HYMANS ROBERTSON

The drivers behind market performance in 2019

Market update

Overview

Risk assets have staged a strong recovery year to date, following the sell-off in Q4 2018. Much of this reflects a significant shift in monetary policy expectations, with many central banks either signalling a more accommodative policy stance or cutting interest rates. However, despite the strong year to date returns, there has been some volatility along the way. Concerns over slowing global economic growth have persisted throughout the year, not helped by the ongoing global trade disputes. The latest, albeit modest, sell-off in global equities and substantial fall in global yields came on the back of Trump's proposal to impose a 10% tariff on the remaining $300bn of Chinese imports not already subject to the existing 25% tariff (Trump has since postponed the imposition on a proportion of this round of tariffs).

The table below shows that UK equities for the year to date have delivered 9.7%, reversing the losses of 2018, even after the recent pullback. Whilst UK equities have underperformed global equities year to date (measured in local currency terms), the UK market's international exposure means that in aggregate, the impact of the ongoing Brexit uncertainty has had a relatively modest impact. Sterling has thus far taken most of the strain, falling against other major currencies.

That said, funding positions will have been adversely affected by the recent turbulence for all but the best hedged schemes with a negligible allocation to equities. We would encourage trustees to balance the need to be alert to the drivers of any change in funding level with the need to take action to alert the investment strategy.

UK	Q3 19*	2019	2018*
EQUITIES	-3.0	9.6	-9.5
BONDS			
Conventional gilts	5.4	10.3	0.6
Index-linked gilts	9.1	17.7	-0.3
Credit	3.3	9.7	-1.5
PROPERTY**	0.2	1.4	7.5
STERLING			
v US dollar	-3.5	-3.6	-5.9
v EURO	-1.1	-0.7	-1.1
v Japanese yen	-5.2	-7.0	-8.3

GLOBAL	Q3 19*	2019	2018*
EQUITIES	-2.8	12.8	-7.4
North America	-2.2	16.0	-4.7
Europe ex UK	-2.2	15.2	-10.5
Japan	-3.9	1.4	-15.3
Dev. Asia ex Japan	-5.9	8.3	-9.1
Emerging Markets	-4.7	5.8	-8.7
GOVERNMENT BONDS	3.4	8.7	1.0
HEDGE FUNDS***	0.7	7.2	-3.2
COMMODITIES	-6.0	1.0	-10.6

Percentage returns in local currency ($ for Commodities and Hedge Funds)
* to 27/08/19
** to 31/07/19
*** to 31/07/19

The market drivers in detail

Slowing global economic growth

Consensus forecasts do not point to impending recession but a slowing in global growth is now a reality rather than a forecast (Chart 1). A slowdown which began in 2018 as China attempted to reign in non-bank lending has been exacerbated by rounds of escalation in the US-China trade war. Trade uncertainty is leading to weakness in business investment and future capex intentions which is negatively impacting the manufacturing sector. The US economy has outperformed developed market peers but growth is beginning to ease here as the effects of the 2018 tax stimulus begin to fade. In general, economies that are more exposed to trade have been more negatively impacted by the slowdown in trade and manufacturing. The Eurozone, and its large export-oriented economies, have slowed markedly – the German economy contracted in Q2 and data to date is pointing to a weak Q3.

Highlighting the weakness in investment and trade, the Global Manufacturing PMI has continued to drift lower and is now below 50 (indicating contraction) and 60% of the economies that report this metric are giving a reading below 50 (Chart 2). In general, consumption has countered weakness in manufacturing – if the scaling back of company investment, in time, leads to job cuts then the resilience seen in consumer spending and service sector activity could falter. Global growth forecasts for 2019 have dropped to 2.6% versus growth of 3.2% in 2020.

Growth prospects in the UK hampered

The UK, of course, faces specific issues which are additive to global concerns – the UK economy contracted in the second quarter, following an unsustainable manufacturing-driven rise in the first quarter. Some of the UK growth slowdown is undoubtedly due to global factors, but investment in Britain has underperformed versus developed peers, pointing to Brexit-related uncertainty deterring corporate spending plans. As another Brexit deadline approaches on 31 October, the Bank of England are expecting further stockpiling which may serve to boost Q3 numbers albeit there is no evidence of this over the quarter to date. Economic metrics will likely prove volatile going forward, but underlying investment remains depressed.

