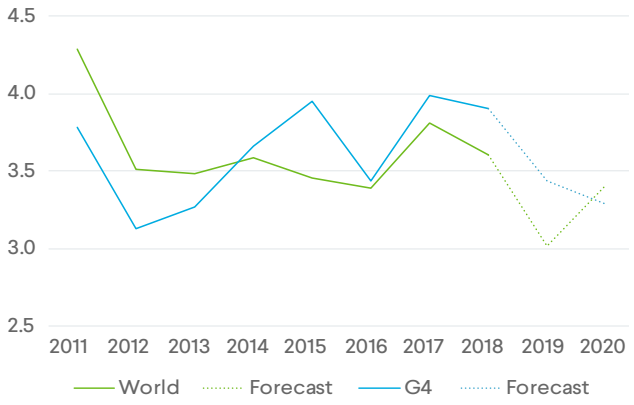
Capital markets update

The ongoing trade dispute between the US and China, and its disruption to global supply chains, continues to impact both realised and forecast global growth. GDP growth for many countries has slowed, although consensus forecasts still suggest most major economies will avoid recession next year. The IMF this month forecast global growth falling to 3.0% in 2019, its lowest level since 2009 and a 0.9% downgrade from the same forecast last summer (Chart 1). In 2020, growth is expected to moderate further in the world's biggest economies, although global growth is forecast to rebound slightly as emerging economies outside China accelerate.

The US economy has outperformed developed market peers but, here too, growth has slowed on 2018's robust pace as tariffs raise costs for domestic producers and consumers. Disruption has been particularly notable in large open and export-orientated economies – in Germany, last year's fall in industrial production has worsened in 2019 on the back of trade uncertainty. Though the UK returned to growth in Q3, following contraction in Q2, forecasts for 2019 and 2020 have fallen, reflecting acute Brexit uncertainty and increasing evidence of its negative impact on business investment.

Chart 1: Realised and IMF forecast growth for the World and G4 (China, Euro Area, Japan, US)



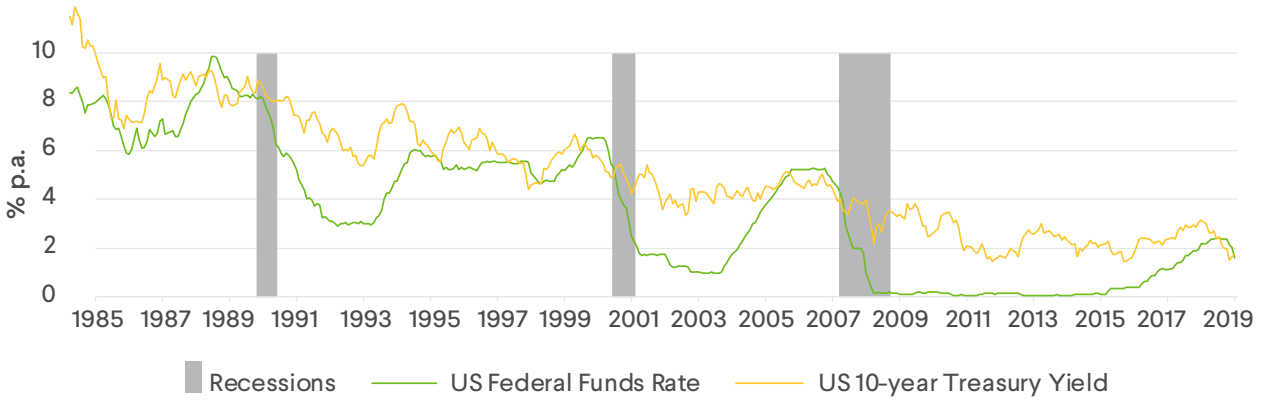
Source: Datastream

Reflecting the weakness in investment and trade, the Global Manufacturing PMI has continued to drift lower and is now below 50 (typically consistent with contraction in the manufacturing sector). Notably, equivalent indices in the US and Germany have fallen to their lowest levels in a decade in Q3. The effects of manufacturing weakness have so far been cushioned in broad economic output, as a more resilient services sector – larger in most advanced economies – has supported labour markets, helping to underpin wages and consumer spending. Unemployment is at multi-decade lows in the US and UK (despite an unexpected 0.1% rise in August) and is at its lowest level since the financial crisis in Europe. However, there are signs of economic weakness spreading beyond manufacturing. Service sector PMIs in the US, UK and Germany disappointed expectations in September, with the latter two falling below 50.

Against this backdrop and with inflationary pressures still largely absent, a shift towards more accommodative monetary policy is now well established. Despite a tight labour market and still robust growth, the Fed cut rates for the third time in three months, while the ECB cut rates further into negative territory and announced it would resume quantitative easing in November. The direction of UK monetary policy will likely depend on the Bank of England's assessment of whether lower growth or higher inflation is the bigger post-Brexit threat.

