Close Brothers Asset Management

Investor **Insight**

Quarterly investment view – Summer 2019

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A strong start to 2019

As we pass the half-way mark of 2019, investors will be pleasantly surprised by how well markets have performed this year, with global equities having now delivered double-digit returns year to date. This positive performance was not just confined to equities. Traditional safe-haven assets, such as developed market government bonds and gold, have also rallied this year. The UK Gilts index is around 5% higher than in December, a significant move. With such strong returns already delivered, the obvious question is what does the rest of 2019 have in store for investors and what factors will determine longer-term performance?

Resilient growth

While economic growth has broadly weakened, growth is not in fact "weak" in all areas of the economy. The US is still experiencing above 3% GDP growth, in comparison with circa 1% in Europe. Why have these two regions experienced such different fortunes? One factor is productivity growth. The US has enjoyed rising productivity growth since 2017, reaching 2.4% YoY in 2019. In Europe productivity growth declined over the same period, falling by -0.5% YoY in 2019.

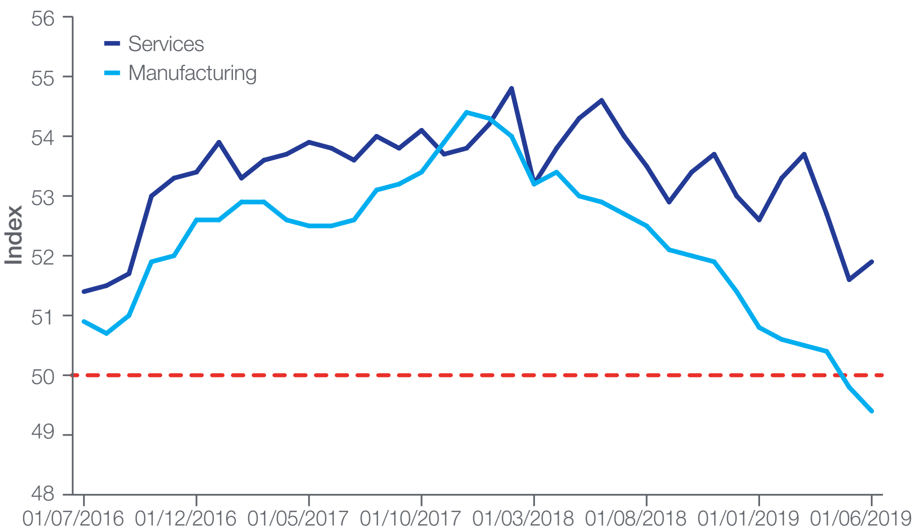
Another factor is trade – the US economy is, relative to Europe's, much less open economy. Total US trade (total imports plus total exports) has amounted to an average of 28% of the US economy and 77% of the European economy over the last 20 years.

We can also see the impact of weaker global trade if we look at the global manufacturing sector versus the services sector, as shown in Figure 1.

The Global Services Purchasing Managers' Index (PMI), a survey based indicator of economic activity, remains in expansionary territory, while the manufacturing indicator has slipped into contractionary territory. This tells us that, while global manufacturing has weakened, the services sector remains relatively resilient which is an important driver of the economy.

In summary, areas of the global economy show resilience despite the challenging trade environment and, more importantly, central bank policymakers have signalled that they are prepared to act to support future economic growth. This in turn provides a positive backdrop for asset prices.

Figure 1. Global PMIs



Source: Close Brothers Asset Management.

The outlook for growth

Although global economic growth remains positive, we have seen a slight deterioration this year and we think there are four main factors behind this:

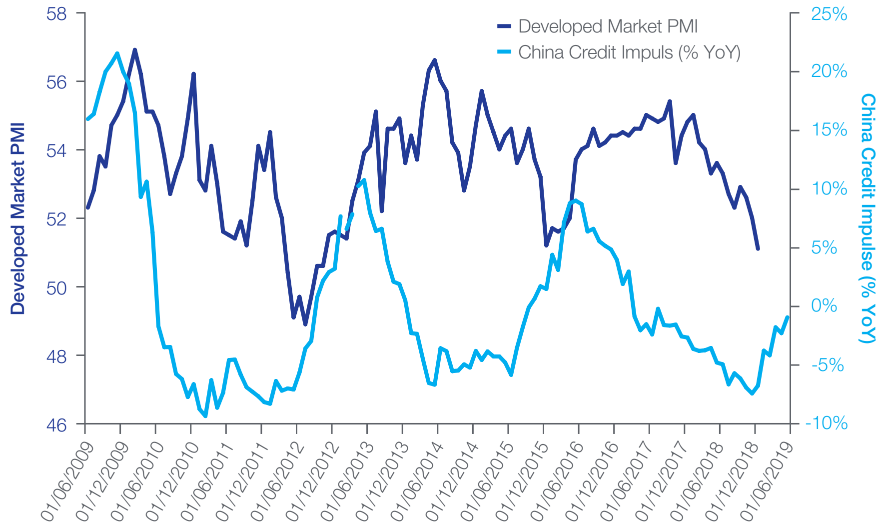
1. Chinese policy makers tightened economic policy in 2017-18, causing growth to slow.
2. The boost from US fiscal stimulus (tax cuts and public spending hikes) in 2017 began to fade, causing growth to return to more moderate levels.
3. The ongoing trade dispute between the US and China has disrupted global economic activity and weighed on trade, export and manufacturing growth.
4. Central banks in the US and Europe had been too tight with interest rate communications and policy with the prospect of steadily rising interest rates leading to a less accommodative economic backdrop for businesses and consumers.

These factors caused significant volatility in 2018, with market gyrations alleviating as we entered 2019. However, the improvement in market tone came as each of these factors slightly changed for the positive as we entered 2019. We discuss each of these factors below.

1. China changing tack

Chinese policy makers have switched from tightening monetary and fiscal policy to stimulating the economy. This is evident from the change in trend of the China Credit Impulse (shown in light blue in Figure 2) which measures the growth in credit relative to the growth in economic output.

Figure 2. Composite PMI Developed Markets vs. China Credit Impulse (3m lead)



Source: Close Brothers Asset Management.

Given the persistent weakness of Chinese economic data, we would expect further easing, which should have a positive effect on growth in other regions. As a result, we would expect to see the dark blue line in Figure 2, which shows the Developed Market Composite Purchasing Managers Index begin to rise, signalling improving conditions in the global economy.

2. A fiscal filip?

Longer-term, it now looks likely that governments will implement supportive fiscal policies. We view this as most likely in the US in the eventuality of a Trump victory at the next election. It is also possible that a new European administration may be able to deliver greater unity on this divisive topic. And, in the UK, the political mood seems to have shifted towards higher spending as the austerity regime ends with both political parties advocating increased government spending, in part to counter possible Brexit related issues.

3. Trade tiffs

Trade tensions persist between the US and China. The June G20 meeting saw some thawing of relations between China and the US – Premier Xi and President Trump agreed to keep dialogue open and not to escalate tariffs further. While this brings some hope of a resolution, existing tariffs will remain in place for the time being, which will continue to impact the global economy. A resolution would provide a definite filip for the economy and for corporate and investor confidence.

4. Rates to the rescue

US economic growth continues to show strength, although forward-looking indicators point to deceleration, in part due to weakness elsewhere in the global economy. Weaker global economic data, coupled with a current lack of inflationary pressures, has led the US Federal Reserve (the Fed) to retreat from raising interest rates and shrinking its balance sheet. Instead, the Fed is now expected to cut interest rates three times in 2019, with a further two cuts expected in 2020. This is a dramatic shift from the prevailing rhetoric of 2018 and will be beneficial for the global economy and asset prices. This is the primary reason we are still positive on company earnings and asset prices.

