



Investment outlook

A monthly round-up of global markets and trends
November 2017

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Investment outlook

The global economic recovery gathers pace

At its recent semi-annual meeting in October, the International Monetary Fund upgraded its global growth forecast by 0.1% for both 2017 and 2018 to 3.6% and 3.7%, respectively. Underlying these forecasts is faster activity in business investment, trade and industrial production to complement strengthening consumption demand. Essentially, the recovery is gathering pace across the globe and becoming self-sustainable. Given that the consensus one-year forward global All Country MSCI Earnings Per Share growth is 11%, against a 20-year average of 15%, the odds are favourable that companies can deliver on fairly conservative earnings expectations.

Moreover, there are limited signs of a significant pickup in global inflation, indicating that considerable slack has yet to be eliminated since the business cycle started back in 2009. This means central banks can be patient in removing monetary accommodation. In short, the driving factors behind the global equity rally, such as improving growth sentiment from key surveys, rising company earnings and easy financial conditions, are intact.

Nevertheless, the IMF singled out the UK as a “notable exception” to an improving economic outlook and cut its long-term growth outlook to 1.7% from 1.9%. Due to the uncertainty surrounding Brexit, the IMF now expects the UK economy to expand at a slower pace than financially-troubled Greece over the next 5 years. Disconcertingly, the Office of Budget Responsibility (OBR) revised down UK productivity (the output per hour worked) to a 0.2% per annum rate over the past five years from its original forecast of 1.6% last March, partly as a result of businesses delaying investment in plant and equipment. Considering that productivity is a key contributor to long-term growth, it will be difficult for the UK to raise the growth-rate of the economy. Going forward, unless there is clarity over the UK’s relationship with the EU, the UK economy is set to grow at a sub-par rate.

Despite the gloomy assessment by the IMF and OBR, there are positive developments in the UK. First, the net rate of return on capital deployed by private non-financial companies is currently 13.1%, equal to its peak in Q3’14, since companies have been increasingly adept at keeping wage rates down. Second, the Confederation of British Industry’s quarterly industrial trends survey of more than 400 manufacturers in October showed that new export orders are running close to their highest level since the mid-1990s. And third, the labour market remains strong; the headline unemployment rate is down to 4.3%, the lowest level in 42 years, and there are now more people working today than ever before. On balance, these factors should prevent the UK from entering a recession.

The key risk for UK financial assets remains Brexit, however, and the uncertainty generated if UK-EU talks progress at the current glacial pace. After the October summit, the EU determined that there was insufficient progress in the talks to enable discussion on future trade relations and transition arrangements to proceed. At least expectations for a break-through are now very modest, so that the risk of a positive surprise is now greater.

Should both the UK and EU fail to reach an agreement, it could not only unsettle global markets, but it would leave sterling vulnerable to depreciation. That’s because the UK runs a sizable current account deficit of 4.6% of GDP, and relies on foreign savings to fund the external gap. More specifically, the current account deficit has increasingly been financed by EU currency, deposits and loans (or financial claims) in the UK. These financial claims are liquid and move quickly between countries. Data from the Bank of International Settlements show that these EU bank and non-bank cross-border financial claims on the UK total around GBP1.1 trillion, as against GBP0.5 trillion in UK claims on the EU. Arguably, the clearest link between Brexit and the impact on the UK financial sector is through these EU financial claims.

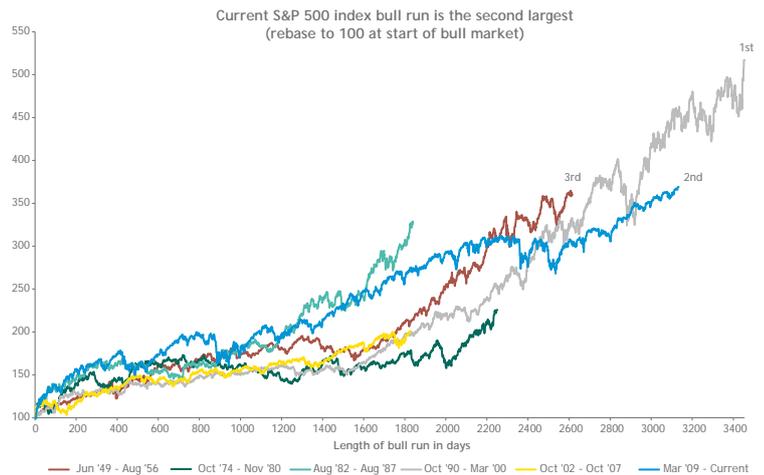
With a “hard” Brexit (i.e. no agreement between the UK and EU) a distinct possibility, as well as lingering uncertainty over the UK financial system’s relationship with EU institutions, there is a risk that the EU repatriates capital from the UK. How much capital leaves the UK will depend on UK-EU politics.

Nevertheless, FTSE 100 stocks with strong overseas earnings stand to benefit from faster growth overseas somewhat, provided that EU capital is not repatriated at such a rate that it leads to an acute tightening in UK domestic liquidity that risks damage to the financial system and lowers economic growth. These companies should also benefit from the translation effect of higher foreign earnings against a potentially weaker sterling. So while the UK-EU Brexit soap opera continues, globalised UK businesses can at least gain some certainty from external demand to drive earnings growth and support the current level of equity prices.

