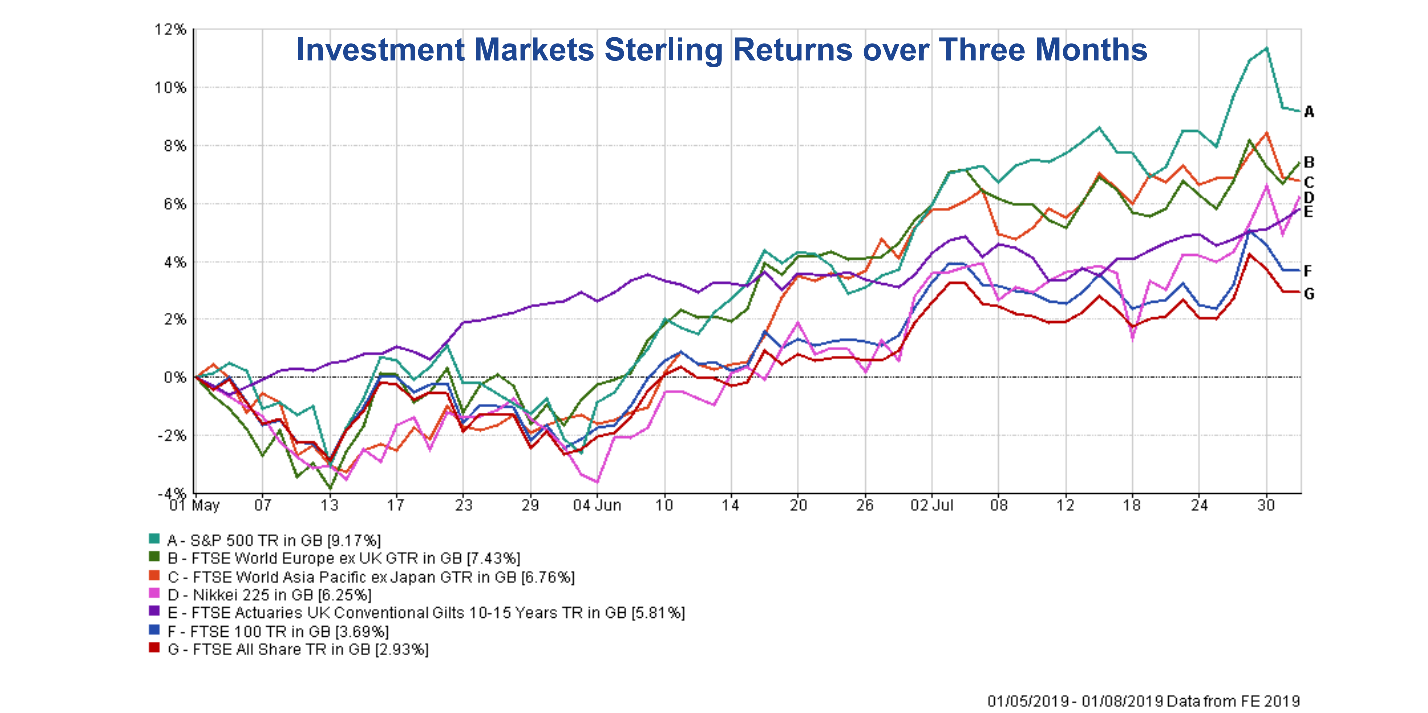
INVESTMENT COMMENTARY

August 2019

Over the past few months, equity markets have performed well driven in part by the expectation that the major central banks would start to loosen monetary policy. The US Federal Reserve (Fed) did cut interest rates for the first time since 2008 but indicated that it was a “mid cycle adjustment to policy” rather than the start of a more aggressive cycle of monetary easing. Markets have fallen in the last few days on this news together with President Trump’s announcement of further tariffs on Chinese imports to the US. The US/China trade talks had recommenced and been described as “constructive”. Company earnings have been relatively strong whilst US economic growth has been maintained at a reasonable level. The new UK Prime Minister is preparing for the UK to leave the European Union without a deal if the European Union does not re-negotiate the existing Withdrawal Agreement – sterling has fallen sharply as a result whilst the internationally facing FTSE100 index rose in price as weaker sterling is beneficial for companies with significant overseas earnings.



