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market outlook.

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contents.

UK	2
Japan	3
Emerging Markets & Asia	4
US	5
Europe	6
Fixed Interest	7

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The UK Economy

The UK equity market is dominated by international businesses, and many of its largest sectors are influenced by global factors rather than domestic politics. After political stalemate and multiple extensions, we are hopeful a general election will break the deadlock. During the past quarter, positive Brexit related developments, such as MPs preventing a hard Brexit, have boosted domestic company share prices and strengthened the pound.

With over 75% of the FTSE 100's revenue originating offshore, it would be rational to expect the stronger pound to weigh on the share prices of international companies. However, when compared to their offshore peers, international businesses listed in the UK trade at a significant discount. Therefore, should there be a Brexit breakthrough, the UK equity market would be appealing for both domestic and international investors.

In terms of the UK economy, GDP has been reflective of depressed UK consumer confidence and slowing global growth. Although, a technical recession (two consecutive quarters of negative GDP growth) seems to have been averted, unless September data (which is released mid-November) is particularly poor. Latest unemployment figures remain low versus historical data, although there was a 0.1% increase when last reported. Similarly, wage growth at 3.8% whilst positive, has slowed by 0.1% from its prior reading. UK Inflation at 1.7% remains well below the Bank of England's (BoE) 2% target, as a result, the BoE is unlikely to increase interest rates any time soon, especially when coupled with initial signs of a cooling labour market. Even a positive Brexit outcome is unlikely to lead to higher UK interest rates in the short term, as any pick up in the pound will lower import costs and weigh on inflation.

The Japanese Economy

Whilst perhaps not the most attractive in investment terms, the past few months has seen Japan become arguably the most active in terms of stimulus, policy and indeed 'pomp and circumstance'. That being said, there have been two predominant drivers of the Japanese equity markets over the past few months, and these have been global growth expectations and of course the long awaited (and much delayed) sales tax hike! It has long been the case that the Japanese economy has been tied in to global growth, and with the prospect for global growth slowing (let's again not forget that slowing growth is still growth!), predominantly driven by trade uncertainties between the USA and China, we saw the Bank of Japan (BoJ) Governor, Haruhiko Kuroda, keep policy unchanged in light of this in the October policy meeting. Truth be told, the persistence with loose monetary policy by the BoJ is not only driven by the global growth concerns, but also by its decision to further increase its sales tax from 8% to 10% at the beginning of October… Now, looking back to 2016 when we saw a significant pullback in Japanese markets following the initial sales tax increase (from 5% up to 8%), the market has reacted somewhat timidly. This is partly attributed to the policy implemented to try and keep the domestic consumer spending. The policy involves a point system implemented by the government, that gives points (that can be spent in selected stores) for consumers that use cashless payment methods… and perhaps more significantly, there has been the introduction of a dual taxation setup. Under the dual setup, certain products will be charged at the old rate (for example, food will remain at 8% unless it is consumed within a restaurant/café, in which case it will be charged at the higher 10% level). The idea behind this is to try and keep core spending from depleting, coming off the back of a strong summer for the Japanese consumer, albeit being driven by the consumer 'filling their boots' before a price hike! This is all however short term, as in reality, the tax hike was much needed in order to help fund fiscal spending; complementing revenues derived from negative rates on government debt issuance.

With the above in mind, and despite a heavy hitting typhoon (Hagibis) in mid-October impacting the country; killing over 80 people, disrupting businesses, and also the much awaited Rugby World Cup, the markets have remained robust in absolute terms. The past month has seen Japan benefit not only from the relaxing of trade tensions between the US and China, but also the euphoria of the official enthronement of their new Emperor, as national pride aided consumption. However, the reality is that the next few months will likely be shrouded with an element of uncertainty as US/China trade talks continue, in addition to trade talks between the US and Japan itself. As, whilst there have been discussions allowing certain trade produce to be tariff-free, there are still large parts of each country's exports that are to be entrenched into a pact (such as Japanese automotive exports to the US).

Despite the ups and downs over recent months, and even with other regions looking more attractive from a short to medium term valuation/fundamental/demographic basis, opportunities still remain. As, with the predominant research and investment putting upward valuation pressures on the large/mega cap businesses, it is the small and midcap stocks that present the greater potential for upside gains.

The Emerging Markets & Asia Economy

With the Emerging Market and Asian asset classes almost solely focussed on the China/US trade debacle, whilst having a strong year on a risk-adjusted basis, this temporary uncertainty has caused many regions within the asset class to moderately lag their western world peers. That being said, the result is a region with an arguably more investable opportunity set. The past few months have presented several developments that, over the medium to long term, make the valuation and growth opportunities even more attractive than prior. Firstly, we have seen policy developments off the back of a successful re-election campaign by Narendra Modi (Indian Prime Minister) earlier this year. September saw the Modi government implement a corporate tax cut regime that saw businesses have their 30% tax rate slashed to 22%, with new start-ups gleaning the benefits of a lower 15% (down from 25%) rate. This stimulus was introduced to stimulate investment, increase corporate profitability and thus employment, wage growth and ultimately steady levels of growth and inflation… it is also the first major policy following the foundation building that has caused volatility in recent years, allowing the Indian market to push on to its next stage of development!