The small 0.25% point BOE base rate increase from the MPC to 0.5% on 2 November in response to the ongoing inflation overshoot is a risk to the equity market. However, it is unlikely to drive the market sharply lower, given that the BOE forecasts just another 0.5% in rate hikes over the next 3 years. Crucially, the MPC dropped a line in its statement that rates would need to rise by more than markets anticipate. In short, the BOE move should be viewed as a “dovish” hike.

Equity markets

The S&P 500 index passed a milestone in September. At the time of writing, the S&P is now up 278% from its low in March 2009 to become the second biggest rally since 1945, beating the 267% gain from June 1949 to August 1956. However, the current market rally performance is still lower than the 417% gain during October 1990 and March 2000.



Source: Thomson Reuters Datastream/Smith & Williamson

Fixed income

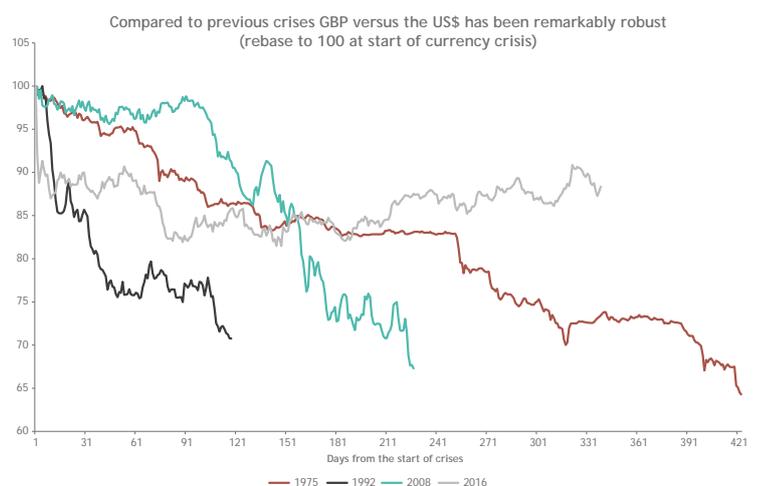
The US 10-year government bond yield has moved up to 2.4% on expectations that President Trump will be able to get tax cuts through Congress. This follows the approval of the 2018 budget through the Senate, which could pave the way for tax reform without the need for support from the Democrats. Nevertheless, the recent rise in US Treasury yields is small when compared to the downward trend in long-term interest rates over the past few decades.



Source: Thomson Reuters Datastream/Smith & Williamson

FX and commodities

Sterling has held-up pretty well compared to previous currency crises. The Bank of England has provided backing to sterling on the expectation that it will raise interest rates to counter inflation that is at the ceiling of its targeted range. However, against a backdrop of sub-par growth, inflation could slow from here to leave the central bank in a quandary on whether to follow through with more monetary tightening. Without higher interest rates, sterling looks vulnerable on the downside.



Source: Thomson Reuters Datastream/Smith & Williamson

Market highlights

Glossary of terms

Market returns (Total return, sterling)	1 month	3 months	1 year
Equities			
FTSE All-World	3.2	3.8	13.9
FTSE 100	1.8	2.8	12.1
FTSE 250	2.0	3.1	18.5
S&P 500	3.4	4.0	13.7
FTSE Europe ex UK	1.5	3.3	19.9
Topix	5.5	6.2	10.1
FTSE Asia Pacific ex Japan	4.8	2.9	14.6
FTSE Emerging Market	3.6	3.8	12.0
Bonds			
UK 10-Year Gilt	0.3	-0.5	1.3
US 10-Year Treasury	0.9	-0.7	-10.2
UK Corporate BBB	0.6	0.1	5.2
Commodities and trade-weighted FX			
Oil Brent Crude (\$/barrel)	6.2	16.4	28.3
Gold (\$/ounce)	-1.1	0.0	-0.4
TW USD	1.8	2.1	-1.3
TW GBP	0.1	1.7	5.3
TW EUR	-0.2	-0.1	3.9
TW YEN	-0.1	-2.1	-9.9

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

FOMC – Federal Open Market Committee is the monetary policymaking body of the Federal Reserve System.

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.

IMF – International Monetary Fund. Is an international organization created for the purpose of standardizing global financial relations and exchange rates.

MPC – Monetary Policy Committee. The Bank of England's interest rate and monetary policy setting committee.

OBR – Office for Budget Responsibility. Is an advisory non-departmental public body established by the UK government to provide independent economic forecasts and 'independent' analysis of the public finances as background to the preparation of the UK budget.

QE – Quantitative Easing. An unconventional monetary policy in which a central bank purchases assets (mainly government securities) from the market in order to lower interest rates and increase the money supply. This, in turn, encourages financial institutions to lend to the wider economy.

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.

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.

Key macro data	2017		Spot rates	31-Oct	Yields (%)	31-Oct
	Latest	Consensus forecast				
UK GDP (YoY%)	1.5	1.5	GBP/USD	1.33	FTSE 100	3.86
UK CPI Inflation (YoY%)	3.0	2.7	GBP/Euro	1.14	FTSE 250	2.68
Bank of England Base	0.25	0.50	Euro/USD	1.16	10 Year Gilt	1.38

Notes

All values and charts as at 31 October 2017. Total returns in sterling. Sources: *FTSE*, *Thomson Reuters Datastream*, *Bloomberg FTSE International Limited* (FTSE) © FTSE 2017. 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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