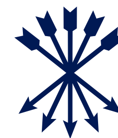
Investment Review – GBP



Second quarter 2019

During the second quarter, the MSCI World Equity index returned +3.2% in local currency terms, or +6.0% in sterling terms, while the price of UK government bonds (+1.4%) followed the trends in global government bonds, which rallied (+2.8%) over the quarter.

Market moves were shaped by two mounting concerns in the quarter: a revival of trade tensions and the impact this could have on the global economy, which appears to be slowing. Yet despite brief equity market volatility mid-quarter, the anticipation of more lenient monetary policy from the US Federal Reserve (Fed) prevented a more significant correction.

Meanwhile, a flight to safety and falling inflation expectations prompted government bond yields to drop, leading to a flattening – and partial inversion – of the US Treasury curve, where the yield on the 10-year US Treasury bond fell below that of the three-month government bond. The global stock of negative yielding debt has more than doubled over the past nine months – driven mostly by European Central Bank (ECB) dovishness – to an all-time high of $13 trillion.

A geopolitical 'wall of worry' remains. In addition to trade worries, Iranian tensions resurfaced and Italy once again seems determined to breach its fiscal limits. The European elections laid bare the fragility of the political backdrop after populist parties secured nearly a third of the parliamentary seats. In the UK, Theresa May's resignation as Prime Minister has paved the way for her likely successor – a notable Eurosceptic – which has significantly increased the odds of a no-deal Brexit later in the year.

On the surface the outlook for risk assets, such as equities, appears to warrant a little more caution. This cycle has finally eclipsed the decade-long upswing of the 1990s to become the longest US economic expansion ever. Echoes of the late 1990s – the prospect of Fed 'insurance cuts' and loss-making technology companies floating their businesses – make for unsettling comparisons. However, while equity market headroom may be lower than it has been for much of the past 10 years, we still believe the global economy will continue to move forwards, perhaps more slowly, but not yet on a scale – in our view – to significantly damage corporate profitability.

Market review

During the quarter, developed equity markets (+3.6% in local currency) outperformed emerging equity markets (+0.6%). The former was driven by strong performance in Europe ex UK (+4.3%), while weakness in developing markets can be attributed to emerging Asia (-1.2%), with its large weighting towards China (-4.3%).

In equity sectors, financials (+5.8%) and technology (+5.6%) outperformed, while energy (-1.6%) was the only sector in negative territory after oil prices came under renewed pressure during the quarter. Brent crude fell -2.7% during the quarter, reflecting concerns over the global trading environment – despite a revival of tensions in the Middle East.

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In fixed income, government bond prices rallied (+2.8%) while the 10-year benchmark yields for US Treasuries and UK gilts fell further, finishing the quarter at +2.0% and +0.8%, respectively. The 10-year German Bund yield remains in negative territory and ended the quarter at a record low of -0.3%.

A glimmer of positive yield for investors was the Austrian government's second issuance of its 'century bond' – a 100-year bond offering a yield of just +1.2%. Despite the less certain economic backdrop, corporate credit performed well: credit

spreads remained relatively tight as the 'hunt for yield' continued afresh. However, higher-quality investment grade (+3.8%) outperformed junk bonds (+2.9%) over the quarter.

In foreign exchange markets, 'safe-haven' currencies moved higher, with the yen (+3.1%) appreciating most on a trade-weighted basis, followed by the Swiss franc (+1.7%) and euro (+1.2%). Sterling (-2.7%) was weaker as Brexit expectations shifted once again. Meanwhile, 'risk-off' sentiment and the possibility of more accommodative monetary policy prompted gold (+9.1%) to move to a five-year high of $1,409 per ounce.

Trade tensions reignite

The US resumed its protectionist efforts during the quarter, raising tariffs from 10% to 15% on $200 billion of Chinese goods and threatening to increase tariffs on a number of its allies, including Mexico and Australia. A brief, yet unexpected, tussle with Mexico highlighted the increasing belligerence of the Trump Administration, which appears unafraid to assert its dominant position globally.

The US withdrew from negotiations with China in what was widely perceived to be the final stage of discussions in late April. At the time, the country also threatened to apply an export restriction on various Chinese companies, including Huawei. China responded with retaliatory tariffs on $60 billion worth of US goods, and threatened to enforce an "unreliable entities" list and to limit rare earth exports. However, the quarter concluded on a more upbeat note after the G20 Summit in Osaka raised the prospect of China–US trade negotiations resuming once again.

A global slowdown under way?

Global growth was remarkably buoyant in the first quarter. The OECD reported that advanced economies expanded at an above-trend +2.5% (quarter-on-quarter, seasonally adjusted annual rate), signalling the end of the soft patch at the end of the year. However, forward-looking indicators suggest a modest slowing. Increasingly volatile data from China – notably industrial output – highlight the visible fallout from trade tensions, with manufacturing sectors firmly under pressure. But manufacturing remains weak globally, with the latest business surveys and industrial production pointing to renewed weakness in Germany in particular, and now even in the US and the UK. Even the less cyclical, service-side of the economy, which accounts for three-quarters of US economic output, is pointing to a modest slowdown.

Consumer confidence remains upbeat, and retail spending in the UK and US appears healthy, underpinned by the strongest labour market and the lowest unemployment rates in roughly half a century. Nonetheless, it remains prudent to expect the pace of growth to slow as we enter the second half of the year.

Central banks shift back to easing mode

Perhaps the most significant event this quarter has been the shifting expectations around central bank policy, particularly in developed markets. After moving to a "neutral" policy stance in the first quarter, the US Fed went further in June, citing renewed "uncertainties" in the economic outlook, and signalling that the rationale for cutting rates was rising. However, the committee's expectations for the path of rate cuts ahead – as shown by the so-called 'dot plot' – remains more muted and less immediate than market expectations of three rate cuts by the end of 2019.

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The ECB has pushed out its forward guidance and suggested that rates are not likely to rise before the summer of 2020 (it previously suggested the end of 2019). More recently, it has even hinted that it could resume its quantitative easing programme, reiterating ECB President Mario Draghi's 2012 commitment to "do whatever it takes".

Even in the UK, policymakers are attempting to balance the current picture of respectable growth – and inflation at target – with the potential disruption of an economically unfriendly Brexit outcome. The Monetary Policy Committee has made repeated attempts to persuade the market that interest rates need to move higher, but money markets remain unconvinced and have priced in a slightly greater chance of rate cuts ahead.

Notes

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