Summer

Market outlook.

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The UK Economy

The Bank of England increased interest rates by 0.25% to 0.75% in August and whilst this was widely anticipated, I think the move was a mistake. I do not believe the UK economy is robust enough to withstand significantly higher interest rates, and I expect it will be some time before any further increases. The UK housing market is already showing signs of stress, with mortgage approvals trending down, house price inflation slowing and some disappointing updates from listed estate agents. Any increase in interest rates is likely to weigh on the housing market and as a result, the consumer, especially with recent data showing consumers spent more than they received in income during 2017. Additionally, the recent spate of resignations by government officials (who were leading the BREXIT negations), does not bode well for consumer or business confidence. Fortunately, the UK equity market is somewhat removed from the UK economy, as it is dominated by companies which generate the majority of their revenues overseas. That said, the state of the economy does weigh on the relative value of the pound, and given its weakness over the quarter, the FTSE 100 was one of the better performing markets over the period, as offshore revenues translate into more pounds.

The Japanese Economy

The recent summer months have been relatively subdued politically in Japan, even seeing Prime Minster Shinzo Abe's approval rating pick up slightly following the corruption scandal that both he and his wife had been embroiled in. This added some much needed stability in not only the country's leadership, but also in the leadership of the Bank of Japan. That being said, like many other regions, much of the action taken has been driven by the apparent protectionism in the United States which was a key driver for the completion of the 'EU-Japan Economic Partnership', a free trade pact between Japan and the European Union, covering virtually all goods and services traded between the two. This move between two of the world's largest economies could be seen as a way to buffer the impact of US protectionist measures. This trade agreement could be seen as a step in the right direction for both the EU and Japan, however, with one of Japans largest trading partners still being the US, and with the Japanese automotive suppliers having far more traction in the US than in Europe, it remains to be seen if this new relationship can subsidise any loss of revenue from potential tariffs imposed by the US. That being said, the US firmly has its sights on trade negotiations with China, but it seems likely that Europe and Japan will too have similar tariffs imposed, certainly on goods that compete directly with US manufacturers.

With the above in mind, there are still fundamental risks in Japan, as inflation remains well below half of the 2% target rate, wage levels are inconsistent, consumer confidence is decreasing adding to the inflation concerns, and retail sales are weak. Coupled with the faltering economic data, there are also concerns that recent results from US technology and pharmaceutical names that have introduced valuation concerns in that space have put pressure on Japanese names that are part of their supply/demand chains, leading to concerns that perhaps valuations in a number of sectors in Japan are looking stretched as a result. Whilst there is hope that economic data will benefit from trade relations with Europe and Japan, driven by US protectionism, short term concerns remain apparent as uncertainty remains.

The Emerging Markets & Asia Economy

It is clear that recent movements in both stock markets in Asia and Emerging Markets (EM) and also their currencies, have been driven by the weight of expectation of a ‘trade war’ with the US. Whilst it is clear that the US president, Donald Trump, is doing more than just posturing (seeing the US impose $34bln of tariffs on China in July), and whilst we have seen local currencies and stock markets weaken moderately, this short term volatility strengthens the valuation position of the Asia and EM asset classes. Valuations remain attractive, and whilst we have seen fluctuations in markets and currencies, key governments/central banks in the regions have yet to react with counter stimulus measures to any great extent. However, that is likely to change given external pressures on the economies. In July we saw China reduce the banks’ capital reserve requirements by 0.5%, coming into play shortly after the first set of US tariffs where introduced. This type of action injects liquidity into the system to act as a counter measure. This could also be supported by a proposed policy to restrict Chinese corporates from issuing dollar denominated debt, as a means of keeping Renminbi (Chinese currency) onshore.

Mexico saw its general election conclude on the 1st July, with left-wing national AMLO (Andres Manuel Lopez Obrador) elected with a majority win. AMLO is due to take seat in December and has already cited that the Mexican people will be at the heart of everything that he does... a comment that was directed at Donald Trump. AMLO is less likely to capitulate on the North American Free Trade Act (NAFTA), a free trade agreement between Mexico, the US and Canada that has been called in to question by Donald Trump. In addition, any notion that Mexico would be paying for a wall separating the US and Mexican border has now become somewhat laughable. And, with South America in mind, whilst Brazil is rife with political uncertainty at present given its multiple corruption scandals and 2017 presidential impeachment, the election that is due in October will inject a much needed stability to its market (assuming a controversial figure does not come to power), which could be a much needed catalyst.

