Smith & Williamson

Investment outlook

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

In this issue

Investment outlook
Global equities continue to be led by US tech companies

Market highlights
Equities, fixed income, and FX and commodities

Market returns
Asset class by asset class

Please read the important information section

Investment outlook

Global equities continue to be led by US tech companies

Global equities continue to be shown leadership by the US tech sector. Collectively, the market capitalization of the top 5 US tech companies (Facebook, Amazon, Apple, Microsoft and Alphabet's Google) is worth more than the 50 largest stocks in the eurozone, while Apple is close to becoming the world's first trillion dollar valued company. Though there are concerns about a bubble in US tech sector stocks, there are considerable differences compared to the valuations during the dot.com frenzy of 2000. The current, equal-weighted forward price-to-earnings (PE) multiple for the top 5 US tech companies is 25x, compared to 63x for the equivalent ranked stocks (Microsoft, Cisco Systems, Intel, Oracle and Sun Microsystems) at the time of the peak of the tech boom in March 2000. More fundamentally, and unlike 2000, the tech sector continues to be backstopped by strengthening tech demand. For example, real investment in US information technology products and software grew 8.2% from a year ago in Q1, the fastest rate in more than a decade. In contrast, following years of disappointing price performance, General Electric (GE) was removed from the Dow Jones Industrials (DJI) stock index. GE was the last original member from the DJI, formed in 1896, and its exit from this benchmark mirrors the shift in the US towards tech as a source of growth over older industries.

Not quite "Arrivederci Roma"

Over in the eurozone, and after five months of deadlock, Italy formed a new government around the anti-establishment and anti-EU Five Star Movement and Lega parties. Uncertainty in the policies of the new administration, including the possibility that Italy leaves the euro, initially sparked volatility in Italian equity and bond prices. However, in his first interview as finance minister, Professor Giovanni Tria, calmed market nerves by stating that Italy remains committed to the single-currency. Moreover, Professor Tria made clear that Rome is committed to reducing the public debt and deficit and will not threaten its European partners in upcoming discussions on fiscal targets. Despite these reassuring comments from the finance minister, the bank-exposed eurozone bourses have underperformed global stocks this year, partly due to concerns over rising interest rates in Italy and the slow pace of dealing with bad debts on bank balance sheets. It is worth noting that JPMorgan of the US is now worth 15 times more than Germany's Deutsche Bank. Around twenty years ago Deutsche Bank was larger than JPM. These comparisons reflect the fact that American banks were quicker to recapitalise and shore-up balance sheets than their European counterparts.

Risks in Emerging Markets and trade protectionism

Emerging Market (EM) risk assets (equities, bonds and currencies) have come under selling pressure over the past few months. Part of the reason lies with the renewed strength in the US dollar, which raises concerns about how these counties will service their USD-denominated debt. The most vulnerable developing economies have been Argentina and Turkey, which have seen their currencies fall sharply year-to-date.

However, it could be argued that financial contagion spreading to the EM complex is limited. First, Argentina and Turkey have been overheating for some time, as evidenced through higher inflation and widening current account deficits, and are an idiosyncratic risk, as against a systemic risk to the EM complex. Second, double-digit forward Earnings Per Share growth in EMs provides an anchor of support to investors. Third, Asian markets are supported by the historic meeting between US President Trump and North Korea's Kim Jong-un in Singapore last month. Although the meeting lacked specific targets in the denuclearisation of North Korea, greater communication by the leadership of the US and North Korea should ease regional geopolitical risk. And finally, stability of the Chinese economy adds another line of support.

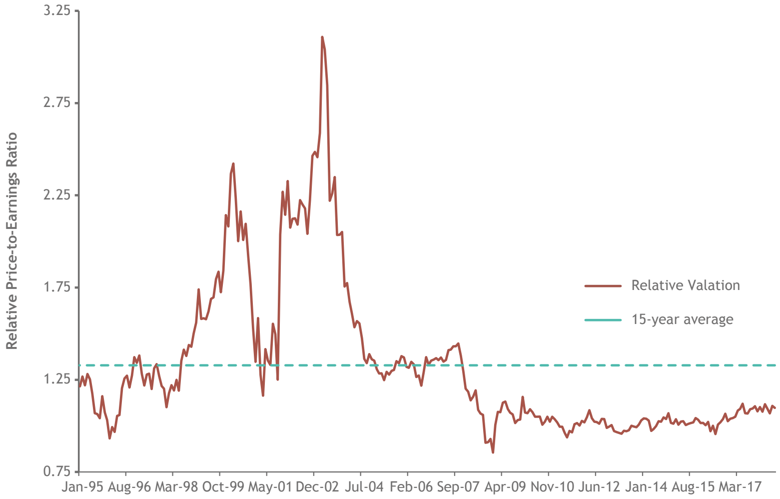
However, the step-up in trade protectionism by President Trump is concerning for markets. In June, the Trump Administration said it will apply 25% tariffs on $34bn of Chinese goods from 6 July. Beijing said it would respond with tariffs on US exports to China. The Chinese government could even target US firms operating in the country through consumer boycotts or increased regulatory checks. This could potentially hit US company profits. Another tail-risk for markets to watch out for would be a devaluation in the renminbi, given the sensitivity shown by markets in the summer of 2015 to the weakness of the Chinese currency back then. For the moment, this looks unlikely, as Chinese exports are still growing strongly and it would go against Chinese President Xi's reform agenda to use the market to allocate financial resources.

Nevertheless, following the correction in EM equities, valuations look more attractive at these levels. We continue to look for strategic opportunities in Far East markets, where we view risks as more balanced with improving underlying fundamentals.

