Summer 2019

market outlook.

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FINANCIAL AWARENESS

contents.

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The UK Economy

With less than three months to go until the October Brexit deadline, the recent establishment of a more Pro-Brexit UK government has elevated fears of a no-deal Brexit. As a result, when compared to other global currencies (on a trade weighted basis) sterling hit an all-time low during the quarter. However, as we have highlighted many times before, the majority of revenue from FTSE 100 companies originates offshore, in currencies other than sterling. As a result, the sentiment towards the UK economy has not been reflected in the performance of the FTSE 100, which has performed well over the past quarter.

Brexit-related developments, such as inventory building ahead of previous Brexit deadlines and reluctance of firms to invest in the UK, is leading to volatile UK economic data. Nevertheless, the labour market remains tight, annual pay growth continues to outpace inflation and consumer spending has remained resilient.

The Bank of England (BoE) continues to base its forecasts on the assumption of a smooth Brexit and in such a scenario, the bank believes it would be appropriate to raise interest rates to stem pent-up demand. On the other hand, the BoE acknowledges a global slowdown and warned a no-deal Brexit would hit the economy and trigger a further drop in the value of sterling. The hawkish undertone from the most recent monetary policy meeting provides some support to sterling, although in reality, given the UK consumers sensitivity to interest rates and slowing global growth, an increase in UK interest rates anytime soon remains unlikely.

The Japanese Economy

The past quarter has seen the Japanese equity markets appear relatively timid when compared to other developed markets globally, and despite previous Market Outlooks citing global trade being the driver of the Japanese Markets and economy, this has largely not been the case in recent months. With US/China trade frictions making little progress as of late, it has been the weak Japanese economy, and hence weighted expectation of policy adjustments to come, that has driven Japanese markets.

It is important to put the Japanese economy into perspective, rather than getting carried away with its progress away from one of a deflationary backdrop over the past few years. Despite trillions of Yen being continually pumped into the system, inflation levels have dropped to below 1%. With that in mind, even though the Bank of Japan (BoJ) Governor, Haruhiko Kuroda, has made no major changes to monetary stimulus, with the U.S Federal Reserve suggesting it may embark on a mini interest rate cut cycle and with his inflation target of 2% seeming like a speck of dust on the horizon, following July's BoJ policy meeting, Kuroda suggested that the BoJ would be accommodative if necessary. He further suggested that slower global growth risks could spread to Japan's economy and prices… however, the reality is, Japan is an economy that is highly tuned in to global growth, and with it likely to slow (let's not forget that slowing growth is still growth) their economy will likely struggle. In addition to this, the unprecedented level of stimulus that the BoJ has already provided has done little to suggest that deflation has been staved off. With that in mind, sentiment has been focussed primarily on the anticipated sales tax hike scheduled for October that will see it increase by 2%. With wage growth continuing to be absent in light of the current levels of stimulus and low unemployment levels, the battle against inflation still waging, the increase in sales tax imminent, and the shape of trade with the US yet to be decided, the opportunities in Japan are limited (this stands separate from Japan's current trade dispute with South Korea that was driven by Korea's demands over insufficient compensation surrounding Japan's occupation of the country spanning 1910-45).

Considering the fractious backdrop in Japan and the upcoming quarter looking like it could be driven by anticipation of the sales tax hike and prevailing trade, relative to other markets it looks like Japan has plenty of headwinds. With that in mind, and with a large proportion of global Japanese exposure flowing into the large cap space via Exchange Traded Funds (ETFs), there appears more value opportunities further down the market cap spectrum.

The Emerging Markets & Asia Economy

There has been very little by way of news over the past quarter flowing out of the Emerging Market and Asian asset classes, with the US and China trade frictions usually taking the headlines. However, with there being somewhat of a stalemate between the two economic superpowers (despite the potential for tariff threats), and with a resolution not looking likely in 2019, it appears that China has been 'slipping under the radar' in terms of stimulus provisions with promises of economic support, whether that be via infrastructure spending via local government bond issuance, or indeed by broader monetary measures. And, with the Hong Kong riots currently taking centre stage in the global media, and China's response to the rioters pivotal in the global opinion on both Chinese President Xi's regime and ultimately on trade, it seems apt that there has been a summer lull in news.