Monetary policy is once again bearing the burden of alleviating the slowdown but many question how effective further easing may be. Even in the US, where rates are comparatively high, there is scant headroom to deliver the level of monetary stimulus seen in previous downturns (Chart 2). October's IMF World Economic Outlook argues that monetary policy should increasingly be coupled with fiscal policy to counter any prolonged slowdown. But it's not obvious to what extent more expansionary fiscal policy will be adopted. The US deficit is already swollen by 2018 tax cuts and record high military spending; pre-election spending wish-lists in the UK may be trimmed by Brexit disruption; Germany is likely to shrug off another rebuke on its fiscal caution in the IMF report. Slowing growth at a time when monetary policy is already easy, and support from fiscal policy far from certain, suggests a cautious outlook is warranted.

Chart 2: US Fed Funds rate and US 10-year Treasury yield since 1985

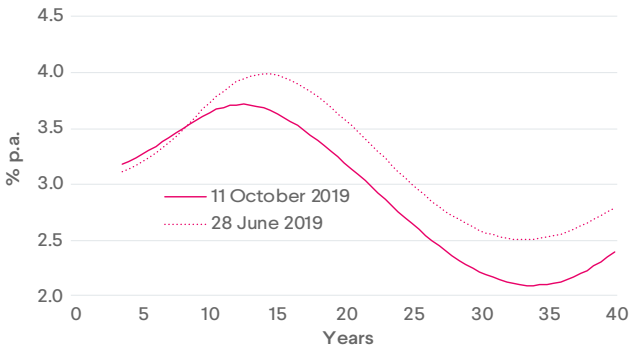


Source: Datastream, Hymans Robertson

Government bonds

Against this economic backdrop, global sovereign bond yields continued their slide. Gilts followed the global trend and nominal yields touched record low levels in August: prospective returns from current levels look derisory. Implied inflation (Chart 3), as measured by the difference between conventional and index-linked gilt yields, has fallen at longer terms. The potential replacement or changes to the calculation of RPI following the government's response to a House of Lords report on the subject, is likely to have been a factor here, with little change at the short end. Whatever the reasons for the recent moves, the variation in inflation pricing by term remains a notable feature of UK gilt markets.

Chart 3: UK forward gilt-implied inflation

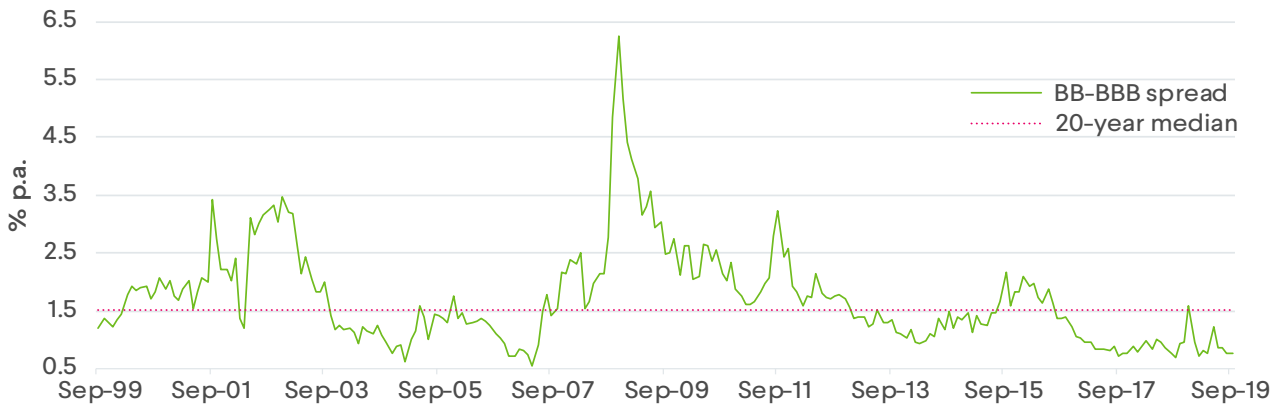


Source: Bank of England

Other bonds

Valuations in global credit markets seem driven more by monetary support than the fundamental backdrop, which is deteriorating. Investment-grade credit spreads are a little below long-term medians on a ratings adjusted basis, while speculative-grade valuations look demanding – at the end of September, BB-rated US high yield spreads were touching a level they have only ventured below 10% of the time over the last 20 years. But conditions are getting tougher – earnings growth of US high-yield borrowers was negative year-on-year in Q2 and debt affordability, as measured by the number of times earnings cover interest expenses, has fallen in 2019. Despite monetary support, these factors are likely to be of material detriment to the credit quality of more highly leveraged borrowers – Moody's forecast the 12-month trailing high-yield default rate to rise from August 2019's actual 2.9% to 3.9% by August 2020. Yet, although risks are rising, the extra yield on speculative-grade debt remains historically low (Chart 4). We are inclined to take a more conservative approach in credit portfolios, both through diversification and even an increased exposure to investment-grade.

