QUARTERLY MARKET OVERVIEW – APRIL 2019

"The fundamental law of investing is the uncertainty of the future"

The first quarter of 2019 started well with a significant rebound, after the sell-off in the last quarter of 2018. However, towards the end of March markets dropped backed slightly following weak economic data from Europe; in turn this fuelled concerns that we were closer to a global recession than the markets had priced in.

Global growth in 2018 was 3.7%, this is expected to fall to circa 3% in 2019. We will explore concerns over a global recession, but indications are that although it is probable, it is unlikely to be in the near term. Some have pushed this out to 2020, and others beyond that. There is general agreement that growth will be lower, and there will be higher volatility.

Covering some of the areas we highlighted in the last review; there is very little point in covering Brexit. Even as I write this, I know that by tomorrow something will have changed. What we expect however is that both the Liberal Democrats and Conservatives will have new leaders over the coming months.

As we expected trade talks with China continue and have been pushed back until at least June. The general feeling is that something positive will come from this. So, this is something we will be watching carefully.

Within this update I want to highlight some reasons to be positive. The table below from Invesco shows the returns over the last five years and expected returns over the next five years:

	Past 5-year returns	Expected Returns next 5 years
US	10.5% p.a.	4.4% p.a.
Emerging Markets	7.6% p.a.	5.3% p.a.
Japan	7.4% p.a.	14.4% p.a.
Europe	5.5% p.a.	8.3% p.a.
UK	4.6% p.a.	12.4% p.a.

The US has driven much of the global growth over the last five years and is now seen as 'fair valued'. The discount between the US and other markets would indicate that other markets are likely to take over the reins.

There are specific pockets of potential value; for example, technology is shifting and those involved in new technology, specifically automation are likely to benefit moving forward. Many of these specialist companies are coming from emerging markets, and especially Asia. It is not impossible to consider a shift in the tech powerhouse from the US to Asia, which may already be happening.

Global growth is more likely to be driven by emerging markets over the coming years; it is expected that by 2030, 7 out of the 10 biggest countries (by GDP) will be from emerging markets.

In summary, the rebound in 2019 was expected after a poor end to 2018. However, the concerns over European economic data have unnerved the markets which led to a pull back towards the end of March. Over the long term the general view is that risk assets remain the best place to get returns, however there is likely to be a shift as to where those potential returns originate.

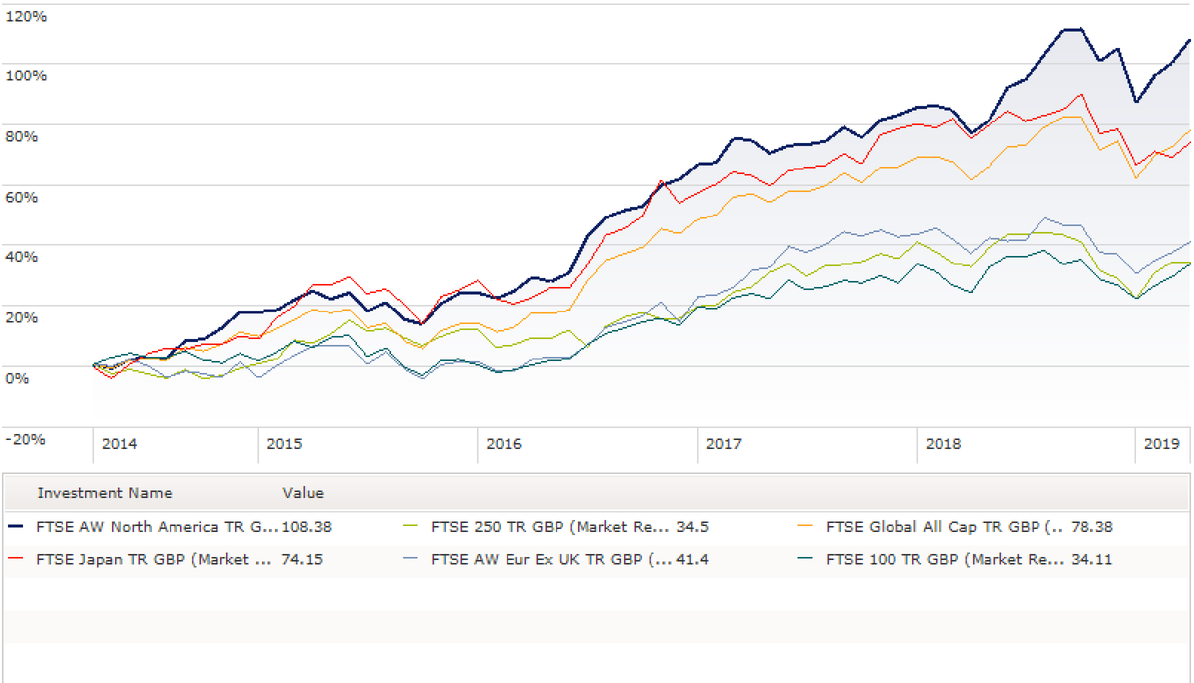
Things to watch over the coming months are the trade talks between China and the US, the impact of Brexit on the UK and Europe (in the UK sterling will be the main mover), politics across Europe (Spain and the UK are the main focus), potential renewed tensions with North Korea and indicators on whether fears of a recession are over or under done.

