Smith & Williamson

Investment outlook

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

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Investment outlook

Economic momentum is gaining traction in the Eurozone, but the political outlook is uncertain in 2018.

Moving towards an investment-led business cycle in 2018

Accommodative monetary policy has been a key driver of global growth over the past eight years. Yet, while economic expansion has broadened, output growth rates have been fairly lacklustre. For example, US annual real GDP growth since 2009 has averaged around 2% in what is the weakest post-war recovery rate. However, slower growth may increase the duration of the business upswing, as it reduces the risk of imbalances in the economy. So, while the US business cycle is one of the longest on record, it doesn't necessarily mean it will end soon. That's because capital expenditure (capex) has lagged the recovery so far. By returning to more traditional drivers of the business cycle, like capex, economic expansion may be extended.

We expect the key macro theme for 2018 to be a rotation of demand from consumers to capex. Business investment should lift business profitability because the demand benefits feed through quickly and costs can be depreciated over time. Simply put, top-line sales growth can be increased faster than costs, allowing higher profit margins and increased growth in company earnings.

In an environment of modest wage gains, investment-led growth shouldn't lead to a material acceleration in inflation. That should mean central banks tighten policy very gradually, if at all. Therefore, steady growth in company earnings and relatively easy monetary policy should underpin further gains in equity prices from current levels.

Global market risk largely revolves around; 1) UK and Eurozone political uncertainty; and 2) the generalised uncertainty in Saudi Arabia/Iran and possible implications for the price of crude oil, inflation and global growth.

Political risks in Europe and the UK

In the Eurozone, economic momentum is gaining traction in 2018. Although the fundamental picture looks broadly favourable for Eurozone stocks, the political outlook is uncertain.

In Italy, the pro-European PD party came third in the recent regional Sicilian election, in what may be a dry run for the nationwide ballot, which is due in March 2018. More concerning is evidence of some polarisation of German voters following last autumn's general election. The Grand Coalition of the CDU/CSU and SPD now controls 56% of seats in the lower house of parliament (the Bundestag), down from 80% in the previous election, and the authority of Chancellor Merkel looks to have been damaged after the poor performance of her party in the election.

The UK economic and market outlook is intertwined with Eurozone political developments. The longer it takes Germany to establish a government, the less time there is for the UK-EU to finalise Brexit divorce terms, a pre-cursor to holding trade talks. Domestically, PM Theresa May's position looks vulnerable, and she appears to be struggling to stop Tory party infighting. Should PM May be forced out, it could lead to a snap election and the real possibility of Jeremy Corbyn entering Number 10.

The US plough horse expansion

US economic expansion can be likened to a plough horse. While the recovery is slow, there is hidden strength underneath. First, rising net household wealth (currently a record 6.7 times take-home pay) from increasing asset prices and employment gains supports consumption. Second, the corporate profit share is currently at a historically high level relative to the last 50 years. And third, after years of rebuilding capital, banks can now extend credit to borrowers. With tax reform and cuts on the horizon, the outlook for the US economy looks reasonably constructive.

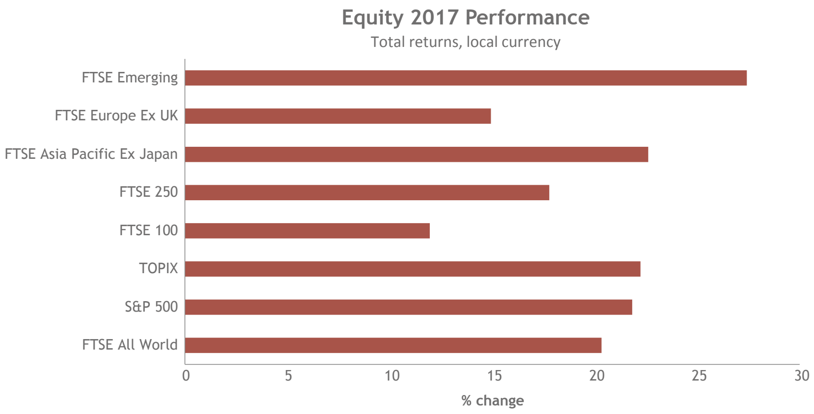
We expect the strengthening economic backdrop to raise company capex plans. Typically, the positive feedback loop between the macro economic backdrop and capex is associated with strong gains for company earnings and markets. A study published by Credit Suisse in November 2017 found that in seven periods of capex-led growth since the 1960s, the S&P 500 stock market index and company earnings rose at an annualised pace of 8% and 15%, respectively, higher than the long-term averages[1].

While US market valuations are elevated versus historical averages, it is worth noting that since the market troughed after the Global Financial Crisis in March 2009, earnings per share have accounted for around two-thirds of the increases in the S&P 500 price performance. As such, current market valuations reflect the ability of US companies to deliver on analyst earnings expectations and should not necessarily be feared by investors, even with tighter US monetary policy.

