africa disappoint by past standards.

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MARKETS

Last year equities sold off in two phases to produce a negative return of 8% globally though such a retreat fell someway short of a classic bear market. Already this year, equities have staged a sharp bounce back with most markets, including the UK, showing around 12-13% returns to end April. This has been mirrored in credit markets with corporate bond spreads narrowing in again, notably in high yield markets.

It would be an overstatement to say that this recovery reflected a return to a risk-on attitude among investors. It is more of a relief rally caused by the end of the monetary tightening phase in the US and a feeling, perhaps now under challenge, that other major risks such as Brexit and trade tensions were dimishing as threats. Wall St has led the way as usual with the S&P showing spectacular gains since end December, fuelled by recovery in technology stocks. There still remain doubts over the high ratings of the so-called FANGS, demonstrated by the cool market reaction to Uber's market debut. The market recovery was also led by industrial and cyclical stocks, in the UK as well, suggesting fears of recession were quite pronounced at the end of the year .

Markets are now treading water, assailed by the new standoff with China and continuing Brexit fears. Nor is there much support from the corporate sector. US earnings are averaging under 5% growth , German companies seem challenged and some UK companies are beginning to cut their dividends after many years of rising payouts. We are in classic late cycle territory with a ten year bull markets that is showing signs of fatigue and a business cycle that is flatlining, even if the upturn has hardly got under way in Europe.

Most recently, there have been signs of weakness in emerging markets again , with China off 15% from recent highs. The reason seems to be the steady rise of the dollar which tightens global liquidity and revives concerns over the large amount of dollar debt held by EM corporations and countries, much of which is short term and needs to be rolled over.

In this uncertain phase for markets, it is no surprise that government bonds have been sought as a safe haven with US yields back down to 2.4% from over 3% last year and less volatile gilt yields back at 1.1%, all for ten year bonds. The carry offered by corporate bonds has led to spread tightening as buyers return but also to the BoE warning about the risks of credit defaults and further downgrades of investment grade bonds to junk status .The UK remains a high risk in this respect though any mark down in sterling over Brexit will provide relief to overseas earners who of course dominate the FTSE 100 index. UK property has held up surprisingly well but will not be immune to bad domestic news.Overseas buyers may come in if sterling falls, as was the case three years ago.

There seems therefore more downside than upside risk to assets at present but a real bear market seems improbable, absent a financial crisis or move back into recession, both of which seem doubtful. The attitude of the central banks to such concerns will be critical. Can they really expand their balance sheets much further given little scope to reduce interest rates, except in the US? Are surplus countries like Germany prepared to relax fiscal policy? A cautious stance still seems advisable.

ASSET ALLOCATION

Reflecting that note, more cash has been raised out of equities, timed happily after the recent rally so that we are normalising around the longer term strategic benchmark. Absolute return funds such as DGFs have disappointed recently and shown they are not immune to market setbacks though of course they are less volatile than equites. The forthcoming valuation will be important in resetting the discount rate used to value liabilities. That in turn will determine the return required of our assets and perhaps lead to another assessment of the appropriate investment strategy.

RFOR FURTHER INFORMATION

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