KINGSWOOD
PROTECT AND GROW YOUR WEALTH

Q3 | 2019

INVESTMENT OUTLOOK

**UPDATED*

SUMMARY

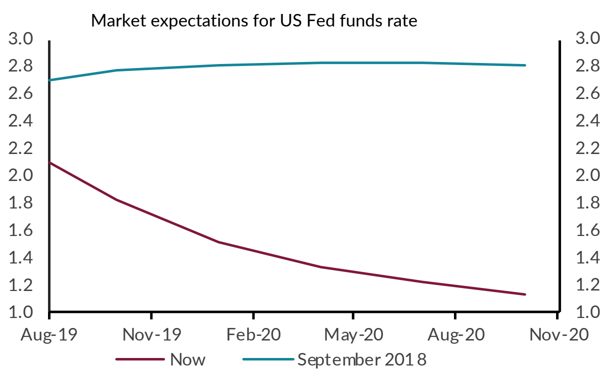
- Despite the rise in US-China trade tensions, the outlook for higher volatility assets has improved now that central banks are easing policy.
- We expect global growth to pick up a little over the coming year and believe the risk of the US falling into recession any time soon is quite small.
- The sharp rebound in markets means much of this good news is now priced in. Even so, we still believe equities have further upside over the coming year.
- This, along with their superior yield, leaves prospective returns from equities looking significantly higher than from bonds, where yields have fallen to exceptionally low levels.
- We increased our equity exposure a couple of months ago and have used the opportunity of the recent correction in markets to increase it further.
- We are now back close to neutral on equities which seems appropriate as potential returns are attractive but risks remain.
- We remain cautious on UK equities despite their cheap valuation because of the increased risk of a No-Deal Brexit and/or a General Election.
- By contrast, we remain positive on emerging markets and the technology sector, where we believe growth prospects remain favourable.

ECONOMIC AND MARKET OUTLOOK

Financial assets saw another strong period of performance in the second quarter. Global equities continued to rebound from their sell-off late last year and, helped by a fall in the pound, returned a sizeable 6.2% over the quarter in sterling terms. Fixed income also fared well, with government and corporate bonds both seeing decent gains.

The **rally in bonds and equities this year has been driven first and foremost by hopes of monetary easing** led by the US Fed. Last autumn, the Fed appeared on auto-pilot and set to continue raising rates. Now, by contrast, it has just lowered rates by 0.25% to 2.00-2.25% and the market believes rates could be cut by a further 1.0% over the coming year – a belief that is likely to prove overly optimistic.

Market expects US rates to be cut a further 1%



Source: Refinitiv

It is not just in the US that monetary policy is now being relaxed. Rates have already been cut in countries such as Australia, India, Korea, South Africa and Turkey. In the Eurozone, the ECB, soon to be under a new President, has all but committed itself to easing policy in September. Even the Bank of England has started to back away from its call for a gradual rise in rates and opened up the possibility of a rate cut.

The relaxation of policy has been driven primarily by worries over the slowing in global growth over the past year. Business confidence, particularly in manufacturing, has been hit hard by Trump's antagonistic trade policies and has fallen close to the lows, seen briefly in 2012 and 2016.

However, the continuing failure of central banks to hit their inflation targets has also been a factor behind this shift in policy. Even in the US, where the unemployment rate is at a 50 year low, **inflation pressures have eased in recent months** and inflation is once again running below the 2% target. The Fed and ECB have also both suggested that a period of inflationary "overshoot" is acceptable to compensate for past "undershoots", implying more relaxed monetary policy.

Encouragingly, the sharp rebound in equities and fall in bond yields have eased global financial conditions significantly. This will provide a stimulus to growth, although the outlook will also hinge on developments in the US-China trade war.

