Summer

Market outlook.

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Written by Peter Quayle & Jonathan Wiseman, Fund Managers, **my wealth**

The UK Economy

Following the UK's decision to leave the EU, uncertainty over future trade agreements and market access is highly likely going to result in investment decisions being postponed, cancelled or scaled back. As a consequence, unemployment could rise which would undermine consumer confidence. We are already seeing housing demand and house sales dropping, with the Royal Institution of Chartered Surveyors index of sales pointing to the fastest decline in transactions since 2008.

Given the consumer accounts for two-thirds of the UK economy, GDP growth is likely to slow and could potentially fall, although we do not expect a recession thanks to the decline in the UK's exchange rate (which will boost exports) and the recent decision by the Bank of England to cut interest rates and expand Quantitative Easing (QE). However, a side effect of the weaker pound is higher import costs which we expect will push inflation up above the BoE's 2% target.

We also expect Philip Hammond, the new Chancellor of the Exchequer, to announce changes to fiscal policy in his Autumn Statement, complimenting monetary policy and encouraging corporate investment.

The Japanese Economy

The past quarter has been relatively muted from the Bank of Japan (BoJ). Expectation of an increase in their QE policy was rife, but disappointment following lack of policy measures continued month on month. In line with this, we have seen little 'significant' weakening of the Yen relative to the US Dollar.

The lack of adjustment to policy has largely been driven by external policy measures. With uncertainty surrounding a rise in US interest rates driven by the Federal Reserve (Fed), and also the depreciation in Sterling driven by the Brexit referendum in the UK, the head of the BoJ appears to be waiting for a more settled overseas environment before assessing the impact of the current policy measures and whether more monetary stimulus is required.

With the above in mind, there is still a huge lack of drive from the BoJ and Prime Minister Shinzo Abe to address the domestic level reform that is required in order to help pull the Japanese economy out of the decades of hardship. With QE and negative interest rates failing to aid the economy in meeting the inflationary goal of 2%, real wage growth lacking, industrial production contracting, and GDP sitting at par (0% quarter on quarter), there is little to suggest current monetary stimulus is working. As such, it is these weak fundamentals and lack of domestic measures that has seen the Japanese equity market be one of the weakest performing year to date, in sterling terms. The short term outlook is likely to be similar given uncertainty around the impact of Brexit and indeed the prolonging of a Fed rate rise cycle, and given fundamentals in Japan have been weak (broadly), this is likely to continue until overseas policy makers sure up policy implementation, and the BoJ and Prime Minister Abe broaden their policy measures to aid the domestic economy… further QE as an isolated policy will likely weaken sentiment over the longer term, weaken faith in policy makers, and cause further outflow of investment from the region.

The Emerging Markets & Asia Economy

The past few months have seen the Asian and Emerging Market regions appear to become a function of the US Fed's propensity to 'raise interest rates'. With the regions trade relations with the US representing a large proportion of their exports, any 'significant' increase in the US interest rates could cause a weakening trade position. However, let's not forget that it is likely that rates will remain lower for longer, and any increase in rates will likely be small. As such, and like we saw in April of this year, Asia and Emerging Markets will likely see a large (but short term) selloff should the US increase its rates by 0.25% later this year, but markets will likely rebound sharply as soon as they realise that any negative implications, as a direct result, will be minimal.

Valuations in the Asian and Emerging Market asset classes continue to look attractive when compared to that of western world economies. With the Peoples Bank of China cautiously enacting policy moves, such as a 0.9% depreciation of the currency (hidden behind the UK referendum in June), and with Narendra Modi's government in India deciding on a standardised goods taxation system, when coupled with attractive relative valuations, the core of these asset classes look strong.

Whilst there are elements of these asset classes that look vulnerable, such as Brazil (that is shrouded by political uncertainty following the suspension of its leader, Dilma Rousseff), on a risk return basis they arguably represent a better investment opportunity than most others, certainly in the run up to 2017.

The US Economy

It has been another quiet period for Fed action this quarter, with the world markets attempting to 'second guess' when the Fed will raise US interest rates… there is yet to be any increase this year, following expectation of four interest rate hikes going into 2016. Whilst this lull in action from the Fed has been arguably beneficial for global markets, a rate rise is inevitable at some stage, and is required to keep the US market stable over the longer term. With this in mind, investor sentiment, and thus global markets, have weakened each time there is anticipation of the Fed increasing rates by a mere 0.25%. For example, following a more positive stance from the Fed and strong US employment data in April, expectation for a rate rise was rife, and as such the Emerging Markets indices fell more than 10% on the year (in sterling terms). This fall was not a true reflection of the impact a rate rise of 0.25% would have on the Emerging Markets, but this short term 'knee jerk' reaction is certainly apparent in the current climate. Once the fear of a rate rise abated, the Emerging Markets corrected (as did other equity markets).