George Ladds

George Ladds, Director, April 2019

DEVELOPED MARKETS

Five year returns 1 April 2014 – 31 March 2019



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The table below produced by Invesco shows where they expect stock markets to be for developed economies over the next five years:

	Current	Expected
S&P 500	2784	3100
Euro Stoxx 50	3298	4000
Nikkei	21385	29000
FTSE 100	7075	9900

This supports their view that returns from the US will slow, and Europe, Japan and the UK will take up the charge. Taking regions in turn:

In the UK there is considerable political uncertainty: we should not expect that to change any time soon. We know that there will be changes within the Conservative and Liberal Democrat Parties. We have the emergence of a potential new party, and questions regarding Corbyn and Labour. Although we thought sense would prevail, no-one can guess the future outcome not only on Brexit but on whether an election will happen.

The UK is suffering from a lack of investment, and a slowdown from trading partners including China and the EU. Growth was 1.4% in 2018, and over the last 3 months 0.2%. These are not startling figures, but the aim must be to keep the UK out of recession.

Unemployment is at its lowest level for almost 45 years, and wages are growing at their fastest rate for a decade with pay rises typically outpacing the cost of living. Inflation has dropped to 1.9% which is below the 2% target. We expect interest rates to sit around 1% but not much higher.

There are clearly positives within the UK, but the average wage post inflation is still £7 a week lower than it was a decade ago. There is also some debate that companies are holding onto workers as they are cheaper than investing. So clearly these are areas to watch.

The UK is unloved; it is seen as cheap, but any form of certainty could be positive for the UK.

Towards the end of March European PMI data (manufacturing indicator) disappointed and was the worst since 2013. Germany and France both saw a significant contraction of industrial output. Germany has been hit by a slowdown in car purchases, it was also caught out by the diesel scandal, and is suffering from competition from electric and self-driving specialists. It is important to stress that this is more about disruption rather than a recession.

Germany also suffered as a result of a drought in 2018. The River Rhine dropped to just two feet in places making it impossible to ship raw materials; this in turn meant that manufacturers had no choice but to put production on hold. Additionally, the economy is reaching full capacity as wage growth is above trend and employment growth has started to slow.

As Germany narrowly avoided a technical recession, Italy dropped into one. Political uncertainty seems to have taken a toll on confidence and activity especially relating to the budget and a very public battle with Brussels. This is something to watch as a new budget battle looms towards the end of 2019.

Spain continues to grow strongly but there is an election this year. Although the Socialist party is likely to be the largest, the Citizens' and Vox parties could pave the way for a 'right of centre coalition'. This political uncertainty could be negative for Spain. It is also worth seeing how the European elections play out.

The Netherlands is another positive for Europe, whereas Belgium is a negative. Macron continues to struggle to get any reform through in France, with protests continuing. So, it is a mixed bag within Europe but there are bright spots, and many expect a rebound in the second half of 2019.

Briefly touching on Japan, this was hit by a series of natural disasters in 2018. Although there is an expectation of a decline in overall demand as the consumption tax comes into play, there will be measures to offset this. This will include free childhood education and infrastructure spending.

Finally, turning to the US. The Fed have moved to a dovish position; concerns over weak economic data and declining corporate earnings meant that rate rises have been put on hold. There is much talk of a recession but many feel this is overstated. There is common agreement that there will be increased volatility and lower returns. Goldman Sachs stated that risk assets will deliver "low but positive returns". Fidelity believes there is too much pessimism priced into the markets.

We will cover trade talks under emerging markets but for US companies, it is important that a resolution is found. Many US companies have their supply chains in Asia and tariffs impact margins and are disruptive. A quick resolve will help profit margins and enables them to focus on investment. At a time when Trump will start to move to full election mode, a positive result is becoming more important.

