HARTLEY ROSS

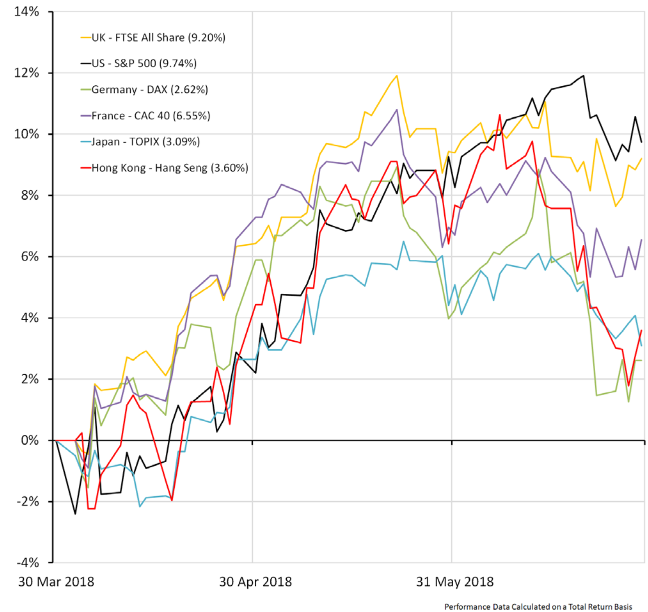
SUMMER OUTLOOK

REVIEW OF THE PAST QUARTER:

Escalation of the US-led trade war has remained the main concern for markets. In May, steel and aluminium tariffs were extended to Canada, Mexico and the EU, all of whom have vowed to retaliate. In June, US President Trump also approved duties on US$50bn of high-tech goods from China, with automobile products from the EU the next likely target. Fears of a global nuclear war, on the other hand, have subsided, with the US promising to halt military exercises in South Korea in exchange for a commitment of "complete denuclearisation" from North Korea following the June summit between the two nations.

Meanwhile, monetary tightening has continued. In June, the US Federal Reserve raised interest rates by 25 basis points and signalled that two more quarter-per cent hikes are likely this year. Also in June, the European Central Bank confirmed that it is likely to completely draw down its monthly net asset purchases by the start of next year. Eurozone rates were, however, left unchanged. The Bank of England also left rates unchanged, although inflation has remained above target, other economic data hasn't been strong enough to warrant another hike just yet.

As well as an uptick in the benchmark ten-year US Treasury yield above 3 per cent in May, expectations of rising US rates have contributed to slides in nearly all emerging currencies. Meanwhile, oil has continued to strengthen, with the US re-imposing tough sanctions on Iran after withdrawing from the nuclear deal, and Venezuela experiencing significant production outages.



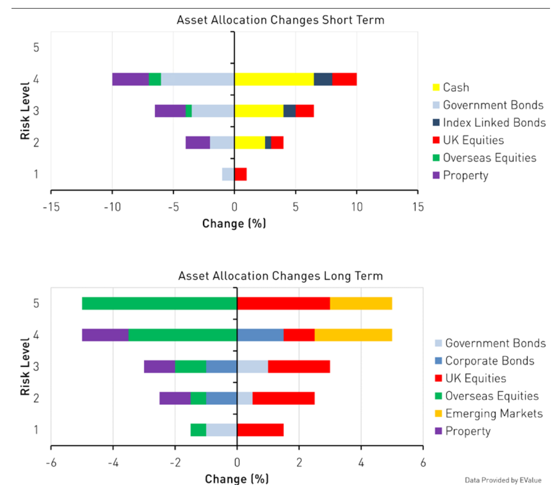
ASSET CLASS RETURNS

UK	US	Japan	Europe	Emerging Markets	Commodities	Property	Corporate Bond	Gilts	Cash
+9.20%	+9.74%	+3.09%	+3.36%	-2.21%	+14.75%	+0.60%	-0.22%	+0.16%	+0.12%

