Spring
2019

market outlook.

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Written by:

Peter Quayle
Fund Manager (UK)

Jonathan Wiseman
Fund Manager (Overseas)

The UK Economy

Despite several attempts, Theresa May was unable to get her Brexit deal through Parliament before the March deadline. As a result, the EU granted extensions giving politicians until October to reach an agreement. In an attempt to break the deadlock, Theresa May has reached out to Jeremy Corbyn in the hope of reaching some form of cross-party agreement. The UK will have to participate in European Parliament elections if an agreement cannot be reached by the latter part of May and so campaign preparations saw Nigel Farage launch his new "Brexit Party". Farage is likely to grab headlines and with polls suggesting there is building support in many regions for a hard Brexit, pressure is likely to mount on the government.

We still believe Parliament will eventually come to an agreement, although we don't think a hard Brexit should be overly feared. In such a scenario, the immediate aftermath would absolutely weigh on sentiment, however it has the potential to open up a whole new world of supply and demand for goods and services, which could redefine the UK and its trading relationships for decades to come. That said, there are many countries within Europe heavily dependent on trade with the UK and with the EU's negotiation priority seemingly the preservation of the European Union, their tactics often seem to overlook that trade is equally important to constituent countries. This gives us comfort that the status quo is likely to prevail. With many political obstacles still to overcome, we expect more twists and turns in the coming months and whilst we can't rule out another referendum or a general election just yet, they are both unlikely and UK politicians have been clear that leaving the EU without an agreement is their least preferred option.

Sterling has continued to take its direction from Brexit developments, and its fall in value since the 2016 referendum has helped boost UK listed company earnings (as the majority of their revenue originates offshore) which in turn has supported share prices. However, should positive Brexit developments lead to sterling strength, it does not mean the negative correlation between sterling and the FTSE 100 will continue to hold. Removing the Brexit uncertainty from the UK increases the appeal of the UK equity market for offshore investors and sterling strength decreases the appeal of offshore investments for UK domestic investors. As a result, Brexit progress and clarity could result in positive flows for UK equity markets offsetting negative earnings translation.

In terms of the UK economy, inventory building ahead of the March Brexit deadline helped GDP beat estimates over the quarter. The number of people in work hit a record high and unemployment remained at its lowest level since 1975. Wage growth remains strong and inflation below the Bank of England's target. This combination of wages rising faster than inflation provides a boost for consumers, whose spending drives the UK economy. This spending was evident in UK retail sales which increased for a third consecutive month in March, beating forecasts of a decline. Whilst this demonstrates the resilience of consumers, the economy is far from overheating and with Brexit kicked back to October, economic data is unlikely to receive another boost from stock piling in the coming months. In conclusion, with inflation below target and Brexit still looming, there is no pressure on the Bank of England to increase interest rates any time soon.

The Japanese Economy

Japan is an economy that is incredibly geared towards global growth, and with global growth expected to slow, this has been reflected in the broader Japanese stock markets. Whilst up over 6% year to date, it is the worst performing asset class in sterling terms. It is important to remember however that whilst global growth is expected to slow, growth is still present. Therefore, even for an economy such as Japan, opportunities are rife with small and medium sized companies significantly outperforming the large cap benchmark. This, as mentioned in previous Market Outlooks, has largely been driven by the under research of companies in this area of the market cap spectrum.

Unlike other global economies, Japan has found itself tangled in somewhat of an economic web. Whilst its immense Quantitative Easing Programme (bond purchasing/printing money) has staved off inflation 'at the margin' (National CPI running at 0.5% - 1.5% below target), it is apparent that they can't withdraw stimulus as wage growth is still absent… and it is wage growth that is needed to solidify inflation without Quantitative Easing. With all of this in mind and with global equity markets performing extremely well year to date, as global growth slows, we still expect a number of core equity markets to continue to tick upwards but it is not likely to be as rampant of an upward shift that we have seen so far in 2019, and we can already see Japanese data begin to stem. Inflation is missing targets, industrial production is contracting, and even though job data is strong, wage growth is absent… and until there is corporate level belief in the effectiveness of Prime Minister Abe's policies, companies are not willing to commit to long term wage hikes. This data, when coupled with the planned Consumption Tax hike in October of this year (8% up to 10%), will likely have a negative impact on Japanese Economic data over the short term, with the only real opportunities from an investment standpoint coming from the massively under researched small to medium sized companies that continue to achieve large levels of excess performance. In addition, there will likely be pockets of euphoria surrounding Japanese markets such as the recent crowning of a new Emperor, which has followed the first abdication of the position in over two centuries… and whilst this will likely drive some market buoyancy, it is difficult to see past the structural problems, and the uncertainty that surrounds the looming trade frictions with the United States!