The US consumer has benefited from lower oil prices (although these have started to rise) as these are seen as a free tax cut and they are seeing wages growing at 2% p.a. (the highest for three years). Generally, things are positive in the US but over the next five years the market returns vs other regions are likely to disappoint as it trades at a premium compared to the likes of Europe, UK and Japan.

The two areas of tension for the US are trade (which we will cover later) and North Korea. The end of talks, and apparent restarting of nuclear activity, could escalate tensions in the region. In a nervous world this might not be good for markets, and Trump may well use his election campaign to play on this.

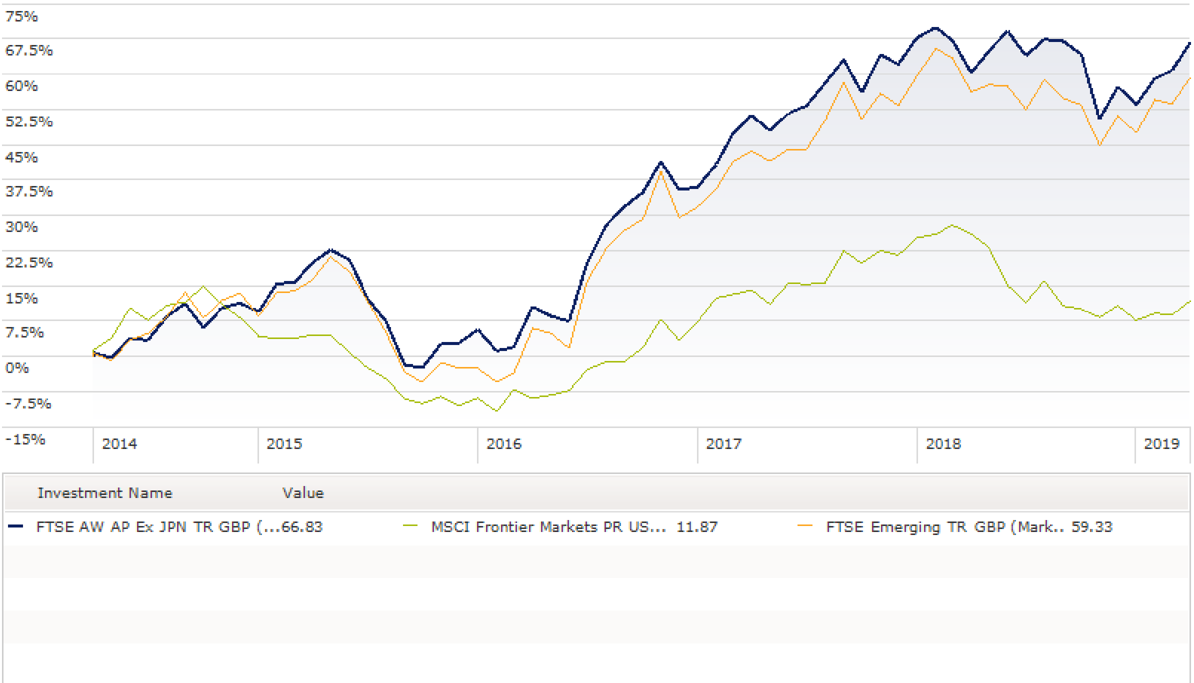
In terms of risks, corporate debt is rising in the US. If there is a downturn, then funding might not be as freely available which could lead to defaults and bankruptcies. If funding is given at a time when companies can least afford it, this puts pressure on balance sheets. All the indicators show that we are not at this danger point but it will likely come, so this is a real risk to the US economy.

In summary, developed economies are a mixed bag. The UK is unloved and cheap. Any resolve will likely benefit the UK, however which areas benefit the most will depend on the outcome. Sterling is the thing to watch. In Europe, although data has been poor, this is expected to change towards the second half of the year.

Watch out for political uncertainty especially in the UK, Spain and Italy as well as on the European Elections. Japan continues to reform and there is an expectation that 2019 will be more positive. The run in the US is likely to slow, and there are risks. The general view is that although a recession is unlikely returns are likely to be lower and more volatile in their creation.

EMERGING, ASIA AND FRONTIER MARKETS

Five year returns 1 April 2014 – 31 March 2019



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The story around emerging markets is unchanged. They are inherently more volatile than developed markets, but investors over the long-term can expect returns in excess of those from developed market equities. Much has been made of the demographics, but this is shifting, and parts of Asia have similar demographics to the developed world. Asia and Emerging economies are growing because they are increasingly embracing the technologies of developed nations and as a result are experiencing an economic catch-up, especially in the levels of income.

