Smith & Williamson

Investment outlook

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

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Investment outlook

Market volatility is a classic mid-cycle tantrum

Last year saw the lowest equity market volatility for 90 years which encouraged a build-up of leverage by volatility-related funds and increased market trend following strategies. So when US Treasury yields rose on the back of overheating concerns in the US economy, investors began to fear the Federal Reserve (Fed) might have to tighten monetary policy more aggressively than the market originally anticipated. The result in early February was a sharp de-leveraging of risk by these investors, a jump in market volatility and losses in global markets. Markets have already largely recovered much of those losses.

It does seem that the recent market volatility is more of a classic mid-cycle tantrum, rather than the start of a bear market – like the 2000 and 2008 moves – for three reasons. First, the growth outlook is improving and broadening. Second, contagion from the equity market has not spread to the credit markets, as it did in 2008. Third, underlying measures of inflation are still subdued. Excluding food and energy, this so-called "core" consumer price measure of inflation is running below 2% for the US, the Eurozone, China and Japan. Provided that inflation remains subdued, central banks are likely to remove monetary accommodation slowly. There is a new Fed Chair, Jerome Powell, who remains an unknown quantity. This may keep markets jittery in the short term, but essentially, we remain positive on markets and would add to equity positions from here.

Fixed income markets

US Treasury yields have risen to nearly 3%, a rate last seen in late 2013. Investors are wary that US tax cuts and increased infrastructure spending could drive yields even higher. However, provided global growth holds-up to backstop company earnings, rising bond yields should not be feared, and particularly when there is plenty of liquidity in the global financial system. It is worth noting that the US$-denominated combined assets of the central banks of the US, Eurozone, Japan and China grew by more than 20% year-on-year in January. Moreover, US share buybacks are running at record rates so far this year, as companies repatriate capital from overseas due to the tax reform.

Importantly, interest rates are still too low to worry credit markets about debt defaults, a more serious risk to equity markets. For example, the cost of servicing US household debt is close to historical lows at 10.3% of take-home pay. The fact is that over the past 10 years US households have reduced debt relative to take-home pay by their biggest amount since World War Two. Lower debt should increase the ability of households to absorb higher rates.

Inflation could however surprise on the upside. Under that scenario, central banks would be viewed to be behind the curve on tightening monetary policy by investors. Bond yields could continue to rise and crimp output growth, increasing the probability that the economic cycle is coming to an end. Equities would struggle to perform under that environment.

Risks and misconceptions about China

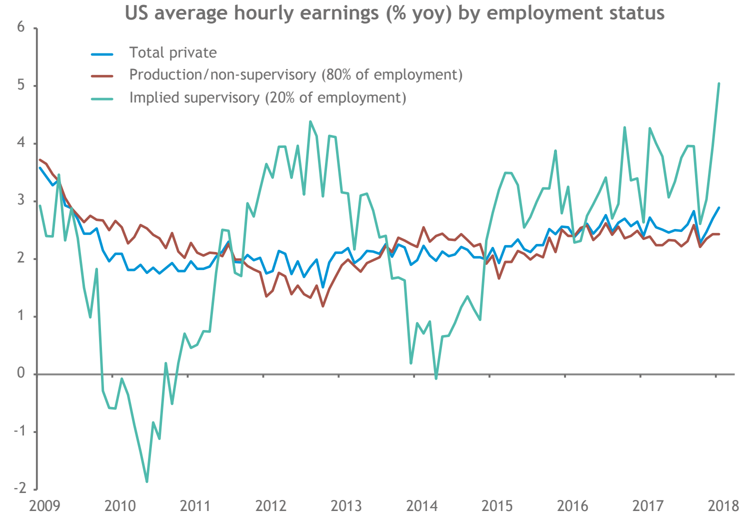
China's remarkable economic development has been viewed with caution in the West. The normal narrative is that China's expansion is driven by an unsustainable expansion in debt that is being used to invest in unproductive assets. Indeed, there is a feeling that China risks a re-run of the Japanese over-investment boom-bust of the late 1980s and early 1990s. Low market valuations on Chinese equities suggest that investors have discounted a high probability that China faces an investment bust and sharp economic downturn. Indeed, the Chinese Year of the Dog that started last month is considered to be a good time to be cautious when it comes to finances. Joking aside, we argue that much of the negative outlook on China in the media is a misconception. Little attention has been given to government reforms. For instance, President Xi announced an economic agenda at the end of 2013 that called for market forces to take a "decisive" role in improving financial resource allocation to tackle the economy's reliance on debt to drive growth. The result is that the capital productivity is rising and Chinese companies have been forced to become more efficient to remain viable concerns.

In a myopic world, China's problem is that structural reforms are slow moving. Yet, if the government continues to implement reforms to deregulate and restructure the economy, China stands a decent chance of a successful transition to sustainable growth and a fully developed set of markets. Over time this should lead to a more balanced assessment of China. Under that appraisal, China would be viewed as an opportunity for investors, rather than a systemic risk to the global economy.

Equity markets

US equity markets sold-off in early February. Part of the reason stems from stronger-than-expected US January average hourly earnings data that could potentially lead to higher inflation and interest rates. However, if this data is broken down, the annual rate of average hourly earnings of managers and non-production workers (the top 20% of employment) jumped up to its fastest rate from available data. Meanwhile production workers (the other 80%) showed no noticeable upward trend. On balance, this wage data does not indicate that the bulk of pay demands are increasing at a sufficiently strong pace to concern the Fed's interest rate outlook.