Elsewhere we have seen a boost for the Brazilian market. Even though recent years have been plagued with uncertainty at both the political and economic level, controversial President, Jair Bolsonaro, has managed to implement a pension reform change that has long been needed. As, with pension liabilities becoming an increasing level of GDP and the country's national debt and whilst this was undoubtedly a difficult policy to implement at both a political and public level, it is widely accepted that the growing pension burden was becoming an economic time bomb! When coupled with a number of other stimuli Bolsonaro is looking to implement, whilst it may still be too early to suggest that Brazil looks like a stable investment case, it is certainly beginning to steady its proverbial ship.

It would of course be wrong of us not to mention the ongoing tensions between not only China and the US, but also South Korea and Japan. Not wanting to belittle the impact on sentiment that continuing trade disputes between China and the US is having on markets, it is largely unchanged. Despite seeing Trump introduce a raft of extra tariffs on Chinese goods at the beginning of August (with a further hike due on the 15th December), the playing field has not fundamentally altered, as we have continually seen this style of negotiating tactic from Donald Trump over the past few years; each time driving both parties to the negotiating table. As such, Trump is due to meet with Chinese President Xi in mid-November, and whilst a total resolution is certainly not envisaged, a partial/temporary resolution and push back on tariffs is. We are nearly a year away from the US election, and from the language out of the Chinese leadership, it is not looking likely that they will capitulate on trade prior. With this in mind and with the consumer in China still spending, valuations continue to look supressed relative to many other markets with the relative potential upside appearing attractive. The same can also be said of the South Korean market, as whilst headline news is rightly depicting political frictions with Japan surrounding wartime crimes, on the economic front they are both close to signing a free trade agreement (Regional Comprehensive Economic Partnership) that is set to be the largest free trade area agreement in history; involving 16 countries. With data from the core remaining robust, seeing broad growth figures remaining significantly higher than western economies, and the hunt for inflation less demanding, the opportunity set from an investment perspective is strong not only over the longer term, but with the Asian and Emerging asset classes pricing in much of the trade frictions already, the short term upside looks attractive on a risk-adjusted basis also. Let's face facts, when comparing politics in many of these countries to most of the West, they appear much more stable also!!!

The US Economy

What more can be said other than 'trade, trade, trade'. Yes, after a quiet beginning to the summer months, it has been again US president Donald Trump and the trade feud with China that has been driving US markets predominantly. As mentioned above, following the shock introduction of tariffs at the beginning of August that involved the US imposing a 10% tariff on a number of Chinese goods, shortly followed by the US Treasury declaring China as a currency manipulator, China responded by imposing tariffs on a number of US goods. This included many agriculture products, a sector that has been quite vocal in the US about the impact the trade frictions are having. Whilst both parties have committed to further tariff increases on the remaining traded goods on December 15th, it is looking like tensions are settling down again, with talks between President Xi and President Trump due in mid-November. It is highly anticipated that further tariffs will be dropped following an announcement by Trump at the end of August stating that the Tariff introduction could negatively impact the US consumer, in addition to subsequent meetings confirming lists of tariff exemptions from both parties.

With trade leading the charge, the US Federal Reserve (Fed) has been accommodative with the Fed Chair Jerome Powell continually reaffirming that the US Central Bank will remain data dependent. The Fed went on to cut rates for a 3rd time this year, slashing them by 0.25% at the end of October. Powell supported the cut by stating rates would remain at current levels so long as the economic outlook stayed within the Fed's expectations. All things considered, and given the US markets have risen around 20% year to date, and with the S&P 500 sitting at all-time highs, investors would not be blamed for taking some profits given potential short term hurdles in the closing few months of the year. It is clear that data in the US has broadly been robust, with trade frictions beginning to eke their way through to some headline figures, seeing manufacturing begin to contract slightly in addition to some mixed wage data; all potentially impacted should trade frictions with China not be resolved. Let's remember, we are only a year away from the US elections, and with Donald Trump wanting to secure a second term, whilst currently again fighting impeachment proceedings, in addition to very few successes on both the trade and political fronts in recent years, he will not likely want to rock the boat too much going into the campaign period! With this in mind, it would be no surprise if we saw a more timid approach to negotiations with not only the Chinese, but also the Europeans and the Japanese, as he will be looking to glean some small 'wins' ahead of his campaign trail. All things considered, the US market has the potential to 'go again' in 2020, as despite mention of an 'inverting yield curve' being a sign of a recession, the market and corporate backdrop is not supportive of this… this stands not just for the US, but in many major economies globally!