Tensions between the US and China have fluctuated markedly over the last few months and have increased once again. This follows Trump's recent decision to impose a new round of tariffs on Chinese imports. Tensions look likely to continue for a while with neither side seemingly willing to back down. Even so, we believeTrump will be very keen to secure a deal ahead of the Presidential election and we still think a **limited trade agreement should be reached eventually.**

The ongoing US-EU trade dispute could also flare up again over coming months with the US threatening to impose tariffs on auto imports. But while this could pose an unwelcome drag on the fragile recovery in the Eurozone, it is unlikely to represent too much of a problem at the global level.

Global business confidence has weakened substantially

Source: Refinitiv

All this leaves us expecting **global growth to bottom out over coming months and to recover somewhat over the coming year.** Indeed, we continue to believe the risk of the US falling into recession any time soon remains low.

The US recovery is now officially the longest ever, which would normally suggest it is on borrowed time. But growth has been unusually weak during this expansion, limiting the build up of the typical end-cycle pressures which cause central bank intervention and ultimately a recession. We are also sceptical that the recent 'inversion' of the US yield curve heralds a recession, as such a development has often done in the past. Most likely, the inversion is down to continuing distortions caused by quantitative easing.

Here in the UK, the outlook for growth continues to revolve around Brexit. Growth was stronger than expected in Q1 but this was due to a temporary, Brexit-related, build up of stocks and the signs are activity has slowed significantly, since then.

If there is a Brexit deal, growth will very likely pick up on the back of a recovery in business investment which has suffered from the Brexit-related uncertainties. By contrast, **if there is a No-Deal exit, there could well be a short recession due to supply disruptions.** But with the consumer currently enjoying real wage gains, spending should hold up relatively well and prevent a more prolonged contraction in activity.

Government bond yields have fallen sharply this year and 10-year yields are down to their lowest since 2016 in the US and UK with new lows in Germany. This decline looks overdone. While the Fed looks set to reduce rates by a further 0.25% - 0.5% over coming months, it is unlikely to continue cutting into next year - as the market now assumes - if growth strengthens, as we expect.

While bond yields should move back up eventually, we are not expecting a major rise for a while. Secular disinflationary forces, such as globalisation and the internet, look set to keep inflation on the low side for the foreseeable future and global liquidity levels remain high. Even so, with government bond yields so low and corporate bond spreads also on the low side, this means **prospective returns from fixed income are limited.**

Return prospects for equities look rather better. Monetary easing is undoubtedly good news as lower interest rates help support economic growth and justify higher equity valuations. Indeed, a famous investment adage is 'Don't fight the Fed'.

The shift to monetary easing justifies this year's rebound in markets and **further gains will be warranted if, as we expect, global economic growth picks up over the coming year**. A strengthening of the global economy would lead to a recovery in corporate earnings growth which generally has slowed sharply and in the US has ground to a halt altogether. Even so, the upside for equities has limitations unless we see a further upward re-rating of valuations - which is not our base case. The price-earnings ratio for global equities is is currently 14.5, a little below the long-term average.

Global equity valuations close to long-term average

Source: Refinitiv

With the outlook still beset by significant uncertainties, a **further re-rating is not obviously justified**. Still, it can be far from ruled out. Equity valuations in the later stages of the business cycle are often on the high side and, relative to bonds at least, equities still look very good value.

Even if the scope for further price gains is not that large, equities also have the advantage, particularly in the UK, of a significantly higher yield than bonds. The 4.3% dividend yield on UK equities compares to a 10-year gilt yield of only 0.50%.

POSITIONING

We have turned more positive on equities as we believe the shift to monetary easing outweighs the dangers posed by the continuing US-China trade confrontation. We increased our equity holdings a couple of months ago and have used the opportunity of the recent correction in markets to increase our exposure to global equities further.

We are now back close to a neutral position on equities, which seems appropriate as potential returns look relatively attractive but risks persist.

