PRIVATE & CONFIDENTIAL

Quarterly Investment Bulletin

July 2019

General Economic Overview – Quarter 2 2019

The key economic influence over the quarter has continued to be the trade battles between the US and China, and to a lesser extent Europe, which has increased the downside risks for investors hoping for a continued recovery in global growth data. Added to this, macro-economic policy has shifted from a likely increase in rates in the US at the beginning of the year, to almost no move expected at the beginning of May, to the pricing-in of 75 basis points of reductions by the end of 2019. At the US Federal Reserve's (Fed) June rate setting meeting seven of the committee indicated that they expected a rate cut by the end of 2020.

After a difficult May, June saw an improvement in markets as they priced in some kind of resolution for the current economic and political impasse. The US earnings season has been better than expected and significant buybacks have supported the advance from the first quarter, as have healthy dividend payments. The global economy has continued to trundle along at modest rates, led in the main by the continued strength of the US. Asia has not been as strong, mainly because of weaker Chinese data, and European data weaker still. This has not been reflected in stock markets this year other than some falls in May as markets remained resilient.

We continue to be in an age of disruption tempered by central bank action to support economies showing signs of weakness. The new neutral, as defined by Pimco in a recent article, is that investors believe that whatever conflict exists (be it political or economic) will not persist for long as central banks stand ready to step in. This was evidenced recently by the Fed pivot and ECB announcements and is why many believe that whilst global growth is tepid, any recession will also be shallow followed by a sluggish recovery. There are, as always, alternative scenarios to this relatively benign outcome. The most debated relate to the current trade tensions between the US and other economies but mainly China. Should this escalate and cause economic damage to the Chinese economy, a possible reaction is currency depreciation which might result in a global deflationary shockwave. In the longer term the economic rise of China may well cause increasing global tensions as the global power order shifts.

Forecasts for overall global growth have come down in recent months, and this is part of the reason for a possible move to more monetary easing which is being predicted. In the US and Europe the growth rate is forecast to fall by close to 1% which may encourage central banks to act once again.

Overall we have had another positive quarter for global stock markets, unusually supported by bond markets, which has led to strong portfolio returns. It is doubtful that this will continue through the year, although economic conditions look unlikely to change in the immediate future, unless there is an unexpected event or a change in investor sentiment.

Equity Markets

The general trend of 2019 has been maintained, although quarter two has been weaker than quarter one. This is partly due to investors taking some profits from the strong first quarter and moving assets into more defensive areas after the tensions in world trade, which have downgraded global growth forecasts. That said, the returns over this year have been very strong – over 13% for the global indices (in £ sterling) with the US continuing to lead the way. The puzzle is perhaps why the equity market and the bond market have both gained ground. Double digit returns for both equites and long-dated treasuries over six months is a rare combination which has previously only occurred during the first half of 1995. Usually equities perform strongly when economic activity is picking up or is seen to be improving, and bonds perform strongly when there is a gloomier forecast for growth or inflation. In theory one of these markets must be wrong, but perhaps the robust performance of both can be put down to the anticipation of central bank easing in the coming months. In the meantime equites continue to forge ahead, ignoring much of the negative news and sentiment.

UK

The UK market has been moving ahead, despite the political and economic pressures being placed on the country by the move towards Brexit. The new political hierarchy is currently being voted on in the Conservative party with the likelihood of the other B word, Boris, taking centre stage.

Like many economies, the UK is moving forwards but only very slowly in terms of economic growth, with multiple distractions delaying inward investment. Perhaps surprisingly, growth is not that far behind other western economies, with the exception of the US. With the growth picture relatively muted the economy is in a more fragile position, although there seems to be little pressure from rising unemployment or inflation to threaten the current status quo. The Bank of England would like to raise rates but is restricted by other pressures as well as the global move to maintain a loose monetary policy. Global trade wars would obviously impact on expansion but markets seem to be ignoring this at the moment.

