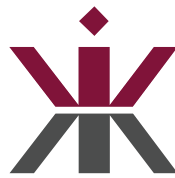


KINGSWOOD

PROTECT AND GROW YOUR WEALTH

Q2 | 2019

INVESTMENT OUTLOOK

SUMMARY

- Global equities have rebounded swiftly from the sell-off last year and have now recaptured almost all their losses.
- The suspension of Fed tightening, along with a bottoming out in global growth, justifies this rebound as the risk of an early end to the business cycle has been reduced.
- We are less cautious than before, but still some way from outright bullish as growth is set to remain sluggish and risks remain.
- We are adding a little to our equity exposure on more positive news but will still remain underweight in both equities and higher volatility assets more generally.
- Within equities, we continue to favour emerging markets and Asia ex Japan and also have significant exposure to specific themes.
- We are less negative on the US than before but remain cautious on the UK.
- Our fixed income exposure remains focused on higher quality and shorter maturity corporate bonds.

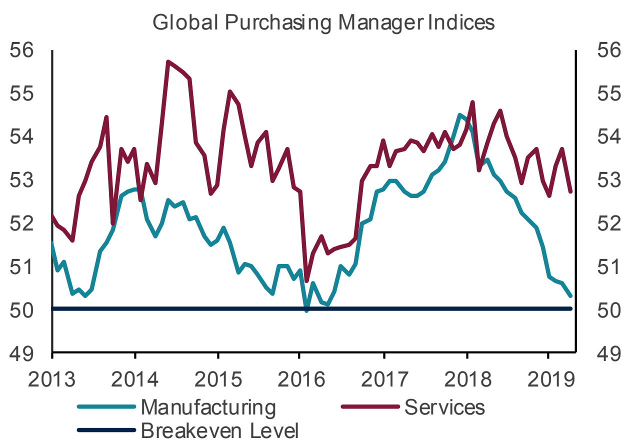
ECONOMIC AND MARKET OUTLOOK

Equity markets have bounced back remarkably fast from their sell-off in the fourth quarter of 2018. Global equities are now closing in on last year's high after falling as much as 20% at their low point in December. The US has led the recovery and is now testing new highs while other regions are still some way below last year's peak.

The rebound has been fueled by two main factors – the realisation that recession fears were overblown and a marked change in policy by the US Federal Reserve (Fed).

A slowdown in global growth led by the manufacturing sector was behind earlier recession worries. However, **fears of a major US-China trade war have so far proven misplaced.** President Trump's new threat to ratchet up tariffs on Chinese imports means a trade agreement is still far from a done deal but **on balance still expect an agreement to be reached.**

Global business confidence starting to bottom out



Source: Datastream

Ironically, just as US-China relations improve, US-EU trade tensions look set to rise with the US threatening to impose tariffs on auto imports, on national security grounds. But any such confrontation should pose a much smaller threat to the global economy than a US-China trade war.

Market hopes of a bottoming out in growth have started to be borne out by the economic data. Crucially in China, the monetary and fiscal stimulus introduced in recent months is bearing fruit. Chinese growth, which had been slowing, levelled out at 6.4% year-on-year in the first quarter.

Growth has also been slowing in the US as the fiscal boost has faded and Fed tightening bites. However, first quarter growth turned out stronger than expected, at an annualised 3.2%. And, with the Fed now 'on pause', US growth looks set to average a respectable 2%, or so, over the balance of the year.

Here in the UK, the story is one of continuing sluggish growth. The strong labour market is supporting consumption and offsetting Brexit-related weakness in business investment. Even in the Eurozone, where structural problems remain a long-term worry, there are signs of activity bottoming out.

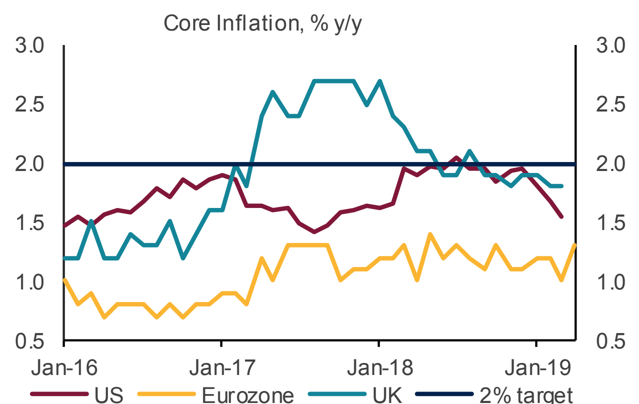
The second key factor driving the market rebound is the Fed's decision to suspend raising rates. The Fed now plans to keep rates unchanged this year, rather than raising them a further 50bps. It is also ending its quantitative tightening in September, earlier than expected. This shift in policy means the risk of monetary tightening pushing the US economy into recession is perceived to be significantly reduced.