THE ACTUARIAL VIEW:

At the start of the year it looked like we may finally have been about to see the long-forecasted rotation from bonds to equities with the end of the multi-year bond bull market. Several months on, however, and things look remarkably different. Inflation seems to be falling once again, and although rates are likely to be raised in the short term, an aggressive rate rise looks unlikely. In addition, various news stories are doing nothing to bring hope to markets – domestically, we have ongoing Brexit uncertainty; and internationally, there is the threat of war (of both the trade and conflict variety) and mixed news regarding economic growth. Furthermore, short-term yields continue to rise; while long term they remain steady, we have not yet seen an inverted yield curve, but this is a bad omen nonetheless, suggesting economic slowdown.

The silver lining is that higher interest rates mean cheaper shares; in fact, the prospects for all asset classes have improved – except for property, which seems to be lagging interest rates. For short-term investors, higher rates make cash look more attractive, while in the long term we see a strong outlook for emerging markets alongside very weak pricing for UK shares.



WHAT TO LOOK FOR IN Q3:

- **UK:** There will be interest rate decisions from the Monetary Policy Committee on 2 August and 13 September. Summaries and minutes from the policy meetings will be published the same day. Office for National Statistics Consumer Price Inflation data and reports for June, July and August are scheduled to be released on 18 July, 15 August and 19 September respectively.
- **US:** There will be interest rate decisions from the Federal Open Market Committee on 31 July-1 August and again on 25-26 September. Minutes will be published three weeks after each decision.
- **Japan:** The Bank of Japan is scheduled to review interest rates on 30-31 July and again on 18-19 September. A summary of opinions from the July meeting will be released on 8 August and minutes on 25 September. A summary of opinions from the September meeting will be published on 28 September and minutes released on 5 November.
- **Europe:** There will be interest rate decisions on 26 July and 13 September. It is currently expected that the monthly pace of net asset purchases will be reduced from €30bn to €15bn at the end of September, subject to data confirming the European Central Bank's medium-term inflation outlook.
- **Mexico:** Presidential elections are scheduled to take place on 1 July.

ASSET CLASS SCENARIOS:

UK EQUITY

Most Likely: Weakening data and Brexit-induced anxiety continue to hold back UK equity markets in general. With UK sterling trading within a tight range, we don't expect that to materially drive markets as it has done in the past. Protectionism and geo-political angst will dampen global growth, creating a ceiling for risky assets. Expect market rotations between domestic-facing and export-orientated companies to continue, with larger dispersion in performance of stocks.

Worst Case: Deterioration in Brexit talks and an escalation towards trade wars will drive higher volatility and cause equity market sell-offs; resilient bond proxy stocks will be preferred. Energy driven inflation lead to further Bank of England rate rises, which add to equity woes.

Best Case: Geo-political tensions and trade war risks subside, while the UK and EU continue to make concessions, meaning UK equities modestly continue their improvement. Overall, investment activity and sentiment improves as a tightening labour market and rising real wages further boost cyclical stocks.

CASH

Most Likely: Core inflation should remain within the 2 per cent-2.5 per cent range and it seems likely the Monetary Policy Committee will vote to keep interest rates unchanged at its August meeting. Headline inflation is unlikely to come down significantly over the coming quarter due to cost pressures from a range-bound oil price. However, on the demand side, consumption and investment look set to remain subdued, helping to offset the impact of these cost pressures.

Worst Case: The worst case for cash savers is that inflation continues to rise with cost-push pressures at the fore. Another likely headwind is UK sterling weakness as Brexit negotiations turn sour and imported inflation compounds woes, with the Bank of England refraining from further tightening for the already weakened consumer.

Best Case: In the likely event that Opec successfully negotiates curbs to supply cuts to arrest oil price increases and geo-political tensions subside, any progress in Brexit negotiations could well be taken by the Bank of England as a signal to continue tightening, especially if wage growth also picks up. In such a scenario, returns to cash would improve.

