Investment outlook

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

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Investment outlook

Equity prices riding high as outlook points to a benign Christmas

A major market driver for the current equity rally has been accommodative monetary policy and a benign economic environment of low inflation and steady growth. Global equities, as measured by the All Country World index (includes Developed Markets and Emerging Markets) are up 192% since reaching a post-Global Financial Crisis low in March 2009. Data from Bank of America Merrill Lynch shows that central banks have cut interest rates over 700 times and expanded their balance sheets by $11.4trn since 2008.

Looking forward, central bankers have recently given financial markets more clarity over monetary policy in 2018. The message is that while monetary accommodation would be reduced, it would not be removed quickly. Consider the ECB. Last month, it announced that it would halve its current rate of asset purchases to €30bn per month starting in January 2018. However, the ECB extended its asset purchase program to at least September 2018. In other words, the central bank left QE open-ended and made clear in its forward guidance that interest rate increases would only follow the cessation of asset purchases. This indicates that the earliest the ECB would increase interest rates is late 2018, or, more likely, 2019.

Over in Japan, the government seems set to continue with the easy monetary policy part of *Abenomics*, due in part to the convincing general election win in October for PM Abe and his ruling Liberal Democratic Party (LDP). In the US, President Trump nominated Jerome Powell to replace Fed Chair Janet Yellen when her term ends in February 2018. Judging from the positive equity market reaction, investors view Mr. Powell as likely to continue the gradual contraction of the Fed's balance sheet, and removal of monetary stimulus, begun under Janet Yellen.

Central banks have good reason to be cautious in tightening monetary policy, since inflation is still far below the targets of 2% for the Fed, ECB and Bank of Japan (BOJ). The key question for equity and bond markets is how long inflation will remain low enough to allow central bankers to reduce monetary accommodation at such a glacial rate. On this point, there seems little to worry about in the short term as wage gains (a key driver of production costs) continue to remain moderate. Even though the US unemployment rate is down to 4.1%, the lowest level in 16 years, average hourly earnings of production and non-supervisory workers (accounting for 80% of private-sector employment) rose only 2.3% from a year ago, which is actually lower than a 2.6% rate in early 2010 when the job creation cycle started. It could be argued that wages have been anchored at low rates by additional labour supply that is not included in the headline U3 (official) unemployment rate. In October, a record 95.4m of working age (16+ years) were not classified to be in the labour force. Of course, not all these people can work, as some workers may not have the right skills or may be retired. Nevertheless, against a backdrop of increased use of technology to better match job offers with applicants (see our October Investment Outlook), US companies can leverage off labour slack to keep wage rates down.

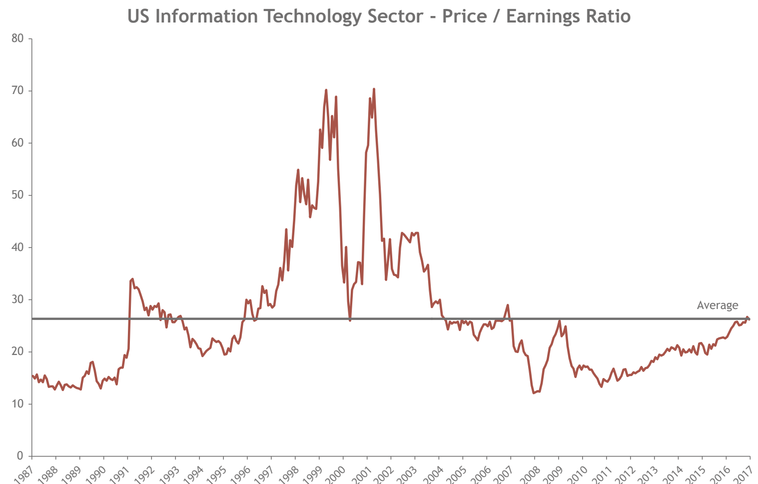
While policy makers will monitor wage rates, they are likely to focus more on unit labour costs (ULCs are defined as hourly compensation rates deflated by productivity per hour) as a guide to future inflation. That's because if wage rates are expanding at a faster pace than productivity growth, it may exert cost-push inflationary pressure on output prices. However, US productivity accelerated to a 1.5% annual rate in the third quarter of 2017 from negative rates a year ago, faster than overall compensation per hour growth of 1.4%, so ULCs fell 0.1%. This suggests downward pressure on inflation is likely to persist. For global equities, the longer easy monetary accommodation is sustained, the greater the room there is for equities to rally.

However, not all central banks face a benign inflation outlook. In the UK, productivity growth is lagging behind wage rates, so that unit labour costs have nearly doubled to a 2.3% annual rate since the Brexit vote in June 2016, leading to higher inflation. Since higher inflation has constrained the ability of the Bank of England to sustain easy money policy somewhat, UK equities have lagged behind global peers this year. Moreover, the threat of an anti-business Labour government and adverse Brexit terms are equity risks for 2018/19.