US average hourly earnings (% yoy) by employment status

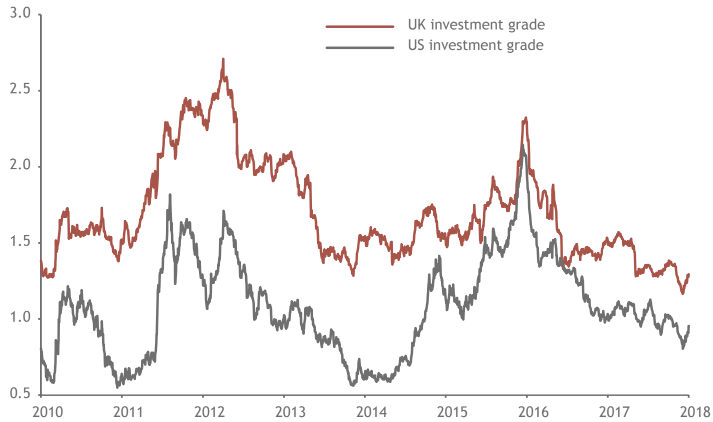


Source: Thomson Reuters Datastream/Smith & Williamson

Fixed income

Equity market volatility did not spread contagion to credit markets. UK and US investment grade corporate debt yield spreads to their respective 10-year government bonds, a measure of credit risk for companies, remain fairly low. That's probably because of buoyant growth in company earnings, backed up by a strengthening global economic activity, and relatively low interest rates. These factors increase the ability of businesses to service debt payments coming due and warrant low corporate credit spreads.

Investment grade corporate bond spreads to 10-year government bond yields (%)

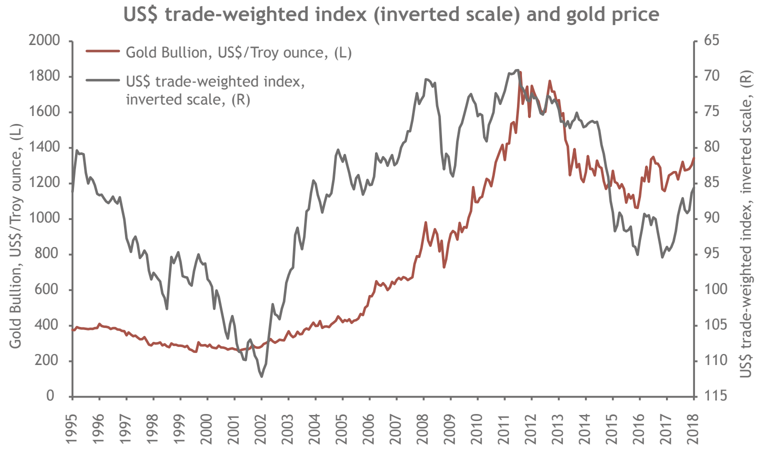


Source: Thomson Reuters Datastream/Smith & Williamson

FX and commodities

The outlook for higher gold prices appears compelling. Quite simply, the world is running out of high-grade, easy to mine gold. On the supply side, data from JPMorgan shows that major gold discoveries are running at multi-decade lows, as large gold companies cut exploration budgets and small-sized miners struggle to raise cash. And with demand driven by rising wealth from higher financial asset prices, the tightening balance in supply over demand provides a fundamental driver for gold prices. Moreover, the inverse relationship between gold prices and the US dollar adds another layer of support for bullion. Gold can also be used by investors as a hedge against geopolitical and systemic financial market risk.

US$ trade-weighted index (inverted scale) and gold price



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	-1.1	1.2	7.8	83.5
FTSE 100	-3.4	-0.5	3.4	37.4
FTSE 250	-2.7	-1.0	7.7	64.1
S&P 500	-0.6	1.2	5.8	119.0
FTSE Europe ex UK	-2.7	-0.9	12.7	65.1
Topix	1.7	1.9	11.4	91.1
FTSE Asia Pacific ex Japan	-0.5	2.8	10.1	45.2
FTSE Emerging Market	-1.1	6.7	15.5	44.0
Bonds				
UK 10-Year Gilt	0.1	-1.1	-1.5	20.8
US 10-Year Treasury	2.0	-5.2	-11.9	14.1
UK Corporate BBB	-1.2	-0.2	2.3	34.5
Commodities and trade-weighted FX				
Oil Brent Crude ($/barrel)	-4.3	3.0	19.0	-41.8
Gold ($/ounce)	-1.7	3.1	5.0	-16.7
TW USD	1.5	-2.5	-7.4	14.8
TW GBP	-1.6	-0.2	1.5	-0.7
TW EUR	-0.6	0.3	8.2	1.8
TW YEN	3.5	3.8	-0.5	-9.6

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	28-Feb	Yields (%)	28-Feb
UK GDP (YoY%)	1.4	1.50	GBP/USD	1.38	FTSE 100	4.02
UK CPI Inflation (YoY%)	3.0	2.50	GBP/Euro	1.13	FTSE 250	2.76
Bank of England Base	0.5	0.80	Euro/USD	1.22	10 Year Gilt	1.53

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.

For further information

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Notes

All values and charts as at 28 February 2018. Total returns in sterling. Sources: *FTSE, Thomson Reuters Datastream, Bloomberg FTSE International Limited* (FTSE) London Stock Exchange Group plc and its group undertakings (collectively, the "LSE Group"). © LSE Group 2018. FTSE Russell is a trading name of certain of the LSE Group companies. "FTSE®" is a trade mark of the relevant LSE Group companies and is used by any other LSE Group company under license. All rights in the FTSE Russell indexes or data vest in the relevant LSE Group company which owns the index or the data. Neither LSE Group nor its licensors accept any liability for any errors or omissions in the indexes or data and no party may rely on any indexes or data contained in this communication. No further distribution of data from the LSE Group is permitted without the relevant LSE Group company's express written consent. The LSE Group does not promote, sponsor or endorse the content of this communication.