TOREVELL &PARTNERS
WEALTH MANAGEMENT

ECONOMIC BACKGROUND – MAY 2019

Slowdown, what slowdown?

Global equity markets and other risk assets continued to rise during April as fears of slowing global trade, protectionist policies and lacklustre inflation have been brushed aside by relatively positive economic and corporate data. All major global equity indices are showing healthy gains since the start of the year which has helped offset the impact of sharp falls towards the end of 2018. Measures taken by the US Federal Reserve (Fed) and other central banks have put further pressure on bond yields and, along with improving sentiment on the US-China trade talks, have led equity investors to take a more optimistic view of the future. This optimism may prove to be short lived, as President Trump's more antagonistic approach to trade talks in early May has seen equity markets fall back from their recent highs.

Economic data has provided reassurance that the US Federal Reserve is unlikely to raise interest rates in the near future and have helped the Fed resist (so far) President Donald Trump's calls for cuts. Our belief is that the President's current pressure on the Federal Reserve is less to do with economic and financial prudence but more with an eye on his bid for a second term in office, with elections 18 months away. The Fed is still on course to withdraw some $200bn of liquidity from the market in September as it reduces the size of its balance sheet; however it might indicate halting this action prior to any potential interest cuts.

The first estimate of Q1 2019 US GDP growth was an unexpectedly high 3.2% (well above expectations of 2.0% and the 2.2% growth figure for Q4 last year) although growth in underlying domestic demand is not as robust. The quarter-on-quarter rise was helped by high inventories, improving trade and government spending, though both consumption and business fixed investments were weaker contributors to growth, signalling that this level of growth is unlikely to be sustained. With unemployment still low at 3.8%, inflation at 1.9% and wage growth of 3.3% it is a positive picture for the US consumer, but the lack of inflation continues to be a source of concern for the Fed.

The Brexit can has been kicked to a new 31 October deadline, releasing some of the immediate pressure in the UK, however with European elections looming in May and no sense that the negotiations between Conservative and Labour parties are yielding any new breakthrough, there is no end in sight. The likelihood of a 'no deal' Brexit is currently seen as a low probability and Sterling has held steady against US Dollar and Euro at 1.30 (USD to GBP) and 1.16 (Euro to GBP) respectively, over the month. The UK Manufacturing PMI survey came in at 53.1 in April, slightly down from the surprising 55.1 in March, but still constructive as business sentiment improved to a 7 month high. UK unemployment remained low at 3.9% whilst wages rose 3.4%, well above core inflation of 1.9%.

Within the Eurozone, manufacturing continues to disappoint, with Germany continuing to lead the downturn (in contrast Greece, expanded at the fastest rate in 19 years, albeit from a depressed base). In France, overall business confidence improved slightly in April, but manufacturing remained weak. In response to the 'gilets jaunes' protests President Macron announced a new round of reforms, most notably new tax cuts. Euro zone inflation remains low at 1.4% y/y, and tepid growth and poor confidence provided sufficient justification for the ECB governing council to leave interest unchanged at 0.0% at its April meeting.

Details on the terms for the new series of the targeted long-term refinancing operations (TLTRO) which the ECB announced in March – the TLTRO-III series, will be communicated at the forthcoming meeting. This is important for the Italian and Spanish banks, who are the largest borrowers of the TLRTO II series.

A key risk in the near term to the Eurozone economy and in particular the automobile sector is that as soon as the US and China come to an agreement, President Trump will turn his attention to Europe. As the 18 May deadline for a decision on whether to press ahead with tariffs on automobiles and auto parts approaches, the hope is with the US election on the horizon and little appetite domestically for tariffs, the extent of any such discussions will be minimal. The lure of using such tariffs as a bargaining tool, perhaps for other waivers, may prove too hard to resist.

In Asia, the Bank of Japan left its short-term interest rate at -0.1% at its April meeting, with new guidance of the intention to leave the short-term and long-term interest rates at these low levels to at least Spring 2020. Japan's manufacturing sector contracted for the third month in a row, with persistent weak demand from domestic and international markets.