UK

The new Prime Minister, Boris Johnson, has declared that the UK will leave the European Union on 31 October 2019 and the government is preparing to leave with or without a deal. With the likelihood of a “no deal” Brexit increasing, sterling fell sharply and consequently the FTSE 100 index increased due to the number of constituent companies which make substantial earnings overseas. The equity market has also been supported by the highest number of private equity deals (£13.6 bn year to date) since 2007. Wage growth accelerated to 3.6% in the year to May 2019, the highest rate since 2008. Wages have now been outpacing inflation since March 2018. The consumer price index (CPI) has risen 2% over the past year. The unemployment rate remains at 3.8% - the lowest level since 1975. After some weakness in May, UK retail sales rose 1% in June so beating expectations of a 0.3% fall. The annual growth rate stands at 3.8% signalling that the UK consumer is supportive of the economy. Economic growth continues to be meagre with a contraction of around 0.1% expected in the second quarter and minimal growth of 0.2% in the third quarter. The manufacturing sector is contracting, reflecting the slowdown in the global economy. The Monetary Policy Committee of the Bank of England (BoE) voted unanimously to maintain Bank Rate to 0.75% at its latest meeting. It has reduced its economic growth expectation for 2019 to 1.3%. Brexit uncertainty is weighing on companies’ spending. The BoE is assuming a smooth Brexit in line with current Government policy of striking a deal. In such circumstances inflation may overshoot the 2% target and Bank Rate may have to rise.

US

Economic growth in the US was better than expected in the second quarter of 2019 with the economy growing at 2.1% pa. Exports have slowed as has corporate investment. Consumer spending has been stronger and government spending has also increased. The US equity market reached record highs on the expectation that the US Federal Reserve (Fed) would start to cut interest rates together with some good company results supporting the index. As expected, the Fed has cut rates by 0.25% to a range of 2 to 2.25%. The decision to cut rates was made against the backdrop of muted inflation and signs of slowing economic growth. According to the Fed, trade tensions and weak manufacturing were having a negative impact. Jay Powell, the Chair of the Fed, described the move as a “mid cycle adjustment to policy”. The equity market fell as this suggested that further sharp interest rate cuts were unlikely. Following the resumption of trade talks between the US and China, optimism had increased slightly. However, President Trump has unexpectedly announced that further tariffs will be imposed on Chinese imports on 1 September which has led to investors becoming more negative. This move puts pressure on the Chinese to reach an agreement and on the Fed to cut interest rates more substantially as higher tariffs could hold back US economic growth. After further negotiations on the budget, a compromise deal has been reached whereby the debt ceiling is suspended for two years. Therefore the government can borrow as much as it needs to pay off its current debts and obligations for two more years. After the suspension ends, the debt ceiling will automatically be raised to reflect how much was borrowed.

EUROPE

Economic growth in the eurozone continues to remain weak with manufacturing affected by trade uncertainty and slower global growth as well as the impact of Brexit. The eurozone economy grew by 0.2% in the second quarter of 2019. The labour market remains strong with the services sector supporting growth. Manufacturing in Germany continues to contract and in France it appears to have stalled. The German government is predicting growth of just 0.5% in 2019, compared to 1.5% in 2018. Trade tensions, weak demand from China and new car emissions tests are among the factors hurting German manufacturing. The European Central Bank (ECB) kept rates on hold at its latest meeting and indicated that the current levels would be maintained until at least the middle of 2020 or could even move lower. Quantitative easing may also be resumed to help stimulate the economy as inflation remained below the ECB's 2% target at 1.1% in July.

ASIA PACIFIC

Whilst politics have taken centre stage elsewhere in the world, Japan remains relatively steady. Prime Minister, Shinzo Abe, enjoys good approval ratings and the government has been stable for six years. Japan is set to raise its consumption tax in October, but there are plans to offset its impact on lower income workers with broad fiscal stimulus. Corporate governance appears to be improving. Stock buybacks have doubled in the past year which augurs well for further developments. Japanese equities offer value relative to other developed markets. The recent political unrest in Hong Kong is weighing on equity market sentiment. The Chinese economy continues to slow with second quarter growth at 6.2%, the lowest level in twenty-seven years. The manufacturing indicators point to contraction in July, the third consecutive month. Non-manufacturing statistics indicate expansion albeit at a slower rate. With economic growth continuing to be impacted by existing and recently announced additional US trade tariffs, lower global demand and tighter property controls, it is likely that the Chinese authorities will loosen monetary policy over the coming months.

