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# Market commentary and outlook

April to June 2018

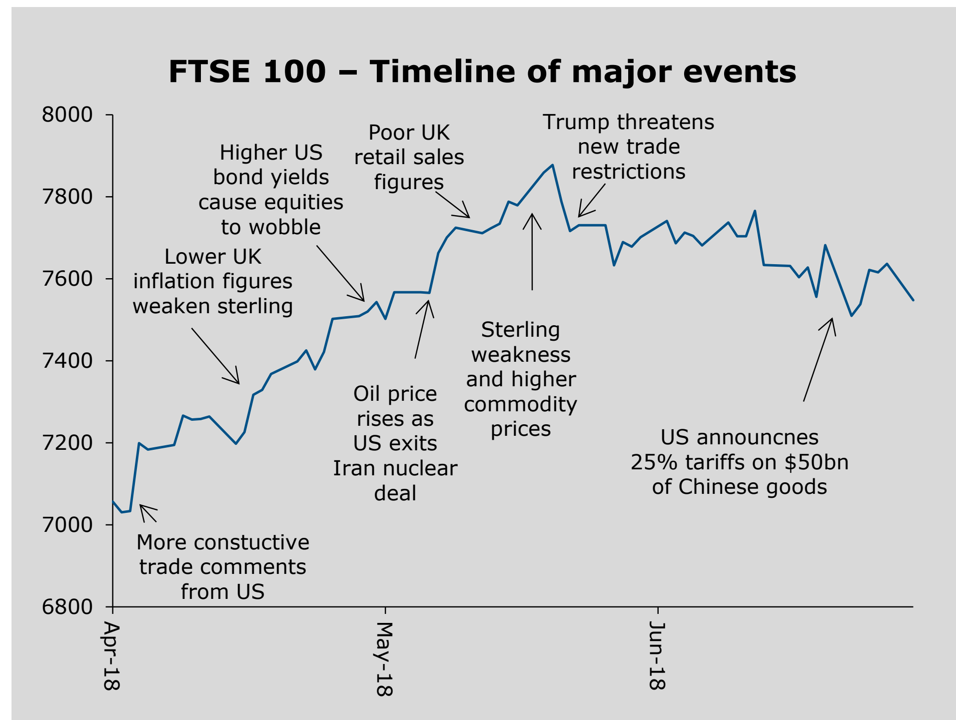
# Market commentary and outlook

**A strong US Dollar and global trade fears**
Trade tensions continued to occupy markets during the second quarter but investors appeared to be adopting a wait-and-see posture. While much of the rhetoric on US trade policy proved to be noise, concerns are growing over what impact the escalating trade war would have on economic growth. A US-China trade war does not just hit the US and China, trade is globally integrated and supply-chains are complex. With Emerging Market economies tightly linked into global supply chains, US-China trade tensions may cause them to be early shock transmitters. The rising US dollar also provided a headwind for non-US assets, and emerging-market (EM) equities suffered the biggest losses. The rising US Dollar and receding Dollar liquidity proved particularly detrimental for the most vulnerable EM countries with large and rising current account deficits.

**Global expansion continues, but more mature and less synchronised**
Global manufacturing activity continues to expand, but the pace of improvement has slowed somewhat. Slowing manufacturing activity is a headwind for export-oriented economies. In China, the industrial sector has slowed materially and risks of a growth recession are starting to increase. Other large economies, including Germany and Japan, have shown signs of maturing as well. After broadly synchronised global acceleration in 2017, the risks of a growth slowdown may be higher than generally appreciated.

**Positive signs from the UK**
The consumer orientated parts of the UK economy have bounced back in the last few months, which is all the more impressive given the stuttering progress in the Brexit negotiations. The major highlight was the release of UK retail sales which showed a 3.9% increase, boosted by the Royal Wedding and unusually warm weather. The encouraging data, alongside further weakness in Sterling, ensured the FTSE 100 index remained underpinned given its many international constituents which receive a boost from repatriating foreign revenues. The more positive tone corresponded with a surprise change in voting at the Bank of England's Monetary Policy Committee meeting, with three members now against maintaining the current interest rate suggesting momentum is building for a possible interest rate rise, with the August meeting the current front runner.

**Earnings season**
The earnings reporting season is nearly upon us and we think this will likely be a very positive season for the US. While there is certainly excitement about stocks given expectations of strong profits, we must be mindful that earnings reports are akin to looking in the rear-view mirror. What will therefore be far more important than the results will be the outlook statements published by the companies.




## Economic risk

- Many asset classes are at high valuations.
- Further interest rate rises are likely. Central banks are less willing to intervene in markets.
- Trade is increasingly contentious and new tariffs have been put in place.
- Debt levels remain high in the West and have grown in emerging markets such as China.
- The midterm elections in November may limit President Trump's freedom to implement further policies to promote growth.

## Market momentum

- Corporate profits are showing better growth than in recent years.
- Consumer and business confidence are generally at high levels.
- Further US interest rate rises look set to be gradual and communicated well by the Federal Reserve.
- Monetary stimulus continues in Europe and Japan for now.