The European Economy

European markets have performed strongly year to date with the majority of performance coming in the first 7 months of the year, despite a veil of negative sentiment. The reality is that despite nervousness surrounding weakening data from the core and seeing a steady drop off in economic confidence, the health of quality corporates remain strong and valuations continue to be attractive on a relative basis; away from the bond proxy income stocks that is.

So, what has actually occurred? Whilst stocks remained attractive, sentiment drifted around uncertainty of trade relations with the US, with trade tensions bubbling earlier in the year. That being said, recent months have seen short term US/Europe trade uncertainties settle due to the unresolved trade dispute between China and the US… allowing the Europeans some breathing space. With this in mind, investor sentiment has been somewhat 'risk-off' year to date, despite European markets being one of the strongest performing asset classes. When you couple the 'perceived' trade uncertainty with uncertainty surrounding Italian leadership and Italy's frictions with the European Union over its excessive debt to GDP levels, it is easy to see why some investors would shy away from the region. It did however seem prudent to hold European equities through the first half of the year, as these uncertainties were just noise, as quality corporates remained strong and were operating on attractive valuations. However, over the past couple of months the lay of the land has changed slightly, with August/September seeing a new Italian coalition government, headed by Giuseppe Conte, formed. This followed a fracture between Conte and former coalition partner and Lega party head, Matteo Salvini. With Salvini being the instigator of much of the anti EU and anti-austerity push, Conte's new coalition with the 5 Star movement seems more likely to reach an agreement with the EU over the spiralling debt to GDP issues. Whilst it is uncertain how long the current coalition will last, the longer term outlook for Italy's debt looks stronger, even if it means there will be volatility over the shorter term as domestic level policy will likely need to adapt to potential measures to sure-up the economy.

Lastly and arguably most importantly is the European Central Bank (ECB) policy. Quiet for most of the year, September saw the now 'former' President of the ECB (Mario Draghi) spearhead his penultimate policy meeting by cutting interest rates further (-0.5% from -0.4%) in addition to restarting "net purchases" (this is effectively Quantitative Easing, the purchasing of debt by the central bank) from November 1st at a monthly rate of 20 billion Euros. There are several thoughts as to why this was done, as whilst it was touted as a response to a weakening set of data and slowing global growth, some believe it was in fact a policy error. Whatever the case, and whilst it did seem out of character for Draghi to make such changes as he was heading 'out the door', it puts his successor, Christine Lagarde, in an arguably more tenable position. Lagarde was former head of the International Monetary Fund and has been vocal about the need for more fiscal adoption amongst European countries. So, whilst it would be difficult to implement broad fiscal stimulus across a remit that covers multiple countries, investor sentiment would likely dictate… and, all of a sudden Draghi's last ditch monetary stimulus makes a little more sense, giving Largarde the platform with which to launch a fiscal charge! With all of this in mind and given how well the European markets have performed year to date, when combined with a drive to align country specific deficits whilst chasing inflation, one would not be blamed for taking profits running into year-end as markets look set to be a little more timid… especially when compounded with the EU's January Brexit extension following the 12 December UK election!

Fixed Interest

Whilst the broader outlook for Fixed Interest assets in recent years has been driven by its correlated movements with Equities (a much greater correlation than when compared to its long term historical average), the past quarter has added an extra dynamic from a central bank perspective, particularly in the UK. As, whilst we are actively seeing a looser stance from the ECB, the Fed and the BoJ, it is the BoE that remains a partial enigma. As, with its Head, Mark Carney, recently strengthening his position stating that the outlook for BoE policy is massively tied to the type of Brexit that is undertaken, any monetary policy will depend on its effects. With this in mind, and whilst the shape of the yield curve remains inconsistent (flattening since its inversion over 3 months ago) and uncertain over the shorter term, we can say that whilst equities appear to be taking a 'breather' from the strong rally they have had for the majority of the year, and with the broader debt market following suit, over the shorter term, cash could be considered as a stronger defensive play; offering up stronger downside protection against the shorter term noise, whilst also offering quick access to other asset classes when a valuation opportunity arises.

As ever, and at the risk of sounding like a broken record, with Central Bank policy being reactive, coming in fits and starts, interest rates remaining low globally largely due to low inflation levels (despite recent pickup in European yields ahead of the ECB QE programme beginning), equity and bond correlations remaining positive, and quality corporates (equities) still appearing massively attractive over the medium to longer term, this is not an environment conducive for the debt space to outperform many asset classes for any prolonged period. However, it is for these very same reasons that the corporate debt space looks the most attractive option within the bond market to hedge and limit downside; certainly over the up and coming quarter, whilst also providing a strong risk-adjusted yield in a world that remains on the search for income!

If you would like to discuss this or any other aspect of your portfolio, please do not hesitate to contact us on **01423 501 401**, Monday to Friday 9am-5pm or you can email us at **info@mzltd.co.uk**

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