KINGSWOOD

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Q4 | 2019

INVESTMENT OUTLOOK

SUMMARY

- Global economic growth should recover a little in response to monetary easing and reduced US-China trade tensions
- A somewhat stronger global economy should drive renewed gains in corporate earnings and equity markets
- While the sharp fall in bond yields earlier this year was overdone, the rebound in yields is likely to be limited
- Return prospects for equities are significantly higher than for bonds or cash
- We are close to neutral on equities as their prospective returns are attractive but significant risks still remain
- We remain cautious on UK equities because of continuing uncertainty despite their cheap valuation
- We are neutral on US equities but positive on Asia and emerging markets
- Within fixed income, we remain cautiously positioned, albeit less so than before

ECONOMIC AND MARKET OUTLOOK

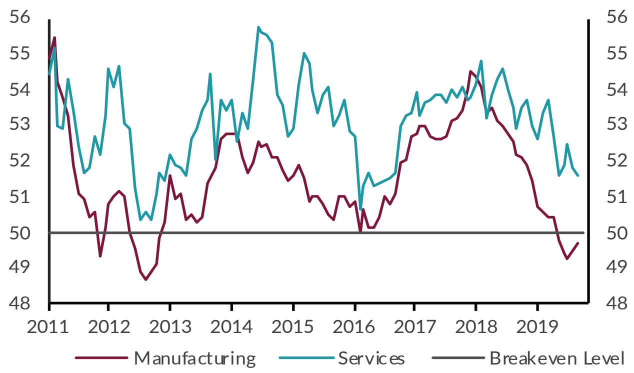
This year's sharp rebound in equity markets petered out in the third quarter with global equities returning a moderate 1.3% – although a fall in the pound boosted the gain in sterling terms to 3.5%. While monetary easing continued to provide support for equities, the ongoing deceleration in the global economy and heightened geo-political tensions limited any gains.

Fixed income, by contrast, had another strong quarter on the back of the US Fed cutting rates by 0.5% and the ECB launching a new round of quantitative easing. Government bond yields fell significantly – particularly in the the UK, where gilt yields fell to new lows as worries of a No-Deal Brexit grew.

The key question facing investors now is whether or not the global economy will soon bottom out. We continue to expect a modest improvement in global growth over the coming year. This is for three main reasons:

First, trade tensions should ease slowly. Manufacturing has been at the forefront of the global slowdown with trade war worries driving business confidence down to the lowest level since 2012.

Business confidence has fallen hardest in manufacturing



Source: JPMorgan

We expect the US and China to eventually agree a limited kind of deal or truce. While it will be very hard to reach agreement on issues such as technology transfer and intellectual property, there are signs both sides wish to contain the conflict. President Trump will be keen to agree a deal ahead of next year's election. Meanwhile, China will want to prevent growth slowing any further as it has already slipped to the bottom of the Government's 6%-6.5% target range.

All the same, the unexpected twists and turns in the trade war over the summer suggest a deal is far from guaranteed. There is also a danger trade tensions may spread to Europe with the US threatening to impose tariffs on auto imports.

Second, the service sector should remain an important source of support. Services, rather than manufacturing, account for the largest part of the major economies and have held up quite well as consumer spending has proven resilient. Tight labour markets mean consumers are enjoying wage gains in real terms. Employment levels also continue to grow and consumer confidence remains relatively high.

Third, monetary easing should provide an increasing boost to activity over coming months. Not only have US rates now been cut as much as 0.75% this year, following the latest move, but rates have also been lowered across the globe – with the notable exception of the UK.

In the Eurozone and Japan, where rates are already negative, there are well-founded doubts as to the effectiveness of further easing. But elsewhere, we believe rate cuts should be of some help in boosting growth. This stimulus, along with the rebound in financial markets, means global financial conditions have eased significantly and more than reversed the tightening seen in 2018.

Fiscal policy should also be relaxed at the margin. Here, the UK will be leading the way, with both the Conservatives and Labour planning a significant boost to government spending. Germany may also bow to pressure to loosen fiscal policy with the economy dicing with recession.