Inflationary pressures easing

At the same time, inflation pressures seem to be fading. Real wage growth in the US, on the back of record low levels of unemployment, has continued to move higher, but the impact of rising wages on broader inflation measures remains elusive (chart 3). Data for the UK and Europe show real wage growth has started to ease a little in recent months but remains positive. Forecasts for inflation indicate that CPI-inflation is around target in the US and UK for the next couple of years and remaining stubbornly below target in the Eurozone.

The subdued inflationary environment provides room for manoeuvre for central banks and, reflecting the risks to global growth, policymakers have started using this room. The messaging from the ECB and the Fed has increasingly pointed towards monetary easing. Notwithstanding the US rate cut in July, US rates markets continue to price in more interest rate cuts than consensus forecasts from the Fed.

Yields pushed lower

The sharp fall in government bond yields (Chart 4) has been consistent with the weakening economic data and concerns surrounding the global outlook – 10-year US treasury yields are 1.6% p.a. below their cyclical peak reached in October 2018. German bund yields are well into negative territory and the German yield curve is now negative at all maturities. Gilt yields have followed these moves lower and are now below the record low levels touched in the wake of the Brexit referendum result in 2016. However, it is difficult to attribute the moves in gilt yields to UK-specific concerns. It is in UK inflation pricing where we see a divergence from elsewhere, suggesting investors are concerned about a near-term spike in UK inflation from potential Sterling depreciation in the event of a no-deal Brexit (Chart 5).

Credit markets largely unaffected

Global credit markets had largely ignored the less positive economic outlook but have started to move wider since the beginning of May, coinciding with further escalation in the US-China trade war. However, the shift in messaging towards looser monetary policy has supported inflows into credit markets year-to-date and spreads remain below where they started the year (Chart 6), but there is scope for disappointment if market expectations of monetary easing prove overdone. Lower underlying bond yields have contributed more than half of year-to-date returns in fixed rate corporate markets. Speculative-grade credit spreads have risen more markedly since the beginning of August, but here too, spreads are well below the levels at which they started the year. Credit spreads remain in-line with long-term medians in investment-grade markets and below long-term medians in speculative-grade markets.

Equities giving back

Global equities have also sold off on escalations in US-China trade tensions, in May and again at the beginning of August, but returns have still been strong year-to-date (Chart 8). Equity markets appear to be more relieved by the monetary policy response of the global central banks than they are concerned by the deterioration in economic backdrop which has necessitated the shift in both messaging and action. Returns in Sterling terms have been boosted by the return of Sterling weakness amid heightened political uncertainty. The safe haven appeal of yen has also seen the currency strengthen this year. Equity valuations are not at extreme levels – an expensive US market is offset by relative cheapness elsewhere. However, market expectations of longer-term earnings growth are potentially too optimistic, leaving a more sustained slow-down in earnings growth as the greatest long-term risk for equity market returns.

Our take on the recent moves

We think the uncertain trade environment means the main risk is of a further slowdown in global growth. Muted inflationary pressures have given central banks more room to cut rates, and risk markets, so far, appear to believe this will act to extend the current economic cycle. It is less obvious whether the risks to longer-term global growth are amenable to being sorted out by monetary policy.

Recent moves in sovereign bond markets may suggest a more difficult outlook than is reflected in the data, but there still appears to be divergence between signals being sent here and what is implied by other asset classes. Moves in equity and credit markets do not appear to be discounting this gloomier outlook. As a consequence, we would continue to advocate holding a little more cash than usual. We continue to prefer equities to property in growth-oriented portfolios and would advocate diversifying credit portfolios, potentially by trimming speculative-grade credit exposures.

Please contact your Hymans consultant to understand what this means for you and your scheme.