Domestically, small and mid-cap stocks have suffered from the Brexit effect and if a deal could be reached, it is likely that these stocks would receive a boost, as would sterling, which may then hit the global exporters. In some ways UK companies are on hold until there is more clarity about leaving the European Union. This has affected industrial production with the latest June data indicating a fall in output as companies and clients have continued to run down stockpiles accrued in the run up to the March Brexit deadline. The PMI has also fallen to 48 in June suggesting further future contraction – this is not entirely due to Brexit factors as a weaker global economy is also affecting industrial production. The focus on capex and business spending highlights the importance of the political environment – business needs a clearer outlook to be able to commit to increased spending. Brexit uncertainty has taken a significant toll on the UK economy by depressing investment and taking GDP growth down from 2% to 1%. There is some light in the consumer sector where demand has been underpinned by a high employment rate and a pick-up in wage growth.

US

The US economy still leads the world in terms of economic output, and is the strongest growing economy in the West. Current tensions between the US and China have continued to dominate headlines as the President has followed through with his increase in tariffs on Chinese goods during the quarter. Despite this, markets have been resilient for most of the quarter with the exception of May when tariffs cut in, and the benchmark S&P index rose to 6.75% in sterling terms over the quarter, once again led by the technology sector and growth stocks in general.

The Fed's switch in emphasis at the beginning of the year was a signal to markets that the central bank was likely to be more accommodative in its approach to adjusting the path of rate rises, despite data being supportive of a growing economy. Trade issues and a wider global slowdown were the main concerns and President Trump has always been keen to ensure that the US stock market retains strength as he builds to an election year. The past month has seen a significant shift in interest expectations and markets are now pricing in 75 basis points of rate cuts in the US by the end of 2019, compared with almost no move expected at the beginning of May. At the US Federal Reserve's (Fed) June rate setting meeting seven of the committee indicated that they predicted a rate cut by the end of 2020.

Growth is expected to fall, largely as a consequence of the fading of fiscal stimulus and the disruption caused by trade tariffs. The benefit from tax cuts has now been largely felt and it would seem unlikely that Congress will approve further fiscal stimulus, given that the budget deficit is running at $975bn (4.5% GDP). Trade issues alone will not derail the US economy but there are other signs that should be considered such as the rate of growth of non-farm payrolls which has been declining in recent months.

Europe

It may appear that there are very few reasons to be positive about Europe at the moment with a confluence of events driving change both politically and economically – the continued development of nationalistic politics, lower economic growth than other economies, Brexit, and the end of quantitative easing programmes. Add in the uncertainty of global worries and slowing Chinese growth, and this picture is undoubtedly challenging, but not insurmountable, particularly if we see a return of ECB support to debt markets and an injection of capital into the Chinese economy, which has been muted on certain quarters.

Valuations offer opportunities for managers to pick up some bargains in relation to other markets, in areas that may not be expected, such as technology, although there are possible value traps in this approach, particularly in the banking sector.

The markets in Europe, in line with most other western markets, have been positive this year, as they have tended to ignore the global threats that exist today.

Asia

The economic scrutiny of China is equivalent to that given to the US now it is a huge element of the global economy. The focus on China relates to the ongoing trade disputes between the global superpowers, which has been partly to blame for more subdued global growth forecasts. As we write this update, tensions have been lifted a little but were very prevalent in the market falls in May. Equally India is now a rising power and has demanded similar focus in recent months as they have gone through another election.

Chinese economic activity and data have been volatile, but the changing timing of the Chinese New Year affects the monthly data in the first quarter. Overall data indicates a slow-down in economic activity and anecdotal evidence of lower numbers of overseas Chinese visitors, and reduced spending by middle class consumers on higher end products, demonstrates that the uncertainty over trade has negatively affected real economic conditions. Chinese exporters have warned that their business is growing at its slowest pace in three years as the trade war takes a greater toll. The latest FT Confidential Research survey of exporters shows that more than a quarter of firms now believe that the trade war is a permanent fixture of relations with the US and not just a passing feature of the Trump administration. The recent Caixan numbers further confirmed that the manufacturing sector in China is under pressure and the FTCR China export index has fallen to a three year low. The Tankan survey of large Japanese manufacturers fell to its lowest level since 2016. This has all had a more volatile effect in the stock market, but overall it was a strong, positive quarter for company valuations.

In India the Modi election victory was very positive for the continuing reform in the economy and political stability. The Indian current account deficit has shrunk in 2019, helped by a lower oil price, which allows for further fiscal expansion. The Indian Reserve bank also signalled further interest rate cuts to boost the economy.