This is not applicable in all areas and parts of Africa are still mired in low-income cycles, whereas in Latin America there is the middle-income trap. Whether an economy grows or not depends on how they adapt to deeper structural factors, such as whether legal and property rights spur or deter investment, or whether the education systems are enough for workers to adopt new technologies. China is now not far from Western standards and yet real income per capita is just 14% of that in the US.

The risk for these countries is where policymakers do not provide the right structural foundations, as the process for catch up can be swift. Japan in the 60s and 70s is an example of this, with incomes catching up with US levels in the 90s, and then a multi decade stagnation. However, wages have remained broadly in line with the US.

Changes in spending habits in these economies is important. 55% of income in rural India is spent on food, in the US it is just 13%. As we see a shift in earnings, there is a move to spending on recreational goods and services, and travel and communication.

It is also important to remember that a lot of the new technology allowing things like electric cars, and self-driven vehicles is coming from Asian economies. Although the US has been the tech powerhouse, this is likely to change in the coming decades.

I struggle with the term 'emerging' or 'developing' economies. These economies make up 40% of global nominal GDP and yet make up just 12% of the All Country World Index weighting. By 2030, seven of the ten world's largest economies by GDP will be from emerging markets. China and India are expected to be at the top. Then other countries will include Indonesia, Turkey, Brazil, Egypt and Russia. The growth expectations of some of these economies is likely to far exceed developed economies. Germany is in the top ten and is expected to grow by 64%, the US 60% and Japan 33%. Whereas Egypt is expected to grow by 583%, India 387% and Turkey 314%.

Trade talks are a big issue, and as expected these were pushed back and it might be June or further away before any resolution comes. There is a positive feeling towards these talks. One of the big hurdles is the protection of intellectual property rights. The tariff increases are expected to be more limited, and as mentioned this should help US companies which rely on China and other Asian economies within their supply chain.

It is expected that China will agree to purchase more US products, and this could reduce sales from non-US companies. There are mixed views on whether countries like Japan and Europe will benefit from a resolve or whether they might lose out.

The danger is that the trade war is unresolved, and it goes into an all-out trade war. This could then spill out to the rest of the world. It is not a scenario we see but Trump is an enigma, and no-one can predict his next move. Logically he needs something positive from this to win the election. He may feel a full trade war will do this, but if this impacts US jobs and businesses it could have the opposite effect.

Looking at some other economies; in India it is five years since Modi and the BJP Party swept to power. There have been significant reforms, but his popularity has dipped. Inflation in India has come down from 11% to 2%, interest rates (although they went up in 2018) are significantly lower and the hope is that if Modi is elected again, then this will bring stability and enable further reforms. One thing that has swung in Modi's favour is the recent spat with Pakistan and this has increased his popularity in recent weeks.

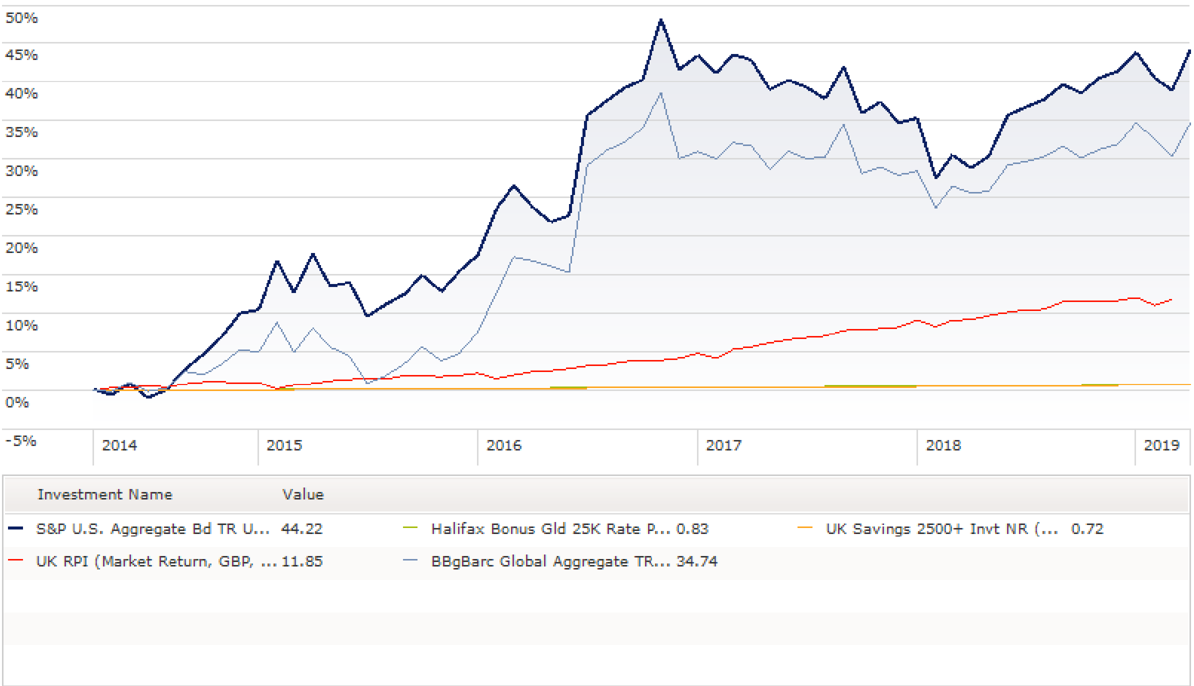
In China they have launched a series of tax cuts worth about 2% of GDP and the PBOC is reducing capital reserve requirements. These changes are likely to have a bigger impact than anything the Fed and ECB do. In Brazil President Bolsonaro is now in office and economic confidence is high. The focus on pension reform seems more ambitious than expected, which has pleased the markets. On the downside corruption still dogs the country and this could be a concern.