[1] Source: Credit Suisse – Rational Exuberance, 6 November 2017
All values and data correct as of 31 December 2017. Sources: FTSE, Thomson Reuters Datastream, Bloomberg
Please read the glossary for key terms

Equity markets

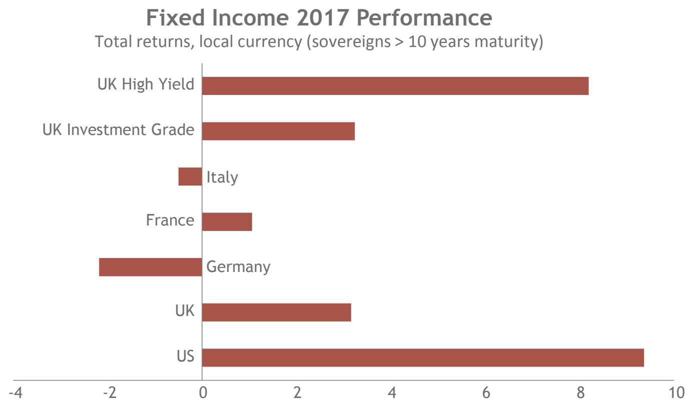
The end of 2017 saw continued equity strength with the FTSE 100 closing the year at an all-time high of 7,687. Further afield, 2017 was a good year for emerging markets, which benefitted from an improving macro backdrop and a weakening dollar. However, technology stocks were the standout performers in 2017, with the technology-focused Nasdaq returning over 30%. Comparisons to the dot-com boom still feel materially different, with the US tech sector trading on a price/earnings (PE) ratio of 26x (according to Thomson Reuters), which is only marginally ahead of the historical average of 25x and far below the dot-com peak of 70x in 2000.



Source: Thomson Reuters Datastream/Smith & Williamson

Fixed income

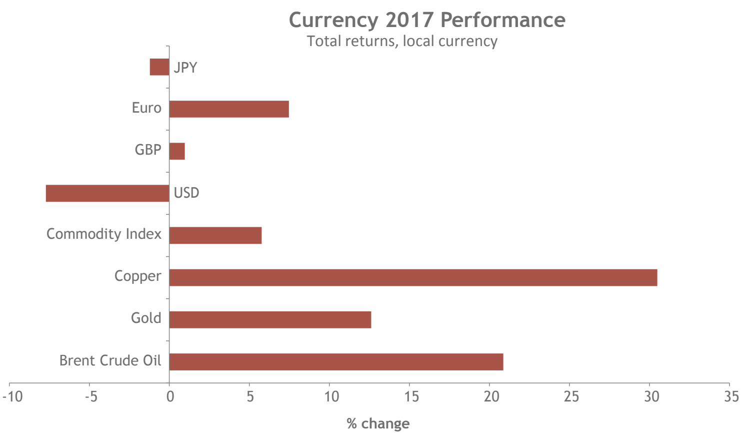
In the fixed income market, US Treasury bonds of greater than 10-years' maturity returned over 9%. This suggests that bond investors are not completely convinced by the recovery of the US economy and a lack of new supply supported Treasuries at the long end of the yield curve. The next best performers in our sample were sterling corporate high yield bonds, followed by UK investment grade corporates and Gilts. The worst performing fixed income instruments were German Bunds.



Source: Thomson Reuters Datastream/Smith & Williamson

FX and commodities

The over-arching theme in currency markets for the whole of 2017 was a weaker US dollar and a stronger euro, as the US growth differential over the Eurozone narrowed and dovish expectations of President Trump's appointments to the Fed interest rate setting committee. In commodities, Brent crude oil enjoyed a strong rally in 2017 on the back of rising geopolitical risks in Saudi Arabia/Iran, as well as strict adherence to OPEC production targets by all member countries.



Source: Thomson Reuters Datastream/Smith & Williamson

Market highlights

Market returns (Total return, sterling)	1 month	3 months	1 year
Equities			
FTSE All-World	1.8	5.1	13.8
FTSE 100	5.0	5.0	12.0
FTSE 250	4.0	4.8	17.8
S&P 500	1.2	5.8	11.3
FTSE Europe ex UK	0.5	0.4	17.5
Topix	1.0	7.7	15.6
FTSE Asia Pacific ex Japan	3.5	7.0	20.3
FTSE Emerging Market	4.2	6.1	21.1
Bonds			
UK 10-Year Gilt	1.3	1.9	2.7
US 10-Year Treasury	0.2	-1.0	-6.7
UK Corporate BBB	1.4	2.1	5.9
Commodities and trade-weighted FX			
Oil Brent Crude ($/barrel)	4.4	15.7	17.5
Gold ($/ounce)	1.9	1.5	12.6
TW USD	-0.8	-0.4	-7.7
TW GBP	-0.8	-0.2	1.0
TW EUR	0.3	1.4	7.5
TW YEN	-0.9	-0.3	-1.2

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.

CDU – Christian Democratic Union of Germany.

CSU – Christian Social Union in Bavaria.

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.

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

PD – Pro-European Democratic Party.

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.

SPD – Social Democratic Party of Germany.

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	31-Dec	Yields (%)	31-Dec
UK GDP (YoY%)	1.80	1.50	GBP/USD	1.34	FTSE 100	3.81
UK CPI Inflation (YoY%)	3.10	2.30	GBP/Euro	1.13	FTSE 250	2.64
Bank of England Base	0.50	0.73	Euro/USD	1.20	10 Year Gilt	1.23

Notes

All values and charts as at 31 December 2017. 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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