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Investment update

Policy pivot

Summer 2019

Support still needed

Trade war taking its toll

Difficult decisions ahead

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Overview

It has been a strong first half of the year for financial assets, in some areas more than recovering the lost ground seen at the end of 2018.

The US stockmarket has yet again been a stand-out performer, with the S&P 500 Index recording its best first half return for over two decades, finishing the quarter close to its all-time high. Even the mainstream UK stockmarket, plagued by Brexit-related issues on the one hand and flattered by international components on the other, has staged a solid return, although it is still some distance from its peak reached in May last year. Bond markets and most alternative asset classes have also made solid progress so far this year, allowing portfolios, even at the very defensive end of the risk spectrum, to make attractive inflation-beating returns.

So where does the current delicate interplay between the ongoing US/China trade war and the prospect of more central bank assistance following softer rhetoric leave us for the second half of the year? In truth, it is possible to see both a better or worse outcome on the trade war leading to elevated market volatility: if trade tensions ease, and economic growth and inflation pick up, the US Federal Reserve ('Fed') is more likely to raise interest rates than reduce them, thereby inducing market volatility. Conversely, if trade tensions become extended or escalate, and this manifests in even weaker economic data, then renewed recessionary fears may spook markets more than the Fed and other central banks are immediately able to fight with further stimulus. Again, this could lead to heightened market volatility. In addition, we have more country-specific issues to resolve, including the not insignificant matters of Brexit and a highly unstable political backdrop in the UK, either or both of which have potential to test market nerves. But throughout all of this we should remember that, as things stand at present, global growth, although weaker, is not actually that bad; many businesses are in a lot healthier state than they were before the last crisis; valuations, on the whole, are not in 'bubble' territory; and monetary authorities are also lending support to risk assets and are fully primed to act again should the need arise. As long as a disciplined investment approach is maintained, then there should be no need to batten down the hatches or take extreme action during any bouts of market stress. Our current neutral stance on equity risk for our range of investment strategies reflects both the opportunities and hazards that are currently being presented, and those that potentially lie ahead. If the outlook does alter materially, either way, then we would expect to make further alterations to our course.

30 June 2019

Support still needed

This year's recovery in values has reconfirmed the importance, more often than not, of staying calm during periods of market stress.

It also shows that markets are frequently driven by something entirely different from fundamental investment metrics such as the visibility and health of corporate profits. In recent months it has been central banks that have once again stepped in to rescue investor confidence, feeding markets' addiction to monetary stimulus and allowing a wide range of risk assets to continue on their upward journey. In the space of nine months, the Fed has altered its policy bias from hiking interest rates late last year (which spooked markets in the final stages of 2018), to a pause in policy (which fuelled the new year rally), to the current rhetoric which now suggests a softer tone once again and something that has extended the market recovery. Other key central banks have also thrown their hats into the ring to lend support, more through words rather than action (so far). However, it is becoming increasingly clear that, with the exception of the US, the amount of policy space that several key central banks have to manoeuvre is becoming quite restricted. In some cases it may require more unconventional methods of monetary support, which in turn may place greater financial strain on governments and banking systems further down the line. In the meantime, the fickle monetary backdrop could spark increased market volatility during the second half of 2019. This will require both a cool head and a degree of agility to navigate safely through what is now a narrower passage with fewer policy options.

The policy pivot from the Fed and other central banks clearly stems from a greater-than-expected deterioration in global economic activity. Robust global economic growth conditions in 2017 and the early part 2018 have now become more subdued, principally through a combination of trade tensions and a continuing undercurrent of slower growth in China. Global economic growth in 2019, as well as next year, is by no means expected to grind to a halt. But what we are now seeing is a much less synchronised world in terms of economic activity, with significant disparity even amongst G7 economies where one would normally expect much closer economic alignment due to global trade links. It is the disruption in the global trade framework that lies behind both the broader slowdown and the more rapid declines seen in specific regions, many of which have other domestic issues to overcome and which are impacting their economic resilience. The recent G20 summit agreement between presidents Trump and Xi to resume US/China trade talks is a positive step, but for several economies the damage has already been done. Markets also need to be careful what they wish for: another U-turn on monetary policy in anticipation of relaxed trade conditions could unsettle markets once again. Whilst the risk of policy error still seems quite high, the recent softer tone should also alleviate some of the concerns that had been building within bond markets. This should provide more scope to remove some of the current safety nets in our positioning and allow a move slightly higher up the risk curve.

Trade war taking its toll

Temperatures may have soared in Europe in recent weeks, but the economic climate has become decidedly chilly.

The euro area's linchpin economy, Germany, has seen a significant stranglehold placed upon its key automotive industry: exports have not only been weakened by the trade war, but also by slowing demand from within the European Union ('EU') and China; tough new EU emissions regulations are also requiring a costly manufacturing switch to both alternative vehicles, including electrification, as well as disruptive shifts in production to lower cost locations. Meanwhile, the fragile state of Italy's long-term financial position, including the country's tender relationship with the European Central Bank ('ECB'), is not inspiring confidence. There is still some hope that the ECB can provide additional stimulus to stave off a deep decline in activity, although this may require more unconventional methods now that monetary policy is already set at its lower bound.