Appendix charts

Chart 1: GDP growth

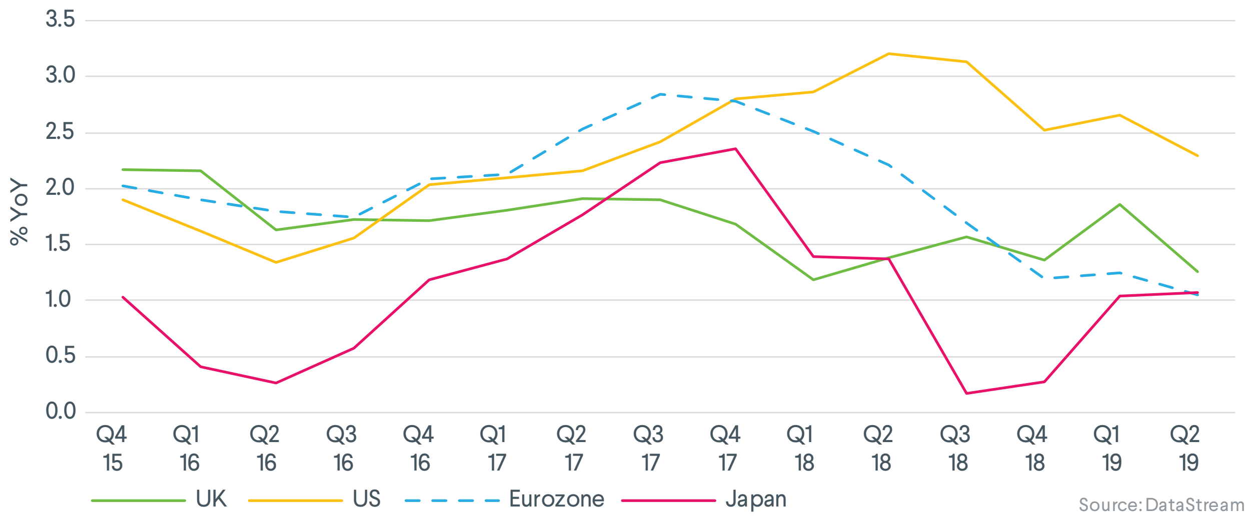


Chart 2: Manufacturing PMI

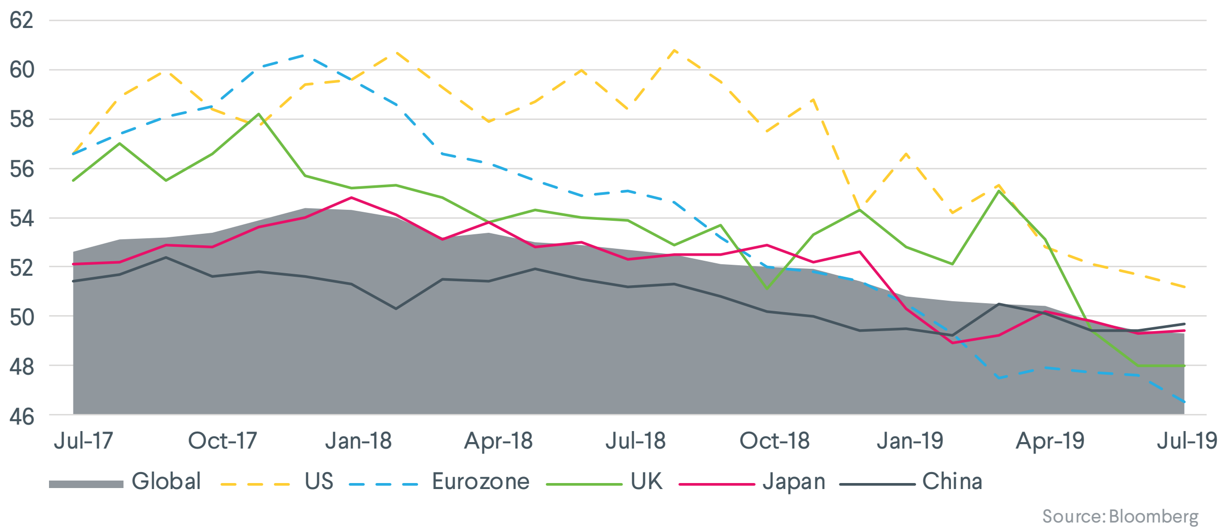