So, whilst the next few months may present some hurdles by way of trade negotiations, growth in many core regions in Asia and EM remains robust, valuations remain attractive, and the perceived impact of any trade frictions will likely be overly priced into the markets… as such, all of these factors will likely increase the attractiveness of valuations ahead of the US midterm elections in November.

The US Economy

Much of the rhetoric in recent months has surrounded the alleged trade war with China. However, whilst we are far from a fully blown trade war, the imposition of tariffs on $34bln of Chinese goods was actioned in July; affecting products such as airplane component manufacturers, medical component manufacturers, and even specifics such as water boiler producers. China, previously vocalising their reluctance to be the ‘first mover’ in any trade spat, responded by imposing counter tariffs on products such as soybeans, pork and electric vehicles. This move by the US, whilst unsettling equity markets globally, saw US markets remain relatively robust. It is unclear as to whether this strength is driven by a flight to momentum stocks and perceived safety, but with Donald Trump still considering imposing tariffs on a further $200bln of Chinese goods, it appears that the market is not yet pricing in the potential risks to the supply chain of American corporates of any counter measures… and as such, valuations are beginning to look a little stretched with the S&P500 not too far off an all-time highs. That being said, at a stock level we are already seeing some of the larger technology names such as Netflix and Facebook disappoint on earnings, whereas year to date it has been the domestically focused smaller companies that have been the strongest performing, being somewhat immune to the imposed tariffs!

July also saw NATO's annual summit, at which Donald Trump accused other members of absorbing US defence contributions (aiding in defence from Russia) whilst also trading with the Russians. He went on to cite Germany as a key protagonist of this whilst also accusing German auto manufacturers of having disproportionately advantageous trading terms with the US. Whilst economic and market conditions do seem uncertain at best over the short term, Trump's suggestions of stronger trade ties with Europe later in July is something to draw confidence from. It is unknown whether this was as a result of other regions forging trade ties with each other, or the realisation that impacts of trade tariffs with China will ultimately impact the US consumer… but what we do know is economic data remains robust with unemployment low, inflation sitting slightly above target, and average wages growing. Whilst there is no denying that over the remainder of the summer we are likely to see some contentious predicaments, whether that be further accusations surrounding the Trump and Vladimir Putin relationship or indeed trade tariff expectations, what is probable is that Donald Trump is likely to slow down in his policy implementations come the midterm elections, as it is likely most of the recent posturing and policies have been to curry favour. As such, we could see US markets remaining stable over the extreme short term being reluctant to price in potential risks, and longer term valuations growing more attractive in value driven strategies as well as further down the market capitalisation spectrum.

The European Economy

The European economy has maintained a relative status quo over the past few months given anticipation of European Central Bank (ECB) tapering announcement and indeed Donald Trump's continual droning and rhetoric surrounding trade! With the former in mind, the broader market appears to have priced in tapering of the ECB's current debt purchasing programme in addition to pushing out any rate rise expectation well into 2019. However, with trade negotiations not only with the UK but also the US on the cards, it would be no surprise to see the ECB's head, Mario Draghi, announce a more accommodative policy and/or tapering approach to buffer any shorter term noise. In addition to this, July saw the German Chancellor, Angela Merkel, meet with the Chinese Premier, Li Keqiang, to strengthen trade ties going forward in light of the actions of the US. This, when married with the launch of the 'EU-Japan Economic Partnership' suggests Europe is less likely to capitulate to the US should trade pressures present themselves… After all, following Donald Trumps 'anti EU/Germany' comments at the recent NATO summit, trade negotiations at least seem likely. All of these factors could suggest that valuations could become more attractive in the European space over the coming months, coupled with a catalyst to aid in their growth as the summer closes out.

Fixed Interest

The bond market continues to offer little by way of long term upside when compared to the equity markets, and current stimulus measures suggest that this will not change any time soon. This stands not only for the UK sterling market, but also global bond markets. The past quarter has seen the US 10 year bounce along its 3% ceiling (breaking through by more than 0.1% only once, in May), and a sharper than anticipated flattening of the US yield curve. Whilst there have been critics of US Federal Reserve Chair Jerome Powell, including Donald Trump, the Fed has not felt sufficient concern to shift the pace of policy change. Elsewhere we have seen Japan maintain its loose easing policy, with

Japanese Government Bond (JGB) prices dropping and yields rising to the highest level in 1 ½ years. Yield pressures did however abate after the Bank of Japan's end of July meeting that saw them remain accommodative after anticipation of tightening. So, with all of this in mind and with rates in the UK forecast to have a negative real return over the medium term, Fixed Interest as an asset class offers little by way of attractiveness; with corporate bonds offering potential for higher levels of total return in the current environment than their government counterparts.

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