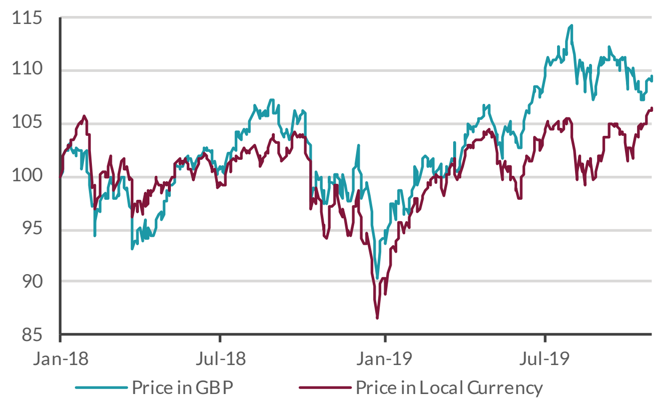
All this leaves us looking for **global growth to bottom out soon** and strengthen somewhat into next year. Indeed, the recent stabilisation of manufacturing confidence suggests we may already be at the low point.

Within the advanced economies, the US has held up best and should continue to fare relatively well next year with growth of around 2%. This is likely to compare with growth of no more than 1% or so in the Eurozone and less than 0.5% in Japan.

The outlook for the UK continues to hinge on Brexit. A No-Deal exit would very likely lead to a short-lived recession. **If, by contrast, as now looks most likely, the latest withdrawal deal ends up being ratified, growth should be in the order of 1%.** It should be noted, however, that the UK has proven far more resilient in the face of uncertainty than many commentators had expected.

If there is a Deal, there will be a transition period lasting at least until end-2020 during which nothing much will change. Even so, the uncertainty over future trading relationships with the EU and elsewhere is likely to remain a significant drag on UK growth.

Global equities just above 2018/19 highs in local currency terms



Source: Refinitiv

Following their sharp recovery earlier in the year, **global equities had been stuck in a trading range since April** but have just recently edged above their 2018/2019 highs.

With the sugar rush from policy easing well behind us, **gains in corporate earnings are likely to be needed to drive equities higher** from here. The problem is that the global economic slowdown has led to earnings growth turning negative – a far cry from the 20%-25% growth seen in early 2018.

If the global economy does pick up momentum as we expect, **this should lead to earnings growth recovering to 5% or so** next year. It could also **produce a modest uplift in equity valuations** as it would ease lingering recession worries. Global equities currently trade on a price-earnings ratio of 15.4x, slightly below their long term average. In the past, by contrast, equities have often traded on relatively high valuations in the later stages of the business cycle. So, there may be room for earnings-led gains in equities to be reinforced by some modest P/E expansion.

Global earnings have been declining recently

Source: Refinitiv

Equities should also continue to gain support from their attractive valuations relative to bonds. This is particularly so in the UK, with the 4.3% dividend yield on the FTSE All Share comparing to a 10-year gilt yield of only 0.6%.

Prospective returns from bonds look very limited. Government bond yields have already rebounded a little from the exceptionally low levels touched in August and should continue to trend higher if worries over growth fade. **Even so, we are not looking for a major rise in yields.** Inflation remains subdued and secular disinflationary forces, such as globalisation, population ageing and the internet, look set to keep it that way. Central banks in turn look certain to keep rates low for the foreseeable future.

This all **leaves prospective returns over the next year looking considerably better for equities than for bonds.** All the same, clear risks remain. Geopolitical threats are on the high side, notably in the Middle East and Hong Kong. In addition, in this new world of permanently lower growth, economies are more vulnerable to negative shocks – particularly as central banks have much less room to ease policy than in the past.

POSITIONING

We added to our equity positions over the last few months as we judged the positive impact of monetary easing outweighed the danger posed by the US-China trade war. **We are now close to neutral** which seems appropriate. Potential returns look reasonably attractive – particularly relative to bonds and cash – but risks persist.

Emerging markets and Asia ex-Japan remain our favoured equity regions due to cheap valuations and relatively strong long-term growth prospects.

They should also be prime beneficiaries of any easing in US-China trade tensions and an upturn in global growth.

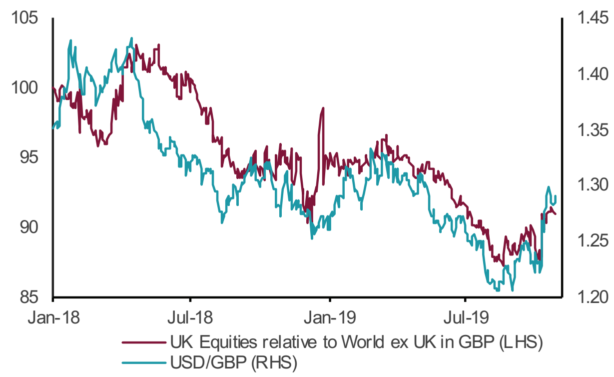
We are neutral on US equities. The relative strength of the US economy is a positive as is the market's high technology weighting. However, valuations are high, next year's Presidential election is a wild card and the US may lag more cyclical markets if the global economy picks up.