## International view

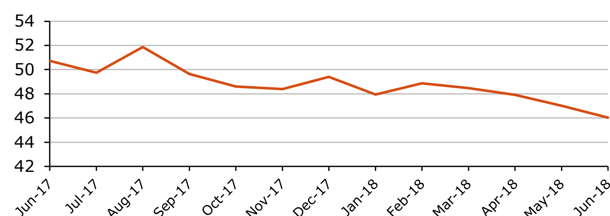
**Positive signs?**
A rebound in retail sales, boosted by the Royal Wedding and unusually warm weather.

**QE to continue**
ECB plans to unwind QE by the end of the year but won't implement a rate hike in the next 12 months.

**"made in USA"**
Lower taxes, high asset prices and deregulation are benefitting the economy and profit growth.

**US–China stand-off**
A full-blown trade war is the largest threat to the economy and asset prices.

# Market commentary and outlook



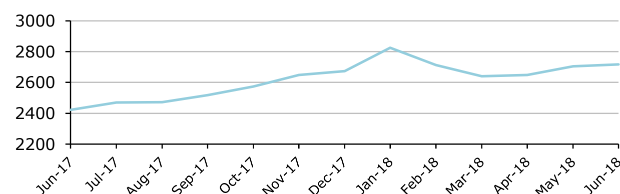

## Emerging Markets

Emerging Market (EM) assets have been under pressure for several months, initially triggered by higher US interest rates and a stronger US Dollar. This was then exacerbated by concerns about external fragility, notably in Argentina and Turkey, and the resulting outflows from the asset class.

We still think EM fundamentals are solid, but the speed of losses in some EM currencies as well as protectionist worries has led to outflows from the asset class. We believe there is scope for some of these headwinds to reserve and for a more stable US rates markets which should support Emerging Market currencies and therefore EM local debt.

In EM, we continue to look for opportunities to add long EM currency exposure, for example, by introducing EM local currency debt position. The local currency debt markets are much larger and, generally, more liquid than the hard currency US$ markets and with our view on EM turning more constructive, we may be approaching a good entry point. Market participants are close to discounting most of the bad news and we think there are now more elements for a positive rebound.

- + Fundamentals are solid
- + Structural reforms continue
- – Setback in the face of Trump's trade wars
- – Rate rises and dollar appreciation have combined to cloud the outlook.



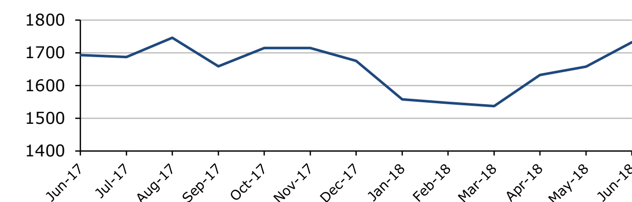

## US equities

US growth has accelerated after a brief soft patch with the most recent economic data exceeding consensus expectations. Monetary normalization is being implemented at roughly a third the pace of a usual cycle, and fiscal impulses have been coming in stronger than originally expected. With the economy and financial markets still having the wind in their sails, we remain vigilant as we transition from quantitative easing (QE) to quantitative tightening (QT) in the US.

Consistent with a late-cycle phase, corporate profit margins have declined from peak levels, but corporate tax cuts and restrained wage growth have allowed margins to stay high and corporate profit growth to remain firm. Over the course of the coming year consumer and business spending should begin to increase, generating above-trend growth, supported by a robust labour market and consumer confidence.

We have recently added a new fund in the US called Miton US Opportunities to take advantage on these favourable trends. The manager has positioned the fund to benefit from the strong domestic economy with a "made in USA" theme being expressed by taking overweight bets in stocks and sectors that look set to benefit from an increase in capital expenditure and consumer activity.

- + Positive earnings momentum
- + Supportive economic data
- – Valuation remain high
- – Trump remains unpredictable




## Infrastructure

Three issues have combined to depress the returns from infrastructure recently; Carillion fallout, the possibility of rising interest rates and UK 'Nationalisation' risk. The chief factor was of course shadow chancellor John McDonnell's comments that if a future Labour government is elected it will "bring back in house" private finance initiative (PFI) contracts as part of plans to roll back private sector involvement in UK public services.

The threat of forced "nationalisation" of parts of British industry has seen some investors running for the hills, and puts misplaced nostalgia ahead of progressive vision. The most politically sensitive UK PFI projects are those involving Schools and Hospitals and whilst some of our funds do have exposure to this area, it is relatively small. We actually think the pullback presents an opportunity, so we have been adding exposure.

There are many reasons why we like infrastructure investment, where the income streams generated tend to be very dependable, either due to public sector support or their quasi-monopolistic nature (e.g. a large power station). These cash flows are either contractually linked or tend to rise in line with inflation which is a major positive. Another benefit from a portfolio construction perspective is the low sensitivity to swings in the economy and low correlation of the returns with other asset classes.

- + Dependable income
- + Uncorrelated return
- + Inflation linkage
- + Long-dated returns
- – Political uncertainty

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