**Market Views**
**August/September 2018**

Against the background of the ongoing trade disputes, US equities continued to be strong over the past month and outperformed other developed markets. Politics are likely to continue dominating our thoughts in the coming months, with Brexit negotiations progressing and US mid-term elections on the horizon.

The US economy remains robust, with strong growth reflected in better than expected survey data, low unemployment and rising wages. As a result, a Federal Reserve rate hike in September is fully priced into markets, with a high probability of another hike in December. Following the tax cuts, capital returns to shareholders and wages have increased but so far, capital expenditure has not benefitted significantly. However, this may take longer to come through. There was a rare piece of positive news on trade in August, with the US announcing a new NAFTA agreement with Mexico. The NAFTA negotiations have now moved to Canada. Negotiations with China continued with Trump escalating tariffs and China retaliating and complaining to the World Trade Organization. US mid-terms will take place in early November and could prove very important if the Democrats are able to win control of the House. This would allow them to block proposals put forward by Republicans and also, could potentially see them launch impeachment proceedings against President Trump.

Looking to the UK, sterling remains sensitive to the Brexit headlines. Recent news from the EU's chief negotiator, Michel Barnier, and others have suggested an unprecedented deal may be done by November. However, detailed examinations of these comments reveal that many of the sticking points remain unresolved, particularly on the Irish border. Positive UK economic data and suggestions of progress towards a deal by mid-November pushed up the pound. This weighed on the UK equity market, given its significant exposure to overseas revenues. Brexit aside, unemployment remains low, wages are ticking up and GDP numbers for July are stronger than expected. Following the rate hike in August, no further rate rises in the UK are expected before the middle of the next year.

In the Eurozone, concerns over the new Italian government sticking to the EU's budget rules seem to have abated. The gap between Italian and German 10-year bond yields has fallen to 2.5% after reaching the widest spread in more than five years at 2.9%. Despite this, rating company Fitch revised their outlook on Italy to negative from stable. With regards to the currency and confidence crisis in Turkey, a tightening from the Turkish Central Bank has helped to regain the market's confidence.

Looking to other emerging economies, Argentina has been hit hard and a 50% fall in the Argentinian peso this year has helped to push the economy into a deep recession. Austerity measures by the government weren't enough to regain confidence so it has asked the International Monetary Fund (IMF) for an emergency bailout of $50bn. Despite this and the world's highest interest rates of 60%, Argentina's crisis is getting worse as markets worry about potential for political backlash against the austerity programme.

On balance, our market view is unchanged. Increased volatility should be expected, due to political tensions and the escalating trade war. Although there are some signs of slowing, we feel that the global economy is still in a relatively good place and equity markets continue to look attractive relative to bonds.

### Market View Changes

- **No change**

## Currencies

| | |
|---|---|
| US dollar | ◀▶ |
| Sterling | ◀▶ |
| Euro | ◀▶ |

After a period of strength, the US dollar has weakened slightly against the pound and euro. While the interest rate differential between the US and other major economies is widening, Trump's unpredictability and the fact that interest rate rises are already priced in means we retain a neutral stance. In the UK, we also hold our neutral position since we feel the currency will be a function of the Brexit negotiations for some time to come. There is potential for a bounce should progress be made, but also potential for further declines if unfavourable exit terms arise or a 'no deal' scenario becomes more likely. On the euro, political uncertainty poses a concern and the recent economic data has exhibited a slight weakening in the region. However, the labour market is tightening and inflation is starting to come through; we feel the outlook for the currency is balanced. Across all three currencies, we expect that there might still be significant volatility throughout 2018.

## Fixed Income

| **Government Bonds** | Conventional | Inflation-linked |
|---|---|---|
| UK Gilts | ▼ | ◀▶ |
| US Treasuries | ◀▶ | ◀▶ |
| German Bunds | ▼ | ◀▶ |

We maintain our negative stance on gilts even after the recent Bank of England (BoE) rate hike. Even though the forecasted BoE end target for base rates is much lower than historic averages, current gilt levels imply that they won't be able to raise rates anywhere near these levels. We acknowledge that Brexit may distort these levels for the near term but current employment trends gave the BoE little room to hold rates where they were. Given robust commodity prices, weak exchange rates and better valuations, inflation-linked exposure retains a neutral stance. Our view on US Treasuries and their inflation-linked peers remain neutral considering the sharp re-pricing that has taken place in both markets year-to-date. Rising inflationary pressures are mitigated by confidence concerns arising from trade rhetoric. The European Central Bank (ECB) recently suggested that they would conclude asset purchases at the end of this year but only start raising rates in September next year. However, there are increasing signs of inflationary pressures building up; hence, we prefer inflation-linked exposure to conventionals. At current valuations, we cannot justify an investment in conventional bunds and retain our negative stance.

**Investment Grade Corporate Bonds** ◀▶

The recent earnings season was strong, resulting in better metrics across the investment grade universe. Valuations have cheapened up in recent months but this mostly reflects the expectations that central banks will seek to support the market less actively in the future. Given that the AT&T and Time Warner merger was given the go-ahead in a historical ruling, we expect that M&A risk will become a bigger consideration over the coming months. Therefore, we would advocate only selective exposure in this market to capture the yield advantage whilst avoiding the event risk.