We are also neutral on Japan. Its cheapness is an attraction but the weakness of the Japanese recovery remains a concern. We are less positive on Europe as the Eurozone recovery looks particularly fragile and valuations are not especially cheap.

We remain somewhat cautious on the UK. While the danger of a No-Deal Brexit has clearly diminished substantially, the way forward is still far from clear. Importantly, the general election scheduled fo 12 December carries a risk – albeit seemingly quite small – of a Labour Government, which would be greeted with alarm by the markets.

These uncertainties mean **we have held back from increasing our UK holdings** – which account for around 35% of our total equity exposure – even though the UK market is undoubtedly cheap. However, we are keeping the proceeds from a recent European equity fund sale in cash temporarily to benefit from any further rebound in the the pound. Sterling and UK mid/small cap stocks should continue to be the asset classes most sensitive to Brexit developments.

Sterling has recovered as have UK equities to a lesser extent



Source: Refinitiv

We also retain a **significant exposure to specific themes.** These include technology, artficial intelligence and frontier markets all of which have good long term growth potential. In addition, we have allocations to infrastructure and global brands, whose defensive characteristics are attractive.

In fixed income, **our focus has been very much on short-maturity, high-quality bonds** as we believe long-maturity bonds carry a significant risk of capital loss with yields so low. However, we have recently diversified our exposure a little. With our increased equity allocation, we want our bond holdings to provide more protection were there to be a renewed growth scare.

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.** The gold price should remain well supported with rates set to stay low and importantly should provide some protection in the event of a major equity sell-off.

MARKET VIEWS

OVERALL PORTFOLIO	PREVIOUS VIEW	CHANGE	CURRENT VIEW	
Lower Volatility Assets	●	-	●	Exposure tilted to shorter maturity high quality bonds, albeit less so than before
Higher Volatility Assets	●	-	●	Should benefit from modest pick up in global growth although significant risks remain
LOWER VOLATILITY ASSETS				
Cash	●	-	●	Cash remains very unattractive with interest rates so low
Government Bonds	●●	⇧	●	Low yields will severely limit returns but should offer protection against a risk-off move
Corporate Bonds (Inv. Grade)	●	-	●	Return prospects somewhat better than for government bonds but still on low side
Index-linked Bonds	●	-	●	Inflation remains becalmed, limiting appeal of index-linked bonds
Lower Volatility Alternatives	●	-	●	Low vol alternative strategies offer only modest returns
HIGHER VOLATILITY ASSETS				
Equities	●	-	●	Renewed gains in earnings should drive equities higher if global growth recovers
Higher Volatility Alternatives	●	-	●	Equity-related alternatives with downside protection are appealing given risks remain
Property	●	-	●	UK property suffering from high street woes and illiquidity is also problematic
Gold	●	-	●	Upside potential limited but good hedge against risk of an equity sell-off
EQUITIES				
REGIONS				
UK	●	-	●	Uncertainty over Brexit and a General Election keeps us cautious despite cheapness
US	●	-	●	High tech weighting is positive but is expensive and Presidential election is wild card
Europe ex UK	●	-	●	Growth is fragile and Eurozone has substantial long-term structural problems
Japan	●	-	●	Good value but continued weakness of domestic economy is a concern
Asia ex Japan	●	-	●	Prime beneficiary of any easing in China-US trade tensions and pick up in global growth
Emerging Markets	●	-	●	Cheap valuations and relatively good long term growth prospects keep us overweight
THEMES				
Global Infrastructure	●	-	●	Defensive sector which should provide some protection in a sell-off
Global Technology & AI	●●	-	●●	Long term growth prospects remain good despite increased regulatory headwinds
Global Brands	●	-	●	Quality focus of strong global brand names is an attraction longer term
Global Healthcare	●		●	Beneficiary of ageing population & biotech innovation but significant US policy risk
Frontier Markets	●	-	●	Attractive because of superior demographics and long term growth prospects
Small & Mid Cap Stocks	●	-	●	Should outperform longer term - outside of recessions

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

Change = change in view over the last quarter

● = POSITIVE ● = NEGATIVE ● = NEUTRAL