All values and data correct as of 1 December 2017. Sources: FTSE, Thomson Reuters Datastream, Bloomberg

Equity markets

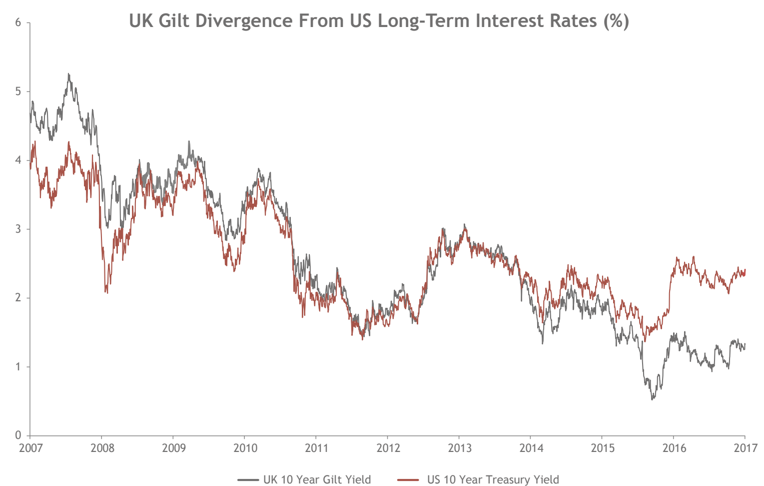
After the sharp rally this year, there are growing investor concerns that US tech stocks represent a bubble that is ready to pop, similar to the dot-com boom that peaked in March 2000. However, there is a material difference between current valuations now and those seventeen years ago. According to data provider, Thomson Reuters, their US tech sector index trades on a price/earnings (PE) ratio of 26x, which is well down on the peak of 70x in 2000, and more in line with the long-term average. A sobering thought is that the current tech PE ratio is equivalent to levels reached in 1997, around three years before the market peaked, and suggests that the rally has further to run.



Source: Thomson Reuters Datastream/Smith & Williamson

Fixed income

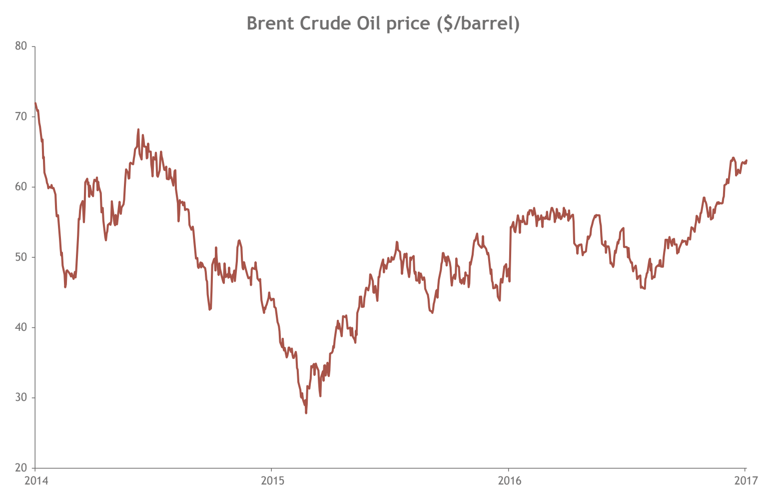
Historically, UK gilts and US treasury bonds have been fairly correlated. However, since the Brexit vote in June 2016, gilts have become less correlated to the treasury market. That's because the bond market has discounted a lower rate of growth in the UK economy relative to the US, due to uncertainty from leaving the EU.



Source: Thomson Reuters Datastream/Smith & Williamson

FX and commodities

The price of Brent crude oil has steadily increased from a post-Global Financial Crisis low in early 2016. Rising energy prices have been driven by strengthening global demand, high Organisation of Petroleum Exporting Countries (OPEC) compliance on oil production targets and rising geopolitical risks in Saudi Arabia.



Source: Thomson Reuters Datastream/Smith & Williamson

Market highlights

Market returns (Total return, sterling)	1 month	3 months	1 year
Equities			
FTSE All-World	0.1	1.1	15.7
FTSE 100	-1.8	-0.7	12.3
FTSE 250	-1.2	1.4	16.9
S&P 500	1.1	2.5	13.4
FTSE Europe ex UK	-1.6	-1.2	25.0
Topix	1.1	4.5	17.0
FTSE Asia Pacific ex Japan	-1.4	-1.1	17.3
FTSE Emerging Market	-1.7	-3.2	18.4
Bonds			
UK 10-Year Gilt	0.2	-2.2	3.1
US 10-Year Treasury	-2.1	-6.6	-6.3
UK Corporate BBB	0.0	-1.0	6.6
Commodities and trade-weighted FX			
Oil Brent Crude ($/barrel)	4.4	22.0	27.4
Gold ($/ounce)	0.8	-2.8	9.0
TW USD	-1.4	0.8	-6.0
TW GBP	0.6	5.5	0.8
TW EUR	1.3	-0.2	7.4
TW YEN	0.7	-1.7	-2.6

Glossary of terms

Abenomics – The multi-pronged economic program of Japanese prime minister Shinzō Abe. Abenomics seeks to remedy two decades of stagnation by increasing the nation's money supply, boosting government spending and enacting reforms to make the economy more competitive.

BOJ – Bank of Japan, is the Japanese central bank.

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.

ECB – European Central Bank, the Euro area's central bank which sets key interest rates and monetary policy.

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.

LDP – Liberal-Democratic Party of Japan.

OPEC – The Organization of Petroleum Exporting Countries, is a group consisting of 12 of the world's major oil-exporting nations.

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.

ULC – Unlimited Liability Corporation. A corporate structure that permits a company to be incorporated and flow all profits and losses to shareholders.This, in turn, encourages financial institutions to lend to the wider economy.

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	Latest	2018 Consensus forecast	Spot rates	30-Nov	Yields (%)	30-Nov
UK GDP (YoY%)	1.5	1.4	GBP/USD	1.35	FTSE 100	3.95
UK CPI Inflation (YoY%)	3.0	2.4	GBP/Euro	1.14	FTSE 250	2.73
Bank of England Base	0.5	0.7	Euro/USD	1.19	10 Year Gilt	1.36

Notes

All values and charts as at 1 December 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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