In summary, the long-term story behind emerging markets and Asia remains. The focus has often been on demographics but the shift in income patterns is important. These economies will catch up in time with developed economies. These consumers will take over from the US as drivers of the global economy.

We also believe that over time there will be a shift in the tech battle. Intel dominated five years ago and have been replaced by TSMC. Western Gaming Companies are being challenged by free models mainly originating out of Asia, and many of the components for the shift to electric cars are being developed in Asia and Emerging Markets. Historically there is always a shift in economic hubs and perhaps the US has had its day. Although Trump may be moving now to stem this it is likely he is too late. These markets will always be volatile but over time they have the potential to outperform developed economies.

CASH

Five year returns 1 April 2014 – 31 March 2019



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Cash has been a negative performing asset in real terms for over ten years. Invesco are suggesting that over the next five years rates in the US will be 2.5%, Eurozone 0.5%, UK 1%, Japan 0.5% and China 4%. This means that those hoping that cash can provide a form of income will be disappointed. Nothing is likely to change anytime soon.

Holding cash for the short term makes perfect sense especially when needed with 12-24 months. However, investors need to rethink holding cash for long periods of time. This may mean taking on extra "risk" to get any returns on capital. This will not appeal to all investors however the longer they leave it, the longer the decline in the real value of the assets.

If Invesco are right, then it will be nearly 20 years of negative real returns on cash. Fixed income is not a haven and returns are expected to be near zero moving forward. To get higher returns on fixed income (debt) then extra risk is needed whether through high yield bonds and/or emerging market debt. If an investor is taking on this extra risk within fixed income, then perhaps they should consider diversification into other risk assets.

It remains a difficult line to tread and in all the years I have written this review it doesn't seem much will change in the coming years.

CONCLUSION

Globally the big question is about recession and when it is going to happen. The markets are nervous as we saw when the European PMI data came out, and the dovish response by the Fed. However, although a recession will be likely the timing could be two years away, or longer.

Long term risk assets appear the best way to obtain returns; cash looks set to be a negative asset class for many years to come. But investors must accept that returns will be lower moving forward and there will be greater volatility.

The driver for returns will likely shift from the US to the UK, Europe and Japan where these markets offer significant discounts.

Over the long-term emerging markets offer sizeable opportunities not only from a shift in earnings in certain economies, but also growth as the tech hub shifts away from the US (which is already happening). The risks from a global trade war should not be understated, but the impact is felt in Asia and ultimately the US where components are sourced from Asian economies.

We will be watching political events in Europe and in particular in Italy, Spain and the UK, and the European elections. Whatever happens with Brexit will be positive for the UK as doing nothing is not good for our economy.

The message is to expect lower returns and greater volatility, but no recession yet.

Source: Charts have been sourced from Morningstar. Other data sourced from Invesco, BBC, Schroders, JPM, L&G, and the Conversation. Any reference to a fund or share is not a recommendation to buy or sell that asset. Past performance is no guide to future performance and investments can fall as well as rise.