INVESTMENT OUTLOOK April 2019

THE OUTLOOK REMAINS SUPPORTIVE FOR RISK ASSETS

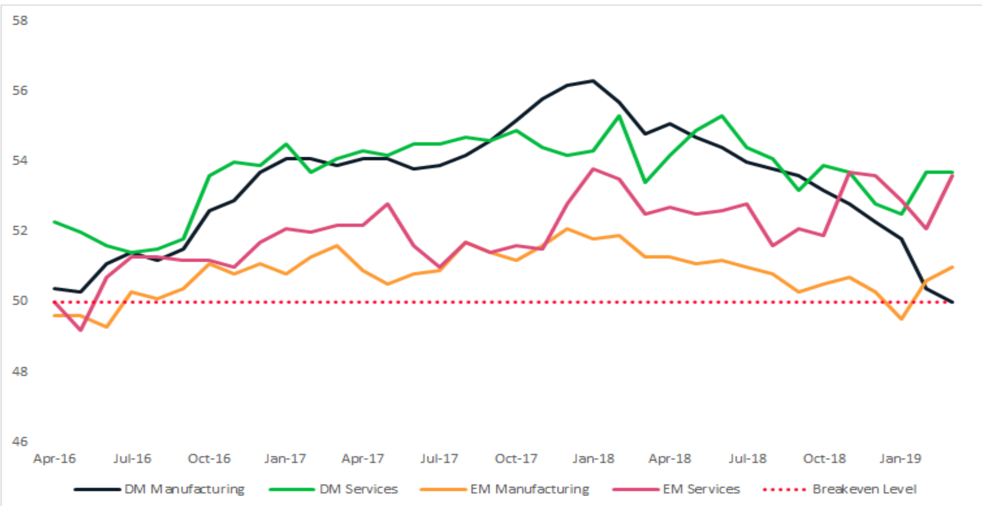
Although global growth is likely to be slightly lower in 2019 than 2018 – which was boosted by strong US growth – it is still likely to be around the post-financial crisis average. In Developed Markets (DM), the US and UK with record low unemployment, are still growing at a sustainable rate. For the UK, Brexit continues to be the main concern; whereas in the US, how long this recovery continues and how it will end remains the key question, although the Fed's recent dovishness is likely to have extended this cycle further. The Eurozone saw a difficult end to 2018, with Germany and Italy failing to grow in the second halves of the year, offset somewhat by France and Spain's firmness. We see this as a temporary wobble, with Eurozone employment growing steadily but there is still some way to go before triggering aggressive wage inflation. Similarly, the recent drifting lower of Eurozone inflation is likely to delay any rate hikes until 2020. Japan is still trying to achieve consistent long-term inflation to address once and for all its deflationary issues. Emerging Markets (EM) on the whole are benefiting from long-term structural reform progress, favourable demographics, and generally, a well prepared monetary and fiscal toolkit ahead of any downturn.

Our base case remains continued positive growth momentum, more volatility than the unnatural lows of recent memory but Q4 of 2018 set the bar quite high.

EQUITIES OVER BONDS

Most major global equities' valuations are at or below their long run averages, apart from the US where they are above. Even without the distortion of Quantitative Easing (QE), this would make a strong case for equities over bonds given where yields currently sit. US bond yields have moved lower since November 2018's peak, although these are likely to drift higher as we see growth and inflationary concerns as unlikely to persist. The UK, where Brexit based uncertainty has supported Gilts and where higher rates would likely attract purchases by pension funds and insurers, remains an idiosyncratic case. Government bond market distortion is especially marked in Europe and Japan where loose monetary policy is likely to persist for sometime. The near universal drift from QE to QT (Quantitative Tightening) will, in our opinion, weigh on bonds more than equities, as bonds suffer more when interest rates go up and money supply tightens. We believe that concerns about growth are overdone and that earnings expectations, especially outside of the USA, are pricing in an overly depressing outlook. Alternatives continue to provide some useful diversification in our investment plans and additional yield.

Services hold firm but trade woes weigh on manufacturing



REGIONAL MARKIT PMIs SINCE APRIL 2016

TOP RISKS

Rapid wage growth
Global employment growth and easy credit, not higher wages, has boosted real consumer spending. A rush of wage inflation could trigger more aggressive monetary tightening, hitting Bonds and Equities.

Rising political turmoil
Current political unrest seems to have minimal global macroeconomic impact outside of localised pain-pockets. The US' focus has shifted from NAFTA and the EU to China where equities look oversold. France and Italy remain points of concern.

Brexit
The Brexit process remains the UK's unknown, but we see little global impact. The outcome set is so wide; from a "no deal" to a complete reversal, giving UK assets a high uncertainty premium.

Hyperactive Fed
Concerns about tighter Federal Reserve Monetary Policy have largely disappeared after weighing particularly heavily on EM assets. The EM growth outlook remains comparatively positive and most countries are well equipped to cope with a gradual QE to QT shift.

Oil
An escalation of Middle East unrest could drive oil prices significantly higher, which would likely only be positive for energy equities.