Chart 3: Core CPI inflation

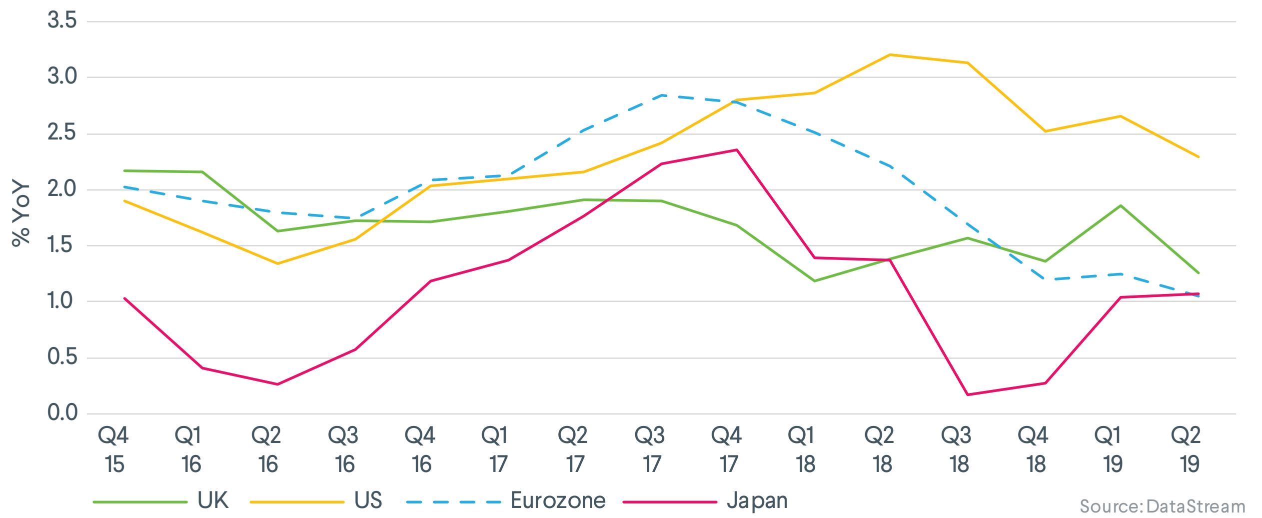


Chart 4: 10-year conventional government bond yields

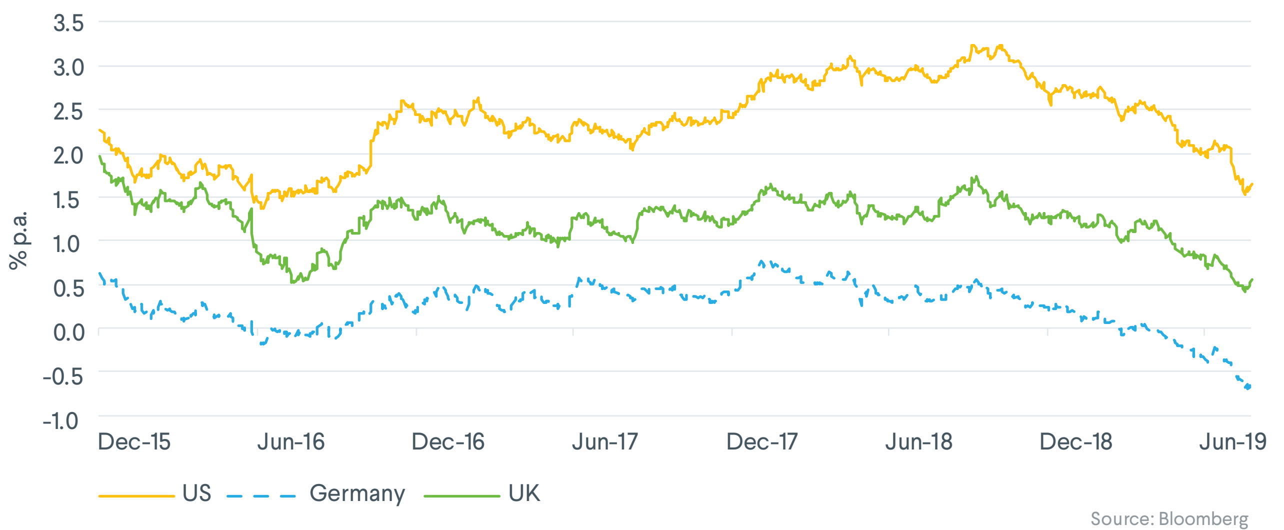