Japan

The policies of the Japanese government have been relatively effective since Prime Minister Abe took the reins, however Japan cannot operate in a vacuum and the economy is influenced by the trade disputes and the slowing global economy. Both political conflicts and demand uncertainty have an impact on market direction. Without any near-term evidence of inflation or the need to have the Bank of Japan (BoJ) raise rates, there is little to excite market participants.

It is interesting to note that, despite the political mayhem in the United States and in China, and most recently the Hong Kong protests over repatriation laws, Japan remains relatively stable. Prime Minister Shinzo Abe enjoys unprecedented approval ratings and the government has been in place for six years.

Japan is more than a cyclical story, but the global economy remains a key influence on the equity market. The main risk from the global economy stems from the ongoing US / China trade dispute as Japan's manufacturing and technology sectors stand to lose in the event of any significant disruption to Asian supply chains. Locally, the decision to increase the consumption tax in 2019 – while welcome in terms of long-term stability – has the potential to undermine near-term growth. The government has outlined plans to provide a broad fiscal stimulus to help lower paid workers which will provide some mitigation. Overall, on current valuations and dividend yields, Japan has a strong case to be held in any global portfolio.

Emerging Markets

Emerging market economies should slow to around 4.4% in 2019 after 4.8% in 2018, but pick-up slightly to 4.6% in 2020. For most of the BRIC economies, we are optimistic that domestic factors can outweigh global problems in 2020. The emerging market area is closely linked to Asia, with the commonality of China across both investment regions, and so the same issues apply with slowing growth and trade disputes still the focus of investor's current considerations.

After a poor May with heightened volatility, markets have recovered in June producing a positive return for the quarter. There has been some encouragement for investors that the trade issues can be resolved since we are close to an election year for President Trump and he will not want to rock the boat ahead of the event.

The region has some advantages in monetary policy – nominal rates are universally in positive territory and in most cases so are real rates. Policymakers are not yet facing the constraint of the zero lower bound, which pushed developed central banks into the realms of QE. Furthermore, existing monetary conditions are not obviously already inflationary. Should the economy require support, there is nothing here to prevent central banks from acting.

Inflation is also a success story in the region overall with a structural shift to lower rates, for example, Vietnam saw rates fall to 2.2%, combined with an increase in real GDP of 6.7% year-on-year. Turkey is perhaps the exception to this trend, whilst Indonesia has significant growth prospects, particularly as political disruption has been resolved with Jokowi winning another term.

The region continues to have great potential provided that outside factors are stable, and that investors continue to be mindful of trade tensions and slowing global growth.

Fixed Interest

In the last quarterly review we pointed to a possible reduction in interest rates in the US following the change in stance by the Fed as we entered 2019 – to move away from the pre-targeted path of raising rates. As we move into quarter three, these predictions have moved on to a wider belief that there will be a reduction in rates in 2019. The question is now the degree of this change as more than one cut has been predicted in some quarters. If the tiller needs adjusting, then we may see monetary easing in this form before the end of the year, but the Fed and other central banks do have other options to try and address the slowing of global growth. One option would be to restart QE and perhaps expand it to give it a wider impact. Currently the Fed has limited QE to buying government bonds and mortgage backed securities but the ECB has expanded this and bought corporate bonds and securities debt, whilst the BoJ is buying equities and real estate. At their peak, the Fed and ECB balance sheet were 25% of GDP and 40% of GDP, respectively. The BoJ and Swiss National Bank (SNB) show that central bank balance sheets can rise a lot further, exceeding 100% of GDP.

The Fed pivot, as it has been called, has had an effect on yields in western markets, particularly on long duration assets which have performed well in 2019, going against most long-term predictions set in 2018. This has wrong-footed many investors who have held shorter duration assets with the aim of protecting against a rising-rate environment. As noted earlier, the puzzling factor for investors at the moment is that both equities and bonds are performing well. This may be the expectation of central bank easing which in turn stimulates activity through lower borrowing costs within the weakening manufacturing sector.

Corporate debt has performed well with yields falling in line with the broader government bond market, and the additional tightening of spreads has also helped to improve returns. Market technicals also provide a strong underpinning for the entire corporate bond market, with allocations to the asset class remaining at high levels and issuance in both euros and sterling at disappointingly low levels since the start of the year. This highlights the need for investors to be vigilant about what they own as there are issues that face corporate debt holders – firstly, the increasingly crowded position in credit, and secondly concerns about credit market structure and liquidity, which has not been tested since the financial crisis.