**High Yield Credit** ▼

We moved negative on High Yield Credit given the historically tight valuations, which were previously justified on low default rates. Highly levered credit was not immune from the recent equity market volatility, with spreads widening rapidly. This sudden repricing led to some outflows from the larger index funds, putting further pressure on the market. Our expectations remain that we are likely to see declining returns but increasing volatility and, as such, we would only seek exposure through flexible managers who are not required by mandate to own debt of highly levered companies.

| **Emerging Market Debt** | |
|---|---|
| Local currency denominated debt | ◀▶ |
| Hard currency denominated debt | ◀▶ |

Whilst broader valuations on the asset class remain attractive, the recent strengthening of the dollar has put pressure on both local and hard currency debt. Turkey was particularly vulnerable to these factors given its twin deficits and subsiding confidence in its central bank independence, resulting in the currency falling in excess of 20% since the end of the second quarter. Whilst there might be some contagion in terms of asset flows, the majority of Turkey's problems are of its own doing and therefore are not an indicator of wider issues across emerging markets. The rise in oil prices this year will benefit some countries but weigh on others and therefore we would only recommend selective exposure that can take advantage of this diverse asset class.

## Equities

### UK Equity

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The FTSE All-Share Index was down a touch over the past month. We believe that the UK equity market looks increasingly appealing, with a prospective price to earnings ratio for the next year of 12.5x and an average dividend yield of 4.5% at the time of writing, on the All-Share Index. This compares very favourably with a muted 1.48% yield on a 10 year gilt. However, with greater clarity needed with regards to Brexit and its potential impact on the currency and equity market, we have remained neutral at this time.

### Europe ex UK Equity

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The Euro Stoxx 50 Index has sold off slightly in the last month, as the Eurozone continues to see a slight weakening in economic data. Banks have been under pressure in recent months, principally due to concerns about their exposure to troubled emerging markets like Turkey. Italian woes have moderated but political concerns remain. Despite this, valuations in the region remain attractive and therefore we feel a neutral stance is appropriate.

### US Equity

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The US economy remains solid and its equity market continues to march onwards, disregarding concerns over trade wars. This allowed the S&P 500 Index to rise 2.3% over the last month, with the noticeable achievements of Apple and Amazon reaching a market capitalisation of $1 trillion. Economic data continues to impress with the consumer confidence and ISM surveys showing that growth is likely to remain robust. The US remains the market that we feel is home to the most high quality companies who can sustainably compound growth over the longer term. Whilst there is likely to be more volatility this year, this continues to be our preferred market and we maintain our positive stance.

### Japan Equity

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Buoyed by a slight weakening in the yen, the Nikkei 225 Index ticked up over the last month. Japan is less affected by trade wars than its global peers because many of its manufacturers already have factories in the US. We have been positive on the equity market since the back end of last year given Abe's policies towards improving corporate governance, dividend payouts rising, earnings improving and sustained economic growth. We see particular appeal in the excess cash flow and dividend growth story. Extended terms for Prime Minister Abe and Bank of Japan Governor Kuroda, have further reassured us on the long-term attractiveness of the Japanese market.

### Asia ex Japan Equity

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Asian equities were weak over August, with China and Hong Kong as the weakest countries due to an escalation in US-China trade tensions. India has also been affected by the trade war, with its currency hitting its weakest level on record against the dollar. However, the surplus that India has with the US is roughly 1% of India's GDP, allaying concerns over this matter. We continue to believe that long term prospects for the Indian market are good and that there is an attractive long-term growth story on the back of Prime Minister Modi's reforms.

### Emerging Markets ex Asia Equity

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Valuations in these markets have cheapened up as a result of Trump's erratic trade policies and the dollar strength seen this year. Latin American countries, especially Brazil and Argentina, have seen their currencies and equity markets slide. The Brazilian real has been affected by the rising US interest rates and by the upcoming election uncertainties, at a time when the country is facing a contraction. Argentina's political challenges and financial concerns have weighed on its equity market, with the Argentinian peso experiencing an extreme drop. On the other hand, some countries have focussed on domestic reform agendas which could result in longer term growth prospects. Given the size of the fall across these markets, we believe that selective opportunities are starting to appear and there is potential for us to turn more positive in the months to come.

**Alternative Investments**
**Hedge Funds/Targeted Absolute Return** ▲

In the alternatives space, we maintain our preference for "Equity Long/Short", "Event Driven" and "Macro" strategies that can come into their own in an environment of increased volatility. From a portfolio construction standpoint, the diversification offered by these strategies is valuable when traditional asset classes (bonds and equities) become challenged. In balanced portfolios, trend following strategies also have diversification benefits and have tended to do well when there is a sustained downturn in equity markets. We have held our positive stance as we believe that, going forward, the search for diversified sources of return within portfolios may become more pertinent than for some time. However, we stress the importance of manager selection in this space.

**Property/Infrastructure** ◀▶

We hold our neutral stance on property and infrastructure but encourage selective exposure. On UK commercial real estate, we are cautious due to the liquidity mismatch, but a yield differential with bond markets supports the asset class. The outlook for the market is muddied by Brexit and so our preference is for German residential real estate due to its attractive fundamentals. On infrastructure, it appears attractive in today's low yielding world but as interest rates rise, this will be called into question. However, it was a strong performer last year and is looking fairly valued. In the UK and more recently Italy, political risks surrounding the sector have increased as far-left parties question lucrative contracts.

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