Chart 5: Implied inflation

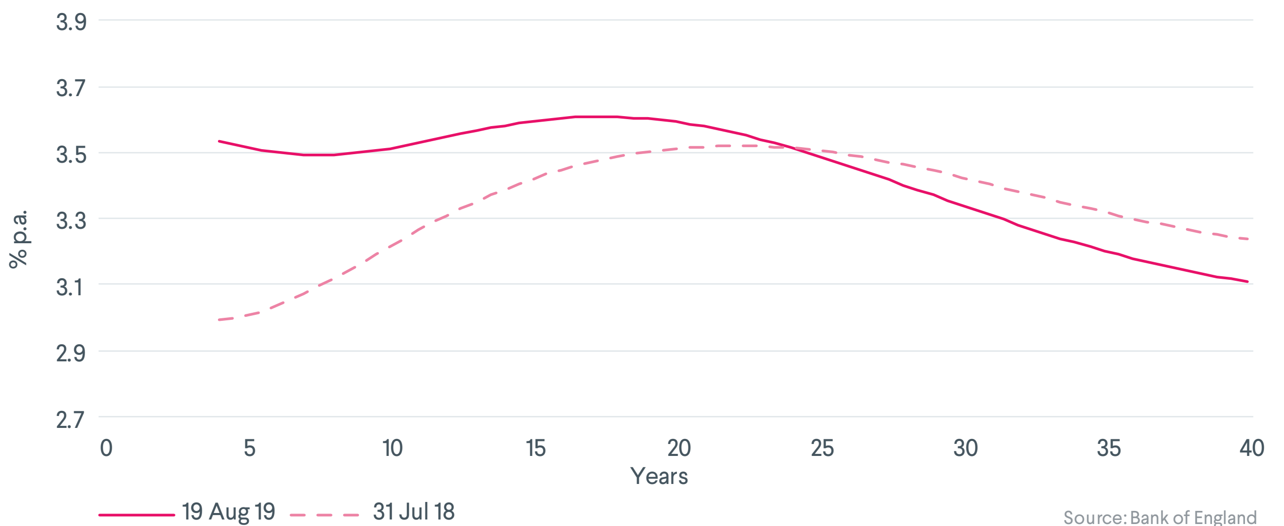
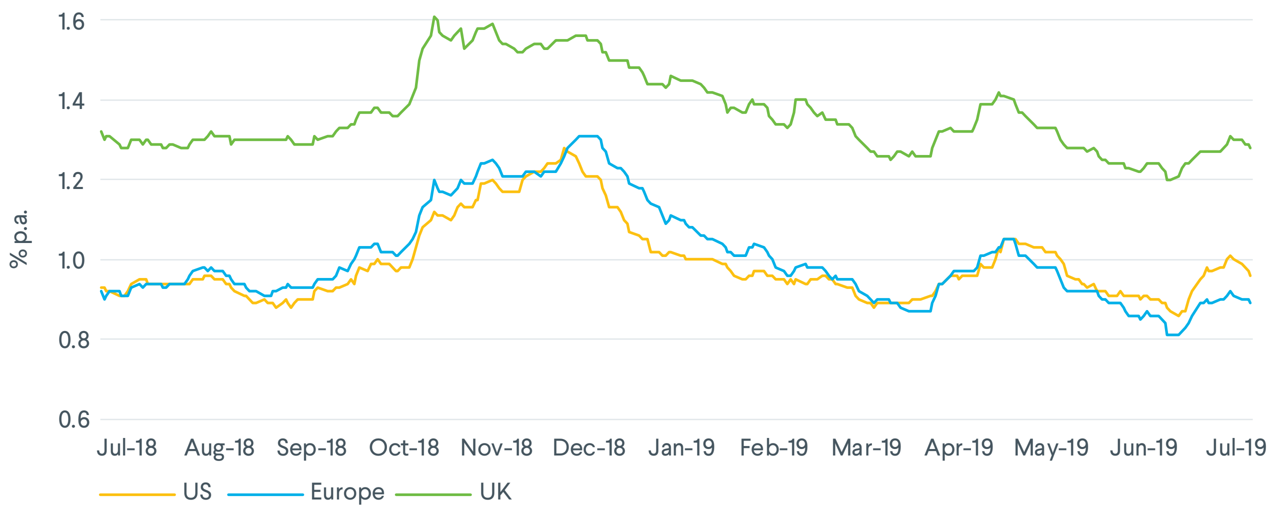
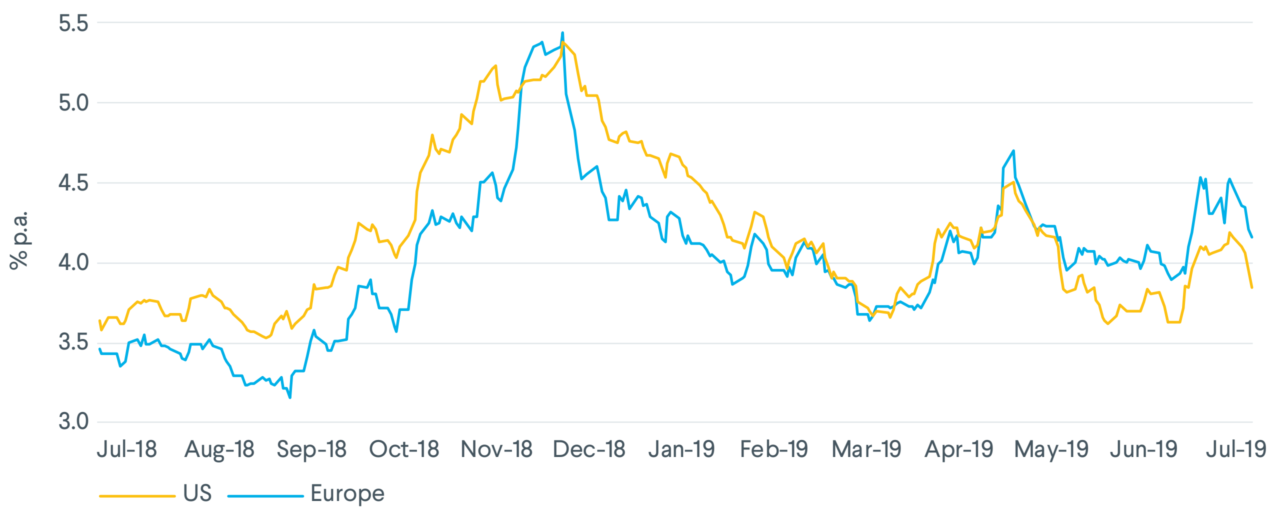


