MARKET COMMENTARY - JUNE 2019

QUILTER CHEVIOT

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Past performance is no guarantee of future returns.

After the strong start to the year, renewed trade tensions and weaker manufacturing data saw profit-taking in May as investors adopted a more cautious stance. The FTSE 100 fell 257 (3%) to 7,161 while Europe ex UK was down 5% in local currency terms, Wall Street 6% and Japan 7%. However, sterling weakness against the dollar – a 3% decline to $1.26 – and the euro and Japanese yen helped cushion losses for UK-based investors. In contrast, bonds appreciated significantly as manufacturing data suggested an increasing risk of recession and earlier than anticipated US interest rate cuts. The US Treasury yield curve again mildly inverted leaving the 10 year yield at 2.1% – below the 2.4% effective rate on Federal funds – while the eurozone and Japanese bond investors continue to face negative yields. The UK 10 year gilt yield closed at a two year low of 0.86% while rising breakeven rates on longer duration index-linked gilts gave a 4% return in May (almost 9% year-to-date). Higher oil inventories resulted in a sharp correction in Brent crude to $64 a barrel. Gold benefitted from unpredictable policy decision-making with the sterling price rising over 5%.

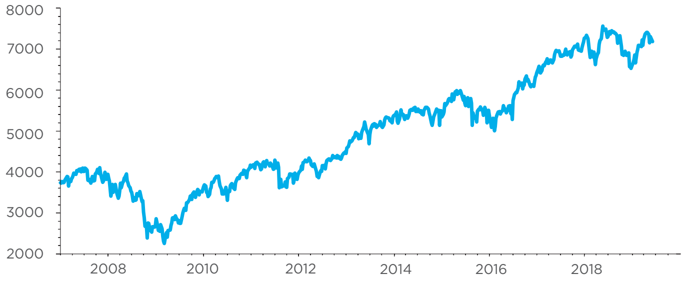
Softer economic data may have been inevitable in response to stockpiling ahead of higher US tariffs, but the magnitude and timing of the downturn in global manufacturing surveys was unexpected. The US is now the only major economy to signal manufacturing expansion, with Chinese manufacturing flat and the eurozone and UK moving further into contraction territory. As trade tensions are unlikely to have reached a peak – President Trump's latest announcement on Mexico would be penal if implemented – and other leading indicators also suggest caution, there are downside risks to current estimates of 2.9% GDP growth (1.6% for advanced economies vs. 4.6% for emerging markets).

Tentative optimism that the Chinese authorities could offset higher tariffs by boosting infrastructure investment has proven short-lived. The decline in exports and domestic activity has been disappointing. As a result, estimates for GDP growth have eased to 6.4% for 2019 and 6% in 2020, with renewed focus on likely policy adjustments and a 25% tariff on $250bn of goods that could reduce GDP by 1% and employment by 4m. However, there is still considerable scope for fiscal and monetary stimulus and the People's Bank of China may allow some currency depreciation accompanied by tighter capital controls/currency intervention. Declining foreign exchange reserves could put further pressure on US Treasury ownership but not to the extent that this affects pricing.

Although the US economy is growing at around 2.7%, a string of negative surprises has again highlighted the risk of recession. Despite lower manufacturing and business investment and a weak housing market, consumers remain the major driver of GDP and are being supported by strong job growth and accelerating wages. After a temporary drag in the first quarter of the year from the partial government shutdown, tighter financial controls and delayed tax rebates, we expect a rebound in the second quarter. This may be as good as it gets but – unless the economy falls off a cliff – talk of recession appears premature. We suspect the Federal Reserve will not change course on interest rates unless there is further poor data.

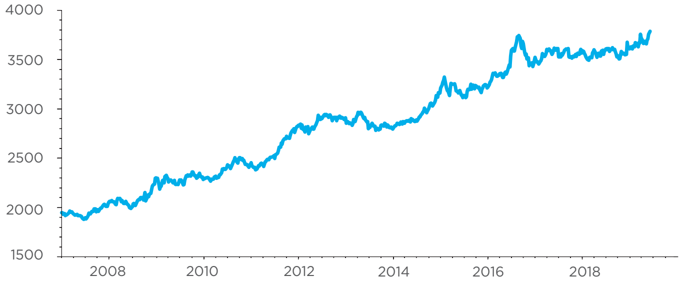
The outlook for Japan and the eurozone is less robust, which is hardly surprising given the escalating trade challenges for economies where around half of corporate revenues are generated overseas compared to less than one-third in the US. Q1 GDP in Japan was higher than expected but there may be a payback in Q2 as inventories unwind and trade tensions impact exports to China. Domestic demand suggests 0.7% GDP growth is achievable but the impending consumption tax increase and a decline in Olympic-related construction is likely to reduce real GDP growth in 2020 to just 0.1%. Although estimates for the eurozone are higher at 1.2%, the pattern of external challenges and domestic resilience is similar. Brexit, exposure to China and uncertainty over US tariffs appear to limit the scope for upside surprises even though expectations are very low. Spain continues to be notably strong with lower imports offsetting declining exports. While a 22% increase in the minimum wage, job creation and rising house prices resemble pre-2008 exuberance, 14% unemployment and improved competitiveness may have made the economy more resilient. Italy is still the eurozone laggard – not helped by being an integral part of the European manufacturing supply chain, policy uncertainty and tighter financial conditions.

FTSE ALL SHARE



Source: Thomson Reuters Datastream 04/06/2019

FTSE BRIT GOVT ALL STOCK



Source: Thomson Reuters Datastream 04/06/2019

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Source: Thomson Reuters Datastream 04/06/2019

The economic and political outlook for the UK is clearly still very uncertain. The Prime Minister's resignation is unlikely to make a material difference to the EU's terms and increases the possibility of a "no deal" Brexit and a general election. There has been surprisingly little discussion about the consequences of a disruptive exit – relying on World Trade Organisation terms could mean a knee-jerk fall in sterling and short-term price rises. Markets perhaps believe the EU will blink first and offer another extension. Q1 GDP beat very low expectations but, despite a modest boost to exports from weaker sterling, the trade deficit has risen to 7.3% of GDP. While consumer confidence has eased, spending has held up, reflecting record employment, modest wage rises and favourable financial conditions.

With Q1 corporate reporting complete – and slightly exceeding downward revisions – attention has returned to forward estimates. Global earnings revisions in May turned sharply negative, although there is considerable regional divergence. Japan and the UK have seen sizeable downgrades but this has not been the case for the US and eurozone. At a sector level, materials, utilities, consumer discretionary and staples have seen the largest reductions whereas energy has emerged relatively unscathed. For the year as a whole, consumer discretionary, financials and utilities are expected to produce the highest earnings growth. Real estate, IT and energy are expected to report modest reductions. After adjustments, global equities are valued on a forward P/E of 15x based on 5% EPS growth. Earnings are expanding more in the advanced economies although emerging market valuations are significantly cheaper. The UK has an above average prospective dividend yield (5% v 2.7%) but is not without risk.

Equities have returned around 10% year-to-date. It is too early to say whether the global manufacturing slowdown is anything more than an inventory adjustment but, as the US/China standoff clearly goes well beyond trade and is unlikely to be resolved at this month's G20 meeting, continuing volatility is inevitable. In the vacuum ahead of a corporate profit upturn, we expect valuations to continue to adjust and have downgraded exposure to risk assets accordingly.

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