Autumn

Market outlook.

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The UK Economy

Uncertainty and underinvestment has weighed on UK consumer confidence since the EU referendum and after a brief lift from this year's summer heatwave, as Brexit negotiations reach a critical point, confidence has taken another hit; similarly, business economic optimism has also deteriorated. Despite UK unemployment being at its lowest level since 1975 and wages about in line with inflation, the lack of confidence and underinvestment is clearly manifested in other data.

Borrowing and low interest rates have helped sustain consumption whilst prices have been increasing (due to sterling weakness since the referendum); however, growth in borrowing dropped significantly in the last quarter. Household savings have also fallen significantly since the referendum; as a result, rather than increasing spending, consumers are likely to rebuild their finances with any wage improvements. This is evident as retail sales have been trending down, the list of high street casualties continues to grow, and car sales fell significantly in September.

This year's Budget was brought forward by a few weeks to allow time for parliament to focus on Brexit, as a deal needs to be reached in the coming weeks in order to meet the March 2019 deadline. The Budget itself contained very few surprises as most headline plans were announced earlier at the Conservative Party conference. It was heralded as austerity coming to an end, although, a lot of the giveaways were not funded by raising taxes but on the assumption of growth, and so any deterioration in UK economy is likely to result in a second emergency budget.

Predictions of when the Bank of England will next increase interest rates have jumped in recent weeks from late 2019 to early 2020 and back to late 2019. After the most recent monetary policy meeting, the bank's governor, Mark Carney, commented that a hard Brexit could trigger a supply side shock, which would push up inflation and warrant tighter monetary policy. In the event of a hard Brexit, sterling is likely to collapse, which would create inflation. In such a scenario, demand for goods and services would also deteriorate and therefore raising interest rates would be inappropriate, as doing so would further suffocate consumers and the economy. As a result the bank would need to support the economy, possibly even cut interest rates and restart quantitative easing.

If an agreement cannot be reached, a hard Brexit is unlikely, the subsequent political turmoil could result in a change of leadership and potentially another referendum, however, the more likely outcome is an extension to the March 2019 deadline. Talks did stall somewhat over the quarter and several key summit dates came and went, however, in recent weeks there has been various signs that a deal will soon be reached. Most recent was a confident letter from Brexit secretary Dominic Raab which resulted in sterling's biggest one day gain since April 2017.

The FTSE 100 is a global index with 70% of its earnings generated overseas. Despite the uncertainty Brexit has created for the UK economy, sterling's weakness has helped boost company earnings in

sterling terms. In the event of deal with the EU (soft Brexit) sterling is likely to recover some lost ground. However, March 2019 is not the end of Brexit, but the date an agreement needs to be in place on how the UK will ultimately separate from the EU. It has already been agreed that there will be a transitionary period under which the UK will remain in the customs union whilst it negotiates a trade deal with the EU. This is scheduled to last until December 2020 but due to the complexity of the negotiations, it is likely to take significantly longer and result in an extension.

A recovery in sterling will create difficult comparisons for offshore earnings, however, a soft Brexit will remove some of the uncertainty weighing on domestically oriented shares. Currency aside, the FTSE 100 is a global index and representative of the global economy and progress with Brexit could see an increase in demand for UK equites as versus other geographic regions they provide a competitively valued way to gain exposure to global growth.

The Japanese Economy

In the past quarter we have seen Japanese policy relatively stagnant, with commitment to buying debt based on the yield curve still etched into policy maker's decisions. Although, that is not to say that this past quarter has been uneventful in terms of future trade prospects. We have seen the finalisation of the free trade partnership between Europe and Japan (EU-Japan Economic Partnership Agreement) that removes import tariffs on virtually all goods and services traded between the regions, and perhaps more importantly we have seen the strengthening in the trade and economic bond between Japan and China. It is these relationships that have been key in sending an anti-protectionism message to the US, especially given the political frictions that have existed between China and Japan in the past. This relationship is crucial for both parties as China looks to decouple its reliance on the US for certain goods (areas where Japan can fill the void), in addition to Japan looking towards China for source of growth and expansion in a world fearful of protectionism.