There has however been some really positive opportunities that have unfolded in these asset classes over recent months, with the Indian election being point and case. Prime Minister Narendra Modi not only maintained his leadership, but his party (the BJP) gained significantly more seats in the upper and lower houses. With his larger coalition party (National Democratic Alliance) drumming up an even larger parliamentary majority, the bedrock that Modi has laid over the past few years paves the way for a smoother transition and roll-out of further policy as the nation strives to stimulate jobs, wage inflation, external investment and ultimately transition its massive population (1.4billion approximately) into a developed nation. Whilst this transition is a while off and whilst we are not likely to see any mass development over the shorter term, the opportunity set for under-researched domestic businesses that stand to benefit from the government tenders on policy-driven contracts, throws forth plenty of long term investment opportunities! After all, this is a country that is led by not only a charismatic leader, but a leader that is soon to feature in the latest Bear Grylls (Man vs Wild) episode!

Elsewhere, we have also seen a new Prime Minister elected in Australia (Scott Morrison of the Liberal-National Coalition), which, whilst out of favour from an investment standpoint due to its commodity bias, has proved to be an uncorrelated diversifier in portfolios over recent years… and the new direction that this centre-right coalition could take the market over the former centre-left Labor party could present investors with potential opportunities as policy rollout becomes clearer.

Latin American countries still remain somewhat of an enigma at a political level, with certainty over Mexican/US relations tainted and AMLO (the Mexican President) yet to make any major strides other than marginally avoiding a recession, despite stagnant growth. However, one positive is in Brazil, surrounding the pension debt pile that has been a massive drag on government finances. Whilst they are some way from enacting a new policy to deal with the national pension debt burden, they have cleared a number of initial hurdles that sees a marked stride in the country addressing its economic issues… and whilst having a volatile outlook at this stage, it is at least a step in the right direction.

The US Economy

For the first time in as long as I can remember, I am not beginning this paragraph suggesting Donald Trump has been responsible for all shifts in the US markets over the past few months… as, in actual fact it has been the Federal Reserve (Fed) and its Chairman, Jerome Powell, that has predominantly driven markets. Earlier in the Summer Powell suggested that the Fed would remain accommodative and would consider cutting interest rates should the prevailing economic conditions remain. This proved to be the case at the Federal Open Market Committee meeting at the end of July that saw the Fed cut rates for the first time in over a decade by 0.25%, leaving the headline rate at 2.25% at the upper bound. Let's face facts, this was clearly a cautious move by the Fed wanting to be accommodative, whilst also wanting to not only maintain faith in policy and the Fed, but also not wanting to deplete their monetary tool kit. As, it would have been more significant to cut by 0.5%, but that would make further flexibility more difficult… and this held true following the cut as Powell went on to suggest that they would look to potentially embark on a 'mini' rate cut cycle, which sends out a clear accommodative message without depleting the current rate levels! So, it could be thought that from an investor perspective, this was a clever way to control market sentiment, as whilst markets came off, as soon as the accommodative stance is swallowed by the market, it is likely we could see a bounce in equity markets.

So, what does this mean for the up and coming quarter… well, the speech from Powell suggests we could see a further 0.25% cut in rates this year, with a view to stimulating the economic environment further. But, not being one to remain unheard, US President Donald Trump did Tweet "Powell let us down". But, to put things in to perspective, a single large cut may have provided some extreme short term euphoria to the market, but would have left little wiggle room going forward. However, 'small and steady' cuts will likely give equity markets and the economy more to fall back on over the short to medium term! With that in mind, and with recent unemployment data remaining low and steady, the Labour Force Participation ticking up slightly, and Consumer Confidence robust, the Fed's play on interest rates is predominantly a method of stimulating inflation that is missing its 2% target… this has largely been as a result of domestic concern over trade frictions with China. So, whilst very little has happened other than a further stale mate between the US and China in late July over trade and some posturing over tariffs, it appears unlikely we will see an agreement any time soon with Trump not wanting to 'drop a clanger' ahead of the 2020 US Presidential Election, and with China seemingly happy to play the waiting game. So, again, this subtle rate move by the Fed seems measured in order to signal to the market that it is prepared to buffer the economy and inflation, whilst biding them enough time to observe the outcome/impact of any trade resolution.