Conversely, in China, the April Manufacturing PMI data suggested progress in the manufacturing sector, albeit small and below the markets expectations. The expansion reflects improvement in sentiment, mainly from smaller companies, from easing financial conditions and recent tax cuts. Much will depend on the outcome of the US-China talks and whilst both parties are showing a willingness to reach a conclusion, there is no end in sight on the specific issues, which are more structural in nature.

Markets

Equity and risk assets in general, have continued to provide investors with an excellent start to the year. The MSCI World total return index returned 3.5% (in Sterling terms) during the month generating a year to date figure of 13.8%. In local currency terms the year to date return is 16.8% for the global index, the best start to a calendar year since 1987.

The key driver of this performance has been US Markets, outperforming the other regions by more than 16%, over the past 12 months. US equity markets broke through their all-time highs in April, (the previous high was reached in October last year), driven by higher than expected GDP growth, investor optimism and better than expected earnings. Performance has been driven by large, global companies, within Information Technology and Consumer Discretionary sectors and in particular 3 companies, Microsoft, Amazon and Apple, who contributed approximately 17% of MSCI USA index return.

1 Year MSCI Total Return, Regional Indices, Sterling.

The US Q1 reporting season is nearing its end with the weighted aggregate of S&P 500 companies reporting a decline in earnings of -2.3%, but growth in revenues of 5.1%[1]. There are concerns that we may have reached peak operating margins, with margins in decline from a peak in Q3 2018 of 12% to a projected 10.9% this quarter, still significantly above their long term average.

Continental European equity markets were the best performing region in April, with the MSCI Europe ex UK returning 4.0% in Sterling terms and 4.8% in local currency. European indices have underperformed their US counterparts by nearly 77% over the past 5 years, despite a record low interest rate environment; weaker growth, earnings, and political uncertainty have hampered the region. Alongside the UK, Europe is a much unloved area for investment in the eyes of global investors.

[1] Source: Factset, 29 April

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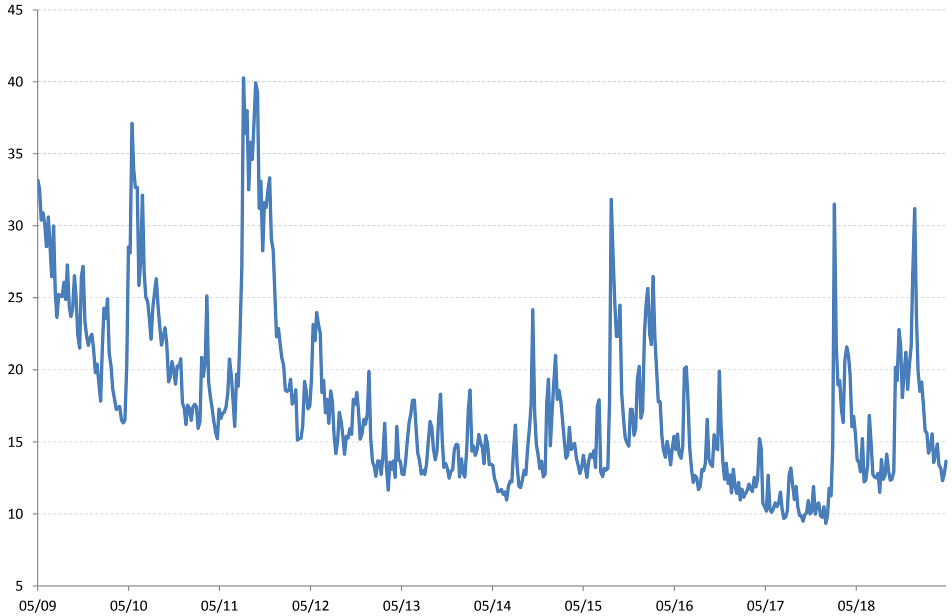
After the relatively tranquil ascent of markets in 2016 and 2017; 2018 provided a reminder that investment markets cannot be expected to rise forever and it is likely that volatility will be a feature of markets moving forward. Investor confidence and expectations remain high and appear at odds with the mixed geopolitical risks and macroeconomic data. A signal of investor (over)confidence has been the decline in the CBOE VIX Index. The VIX index reflects a consensus view of option traders of how volatile investors in S&P500 options expect to be over the pursuing 30 days. Often referred to as the 'fear index', it is one of the tools investors have to monitor investor sentiment. The index has retreated sharply from the highs of Q4 2018, reaching 36.1 in December, it has since traded at 12.0 before rising to 13.1 by the end of April, still below its long term average.

