HARTLEY ROSS

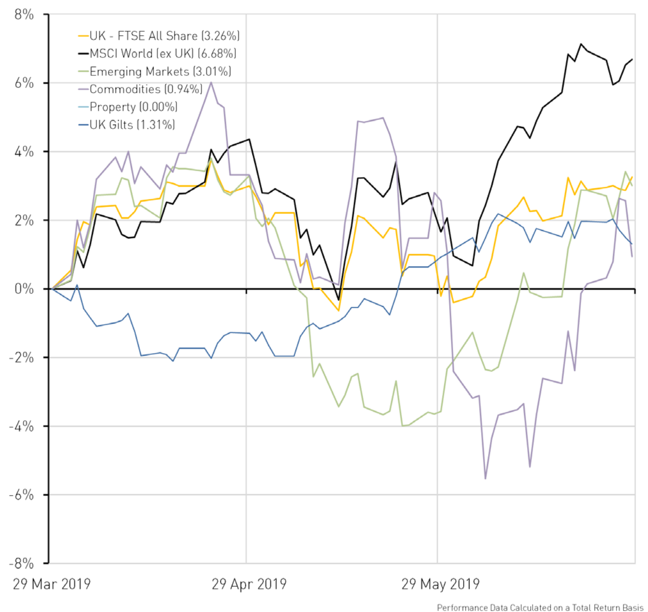
SUMMER OUTLOOK

REVIEW OF THE PAST QUARTER:

Just as global growth has started to stabilise, it is at risk of being derailed by multiple headwinds. Uncertainty is very much the narrative this quarter as political risks heightened, causing markets to become even more jittery. The hardball style of the self-proclaimed 'Tariff Man', US president Donald Trump, has seen the US-China resolution blow up, and while trade talks are scheduled to restart, whether a meaningful outcome will emerge remains unclear. Elsewhere, additional sanctions will be applied by the US to Iran in response to Iran shooting down a US drone. As a result, supply-shortage fears have pushed up the price of oil.

Meanwhile the US Federal Reserve (the Fed) has continued to take a hands-off approach, hesitant to not tinker with a fragile global system. However, compared to the prior quarter the market is convinced that the Fed will relax its stance and apply interest rate cuts this year.

Over in the eurozone, the region continues to be hampered by political risk. Italy and the EU restarted their conflict over the nation's refusal to curb public spending. The key difference this time is that populist support has swelled to such an extent that Italy is comfortable with not backing down from EU threats. In the UK, it has been an eventful quarter as Theresa May relinquished power after repeatedly failing to get parliament on board with her withdrawal bill. Boris Johnson is in pole position to be new prime minister.



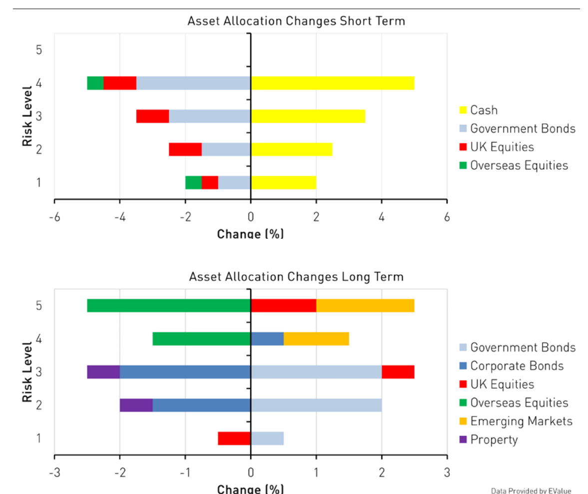
ASSET CLASS RETURNS

Cash	Government Bonds	Index Linked Bonds	Corporate Bonds	UK Equities	Overseas Equities	Emerging Markets	Property
0.00%	+1.31%	+1.89%	+2.04%	+3.26%	+6.68%	+3.01%	0.00%

THE ACTUARIAL VIEW:

Markets look to have well and truly recovered from their December meltdown, it is not clear though whether this has been driven by improvements in the prospects for the underlying businesses, or simply that any alternatives have got worse. The news can be difficult to keep track of, with ongoing political and economic uncertainty. Yet some GDP figures have turned out better than expected, which has indubitably provided a boost. While forecasts were predicting a slowdown, what the actual results revealed was a slightly slower slowdown, so it was hardly all good news. The International Monetary Fund is forecasting global growth projections will be at their lowest level since the financial crisis. On balance it seems that negative news outweighs the positive.

From a modelling point of view this translates into assets being more expensive than they were previously, with no improvement in the underlying prospects. This means only modest changes to the asset allocation models themselves. There are some relative changes – for example, emerging markets were slightly less affected, meaning we can be slightly more positive on them. The biggest change is that cash now looks a better prospect over the short term than bonds. thanks to the risk/reward trade off.



WHAT TO LOOK FOR IN Q3:

- **UK:** The Monetary Policy Committee (MPC) announcements and minutes, along with an inflation report, are to be released on 1 August.
- **US:** There will be interest rate decisions from the Federal Open Market Committee (FOMC) on 30-31 July. Minutes will be published three weeks after each decision. The FOMC projection for inflation and economic growth is due 18 September. Non-farm payrolls, which indicate wage growth, are set to be released on 1 August.
- **Europe:** Quarterly GDP estimated data is set to published on 31 July. A European Central Bank Monetary policy meeting has been arranged for 25 July.
- **Other data:** China year-on-year GDP growth and industrial production is to be released 15 July.

