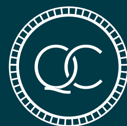

MARKET COMMENTARY - APRIL 2019

QUILTER CHEVIOT

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Past performance is no guarantee of future returns.

After a turbulent end to 2018, global equity markets recovered most of their losses in Q1 as the US and China appeared close to a bilateral trade agreement and the Federal Reserve indicated that it would, if necessary, delay normalising monetary policy to avoid recession. The FTSE100 rose 551 to 7,279 - a total return (including dividends) of 8% over the quarter. The broad-based US indices gained 13% in local currency terms - marginally higher than the 12% return on European equities. Japan, Asia and emerging markets lagged at around 6%. For UK investors, sterling's modest rally to $1.31 depressed international returns by 2%. Global bonds were the major surprise as slower growth prompted a sharp fall in yields and a flattening curve. The German bund yield turned negative again while the decline in yields on 10 year UK Treasuries to 1% meant conventional gilts returned 3% and longer duration index-linked 7%.

OPEC's continuing supply discipline saw Brent crude rise from $54 to $68.

The prolonged US/China negotiations and stalled ratification of US-Canada-Mexico trade flows are taking their toll on global trade and GDP. The decision to delay any announcement on tariffs until April suggests a bilateral agreement is on the horizon although the details still have to be finalised. Agreement has been reached on stricter enforcement of international trade protocols and China is expected to pass legislation protecting foreign intellectual property rights. However, a "great deal for America" is likely to require a substantial increase in exports and the US economy may not have the productive capacity to deliver this without diverting shipments.

Global growth in Q1 appears to have slowed to around 3.2% from a peak of 4% this time last year. Although weaker GDP and trade are broadly based, the outlook for

individual economies is becoming more disparate. The loss of momentum was not unexpected but a particularly weak Eurozone manufacturing survey in March - showing a significant decline in export orders - suggested a Chinese recovery may lag expectations. Global GDP estimates assumed that US growth, while remaining balanced between consumption and investment, would slow to around 2.5% in 2019. Following a weak Q1 - caused partly by the government shutdown - consumer confidence, retail sales, capital goods orders/shipments and the recent strong non-manufacturing ISM survey are indicating a pick-up in Q2. Softer non-farm payrolls and core inflation below the 2% target mean the Federal Reserve can be more accommodative and reduce interest rates if the data weakens. Inversion of the US Treasury yield curve for the first time since 2007 has flagged an increasing risk of recession but, given subdued cost pressures, the Fed may be willing to see inflation run slightly ahead of target and allow the yield curve to steepen naturally now short rates have normalised.

China remains key to the global growth outlook. The economy is part way through a structural transition with policy stimulus aimed at job creation and keeping GDP close to 7%. As global trade slowed in 2018, the authorities targeted infrastructure as well as corporate taxation in the expectation that the latter would lead to higher private spending without increasing levels of debt. While the stimulus is modest by historical standards, the benefits have begun to materialise with a pick-up in manufacturing business surveys, particularly for small and medium enterprises. Production and new orders show the largest increases although external demand still appears soft. The non-manufacturing business survey has also improved and remains in expansion territory. Other data shows a small recovery in nominal retail sales despite higher unemployment. Overall, recovery appears to be underway albeit other global trade indicators - Asian business surveys as well as Korea and Taiwan export orders - suggest expectations may be over-optimistic in terms of magnitude and timescale.

Japan and the Eurozone have been hit by their exposure to China and this has resulted in downgrades to GDP estimates. Despite years of 'Abenomics' to broaden the economic base, weak exports and industrial production plus the imminent hike in consumption tax mean Japan is still heavily dependent on global trade and will be lucky to escape a mild recession this year. Reports suggest that the outcome of the traditional spring wage negotiations may be lower increases than last year. This reinforces the disinflation scenario and increases the likelihood of further easing by the Bank of Japan.

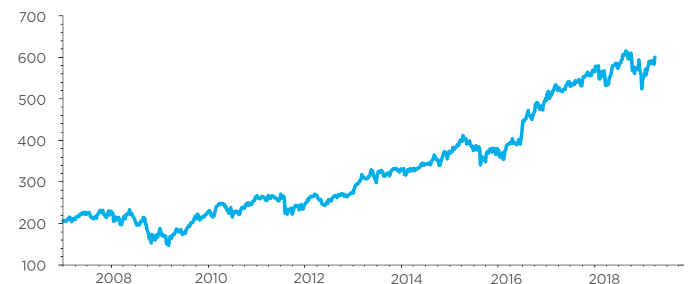
FTSE ALL SHARE

Source: Thomson Reuters Datastream 03/04/2019

FTSE BRIT GOVT ALL STOCK

Source: Thomson Reuters Datastream 03/04/2019

FTSE ALL WORLD £ - TOT Return IND



Source: Thomson Reuters Datastream 03/04/2019

Eurozone economic data has been weaker than expected. Even the European Central Bank has acknowledged the risks to growth and downgraded its 2019 GDP estimate to 1.1%. However, most member states have seen a sharp decline in unemployment and higher consumer spending. Spain continues to lead the pack and improved competitiveness means its exports have fared reasonably well. By contrast, France has experienced a marked export slowdown and widespread disruption from "yellow vest" protests. Slowing global trade and exports have impacted Italy and Germany with the former technically in recession and the latter dangerously close to one if there is no pick-up in H2 and/or the US introduces auto tariffs. The ECB has retained its forward guidance on low interest rates but, as these are already at rock bottom, more esoteric measures may be needed to avoid deflation.

29 March has come and gone without an agreement on the terms of UK withdrawal so the economic and political outlook remains unclear. With the cabinet and both major parties holding such polarised views, it is difficult to see a workable solution being achieved during the short extension granted by the EU. Given the option, the electorate would probably vote for a 'sensible' compromise but even a snap election seems unlikely to produce a decisive result. Meanwhile, the economy continues to grow in line with the European average. Low unemployment and a modest increase in real disposable incomes have supported consumer confidence and maintained spending. Although manufacturing has had a short-term boost from stockpiling, business investment is expected to contract this year. Improved public finances mean the government has some scope to adjust austerity measures in the event of a disruptive Brexit.

Global earnings growth estimates have been revised down in recent months to around 5% v 14% in 2018. Corporate guidance and analysts' estimates are positioned for a cyclical upturn in China, Asia, emerging markets and the Eurozone with consumer sectors and financials (excluding banks) topping the league tables. The equity rally in Q1 and lower earnings mean forward valuations have risen towards the upper end of their twelve-month range. While 15x does not appear unreasonable in absolute terms, in the absence of a material improvement in the global growth outlook companies will have to deliver - and potentially surprise on the upside - if markets are to make significant progress.

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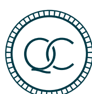

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