Stable employment and growth data in the US suggests that at some stage a rate rise in the US is likely, and indeed healthy. This is not to say that the aforementioned volatility will not occur going forward as a rate rise does draw closer, but it is important to remember that rates are expected to remain lower for longer; so whilst an increase of 0.25% in the US interest rate will likely cause global markets to contract in the short term, as soon as markets reflect, a correction is probable. With this in mind and with the dollar likely to remain strong in sterling terms, the US has appeared a 'safe haven' from volatility and poor performance year to date… this is only offset by valuations looking much more 'toppy' than most other equity markets.

Also, let's not forget, with the US elections on the doorstep, and a certain Mr Trump and Mrs Clinton (neither of whom are overwhelmingly popular with the US public) the two candidates, volatility is all but assured, if not through the sheer uncertainty, then through the potential for Mr Trump to succeed. Whilst it is not likely that Donald Trump will, or will be allowed to, actually go ahead with some of his campaign policies, this unknown will be key to dictating market direction.

The European Economy

One of the key drivers to European equity markets over the past few months has inevitably been the UK referendum. Even with the broader market expecting a vote for the UK to stay within the European Union (EU), fear of an exit caused nervousness and volatility in the run-up. In the wake of expectation being incorrect and the 'vote leave' campaign being prevalent, markets have been strong since. The vote to leave has had many ramifications, but two come to the fore: firstly, the vote to leave presented global growth concerns and uncertainty to the Fed, delaying them raising rates, a major buoy for many global economies. Secondly, following a positive vote for the incumbent in the Spanish elections just days after the UK referendum, there is suggestion that the uncertainty that shrouds the UK has caused fear amongst European voters who may vote for 'what they know', instead of opposition parties that includes the 'anti-establishment' parties (such as UKIP in the UK). It is this fear of the unknown that has arguably and marginally reduced the level of political uncertainty in continental Europe, thus potentially reducing the likelihood of a 'domino effect' scenario of other EU member states holding referendums and too splitting from the EU.

With the above in mind, the European Central Bank (ECB) and its head (Mario Draghi), have taken little policy action in recent months. It could be thought that this is a sensible course of action in order to wait and see the economic impact of recent events, awaiting markets to settle, and for current policy measures to take effect before making any adjustments to interest rates, the QE policy etc. With domestic political and global events holding back valuations, European equity markets have looked more attractive than many other asset classes in valuation terms, and with the ECB now buying corporate bonds as well as government bonds, there is a strong chance that money may be able to 'get to work' where it is required!

Fixed Interest

The EU Referendum had a notable impact on fixed interest markets. The vote to 'Leave' meant global sovereign markets quickly repriced, taking yields on most developed market sovereign debt issues to record lows. Although yields on UK government debt hit record lows during the quarter, with the benchmark 10 year yield fell below 1% for the first time, they still offer a reasonable return when compared to some of their developed market peers. For example, in Switzerland the 40 year government bond yield has turned negative during the quarter.

Although on fundamental valuations the majority of developed market sovereign debt may appear expensive, this must be weighed against encouraging technical factors: globally, central bank policy remains incredibly supportive for fixed interest assets. This is especially true in Europe, where we have seen the inclusion of corporate bonds in the European Central Banks's monthly asset purchase programme, adding to the already substantial programme.

Corporate debt does appear to offer more value than government debt when looked at on a relative valuation basis, although equity markets appear to be offering stronger risk return opportunities. As bond yields have fallen, companies have taken this opportunity to issue longer dated debt, and at lower yields than they would have been able to do so previously. This has resulted in an increase in the duration (sensitivity to changes in interest rates) of bond indices. Whilst the broad expectation of the market is that US rates will be "lower for longer" (lower does not mean it won't increase at a slow pace), it is important to remain mindful of duration risk: active management of duration positioning is key in what continues to be an uncertain environment for interest rates.

Contact us

0800 028 3200

www.wealthatwork.co.uk/mywealth

@_mywealth

mywealth@wealthatwork.co.uk

my wealth

WEALTH at work