With the above in mind, and whilst Japan does have its attractions over the long term, the fundamentals remain weak and the reliance on policy remains strong. With the announcement of an increase in the GST (goods and services tax) to 10% as of October 2019, this will put pressure on the consumer in an environment that is still starved of wage growth… that being said, the revenues generated will likely be a signal for increased fiscal spends in 2019. Japan is still seeking inflation, and despite a hugely wage inflationary environment with jobless rates low, and a 'job to applicant ratio' increasing to 1.64, it is baffling why this does not exist. The lack of wage growth and thus inflation suggests corporates have little confidence that the economy can remain stable without policy backstops. With unions reigning supreme, if the market came off, corporates would find it incredibly difficult to reduce wages and/or the size of their workforce to accommodate, making them non-committal to wage growth. In the run up to 2019 it is clear that at a stock level there are masses of under researched companies further down the market cap spectrum in Japan that look attractive on a valuation basis.

The Emerging Markets & Asia Economy

It has been a fun packed quarter for the Asian and Emerging Markets, seeing sentiment continually compress valuations making them look continually attractive as a long term investment given the optimum entry point! Clearly by far and away the largest influential factor has been the trade frictions between China and the US. We saw an initial $50 billion of Chinese goods taxed by the US mid-year, with China retaliating in an identical fashion. In September the US imposed a 10% tariff on a further $200billion of Chinese goods, but this time China retaliated with a tax on $60billion of goods. The Chinese approach has been much more measured, targeting key industries in the US whilst blending

it with domestic level stimulus such as cutting the banks' capital reserve requirements in October (to stimulate lending and relax a tense banking environment), in addition to planned 2019 tax cuts that amount to approximately 1% of Chinese GDP (including a shift in personal income tax brackets that will stimulate an expansion in domestic consumption). These stimulus measures are all levers that China can begin to pull to counteract US tariffs, particularly ahead of 2019 when we will see current US tariffs increase from 10% to 25%, in addition to the last $267billion of Chinese goods likely to be taxed. A meeting between US President Trump and Chinese Prime Minister Xi is to take place in November; however it is unlikely that either party will back down over trade. Negative sentiment has caused volatility in Asian and EM markets in 2018, suggesting it has priced in much of the impact of trade frictions into their markets and currencies. However, let's remember that whilst there has been a lot of nervousness around trade with the US, in addition to stimulus, China specifically has looked to build stronger trade ties with Japan, Europe and India etc. to buffer the impact to exports, in addition to domestic demand continuing to increase, inflation remaining buoyant and GDP running at 6.5%.

Outside of trade tensions we have also seen a number of landslide political changes within the regions. We continue to see large scale policy changes in India, seeing a landslide court ruling overturning a 150 year ban on same-sex relations (that held a maximum sentence of life in prison!). This is further evidence of the level of change and anti-corruption that makes India truly unique as a long term investment case. India is also considering introducing an ethanol mix into its fuel that will not only improve the environmental efficiency of vehicles, but also compress a rising oil price… bearing in mind ethanol is a product of sugarcane, something that India is one of the largest producers of globally, this should further aid in price reduction of fuel in the region, benefiting corporates. We have also seen Brazil elect a new president, Jair Bolsonaro. This appointment marks a large shift in Brazilian voter opinion by appointing a Populist, Far Right ex-military officer who is openly sexist, racist and whose campaign was based on being 'pro-military dictatorship'. Whilst one may wonder how he was voted in, much of the Brazilian population has been driven by the need for change following a raft of political corruption scandals, and with Bolsonaro being a 'new face' with little political background in addition to being pro-business, it was this that garnered favour. That being said, the Brazilian market rallied at the prospect of a pro-business government, but this could be short lived as to make any significant changes to regime policy, he will need the approval of a congress of which his party only has 10% of seats and a lot of 'enemies'. With that in mind, it seems sensible to wait for markets to settle after the initial rally to see if a true policy catalyst is introduced to make any uplift sustainable.

The US Economy

Trade disputes have again dominated US news over the past quarter, however the recent October corporate reporting season has been a mixed bag of data, with some companies struggling to make the cut. Alongside this we are beginning to see the Chinese/US tariff battles begin to work their way through to corporate numbers with a number of manufacturers having increased costs at the top line driven by import tariffs and increased demand and thus cost of US manufactured raw materials. This is causing valuations to pull back, and whilst they are still high, the sell-off in the US markets in October has been arguably healthy. Fundamentals in the US remain strong, seeing Gross Domestic Product (GDP) and employment data remain healthy… however complacency should not set in, as going into 2019 the current weakening inflation data, inconsistent corporate earnings and 'risk off' sentiment could signify a shift in the economic cycle. With corporates yet to see the true impact of trade frictions, this could see the slack in the labour market tighten; manipulating unemployment higher, stagnating wages and putting downward pressure on inflation.