The Fed is not the only central bank to turn more dovish. The European Central Bank (ECB) has pledged to keep rates at their current super low levels until at least year-end and a rate rise looks unlikely for the foreseeable future. As for the Bank of England (BoE), it is hoping to be able to raise rates but only 'at a gradual pace and to a limited extent'.

This dovish shift has been driven both by growth worries and the continuing low levels of inflation. Wage increases have picked up in the US, UK and Eurozone as a result of their relatively tight labour markets. But there is no sign of this feeding through into higher inflation. In fact in the US, underlying inflation has started to fall again and at 1.6% is running significantly below the Fed's 2% target. Even if US inflation does pick up, the Fed is very likely to tolerate some overshoot above 2%.

All this leaves the macro backdrop looking rather less threatening, **reducing the risk of an early end to the business cycle.** While we believe this improvement validates the recovery in markets, we don't believe it justifies further significant gains in equities.

Inflation Pressures Remain Subdued Everywhere



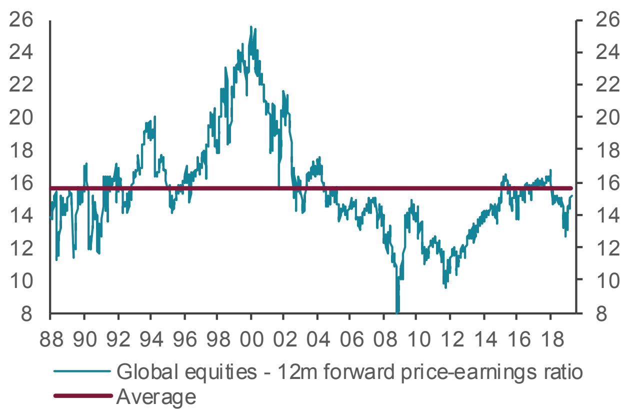
Source: Datastream

Global equities now look fairly valued with the price-earnings ratio close to its long-term average. While the global economy looks rather more secure, the outlook is not obviously rosy enough to justify a further upward re-rating. That said, the lacklustre returns available on other asset classes, still relatively

easy monetary conditions and cautious positioning of investors means such a re-rating can be far from ruled out.

Growth is set to remain sluggish and inflation low, leaving **global economies quite vulnerable to any external shock** - particularly as central banks have little ammunition to counter threats to economic activity. Meanwhile, the retrenchment by the banks has **reduced market liquidity and left markets prone to overreact** to any scare - as they did in the recent sell-off.

Global Equity Valuations in Line with Long-Term Average



Source: Datastream

Government bonds are certainly viewing the world with more trepidation than equities. 10-year US Treasury yields are 70bp below their November high – hardly a resounding vote of confidence in a firm economy. Indeed, the markets are assuming the Fed will cut rates over the coming year despite the Fed itself continuing to forecast one more rate hike next year.

If there is no further re-rating, **then earnings will have to drive any increase in equity prices.** Global earnings growth has slowed substantially from over 20% last year, on the back of US tax reforms, to a moderate 5%. **Earnings gains look set to remain modest**, particularly as margins could come under pressure if companies struggle to pass on higher wages to the consumer.

Even if the scope for price gains is limited, equity returns will be propped up by the dividend yield. UK equities are yielding 4.3%, considerably more than the 1-2% yield on UK cash or Gilts. Fixed income returns will anyway face a drag if as we expect government bond yields trend slowly higher from here.

Credit spreads have reversed much of their widening in the fourth quarter and look likely to remain around current levels. The rise in corporate leverage is a long-term worry, but while growth continues and rates remain relatively low, should not pose too much of a problem. The bottom line is we **expect equities to deliver somewhat higher returns than bonds but to suffer further sporadic spikes in volatility.**

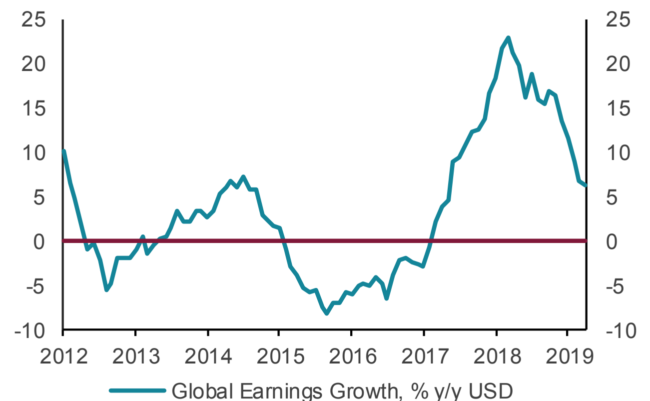
POSITIONING

Fearful of exactly the kind of sell-off we saw in Q4 2018, **we have been cautiously positioned for a while now** – overweight lower volatility assets at the expense of higher volatility ones, particularly equities. Recent developments leave us less cautious than before but still some way from outright bullish. **While we are increasing our exposure to equities, we will still retain an underweight.**