Japan is in a similar position to Europe, with the open nature of its economy leaving it quite vulnerable to an escalation of the trade war. It too is also running out of road on the policy front with an increasingly impotent central bank. A planned sales tax hike later this year, whilst perhaps providing a boost to the country's near-term finances, could also prove challenging for consumers thereafter.

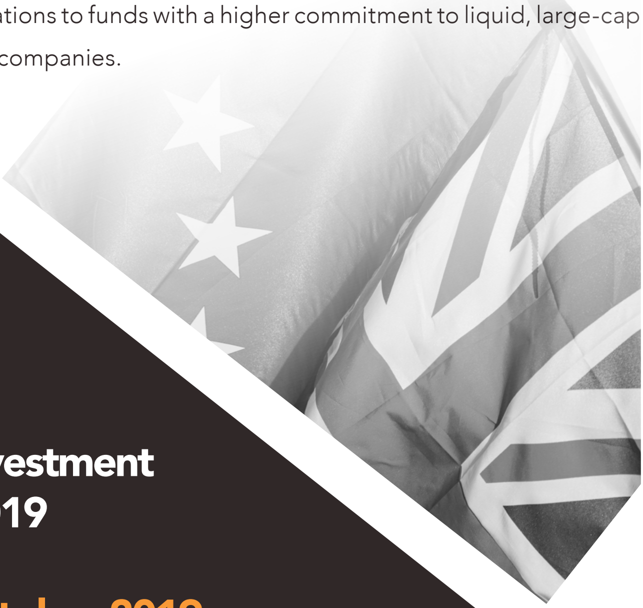
It is not worth abandoning investment in Europe and Japan altogether, particularly since market valuations remain quite attractive relative to other developed regions. Nevertheless, we feel it is appropriate to lighten the load a little and allocate some more to the US, which has more wiggle room on the policy front and also more levers to maintain and stimulate growth at a fundamentally higher level than many other developed world countries. With the US election drawing closer we should perhaps also not underestimate President Trump's potential initiatives to keep the American dream alive. Market valuations may be more elevated in the US than elsewhere, but for a good reason. Careful stock and sector selection by active managers can hopefully avoid most of the valuation potholes in a market that continues to offer a wide universe of investment opportunity. The additional strong underpin of both policymaker and political support is an added bonus.

Difficult decisions ahead

A large Brexit cloud continues to loom over the UK.

A whole host of economic forecasters, including the UK's own Office for Budget Responsibility, have steadily revised downwards their economic growth expectations, whilst various business surveys indicate that the economy is possibly closer to zero growth. Having recently kept interest rates on hold, the UK's Monetary Policy Committee ('MPC') is coming under some pressure to reverse last summer's decision to hike rates. But the MPC is in a slightly awkward space policy-wise, particularly with wage growth still trending upwards but this not being accompanied by a pick-up in productivity. Fundamentally, the MPC probably ought to cut interest rates to address the economy's Brexit battering. Whichever way one looks at the backdrop, more relaxed monetary policy does look necessary to smooth the UK's exit from the EU, particularly with the UK seemingly edging closer towards the harder option. Sterling has already weakened quite significantly against most major currencies and is likely to come under further pressure from a combination of more relaxed monetary policy and a harder line in finding a Brexit solution, not to mention the possibility of instability brought about by a potential change in government.

All this uncertainty highlights to us that continuing to allocate more risk capital outside the UK than in it, either directly or indirectly, is probably still a sensible plan. To this end, whilst maintaining our current exposures to the UK stockmarket *per se*, we are further increasing our tilt away from the domestic economy by switching a little more of clients' UK allocations to funds with a higher commitment to liquid, large-cap international companies.



Save the date

Bordier UK Investment Conference 2019

Thursday 3 October 2019

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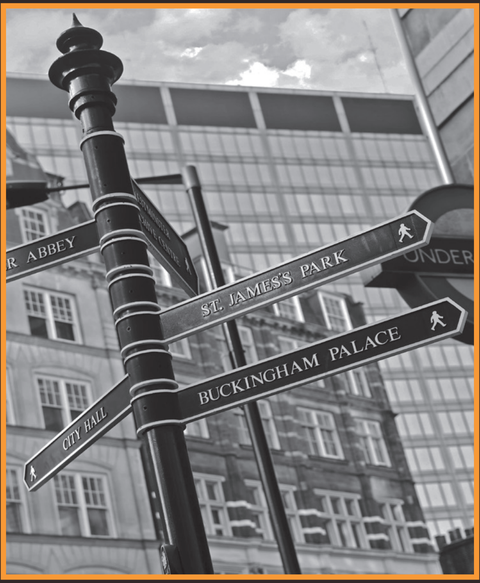

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