ASSET CLASS	OUTLOOK	RATIONALE
EQUITIES		
UK	=	Valuations remain low despite UK equities' large overseas component (around 70% for FTSE-100 and around 50% for FTSE-250). Negative sentiment around the Brexit process continues to weigh on investor appetite. The index is more diversified than before the financial crisis, but the FTSE retains a large commodity and financials exposure in both sectors tend to be procyclical. Should the Brexit process be smoother than expected then a rapid rise in sentiment could support UK equities.
US	−	US valuations remain stretched versus other developed markets. At the same time the US 10-year interest rate has fallen but is still firmly above the S&P500 div yield. The tax cut-fuelled economic acceleration is largely behind us. We believe growth concerns are overblown which would see tighter than expected monetary policy, there's also the potential for greater wage inflation to see greater pressure on margins and then valuations.
Europe ex UK	+	Growth remains above trend, employment and inflation are drifting higher without being threatening and monetary support is only being very gradually withdrawn. Underlying fundamentals remain positive for Eurozone stocks and valuations remain comparatively attractive given the early economic cycle point. Politics (Italy, France and Germany) remains a concern. A US and China trade war would likely impact Europe but the EU and US have agreed to work together (for now).
Japan	+	Japanese equity valuations remain attractive in absolute and relative terms. A pivotal pillar of this view is Abenomic's continuation providing fiscal and monetary support, which is accompanied by solid corporate fundamentals and continued reforms. A key risk is that the global recovery falters lifting JPY and delivers a double punch to the Nikkei's important exporter segment.
Emerging Markets	+	This economic cycle EM equity performance has lagged DM. Fairly steady aggregate EM growth hides the vastly contrasting performances. China's reform policies, especially those aimed at increasing domestic consumption, remain supportive for regional growth. India should benefit from further reforms, although depend on the Q2 election's results. US-China trade tensions remain an overriding concern. While looser Fed rate policy has been supportive for EM markets, weaker US growth would be a worry.
Asia Pacific ex Japan	+	Attractive valuations (strong expected returns) are complimented by a high dividend yield and still historically low P/Es. The main risks remain a trade war, slowdown in global growth or stronger USD/higher yields hitting corporate refinancing.
FIXED INCOME		
Government bonds		
UK	=	Gilts have benefited from continued Brexit uncertainty. Despite low yields, pension and insurance firms remain buyers. The main risk is a growth shock coupled with sustained inflation driven by sterling weakness. The UK offers unique diversification properties due to idiosyncratic factors (Brexit).
US	=	The Fed is now expected to leave rates on hold through 2019. This has provided a lift to bonds reflecting US growth concerns and the fact that inflation remains around trend levels and the Fed has shown some willingness to let inflation "run hot". We see the main risk as labour market tightness finally drives wage inflation higher, demanding higher rates.
Europe ex UK	−	ECB government bonds are dramatically overvalued due to QE. The end of ECB QE is likely to see yields drift higher, albeit slowly, although this process has longer to run than the US or UK.
Japan	−	Japan bonds offer little income and remain severely distorted due to the BoJ Yield Curve Control program. While the BoJ might alter this program there's little expectation for significant near to medium term change. Equities are the attractive way to capture Japan's economic improvement.
Emerging Market	+	EM government bonds continue to offer a strong yield premium above DM alternatives. Similarly, their currencies appear to be structurally undervalued offering a compounding supportive factor. Comparisons with the 1998 EM crash are overdone, with external debt, FX reserves and CA balances significantly firmer. The main risk is that Fed's bias returns to be hawkish.
Corporate Credit		
UK	=	The BoE's bond buying program has distorted the market but spreads have widened since the start of 2018 making these bonds more appealing. Low default rates and international diversification of UK companies leave us more optimistic than the market but still cautious enough (Brexit) to be neutral.
US	=	Corporate spreads have reversed most of their recent rise after further Fed hikes were priced out by the market. The margin of safety is therefore much smaller but still close to the post-crisis average. Recession risk remains low in our opinion which is key.
Europe ex UK	−	The ECB's bond buying program has left this market unattractive. Despite low default rates tight spreads make these bonds uncompelling, particularly compared to equities.
Japan	−	Similar to Japanese government bonds, Japanese corporate bond prices have been distorted by QE. We prefer equity exposure especially as Abenomics continues.
ALTERNATIVES & THEMATIC		
Commodities	=	Growth concerns have seen a volatile recent period for Commodities. Oil's outlook remains uncertain given the nimbleness of shale oil. Global demand remains crucial for commodities overall but price levels are overly downbeat in our estimations.
Global Real Estate	+	Globally real estate remains appealing given constrained supply and modest leverage compared to prior cycles. Rents remain linked to GDP and inflation offering a float rate equivalent with capital growth. It also provides diversification against equities and bonds except in a severe economic drop.
Private Equity	=	Public market valuations remain high which increases competition in the private market. This is combined with a record level of assets (indicated by fund raising data) chasing those opportunities. Lower rates will be supportive but the economic cycle dominates.
Gender Equality	+	Academic research has shown that companies with greater diversity show strong long-term productivity, return on equity and dividend growth.