Emerging markets and Asia ex Japan remain our favourite equity regions due to their relatively cheap valuations and relatively strong long-term growth prospects. However, we are **scaling back our sizeable exposure to frontier markets.** While we still are positive on this area longer term, recent performance has been disappointing.

We also retain a **significant exposure to specific themes** - such as Technology, Infrastructure, Global Brands and Frontier Markets - which we think offer superior opportunities to developed equity markets generally.

Global Earnings Growth has Slowed Substantially



Source: Datastream

We are topping up our US exposure modestly. The Fed no longer poses such a threat and US equities should continue to benefit from their relatively large weighting of technology stocks.

As for UK equities, they are relatively cheap but are likely to continue to struggle with Brexit still a major source of uncertainty and the risk of a general election being called. With some 60% of our equity holdings outside the UK, **portfolios should be relatively well protected against any unfavourable Brexit or political outcome.**

Within fixed income, we believe bond yields will trend higher and we continue to **favour shorter duration bonds.** Our focus also remains on higher quality names. Given the lacklustre outlook for the main asset classes, we also retain some **exposure to alternative assets** which offer better prospective risk-adjusted returns. Finally, we have an allocation to gold as protection against a renewed major equity sell-off.

MARKET VIEWS

OVERALL PORTFOLIO	PREVIOUS VIEW	CHANGE	CURRENT VIEW	RATIONALE
Lower Volatility Assets	●● (positive)	⇩	● (positive)	Overweight with focus on shorter maturity higher quality corporate bonds
Higher Volatility Assets	●● (negative)	⇧	● (negative)	Less cautious than before but still far from bullish and retain an underweight
LOWER VOLATILITY ASSETS				
Government Bonds	●● (negative)	-	●● (negative)	Yields are low and should trend higher, severely limiting prospective returns
Corporate Bonds (Inv. Grade)	● (positive)	-	● (positive)	Return prospects somewhat better than for government bonds but still on low side
Index-linked Bonds	● (negative)	-	● (negative)	Inflation remains becalmed, limiting appeal of index-linked
Lower Volatility Alternatives	● (positive)	-	● (positive)	Alternative strategies investing in credit should provide protection and modest returns
HIGHER VOLATILITY ASSETS				
Equities	●● (negative)	⇧	● (negative)	Fed policy change removes a major risk but scope for further gains is limited
Higher Volatility Alternatives	● (positive)	-	● (positive)	Alternative strategies are appealing given muted return prospects for mainstream assets
Property	● (negative)	-	● (negative)	UK property would be hit hard in any recession and its illiquidity is also problematic
Gold	● (positive)	-	● (positive)	Gold can be volatile but is a good hedge against the risk of another major sell-off
EQUITIES				
REGIONS				
UK	● (negative)	-	● (negative)	Continued uncertainty over Brexit keeps us underweight even though the UK is cheap
US	●● (negative)	⇧	● (negative)	The US is relatively expensive but pause in Fed hikes removes a major headwind
Europe ex UK	● (negative)	-	● (negative)	Growth is fragile, major structural issues remain and ECB's room for manoeuvre is limited
Japan	● (neutral)	-	● (neutral)	Increasing focus on shareholder value is positive but Japan's cyclicality is a negative
Asia ex Japan	● (positive)	-	● (positive)	Cheap valuations and relatively good long term growth prospects keep us overweight
Emerging Markets	●● (positive)	⇩	● (positive)	Attractive for similar reasons to Asia. Reducing sizeable frontier market exposure
THEMES				
Global Infrastructure	● (positive)	-	● (positive)	Infrastructure is a defensive sector and should hold up relatively well in any sell off
Global Technology & AI	●● (positive)	-	●● (positive)	Long term growth prospects remain strong despite increased regulatory headwinds
Global Brands	● (positive)	-	● (positive)	Defensive nature of strong global brand names is an attraction longer term
Small & Mid Cap Stocks	● (positive)	-	● (positive)	Should outperform longer term and extended business cycle is a positive

Our view reflects our assessment of the relative atttractiveness of each asset class after taking into acccount its riskiness/volatility

Change = change in view over the last quarter

● = POSTIVE ● = NEGATIVE ● = NEUTRAL

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