Lower grade bonds have been in demand for yield purposes and perhaps these assets have reached levels that no longer offer a sufficient premium to more highly-rated bonds for the additional credit risk involved.

Property

In the UK the same themes tend to dominate the sector, with UK commercial property market returns continuing to be moderate and the ongoing Brexit uncertainty leading many investors to reduce or sell out of their property allocations, which is putting pressure on capital values. A disorderly Brexit may have a particularly negative effect on the London property market and many UK fund managers are reducing or avoiding Central London property, although it has continued to be supported by overseas investors. The area of distribution / logistics / warehousing remains popular due to the demand for last mile delivery, same day delivery, click and collect etc. but this has pushed up purchase prices and driven down yields. Of the three core property sectors, Retail is undergoing the greatest amount of change. Structural shifts in the way we shop are forcing retailers to look at whether their stores are fit for purpose and in the right location. Profitability is being squeezed and even well-known brands have started to suffer, resulting in some having to employ Company Voluntary Arrangements to manage their rental commitments. Capital values have fallen in response to rental declines and the impact is being felt across all retail sub-sectors, with the greatest effect on secondary stores in compromised locations. Liquidity levels within commercial property funds remain above average in many cases, which is a longer-term effect of the 2016 EU referendum result and the subsequent investor sentiment towards the asset class. This may continue for some time, particularly with the ongoing Brexit uncertainty and will impact absolute returns – if fund managers can generate any returns in addition to the natural income this will be a very positive outcome.

The global REIT / property securities market is sensitive to interest rate movements and is dominated by US assets within the global REIT space, therefore the path and outlook for US interest rates and US economic growth will be important influences on future returns. Global growth is slowing and the Federal Reserve has paused its interest rate hiking cycle. The fixed income market is now pricing in rate falls for 2019, which would be positive for the property securities market, but there is the possibility of an interest rate surprise, so there remains the potential for a negative knock-on effect to property securities / REITs should markets need to re-price. This is something to watch.

Summary

Whilst the second quarter of the year proved more volatile, markets delivered a positive return. After the setback in May markets enjoyed a strong rebound in June, driven both by hopes of a positive outcome for trade relations at the meeting between Donald Trump and Xi Jinping, and by a re-affirmation of the pivot in monetary policy, mainly by the US Federal Reserve, but also to some degree the ECB. As a result, the US market has achieved its best first half year return in more than two decades. The 6.9% rise for the market in June was the best for that month since 1955, leaving the S&P up 17.3% since the start of the year. This is the benchmark's strongest first half year performance since 1997.

During the second quarter further evidence emerged of a slowdown in the global economy with even the most recent data in the States demonstrating a pullback in the economic growth rate. This demonstrates the importance of central bank policy and global monetary conditions on the market cycle. Market optimism that the Fed and other central banks are willing to ease monetary policy aggressively has under pinned equity markets, despite the fact that the second quarter has seen a continuation of negative demand shocks in both advanced and emerging economies.

Although equity markets have been universally positive there has been more volatility during the quarter, especially in May when investors were spooked by the escalation of trade disputes between the US and China. Inflation has helped, having remained surprisingly quiescent, allowing the Fed to pivot toward a more dovish stance. Given the late stage of the US cycle, this has been a surprise, and suggests that structural factors may be weighing on prices and preventing the normal cyclical pickup. One such factor would be the intense competition in the retail sector as a result of the rise of internet shopping. More generally, geo-political risk, as measured by the GPR index (geopolitical risk index), remains elevated – analysis shows that high levels of the index are associated with weaker economic activity and in the current environment this will weigh on capex.

The US Federal Reserve appears to be acting pre-emptively, motivated to extend the current economic cycle as soft global growth and persistently low inflation risks depress expectations further. The European Central Bank (ECB) is discussing further easing options while the Fed's dovish rotation has permitted a number of emerging market central banks to pursue more accommodative policy. The global economy continues to face a number of challenges, and while services and consumer sensitive sectors have been broadly resilient to the downturn in manufacturing, global trade growth remains depressed, hindering the ability of open economies to accelerate markedly. China is increasingly important in global terms and it can be argued that their transition to a more domestically led economy is one of the reasons for the fall off in global GDP growth. This affects both consumer goods and commodities and has affected economies in a wide number of regions.

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