The Emerging Markets & Asia Economy

Despite trade between China and the US dominating headlines, there has been little definitive progress outside of Donald Trump's comments stating that they are closing in on a deal. That being said, whilst it is likely that this could be true, the deal will potentially be laced with tariffs and conditions… as, let's face facts, the sticking point over 'Intellectual Property' remains, as does Trump's request that China abides by any agreement for a period of time before the US remove tariffs, which does not seem likely! So, with relations between China and the US progressing, but an end date uncertain, it has actually been Indian policy and elections that have been prominent over the past few months. Polls taken at the beginning of the year suggested that current Prime Minister Narendra Modi would maintain his seat with a significant coalition. However, following the introduction of 150% sales subsidies on agriculture products, and annual 6,000 Rupee assistance to farmers amongst other things, polls last month suggested a Modi majority. So, with a population of over 1.3 billion (over 800 million registered to vote), the voting process is over a month long; starting 11th April with over 7 phases and ending 19th May, with votes counted 23rd May. A positive result for Modi, which seems likely, could see the market and currency receive a further boost, like we have seen over the past few months in anticipation of the election (with India being one of the strongest performing markets in sterling terms). With most of the foundation policies now 'laid', and the majority of the downside of these adjustments now priced in to Indian markets, Modi's re-election could be a strong catalyst for the Indian market to strengthen further.

Elsewhere, we have seen Brazil take a step towards resolving the enormous pension debt pile with President Bolsonaro's proposed Bill passing its first legislative hurdle at the end of April, seeing the lower house vote in favour of the Bill as constitutional. Whilst there are still many months to go and six further votes in order to pass the bill, it is a significant first step for Brazil to take in order to address the largest drain on the country's economy.

Considering all of the above, and remembering that much of the Eastern bloc of the Emerging Markets as well as broader Asian markets priced in much of the concern surrounding trade in 2018, valuations are among some of the most attractive globally. China exceeded growth and trade expectations with the former coming in above expectation at 6.4% and the latter seeing exports exceed expectation by a staggering 15% at 21.3% in March. This, coupled with a strong run in Indian markets following domestic policy adjustments and ahead of an election, continues to make the Asia and Emerging Market space the most attractive throughout 2019, especially given the kicker they received to local currencies (and markets) following the US Federal Reserve's cautious stance that suggested a rate cut is possible. However, the opportunities will be country specific, with areas of volatility such as much of Latin America still apparent!

The US Economy

It has recently been a struggle to know where to begin when assessing the US economy, but by comparison to recent years, the past few months have been somewhat tepid by the country's standards under the Trump regime! So whilst the US has largely been at the centre of many political and economic news pieces, and has been a primary driver of markets, we have seen little of this in recent months.

With the above in mind, we must not forget that there is a fair amount of overhang left from ongoing trade and political tensions that is yet to be resolved. In February we saw US President, Donald Trump, walk out of a summit with North Korean Leader, Kim Jong-Un, which was intended to make progress, with Pyongyang giving up its nuclear weapons and aspirations. The talks broke down after the two leaders could not agree over how to progress, with Kim wanting all sanctions lifted in their entirety, and Trump stating that this was something the US were not prepared to do. The end of April saw Kim meet with Russian Prime Minister, Vladimir Putin, to discuss the current sanctions and relations with the US. Whilst initially it would appear that Trump has pushed the Russians and North Koreans together, Putin was firm in his backing of the denuclearisation of Kim's regime, whilst also backing the independence and sovereignty of North Korea during and after any process is rolled out. Although no major progress was made during this meeting, it did build trust between the two countries and at the same time saw Russia largely back the stance of the US, abating any markets fears!

In addition to North Korean relations (and arguably more importantly - trade!!), to reiterate the above, little definitive progress has been made between the US and China, with the deadline for the imposition of the US trade tariffs being pushed back several times. That being said, this implies both parties are keen to strike a deal, and whilst Chinese Premier, Xi Jinping, has been hesitant due to the reluctance to comply with suggested US terms surrounding the removal of US tariffs and indeed terms surrounding intellectual property rights, in a trade speech in April he implied that China was prepared to make concessions. So, what does this mean? Although it is hard to say what the final agreement will look like and when it will be imposed, it is likely that any agreement will be laced with tariffs on both sides. However, this can be seen as a slight positive for markets, as 2018 saw many key global markets price in an ongoing trade war. Whilst we may not see the strong performance of global markets 'year to date' continue for the rest of 2019, valuations in many markets, and an element of trade certainty with China, suggests broader markets will remain robust. This is also supported by the dovish tone struck by the head of the US Federal Reserve, Jerome Powell, back in March. Powell stated that there will be a strong focus on inflation when considering interest rate levels going forward, with a view to achieving their 2% inflation target. Global markets reacted positively to this news, particularly in Emerging Markets as the expectation of a faltering rate rise cycle in the US (and even the potential for interest rate cuts) saw Emerging Market equities and currencies breathe a collective sigh of relief. However, it is difficult not to get caught up in the hubbub of media interpretation as in reality, the Federal Reserve remains accommodative and data dependent with no predefined path for interest rates. In fact, this should be considered a massive positive for equity markets, particularly in the US, as a 'data dependent' path allows for immediate policy adjustment! So, even though US equity valuations seem a tad 'toppy' when compared to other regions, strong growth and employment data supports the potential for further gains in the months to come.