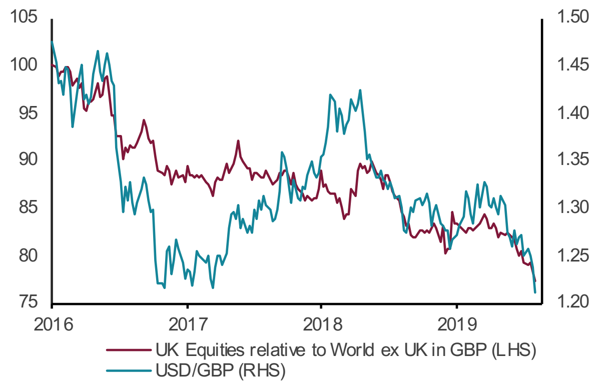
Emerging markets and Asia ex Japan remain our favourite equity regions due to cheap valuations and relatively strong long-term growth prospects. They should also be prime beneficiaries of a pick up in global growth over the next year.

We also retain a **significant exposure to specific themes** - such as technology, artficial intelligence, infrastructure, global brands and frontier markets – which we believe offer superior opportunities in the medium to long term.

We are neutral on US equities which have resumed their long term outperformance. Fed easing is a major positive as is the market's high exposure to the technology sector. But its relatively high valuation may limit the scope for further gains. **We are also neutral on Japan.** Its increasingly cheap valuation, following the recent underperformance, makes up for the weakness of the Japanese economic recovery.

We are less positive on Europe due to the longstanding structural issues facing the Eurozone and some scepticism over the effectiveness of any further easing by the ECB. **We also remain cautious on the UK** which has continued to underperform. While UK equities look increasingly cheap, the risk of a No-Deal Brexit and/or General Election means the danger of further underperformance remains.

UK equities have continued to underperform



Source: Refinitiv

Our **portfolios should be relatively well protected against either eventuality** as some 65% of our equity holdings are international. Around 75% of UK FTSE 100 revenues also come from overseas. We assume the pound will continue to bear the brunt of any sell-off which will boost the value of overseas assets, in sterling terms.

In fixed income, our **focus is on higher-quality short-duration bonds** but with the global economic outlook looking more secure we intend to diversify our exposure a little.

We also have a **weighting in alternative assets** which gives exposure to equities in a risk controlled manner. Finally, we have an **allocation to gold**. We are less positive on gold than we were as the price has risen substantially this year and the risk of a major equity sell-off seems smaller than it was.

MARKET VIEWS

OVERALL PORTFOLIO	PREVIOUS VIEW	CHANGE	CURRENT VIEW	RATIONALE
Lower Volatility Assets	● Positive	⇩	● Neutral	Our holdings remain focused on shorter maturity higher quality corporate bonds
Higher Volatility Assets	● Negative	⇧	● Neutral	Renewed central bank easing has improved the outlook for higher volatility assests
LOWER VOLATILITY ASSETS				
Cash	● Negative	-	● Negative	Cash remains unattractive as returns remain exceptionally low
Government Bonds	●● Negative	-	●● Negative	Yields are very low and should eventually trend higher, severely limiting p 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	⇩	● Neutral	Alternative strategies investing in credit offer only modest returns
HIGHER VOLATILITY ASSETS				
Equities	● Negative	⇧	● Neutral	Easier Fed policy is a major positive although scope for further gains is not that great
Higher Volatility Alternatives	● Positive	-	● Positive	Alternative are appealing given quite 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	⇩	● Neutral	Gold is a hedge against a major equity sell-off but this danger is reduced
EQUITIES				
REGIONS				
UK	● Negative	-	● Negative	Continued uncertainty over Brexit keeps us underweight even though the UK is cheap
US	● Negative	⇧	● Neutral	The US is relatively expensive but prospective Fed easing is a major positive
Europe ex UK	● Negative	-	● Negative	Growth is fragile and structural problems remain but renewed ECB easing will be positive
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
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	Quality focus of strong global brand names is an attractive longer term
Global Healthcare	● Neutral	⇧	● Positive	Beneficiary of ageing population and biotech innovation but there is US policy risk
Frontier Markets	● Positive	-	● Positive	Attractive because of superior demographics and long term growth prospects
Small & Mid Cap Stocks	● Positive	-	● Positive	Should outperform longer term - outside of recessions

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

● = POSITIVE ● = NEGATIVE ● = NEUTRAL