Chart 6: A-rated investment-grade corporate credit yield spreads



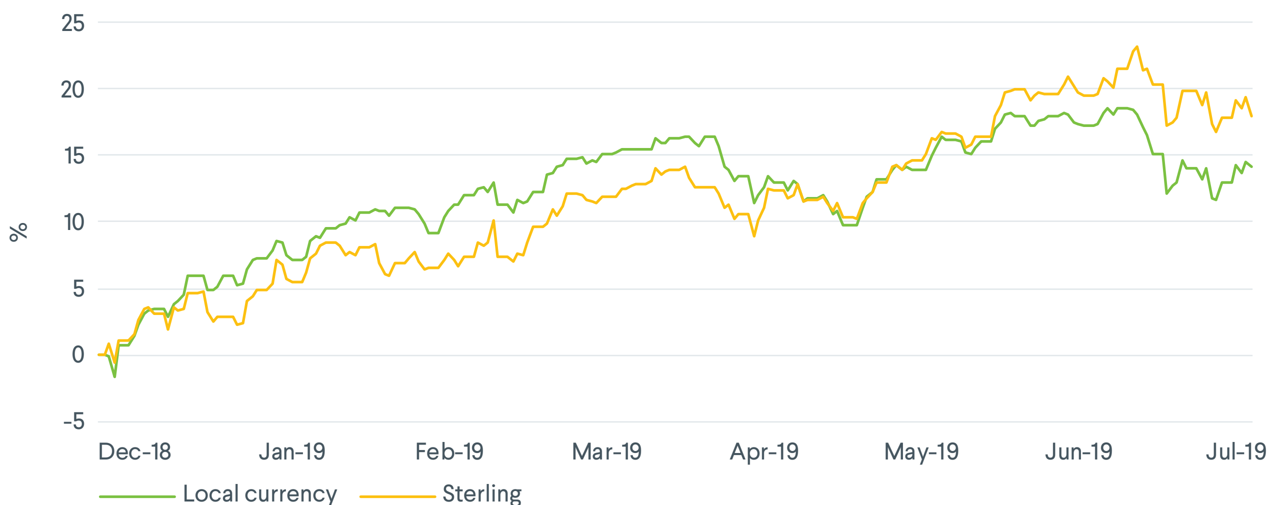
Source: ICE Index Platform

Chart 7: US and European High Yield credit spreads



Source: ICE Index Platform

Chart 8: Global equity year-to-date total returns



Source: DataStream