Chart 4: US corporate credit yield spread on BB-rated speculative-grade over BBB-rated investment-grade

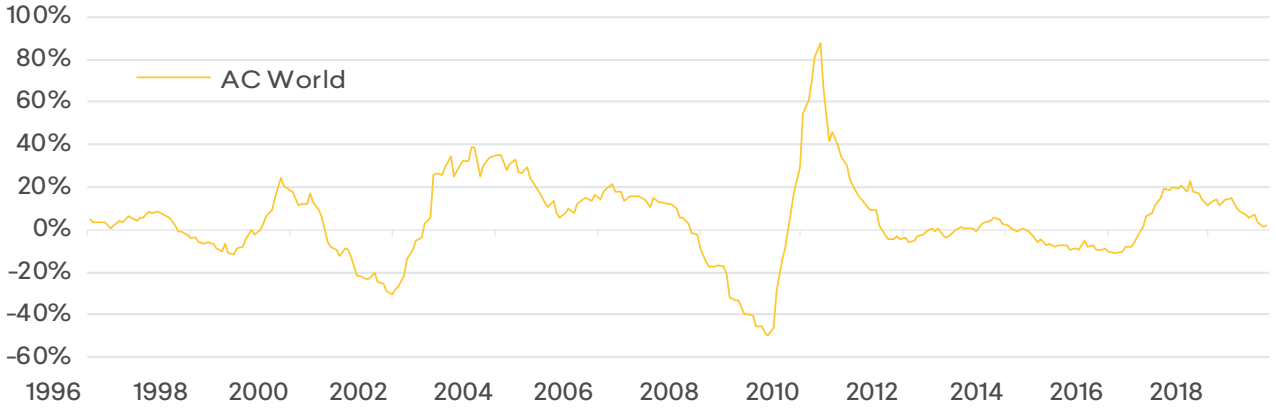


Source: ICE Index Platform

Equities

Despite recent concerns about trade and an ongoing industrial slowdown, global equity indices edged higher in Q3. These concerns had resulted in significant cuts to Q2 earnings forecasts and the fact that the outturn was not as bad as feared paradoxically provided markets with some support. Nevertheless, slowing economic momentum is prolonging the deceleration in earnings growth that has been in place for over a year now (Chart 5).

Chart 5: MSCI All-Country World year-on-year earnings growth in $ deflated by US CPI



Source:Datastream, Hymans Robertson

Consensus expectations still point to a rebound in earnings growth to around 10% for global equities in 2020. Realising these forecasts would require more positive news on the macroeconomic front than currently looks likely. While falling short of an ambitious forecast need not be calamitous for equity markets, it will make it harder to wring out further gains, when key valuation measures are already slightly above long-term median levels.

Property

In aggregate capital values have continued this year's steady fall, although annual rental growth has arrested its downward slide in recent months, remaining marginally positive, but well below CPI inflation. These figures continue to mask stark divergence within core property markets. While 12-month rental growth remains positive for industrials and offices, even rising in the latter case, retail rents continue to fall, albeit at a declining pace. Office capital values have been flat year-to-date and industrial values marginally positive, but retail capital values have fallen over 8% in 2019.

Perhaps of more significance than rental growth, the latest survey evidence from the Royal Institution of Chartered Surveyors points to a difficult fundamental backdrop – overall occupier demand remains weak, while available space has increased; not surprisingly, inducements offered by landlords (such as rent-free periods on new leases) are increasing. Despite this, property yields remain low relative to history, both in absolute terms and relative to equity dividend yields. A comparison with gilt yields is more forgiving, though this may not be considered a high bar in the current environment.

Conclusions

A slowdown in global growth is well established and broad-based, as the trade conflict between America and China takes its toll on the world economy. Global central banks are trying to help, but traditional, and even not-so-traditional, monetary policy toolkits are looking increasingly bare. Until now, manufacturing has borne the brunt of the slowdown, but there are signs the contagion is spreading to the services sector. This, in turn, could quickly deflate the current buoyancy in labour markets, impacting consumer confidence and spending and leading to a more protracted slowdown.

While sovereign bond yields were marked significantly lower reflecting the gloomier outlook, valuations on risk assets, in general, have not. But the deterioration in economic conditions is beginning to impact credit and equity market fundamentals. Our view is that valuations here reflect economic outcomes that may be plausible, but as an upside surprise rather than a reasonable base case. We are growing more cautious here as a result, and so we would continue to advocate holding a little more cash than usual. We continue to prefer equities to property in growth-orientated portfolios and would advocate diversifying credit portfolios, potentially by trimming speculative-grade exposures.

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