ASSET CLASS SCENARIOS:

UK EQUITY

Most Likely: With central banks holding interest rates constant amid recessionary fears, the potential for rate cuts has increased, which could be positive for UK equities. However, this will likely be outweighed by negative investor sentiment as UK businesses stop stockpiling and political uncertainty heightens following the extended Brexit deadline and hardliner Brexiteer Boris Johnson potentially in the PM role, which increases the threat of no deal. UK equities will thus likely lag their developed market peers and could well see a softer quarter, especially given the solid start to the year we have witnessed.

Worst Case: The UK leaving the EU with no deal (more likely under a Johnson PM-ship), followed by a surprise interest rate hike as inflation sets in, would likely see a broad sell-off in UK equities, given the long-term headwinds, increased recessionary risks and negative sentiment toward the UK economy this outcome would imply.

Best Case: With the probability of another referendum significantly lower with two pro-leave PM candidates, a soft deal would likely be the best outcome of the possible Brexit option-set - this is what markets have largely been expecting. Coupled with an interest rate cut, this would be particularly positive for UK equities.

GLOBAL EQUITY

Most Likely: The market expects the Fed to cut interest rates over the summer as economic data in the US weakens. We expect trade war tensions and political uncertainty to persist, potentially weakening investor sentiment. In Europe, economic growth is resilient; however, the political environment remains fragile, meaning further uncertainty for markets. Overall, we expect volatile periods of performance for global equity markets over the summer.

Worst Case: US president Trump continues to threaten other nations with sanctions and trade spats, resulting in downward pressure on markets. Political sentiment in Europe continues to worsen with the Brexit deadline looming and Italy's budget controversies continuing, potentially weakening investor confidence.

Best Case: President of the European Central Bank Mario Draghi has spoken of the possibility of further easing, indicating to markets the European Central Bank will support markets if necessary. This extends to other regions, as in both the US and Japan monetary policy remains accommodative. Trump changes tact on his approach to trade and international relations, easing tensions.

EMERGING MARKET EQUITY

Most Likely: Sentiment towards emerging markets is likely to remain positive as the Fed adopts a more dovish stance. The outcome on the US-China trade deal is yet to be reached so more trade-sensitive areas could be volatile in the meantime.

Worst Case: Any disappointment on the trade front or the market pricing in fewer than three rate cuts would be a negative catalyst. Sensitive areas like China and South Korea look particularly vulnerable where growth is already slowing before accounting for potential trade-conflict effects. Elsewhere, execution risk looms in Brazil around political reforms and results are required to justify high expectations.

Best Case: Sentiment would improve further if a US-China deal is reached. The market's expectations of at least three interest rate cuts in the US should prove most beneficial to Brazil, Turkey and Argentina. India appears especially compelling under its prime minister, Narendra Modi, who secured a second term with a bigger majority, ensuring a continuation of his pro-market reforms, which could attract more investment into the country.

CASH

Most Likely: Following the signal sent by the Fed to financial markets, the BoE has also signaled its intention to maintain its interest rate policy for a while. Core inflation should remain within the 2 per cent to 2.5 per cent range, which means returns from cash remain negative. Headline inflation is unlikely to come down significantly over the coming quarter due to UK sterling's weakness and lack of labour force.

Worst Case: The worst-case scenario 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 BoE refraining from further tightening for the already weakened consumer.

Best Case: Any progress in Brexit negotiations could well be taken by the BoE as a signal to continue tightening, especially if wage growth surprises to the upside. In such a scenario, returns to cash would improve, despite staying negative. Similarly to government bonds, cash could also act a safe-haven with financial markets being undermined by global trade tensions.

FIXED INCOME

Most Likely: Which central bank will cut its interest rates first? Expectations for the Fed to cut interest rate levels are high, while the US economy is showing resilience. The returns on bond markets are likely to stay volatile as investors will wait for any indication of a recession. With the risk of increasing interest rates being limited, credit markets might outperform if companies keep on improving their balance sheets.

Worst Case: After several years of monetary stimulus, we might have reverted to a normal situation where any sign of wage growth and inflation is bad news for bond markets. Markets have quickly interpreted the Fed's recent decisions as: the recession is down the road. Any sign that global economies are nowhere near recession could bring yields up, which will drag both government and corporate bond markets. The oil price and the relations with Iran could also be negative.

Best Case: Bond markets might have already priced in negative news – as such the upside is now limited. But political uncertainty will continue to act as a drag on bond yields, anchoring the investors' expectations to lower levels from current ones. Companies might further delay their capital expenditure decisions and lower their debt level. The low level of debt supply relative to demand might boost bond prices.

PROPERTY

Most Likely: In the UK, as for the past three years, Brexit talks are dominating sentiment and we should see returns in the sector closely linked to news coming out. Elsewhere, with interest rates still low compared to property yields, further progress should be made, and a weakening pound will help the overseas investments of UK investors.

Worst Case: A softening in the US economy and the Fed cutting interest rates would be negative signals for US property investors and could spill over to the rest of the world. In mainland Europe, Germany dominates the market and further rent-control news could undermine investors' sentiment. The UK could follow the US path if the likelihood of a no deal materialises and signs of a recession show.

Best Case: A resolution (or even the perception of a resolution) to the chaotic Brexit negotiations with the EU would lift uncertainty off investors' shoulders and, provided the outcome is a trade deal, would give reassurance about the future of the UK economy. On the other side of the pond, an interest rate cut could reinvigorate the market by making mortgages more affordable.

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