Equity markets

The technology sector currently trades at a 10% Price-to-Earnings premium to the broad market in the US. This is higher than two years ago when it was slightly cheaper than the broader market, but is some way below its long 15 year average premium of around 30%. This average includes heady valuations reached during the exuberance of the dot-com boom in 2000, but current relative valuations are still well below those at the top of the market in 2007, when the sector reached a premium of over 40%.

US technology sector valuation relative to the market

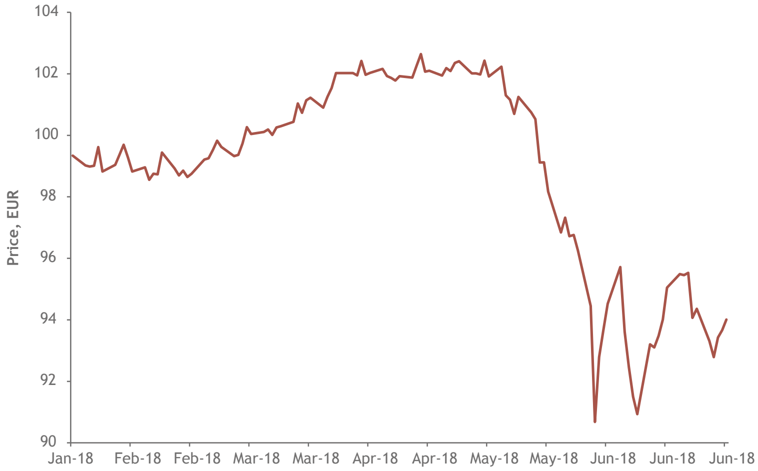


Source: Source: MSCI/Bloomberg/Smith & Williamson

Fixed income

Italian bond prices fell as the new centre-right coalition government took office. Investors fretted over the administration's views on the euro and its fiscal policies. Politicians have made a series of statements to reiterate their commitment to the single currency and outlining policies in fiscal responsibility which have gone some way to assuaging the fears of market participants.

Italian 10-year government bond price

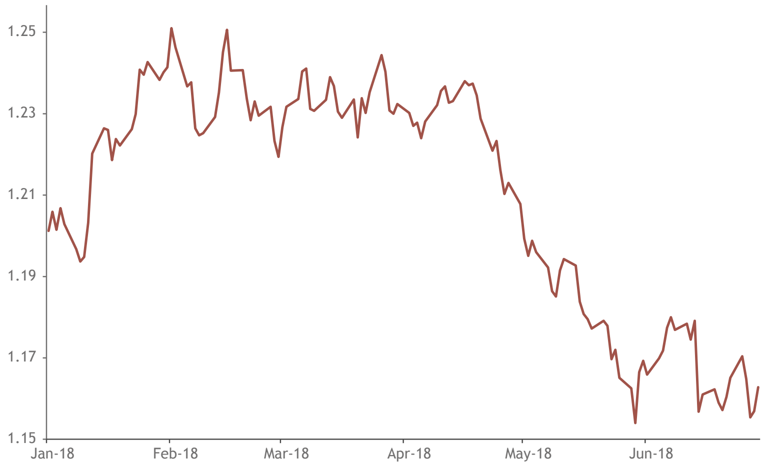


Source: Bloomberg/Smith & Williamson

FX and commodities

The euro has been weak over the last few months as the gap in economic progress between the US and the eurozone grew wider. The eurozone also continues to struggle with the refugee crisis and a politically weaker Angela Merkel in Germany. The euro's decline paused in June, as perhaps the worst-case outlook for Europe was priced in by foreign exchange markets. From the base of low expectations, Europe has the opportunity to surprise on the upside with forthcoming economic data. If that is the case we should expect to see some strength in the single currency.

EURUSD Spot Exchange Rate - Price of 1 EUR in USD



Source: Bloomberg/Smith & Williamson

Market highlights

Market returns (Total return (%), sterling)	1 month	3 months	1 year	5 year
Equities				
FTSE All-World	0.2	6.9	9.4	85.3
FTSE 100	-0.2	9.6	8.7	48.6
FTSE 250	0.1	8.1	10.6	72.4
S&P 500	1.4	9.9	12.5	115.6
FTSE Europe ex UK	0.3	3.4	2.5	65.1
Topix	-1.9	3.1	9.5	74.2
FTSE Asia Pacific ex Japan	-2.4	2.4	5.3	57.9
FTSE Emerging Market	-3.1	-2.4	5.9	47.2
Bonds				
UK 10-Year Gilt	-0.4	0.8	1.3	27.6
US 10-Year Treasury	0.6	5.6	-4.2	24.8
UK Corporate BBB	-0.5	-0.4	0.7	35.5
Commodities and trade-weighted FX				
Oil Brent Crude ($/barrel)	2.3	13.3	66.1	-22.6
Gold ($/ounce)	-4.1	-5.5	0.6	2.9
TW USD	1.5	4.7	-0.3	15.9
TW GBP	-0.5	-2.2	0.7	-2.8
TW EUR	0.4	-1.9	2.1	-1.0
TW YEN	-1.0	-1.0	1.7	-4.1

Glossary of terms

EPS – Earnings per share is the portion of a company's profit allocated to each outstanding share of common stock.

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.

Equities – A stock or any other security representing an ownership interest.

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.

Key macro data	Latest	2018 Consensus forecast	Spot rates	30-Jun	Yields (%)	30-Jun
UK GDP (YoY%)	1.2	1.30	GBP/USD	1.32	FTSE 100	3.84
UK CPI Inflation (YoY%)	2.4	2.50	GBP/Euro	1.13	FTSE 250	2.71
Bank of England Base	0.5	0.75	Euro/USD	1.17	10 Year Gilt	1.33

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 30 June 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.

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