Smith & Williamson

Investment outlook

A monthly round-up of global markets and trends
February 2018

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Investment outlook

Look outside the UK for investment returns.

Amid the constructive outlook for global equity prices, the UK appears the exception, with the FTSE 100 Index lagging its peers so far this year in local currency terms. The UK is the one major economy where GDP growth is not expected to accelerate in 2018. In part this is due to rising political risk and the trickle-through impact it has on domestic demand.

Brexit: winning or losing?

Although PM Theresa May secured a Brexit divorce deal in December and has moved onto UK-EU trade talks, it has come at a cost. The UK apparently faces a binary choice between i) being a member of the internal market and customs union (a similar deal to Norway's relationship with the EU), or ii) accepting a Free Trade Agreement (like the Canada-EU deal), with limited market access for services, but free trade in goods. Unless the EU softens its stance that the UK cannot "cherry pick" Brexit terms, it is becoming clear that the British government has to accept a Norway-type deal, or no deal. For Brexit-supporting Tory MPs, who were reluctant to approve a c. £40bn financial settlement with the EU, the divorce agreement may not buy the status quo. It could instead deliver a rather more restrictive trade agreement, with free movement of labour intact, as well as budget contributions and jurisdiction by the European Court of Justice. This may in turn lead to a backlash within the Tory party that leads to a snap general election.

With the Tories lagging behind Labour in the opinion polls, the real risk to UK investors is that the chance of Jeremy Corbyn becoming PM has increased. A Jeremy Corbyn government could mean a reversion to 1970s hard left policies of nationalisation, punitive taxes, fiscal relaxation and other monetary experiments. Given these concerns, it is not surprising that UK equities are underperforming global markets. On a fundamental level, we believe that investors should be looking outside the UK for equity returns in order to take advantage of faster growth in company earnings, still accommodative policy and less political risk.

Making America great again - dollars and sense

A key risk for equity markets would be if Treasury bond yields rise quickly and this leads to a sharp appreciation in the US dollar, the world's reserve currency. Conceptually, dollar appreciation is a substitute for monetary tightening that raises credit risk for borrowers with exposure to dollar-denominated debt. It draws dollar liquidity away from the rest of the world (e.g. emerging markets), and could potentially lead to a tightening in market liquidity and renew deflationary forces in the global economy. Nevertheless, we see the risk of dollar appreciation as fairly low for three reasons, and they are largely related to President Trump.

First, Mr. Trump can use his notorious Twitter feed to influence a lower dollar exchange rate. For example, President Trump's comment in a Wall Street Journal interview that "our dollar is getting too strong" in January 2017 ended the upward trend in the dollar that began some years previously. If the president really wants to fulfil his presidential slogan to "Make America Great Again", and increase the competitiveness of the US sufficiently to bring jobs back onshore, then he needs the dollar to depreciate.

Second, Mr. Trump can influence monetary policy somewhat through his appointments at the Federal Reserve (Fed). Members' terms are staggered so that the President can only appoint two members and a chair during each four-year term. However, given current vacancies, Mr. Trump will have the opportunity to replace all Fed governors during his term in what will be the biggest regime change at the central bank since 1936. He may pick more dovish candidates in order to keep interest rates down to finance his infrastructure spending plans. With these personnel changes expected, the Fed's current interest rate projections, which are higher than market forecasts, should probably be taken with a pinch of salt.

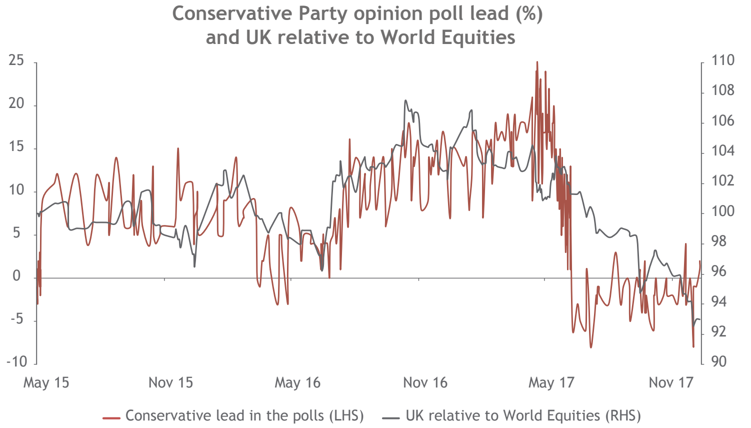
Third, Congress has agreed to legislate most of Mr. Trump's tax cutting and tax reform agenda. The end result is that it should lead to a widening fiscal deficit. Historically, a wider US budget relative to the rest of the world has often led to a weaker dollar. That's because greater US fiscal expenditure increases the supply of dollars in the global economy and reflates growth in other parts of the global economy.

Moving into 2018, the dollar has resumed its downward decline, but it has not had an adverse impact on markets. That's because US import price inflation remains fairly low and has had a limited impact on raising consumer prices. Provided global inflation remains benign (our base-case view), a weak dollar should continue to support both market liquidity and equity prices.

Equity markets

Equity markets have enjoyed a strong start to 2018, with the UK lagging behind global markets considerably. This was part of a trend seen in the second half of 2017 beginning with the UK General Election result, which removed Teresa May's majority in parliament.