So, with the above in mind the next few months become key. President Trump has already criticised Jerome Powell, the head of the Federal Reserve Bank (Fed) for the projected steepness of the rate rise cycle. Whilst the projected cycle could prove to be a policy error should it come to pass, the Fed remain data dependent and any cyclical shift would likely be met with a slowing in the pace of the already glacial rate rise policy; which is why the likelihood of multiple increases in the short term are decreasing should the markets continue to reign in. Let's remember that 10 years on from the

economic crisis, we are yet to see a cyclical shift in markets and should this come about, we would likely see the ‘growthy’ and small cap names suffer over the short term; with the small caps accelerating strongly once the turn has been made, accompanied by the mid cap value names.

The elephant in the room over the coming quarter is November’s US Mid Term elections. This is arguably key to both US markets and sentiment going into 2019. At present, Trump’s Republicans have control of both the upper house and lower house but given their slender majority in the lower house, it is expected that the Democrats could claim the majority which would make further policy implementation by the Trump administration much more difficult. This could aid in a cyclical shift causing a short term contraction in markets, which could be thought to be healthy in the long term.

The European Economy

The past quarter has been a quiet one economically for many countries within Europe. The European Central Bank (ECB) has kept policy unchanged throughout the period and has confirmed that debt purchasing (Quantitative Easing) will cease by the end of the year, with interest rates likely to remain at -0.4% going into 2019. But, with markets not pricing in a rate rise for quite some time, and with the ECB’s accommodative and data dependent stance, it would not come as a shock to us if interest rates began to increase slowly should the climate and fundamentals continue to improve. That being said, we are not likely going to see any severe shifts in policy ahead of a change in the Head of the ECB this time next year, with Mario Draghi wanting to close out an arguably successful 8 year term unscathed. His term, amongst other things, has seen unemployment slowly improve and an avoidance of deflation.

Despite a broader calm, clearly there has been some recent friction between the Populist Italian Five Star government and the EU over the agreed cuts to the Italian budget deficit in recent months. The EU took the unprecedented step of formally rejecting Italy's Budget, which proposed pushing the country's budget deficit as high as 2.4% of gross domestic product over the coming years. This means Italy would be ignoring the EU mandated 0.8% plan for 2019, and nearing 0% by 2020. The current Italian ‘debt to GDP’ sits at approximately 130%, which already breaches the EU’s 60% rule that should see Italy impose a much quicker adjustment path than they appear to be willing to accept! However, despite the Italian rhetoric, the European project remains intact and arguably looks stronger in wake of the Brexit issues, and this doesn’t look likely to change any time soon. With valuations in the region looking strong on a relative basis, and with a continually accommodative central bank, it continues to look one of the most attractive equity asset classes for investment opportunities heading into 2019… and let’s face facts, we have not yet begun to see the benefits of the free trade alliance with Japan work its way through to corporate margins yet, and when coupled with potential trade ties with China (negotiations are ongoing), the outlook remains strong in spite of uncertainty surrounding US trade relations.

Fixed Interest

October has been slightly unique and has offered a positive sign of normalisation for broader markets in that the textbook negative correlations between bonds and equities returned. Whether or not this normalised correlation is prolonged remains to be seen, but with rates broadly rising, albeit at a slow pace, bonds remain unattractive from a long term investment perspective. Italian yields have been volatile with a spike in the 10 year over recent months driven by the growth and debt concerns, and US 10 year yields hovering above 3% which is conducive to the strength of the equity markets in the run up to the October pull back. The opposite is reflected in the UK debt market with the equity market uncertainty seeing the Government 10 year yield fall approximately 17% from its

2018 peak in October. So what does all of this mean? It is again echoing sentiments that whilst there has been recent equity market weakness, the risk off trade is not a fleeting drive to the bond markets, with global interest rates continuing to rise, corporate credit spreads at tight levels, and equity market opportunities in the right regions having stronger risk adjusted opportunities. In line with this, it is the corporate bond market that is likely to see the most benefit from the current economic backdrop, but with yields going up at a glacial pace, it is difficult to build a case for holding anything other than par level duration. So whilst bonds have held up well in the recent market pull back, the current conditions are not supportive of a prolonged allocation, with rates likely to creep up slowly and yield curves likely to follow a similar trajectory.

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