The European Economy

The past few months have been a staggered blend of fringe uncertainties for the European markets surrounding not only Brexit negotiations, but also trade frictions with the United States. In addition, we have also seen the Centre Left Socialist party win the elections in Spain. However, despite this, Central Bank accommodativeness and indeed valuation opportunity have prevailed.

Touching on the Spanish elections first, whilst Prime Minister Pedro Sanchez's Socialist Party did not win the majority and are on the hunt for a coalition, this is a far cry from the momentum that the far right parties were gathering in the polls. Even though it is true to say that the extremist right did poll higher than in previous elections, a more centrist party prevailed. This echoes the wide spread elections in Europe in 2017, when worries of extremist parties coming to power were considerably abated and markets flourished.

Being UK based investors, it is hard to conceive a scenario where Brexit is not as impactful on Europe as it is on the UK, but whilst not meaningless, the European markets and broader economy are much less likely to be as geared into a 'less than perfect' Brexit scenario than the UK. With this in mind, much of the focus of key European markets has turned to potential trade frictions with the US, particularly with President Trump beginning to cite Europe as the next target for trade negotiations (once an agreement is reached with China). As such, we have seen sentiment in manufacturing bases such as Germany, and sectors such as automotive and technology fall out of favour. Whilst one must be cognisant of the risks facing Europe over the coming year, it is not all 'doom and gloom'! The European market is facing both European Parliamentary elections in May in addition to appointing a new European Central Bank (ECB) Governor in October/November. Even though the European Parliament will likely continue to be nothing more than a sounding board for anti-establishment protest votes, we have seen an incredibly accommodative stance from the ECB that looks like it will be maintained. In March, not only were expectations of an interest rate rise pushed further out, but the introduction of TLTRO 3 (Targeted Long Term Refinancing Operation) was introduced; a method of lending money cheaply to the banking sector in order to stimulate lending, spending, and thus inflation. This stance by the ECB will be in place, as too will be their accommodative nature, throughout any potential trade hiccups over the coming months. So, whilst the market has rallied strongly year to date, and whilst there are some headwinds throughout the rest of 2019, valuations remain attractive, growth, whilst slowing, will likely remain, and isolating opportunities in the right areas will be the key to obtaining returns. I heard a phrase coined from the 'Goldilocks' scenario you have heard us use in the past, and that is 'Slowdilocks', which refers to the climate being one of slowing growth, but plenty of opportunity… as, let's remember, slowing growth is still growth none the less!

Fixed Interest

Central Bank dovishness has dominated the yield curve over the past few months. In particular, the US Federal Reserve redirecting its interest rate policy to focus on inflation data. As with recent US inflation data missing the 2% target, and with the Fed recently stating that the next interest rate move could be a cut (in order to stimulate lending, spending and thus price growth); short-term, the concern of an increasing yield curve inversion is certainly justified. However, this must not be seen as a precursor to a recession as media hype may suggest, as the backdrop has been unique! In this instance, fundamentals remain robust, and it is solely the accommodative stance of the Central Bank and the pre-emptive nature of investor sentiment that could be held responsible for a yield curve inversion, as it is short-term policy that could drive the short to medium end of the curve down. It is important to remember that rates are still low, so any small cuts would not signify a cutting cycle, but rather a policy adjustment which is good for the economy and even better for markets!

Whether you look at the US, the UK, Europe, China, India (the list goes on), Central Bank dovishness has been a theme over the past quarter; seeing accommodativeness becoming prevalent in key economies globally and driving yield compression. Also considering the volatility in the Fixed Interest space year to date, and the remaining correlation between 'it' and equities, with policy remaining accommodative and global growth (whilst slowing) still present in many economies, the equity markets still appear more attractive not only from a policy perspective, but also a valuation one. With this in mind, it seems logical that the corporate debt space remains more attractive than government debt going into Q3 as given the positive correlation and the potential upside for equities throughout summer, this segment of the debt space would capture some of the upside, whilst aiding risk return attributes.

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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