Chicago Board of Exchange (CBOE) Volatility Index, VIX.

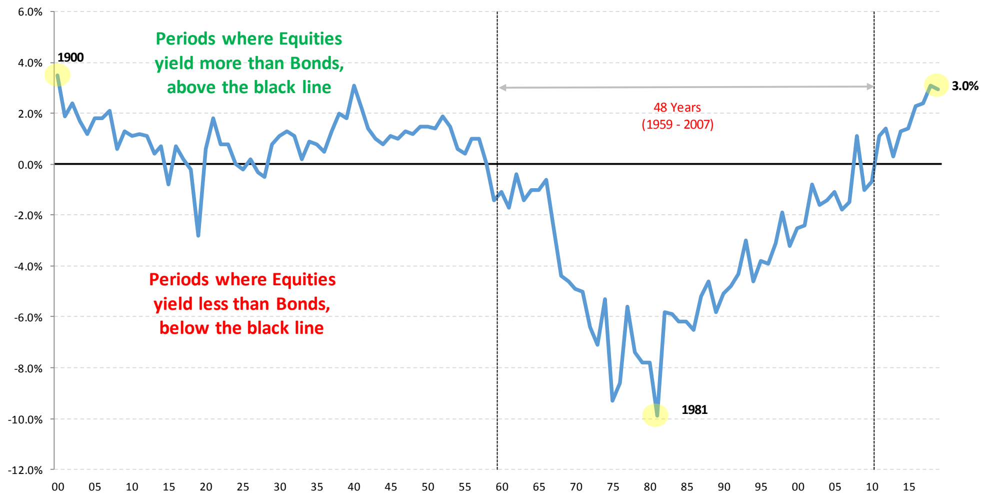


Source: Torevell Partners, Federal Reserve Bank St. Louis (FRED), CBOE.

UK Government Bonds vs UK Equities

The chart below was highlighted in a meeting with Montanaro Asset Management earlier this month. It shows the long term history of equity and gilt yields, relative to each other and serves as a useful reminder of where we are, relative to history with regards to asset prices and interest rates. Over the past decade we have been used to the idea that dividends are higher than yields on government debt but this has not always been the case. The current 3.0% figure highlighted on the right of the chart is calculated simply by taking the dividend yield on the FTSE All Share, as of 30 April, of 4.1% and taking away the yield on a 10yr UK Government Bond which was 1.2% at the same point.

UK Equity minus Gilt Yield (1899 – 2019)



Source: Torevell & Partners, Montanaro, Barclays Equity-Gilt Study, Bloomberg. Data to 30/04/2019.

Over the last 3-4 decades we have seen interest rates (and gilt yields) fall sharply, with the largest negative yield gap in 1981, when the 10yr Government Bond yield peaked at 16.0%. As you see from the chart, current levels of UK Equity yield relative to Government Bond yields represent the some of the most extreme in the past 100 Years. A reversion to the mean would require a sharp fall in gilt prices, a rise in share prices, or a significant reduction in dividends.

Summary

Worries of global growth appear to have abated since the start of the year, helped by the actions of the global central banks particularly those of the United States and China.

Markets have taken a positive view on China's fiscal and monetary plans to soften its slowdown and potentially help global growth over the next 12 -18 months. If China, as the world's second largest economy and largest contributor to global growth, can exceed expectations, it could provide a tailwind to global markets. Global trade risks still remain, particularly if an agreement between US-China is not achieved, the US decides to impart tariffs on cars and auto parts affecting Germany and Japan, and of course with Brexit.

US markets have hit all-time highs on better than expected (or at least less bad than feared) earnings and revenue growth, where it appears the US corporate world is in good health. However net profit margins are decreasing and a number of companies in the quarter have highlighted rising wages and labour alongside higher raw material and input costs. US markets appear to be fully priced in, with potential for a market retreat if economic and corporate data disappoints.

With fixed income yields unsustainably low (and prices high) we continue to believe that equities offer better potential returns than fixed income securities, and although equity valuations on the whole are at long term averages, there are large variations around the world, providing the opportunity for fundamental stock pickers to benefit over the long term.