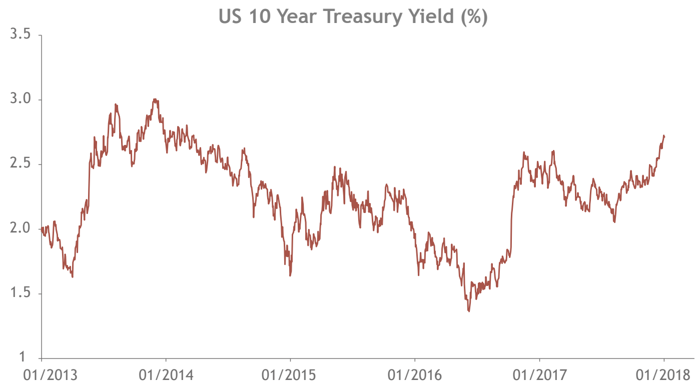
The rise in support for Jeremy Corbyn has seen UK equities start to trail global equities, in part due to the perceived risks of a would-be Labour government. Jeremy Corbyn can lie low and let the divided Conservative party fight over the terms of Britain's departure from the EU. In this scenario, UK equities will continue to underperform.



Source: Thomson Reuters Datastream/Smith & Williamson

Fixed income

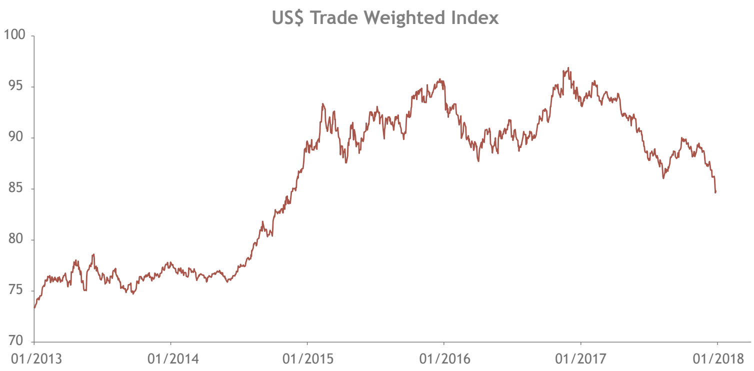
As of late January US 10-year Treasury bond yields rallied to over 2.75%, a level last seen in March 2017. However, it could be argued that low consumer price inflation might limit significant upside to Treasury yields.



Source: Thomson Reuters Datastream/Smith & Williamson

FX and commodities

The trend of a weaker US dollar continues and has seen sterling break the $1.42 level for the first time since the Brexit referendum result in June 2016. This is mainly the result of the weaker US dollar, with the Euro exchange rate fairly stable against sterling. Meanwhile, commodity markets saw the crude oil price move briefly over $70 a barrel, rallying from just under $45 a barrel in June 2017.



Source: Thomson Reuters Datastream/Smith & Williamson

Market highlights

Market returns (Total return, sterling)	1 month	3 months	1 year	5 year
Equities				
FTSE All-World	0.5	2.4	13.4	93.6
FTSE 100	-2.0	1.1	10.4	44.7
FTSE 250	-2.2	0.5	14.6	77.5
S&P 500	0.6	2.9	11.8	133.3
FTSE Europe ex UK	1.2	0.2	18.2	72.0
Topix	-0.8	1.3	12.5	101.5
FTSE Asia Pacific ex Japan	-0.3	1.8	15.4	55.7
FTSE Emerging Market	3.6	6.1	22.0	48.4
Bonds				
UK 10-Year Gilt	-2.5	-1.0	1.6	22.3
US 10-Year Treasury	-7.2	-8.9	-11.8	18.3
UK Corporate BBB	-0.4	1.1	6.1	37.6
Commodities and trade-weighted FX				
Oil Brent Crude ($/barrel)	3.0	12.3	22.2	-40.8
Gold ($/ounce)	2.9	5.7	10.8	-19.4
TW USD	-3.3	-5.3	-7.9	16.1
TW GBP	2.3	2.0	2.9	-1.1
TW EUR	0.5	2.1	7.9	0.8
TW YEN	1.1	0.9	-2.6	-12.2

Glossary of terms

Bonds – the relationship between price and yield. Yield is the return you get on a bond. When the price of a bond changes prior to maturity due to supply and demand pressures, so does its yield. When the price of a bond goes up due to demand, the yield goes down to compensate. This is so the bond's fixed rate of return (coupon) remains relatively constant – and vice versa. A bond's price and its yield are inversely related. A key factor which influences a bond is the prevailing interest rate. When interest rates rise, the prices of bonds fall, thereby raising yields. This is because the older bonds are sold in order to buy new higher-yielding bonds.

Fed – The Federal Reserve. The central banking system of the US. Sets key interest rates and monetary policy.

GDP – Gross Domestic Product. The monetary value of all the finished goods and services produced within a country's borders in a specific time period. This includes all of private and public consumption, government expenditure, investments and net exports.

Key macro data	Latest	2018 Consensus forecast	Spot rates	31-Jan	Yields (%)	31-Jan
UK GDP (YoY%)	1.5	1.40	GBP/USD	1.42	FTSE 100	3.9
UK CPI Inflation (YoY%)	3.0	2.30	GBP/Euro	1.14	FTSE 250	2.7
Bank of England Base	0.5	0.73	Euro/USD	1.25	10 Year Gilt	1.52

For further information

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Important information

Please remember the value of investments and the income from them can fall as well as rise and investors may not receive back the original amount invested. Past performance is not a guide to future performance.

Notes

All values and charts as at 31 January 2018. Total returns in sterling. Sources: *FTSE, Thomson Reuters Datastream, Bloomberg FTSE International Limited* (FTSE) © FTSE 2018. FTSE® is a trade mark of the London Stock Exchange Group companies and is used by FTSE International Limited under licence. All rights in the FTSE indices and/or FTSE ratings vest in FTSE and/or its licensors. Neither FTSE nor its licensors accept any liability for any errors or omissions in the FTSE indices and/or FTSE ratings or underlying data. No further distribution of FTSE Data is permitted without FTSE's express written consent.

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