EMERGING MARKETS

The outlook for many emerging markets is linked to the progress of the US/China trade talks. Recent developments have not been beneficial. However, with cuts in US interest rates, central banks in emerging markets may now follow - which may stimulate domestic demand. The US dollar could also weaken against emerging market currencies which should help the latter. Key economies in Latin America, such as Argentina and Brazil, are now embarking on reforms which should support sentiment. In Asia, there are countries also set on economic reforms such as Indonesia and India.

COMMERCIAL PROPERTY

Sentiment towards the retail sector continues to be negative as online spending increases. Solid demand persists across the industrial sector, demand in the retail sector remains very poor - whilst in the office sector demand is steady. Availability of space reflects these levels of demand across the sectors. Rents are expected to dip marginally over the coming months in general terms, with weakness in the retail sector persisting. Office rents are expected to remain relatively flat with prime office rents rising and secondary ones likely to fall. The industrial sector looks set to deliver further solid near term rental growth. More recently - although still active - demand from overseas investors has fallen across the market. It remains to be seen if the recent fall in the value of sterling may lead to renewed interest.

FIXED INTEREST

With global growth continuing to weaken, central banks seem to be considering monetary easing whilst the US, Australia and New Zealand's central banks have already taken action. Mario Draghi, the President of the European Central Bank (ECB), believes that there is room for rate cuts into even more negative territory. There also seems to be some possibility that the ECB can start to purchase corporate bonds again which would be supportive. Fixed interest assets continue to offer diversification benefits, but government bond yields are relatively ultra-low in developed markets with an increasing proportion of the bond market exhibiting a negative yield. Investment grade corporate bond spreads look reasonable but yields are relatively low given minimal risk-free rates. Interest rates in the developed world are now likely to re-converge as the US cuts interest rates.

OUR VIEW

Relatively robust economic growth in the US, combined with acceptable corporate earnings figures, presents a stable picture when allied with modest inflation and a reduction in interest rates. There are signs that a 'boom' has been averted, which may in turn mean there is no reason for a 'bust' anytime soon. A stable US economy is good news for the rest of the world, although the fall in US export volumes indicates that even the US is not immune from global headwinds.

Brexit uncertainty is strengthening the outlook for the UK's large-cap companies as their overseas earnings are flattered by the fall in the value of Sterling. We remain of the view that such companies remain under-valued in many cases and that they continue to present enticing prospects for investors. Domestically focused companies are vulnerable to either a perceived or actual fall in economic activity as a result of a 'no-deal' Brexit. The continuing rise in 'real' earnings is beneficial to an economy so much influenced by consumer behaviour. UK assets remain toxic to investors owing to the uncertainties of Brexit but the fall in the value of Sterling makes valuations attractive.

Europe is relatively moribund presently awaiting direction from the ECB and missing direction from a politically weakened Angela Merkel. European equity prices have to a significant degree recovered from their winter lows with French equities especially in favour. The spectre of trade tensions with both the US and the UK will act as a constraint in the shorter term at least.

We remain relatively positive about Japan, Asia Pacific and Emerging Markets. For the Sterling investor the Japanese Yen provides a useful hedge as Sterling falls in response to 'Brexit' uncertainty. Asia Pacific and Emerging Markets are diversified areas of investment and we rely on specialist fund managers to identify the opportunities. A large and increasing population of educated, affluent sophisticated consumers in Asia Pacific makes the region attractive whilst consumer enfranchisement remains an exciting theme amongst the often poorer populations of emerging market economies.

UK fixed interest and global bond funds remain attractive safer havens for Sterling investors with commercial property offering far less certain rewards over the shorter term. We have maintained or added to our stock of UK fixed interest with the focus on gilts, higher credit quality Sterling corporate bond and global bond funds for diversification.

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