Global equity markets suffered a sharp dip towards the end of 2018, in large part due to escalating US-China trade friction and concerns that the Federal Reserve was raising US interest rates too aggressively in the face of a global economic slowdown. Happily, investors have since come round to a more constructive view on these issues and markets have enjoyed a meaningful recovery so far this year.

Trade - some progress, but protectionism remains a risk

US-China trade talks are ongoing and the outcome is still far from certain. However, progress has been sufficiently good for President Trump to delay further trade tariffs that were originally planned for 1 March. Instead, he is maintaining the existing tariffs whilst putting pressure on China to honour its commitments to purchase more US goods and make progress on resolving concerns related to state-aid subsidies, market access, forced technology transfers and intellectual property rights.

Trade protectionism clearly remains a risk for markets. In the same way that globalisation and the expansion of free trade has been a tailwind for economies over recent decades, a resurgence of protectionism would be a headwind. In particular, an escalating trade war between the two largest economies in the world could do meaningful damage to global growth prospects. However, with the 2020 US presidential elections looming and President Trump keen to deliver a political “win”, the risk of tensions escalating appear to have eased – at least in the short term.

Central banks turn more dovish and bond yields fall again

On the issue of US interest rates, the Federal Reserve has made a fairly dramatic shift towards a more “dovish” policy. When monetary policy turns dovish, it means policy makers are starting to favour looser, more accommodating policy in order to stimulate growth in the economy. Citing international economic weakness, the Federal Reserve has put a stop to its repeated signaling of additional interest rate hikes, replacing this with a new mantra of data-driven patience. In addition, it has decided to halt the reversal of quantitative easing so as to maintain excess liquidity in financial markets.

Taking their lead from the Federal Reserve, a growing number of other central banks in both advanced and developing countries have now also adopted a more dovish approach. On the one hand this economic assistance should be supportive for markets over the rest of the year. On the other hand, it supports the viewpoint that the outlook for the global economy is worsening - and this has nudged some investors towards the safety of government bonds. Indeed, yields on several benchmark bonds have fallen fairly sharply as a result of price rises. Of particular note is the fact that Germany’s 10-year Bund yield drifted into negative territory for the first time in three years. German Bunds are widely considered the safest investments in the euro area, but the move into negative yields means that this safety comes at the price of a guaranteed nominal loss if the bonds are held to maturity.

Are fears of a deepening global slowdown justified?

Given the length of the current economic cycle and persistent signs of soft economic data, it is not surprising that fears of a deepening global slowdown persist. Specifically, US economic
growth is set to moderate as President Trump’s 2018 fiscal stimulus fades, China is seemingly struggling to maintain a desired growth rate of 6% per annum, and the political issues holding back the European economy are well known.

Of late, particular attention is being paid to the US yield curve. For the first time in over 10 years, the yield on three-month US bonds rose above the 10-year yields - something that is seen as an indicator that a recession could be coming. The underlying rationale is that investors typically expect to be compensated more to wait longer to get their money back, so a 10-year US Treasury bond should normally pay more than a three-month US Treasury bond. When investors are willing to be paid less to wait longer it is an indication that they do not have much confidence in the long term outlook for the economy.

For our part, we continue to believe that fears of an imminent global recession are overblown. Whilst the pace of growth looks set to slow, the global economy should nonetheless continue to grow in 2019 against a supportive backdrop of low inflation and more dovish central banks. Whilst the US yield curve has technically inverted, it is arguably closer to being flat than a clear and unambiguous inversion.

UK Politics

Closer to home, Brexit uncertainty continues. At the time of writing, the EU has agreed to delay the UK’s departure. However, Westminster remains in a state of political deadlock and it is fair to say that a wide variety of outcomes remain possible. A snap general election or second referendum may well be needed to overcome the political impasse, and we could yet end up with anything from a no-deal Brexit to remaining in the EU.

Alongside Brexit risk, investors in UK assets also need to take into account the possibility of a far-left Labour government under Jeremy Corbyn, especially in the event of a general election being called. On this point it is worth noting the breakaway of the "Independent Group" of MPs that have subsequently renamed themselves "Change UK". On 18 February, eight MPs resigned from the Labour party to form this group and were promptly joined by three Conservative MPs. This is the biggest break in Britain’s political system since the formation of the SDP by moderate former MPs in the early 1980s and early analysis suggests Change UK are more likely to draw votes away from the Labour party, thereby reducing the chances of a far-left government under Jeremy Corbyn.

In the meantime, the value of sterling continues to act as a barometer for the market’s confidence around Brexit and the perceived risk of a Corbyn-led government. Interestingly, sterling has in fact appreciated against both the US dollar and euro over the first quarter of the year (by approximately 4% and 5.5% respectively), despite the ongoing political uncertainty.

Conclusion

Our investment strategy has not changed. We remain convinced that equities will deliver the best long term returns compared to the alternatives of cash and fixed return investments. Following the pull-back towards the end of last year, equity valuations are more reasonable and there seems to be a healthy degree of scepticism in the market – a good sign that investors are not overly optimistic. Having said this, there are areas of the market that look conspicuously expensive and are therefore likely to deliver disappointing returns over the next 5-10 years. In particular, we would highlight the US equity market and long dated government bonds. The former has enjoyed a decade of strong outperformance but now looks anomalously expensive. The latter have enjoyed a 35-year bull market and, in our opinion, do not now offer any chance of positive real returns for long term investors. This is most obvious in the instance of the 10-year German Bund highlighted earlier.

For our part, we will continue to tilt our portfolios away from these expensive areas of the market. In contrast, we are attracted towards pockets of value and there is perhaps no greater example of value in the equity space than the UK stock market. The discount applied to UK sourced revenues for listed companies across the global market has reached such an extreme that, according to fund managers Invesco, the valuation ascribed to £1 of UK sourced revenues, irrespective of which market the company is listed on, is now approximately half that of revenues sourced in the US. This seems overly pessimistic and perhaps fails to recognise the underlying health of the UK economy, which continues to deliver steady, if unspectacular, economic growth.