The European Economy

With certainty surrounding global trade action drifting in recent months, and Brexit issues being UK centric (surrounding the leadership race), the dominating factor has been that of the European Central Bank (ECB) leadership and policy. A quick and largely unanimous decision was made earlier in the summer that the sitting head of the International Monetary Fund (IMF), Christine Lagarde, would replace Mario Draghi as ECB President. With Lagarde having an accommodative background with her time at the IMF, the market took it as a positive sign.

Largarde's appointment further supported the accommodative speech delivered by Mario Draghi in early June that saw the market build in expectation of further interest rate cuts by the ECB. However, it could be thought that the acceleration in markets following Draghi's press conference was 'investor sentiment' over analysing his transcript. In reality, all that Draghi stated was the Central Bank remains accommodative, and with that comes the possibility of further monetary stimulus; whether that that be interest rate cuts, Quantitative Easing, or indeed anything else… and, let's face facts, with a new incoming ECB President, an accommodative speech allows flexibility going forward without boxing Lagarde into a corner! All things considered, whilst it looks unlikely that we will see a meaningful rate cut cycle in Europe any time soon (with headline rates already at -0.4%), a key element of Draghi's speech that went largely unrecognised was him stating that they would reconsider the 'capital key' (a country's percentage size within the European Union (EU) defined by its population and Gross Domestic Product) as a way of distributing stimulus. This could be quite an important statement, as it would allow for a more sector/country specific targeting for future stimulus measures.

Whilst there remain worries over Italy's debt pile, and with the current Italian leadership's frictions with the EU surrounding it breaching the EU's 60% debt to GDP maximum (Italy is currently at 130% approximately), in addition to France's debt pile building, the accommodative stance of the ECB when coupled with strong valuations (in relative terms) on a regional/sector specific basis, we could see European markets maintain traction going in to the end of the summer. It must also be remembered that despite the negative sentiment surrounding Europe; whether it be Brexit, Italian debt, trade etc, we have seen consumer confidence, industrial production and inflation all pick up in recent months, which is further supported by the consistent downward trend in unemployment. So, whilst there are multiple hurdles for European countries to overcome, the ECB's accommodative stance and the region's strengthening data in some key areas presents a strong investment opportunity in the right areas were valuations have been compressed by sentiment!

Fixed Interest

This year has been a broadly 'risk-off' bull market for all asset classes, but it must be remembered that whilst all key asset classes are largely in positive territory this year, even in the Fixed Interest arena, this is predominantly due to positive correlations between equity markets and bonds remaining in situ. With that in mind, not a lot has altered within the Fixed Interest arena over recent months other than prevailing yield curve anticipation that has been driven by central bank expectation, seeing a recent pick up in some major yield curves globally (despite being largely down on the quarter). The accommodative stance taken by the US Fed and indeed the ECB, has pushed the curve higher in order to try and buck the trend of asset expansion in the equity space. However, all things considered, a veil of uncertainty still remains on the shape of many global yield curves and the potential for an inversion, particularly in the US given the potential short term nature and low level of the expected monetary stimulus (interest rate cuts). In addition to this, we have also seen a broader issuance of high yield debt primarily driven by a yield-starved market looking to subsidise a typically slow summer period.

So, given the summer months have a tendency to be rather quiet in terms of news, particularly between government and central bank holiday periods… and with the prospect of a calamitous trade dispute between the US and China not likely, certainly over the coming few months, there is little to suggest that bonds can shed their current equity correlations, nor to suggest that there is anything substantial enough to unhinge the equity markets over the shorter term. So, with that in mind, the Fixed Interest space offers little by way of returns other than that of a limited downside hedge, should we see a global recession which does not look likely! That being said, given the current relationship between bonds and equities, it remains the Corporate Bond space that offers the better risk-reward characteristics over the near to medium term should equities continue to be robust.

If you would like to discuss this or any other aspect of your portfolio, please do not hesitate to contact us on **0800 049 2011**, Monday to Friday 9am-5pm or you can email us at **affinity.advise@wealthatwork.co.uk**

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