GLOBAL EQUITY

Most Likely: The global economic expansion is likely to continue over the quarter, albeit with less upside for global equities than previously anticipated. The US Federal Reserve is sticking to its plan of slowly increasing interest rates, but elsewhere central bank policy remains loose. This cautious approach is reassuring and reduces uncertainty surrounding over-tightening or any additional shocks to the market.

Worst Case: The ongoing trade spat between two of the world's largest economies, China and the US, could lead to more uncertainty and volatility in global equity markets. The worsening political atmosphere in Italy continues to weigh on investors' minds, and has further potential to hurt European equities – particularly banks, which have taking a hit over the last quarter. The euro could also be under pressure as the EU gets dragged into the trade tariff war.

Best Case: US tax cuts are likely to benefit the consumer, something we've begun to see over the last quarter. On top of this, OPEC's latest decision to increase output in order to create a ceiling for the oil price should reduce the negative impact on real consumer spending. Any ease in trade tensions stands to reduce market volatility and allow fundamentals to drive global equities.

FIXED INCOME

Most Likely: In response to forward guidance from the Bank of England, bond markets have priced in a high chance of a rate hike at the next quarterly policy meeting in August. We expect volatility to remain, albeit to fluctuate as credit spreads widen. This means that investment-grade bonds could recoup losses made in the first quarter.

Worst Case: The UK yield curve could invert if there is another bout of inflation generated by higher oil prices, with pressures from tariffs coming through in the medium term. Weakening macro indicators and mounting Brexit risks could all point to a recession. In this scenario, we would expect high-yield bonds to significantly underperform the broader bond market.

Best Case: We might have passed the point of peak growth for this year. Forward-looking indicators like business surveys and some monetary indicators suggest that weaker growth lies ahead, which will force central bankers to delay their policy tightening. It also eases our concerns for a major bond rout in 2018. Government bonds will maintain their momentum over the summer and investment grade bonds are likely to follow.

EMERGING MARKET EQUITY

Most Likely: Emerging markets are likely to be volatile over the quarter as markets digest the uncertainty around intensifying trade tensions between the US and China. The recent divergence among emerging-market country performances could narrow as trade tensions dominate market moves. Domestically-focused companies are likely to be the winners over global export-heavy companies.

Worst Case: Emerging markets would continue to struggle if the US dollar continues to strengthen or if the US Federal Reserve surprises with more hikes. Intensifying trade war fears and market volatility could dampen business and consumer sentiment, resulting in a second-order effect in the form of weakening global growth. China could retaliate by going beyond trade and punishing US firms from doing business in China, which would hurt global growth.

Best Case: Easing trade tensions between the US and China would lead the market to focus increasingly on fundamentals where companies are broadly showing signs of improvement from a cash flow and earnings perspective. If the US dollar reverses from its recent position of strength, emerging markets would experience a much-needed tailwind.

PROPERTY

Most Likely: In continental Europe, low rates still make property an attractive asset, and its position in the property cycle means the outlook is more favourable there than in the UK. US real estate investment trusts (REITs) have so far been supported by a strengthening of the US dollar versus the pound, and some segments of the market still trade at large discounts and could see investors grab opportunities there.

Worst Case: In the UK, Brexit talks are still the main source of risk. Every business voicing its concern is likely to induce a market reaction. The recent strong performance of the industrial property sector could also be at risk of profit-taking. Elsewhere, the US property market is probably the most sensitive to an interest rate rise, as we saw in Q1. While the US Federal Reserve's decisions reflect a stronger economic environment, property yields are less attractive given their riskier nature.

Best Case: Continental Europe could benefit from further consolidation thanks to cheap financing, and spreads still justify the attractiveness of the asset class. Any outcome favourable to UK businesses in the Brexit negotiations is likely to lift investors' sentiment, despite unchanged fundamentals. Trading opportunities in US REITs are also on the table, given the country has lagged other regions on a yearly basis.

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