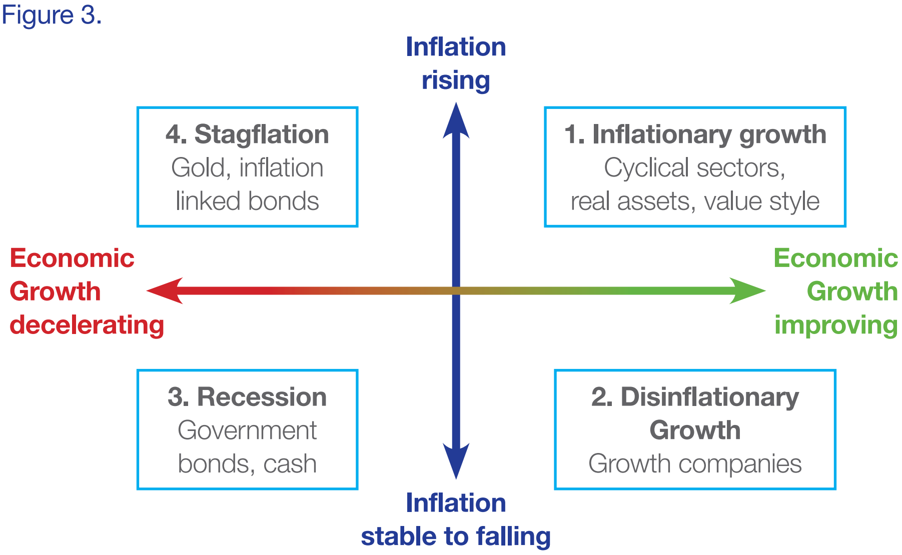
Which assets perform best in this phase of the cycle?

From assessing the various indicators available to us, we conclude that the global economy continues to expand. Likewise, inflationary pressures appear to be waning owing to long-term structural disinflationary forces such as the adoption of new technologies by the consumer and industrial companies.

These low inflationary pressures mean that interest rates are likely to stay low or even fall, providing support to the real economy. Through the financial channel this also has the side effect of sending bond yields lower, which in-turn reduces the discount rate investors use to value assets, pushing present values higher.

This suggests that the economy is moving from expectations of rising interest rates and inflation to a more disinflationary growth phase. Figure 3 looks at which asset classes and investment styles benefit from both different inflation and economic growth rates. In such a disinflationary growth phase (see quadrant 2 in Figure 3)

Figure 3.



Source: Close Brothers Asset Management.

growth of any kind is valued highly.

In this phase, stocks with strong growth characteristics, robust free cash flows and healthy dividend yields are likely to deliver the strongest performance and our portfolios have exposure here.

Our positioning

Equities

We believe that equities can outperform bonds in this phase of the economic cycle. We also recognise that equities have had a large upward move since the fourth quarter of 2018 which has considerably benefited client portfolios. As a result we have modestly trimmed exposure to equities and taken some profits in those equities with large gains in order to keep our powder dry to take advantage of future opportunities on any pullback in markets.

We like quality companies with strong balance sheets and good cash flows. In the US, we continue to favour technology shares as corporate expenditure on digitalisation of businesses continues apace. All companies have to come to grips with how software, artificial intelligence and use of digital technology can improve customer propositions and/or be used to enhance efficiency. We particularly like technology companies exposed to the digitalisation of established and industrial businesses.

We also favour global leaders in the financial, healthcare, and consumer discretionary sectors in the US. We like equities in the emerging markets where the long-term demographic growth story remains intact.

In the UK growth has been weak with Brexit and election fears weighing on activity, so here we favour large companies with genuinely global exposure rather than those wholly exposed to the domestic economy.

Bonds

We think bonds look less attractive from a valuation perspective. While policy rates may fall, pushing bond prices higher, valuations are currently demanding. With this in mind, we are underweight bonds and are keeping duration short, investing in UK government paper and high quality corporate debt, which continues to offer a relatively attractive yield, while also remaining less sensitive to interest rate rises.

Assets offering diversification

Because of the possibility of volatility, we are also seeking assets that offer diversification and we have increased our exposure to these alternative assets, depending on the mandate. This includes exposure to: gold, absolute return investments, and infrastructure investments with dividend yield support, all of which offer risk diversification.

We consider gold a useful diversifier in the current economic environment as lower bond yields reduce the opportunity cost for holding an asset which yields nothing itself, and historically it has performed well in times of heightened geopolitical tension.

In summary

Investors have benefited from the strong performance in equity assets during the first half of 2019. Nevertheless, we believe that risk assets remain attractive and that equities should outperform bonds. Economic growth remains positive, central bank policy is supportive, and valuations are not extreme - we think equities are more attractively priced than bonds. However, much of this good news has already been discounted in the strong stock and bond markets this year hence, near term, we have a note of caution as we could well see a market pullback or consolidation from here.

As multi asset investors, we like exposure to growth themes counterbalanced with portfolio investments that provide ballast. Our base case remains that 2019 will be a positive year for returns – likely even greater than long-term averages – and will be a year where we can continue to add value through our global research and security selection.

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