Capital markets update

Consensus forecasts do not point to an impending recession but it is fair to say we are "late-cycle" – global growth is expected to slow and the risks to the downside have increased. Actual realised "hard" economic data and surveys reflecting sentiments and beliefs, so called "soft" data, have pointed to a slowing of the global economy in the second quarter. While the US economy continues to outperform global peers, growth eased to 2.3% year-on-year in the second quarter. Monthly GDP figures revealed the UK economy showed signs of weakening in the three months to April, with the economy shrinking 0.4% in April, mainly due to a dramatic fall in car production, with uncertainty triggered by the initial Brexit deadline leading to planned shutdowns. To some extent, a slowdown in Q2 was expected: in the US, as the effect of last year's tax cuts has fallen off and, in the UK, the boost from early completion of orders ahead of the UK's original EU departure date has faded.

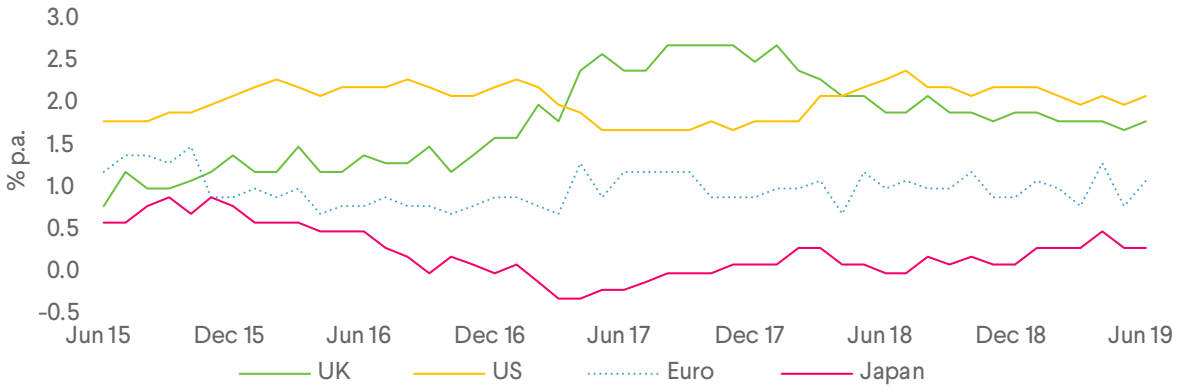
However, anxieties about cross-border trade are creating a more difficult business environment. After being revised sharply lower in the first quarter, global growth forecasts for 2019 have now settled around 2.7%, versus growth of 3.1% in 2018. However, the second quarter has seen forecasts for global growth in 2020 being revised lower. Continuing deterioration in expectations for global manufacturing, as indicated by the manufacturing Purchasing Managers Indices (PMIs), suggests momentum is more fragile than anticipated.

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 1). 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 is around central bank targets in the US and UK for the next couple of years, and remains 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 are hinting at using this room. Messaging from the European Central Bank (ECB) and the US Federal Reserve (Fed) has increasingly pointed towards monetary easing. Notwithstanding the US rate cut in July, we note the US rates markets continue to price in more interest rate cuts than consensus forecasts from the Fed. The situation is less clear cut in the UK, where the Bank of England (BoE) is reluctant to commit to rate cuts or hikes in advance of the Brexit outcome.

A disorderly Brexit might harm short-term growth, which would support the case for lower rates, but could trigger a further fall in sterling, creating a spike in inflationary pressures. This would potentially require interest rate rises to return inflation to target, in line with the BoE's central mandate. Notably, the second quarter saw a return of sterling weakness – it slipped 3.5% in trade-weighted terms, as political uncertainty grew.

Chart 1: Core CPI Inflation

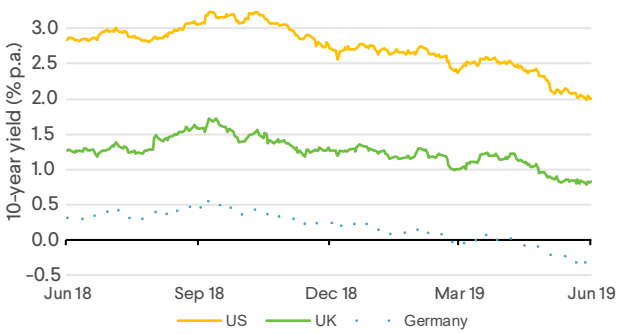


Source: Datastream

Government bonds

A sharp fall in government bond yields (Chart 2) has been consistent with the weakening in economic data and concerns surrounding the global outlook. 10-year US Treasury yields slipped almost 0.4% p.a. in the second quarter. Gilt yields, both nominal and index-linked, have followed the global trend, nearing record low levels. While both domestic and global economic risk, as well as hedging demand, may prevent a rise in UK yields in the short-term, they remain at levels which are at odds with even a subdued long-term economic backdrop. We continue to see little medium-term value offered by current yields.

Chart 2: Conventional government bond yields



Source: Bloomberg

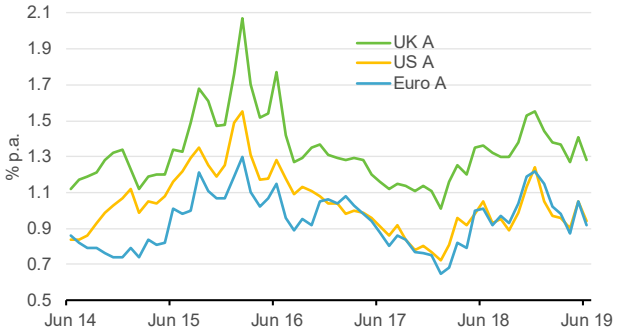
Other bonds

Global credit markets have largely ignored the less positive economic data and outlook: credit spreads snapped back in June after a brief sell-off in May, to end the quarter generally tighter. Sharply lower government bond yields may help to stabilise or lower costs for companies that refinance debt at lower interest rates and longer maturities and, despite global growth risks, the default environment is predicted to remain benign for now. The shift in messaging towards looser monetary policy has supported inflows to global credit markets this year, but there is scope for disappointment if market expectations of monetary easing prove overdone.

Sterling corporate investment-grade yield spreads have largely followed global moves (Chart 3) and the premium over equivalent global peers is not out of line with historic norms. Global spreads remain around long-term median levels. Lower underlying government bond yields have contributed more than half of year-to-date total returns in fixed-rate corporate markets, but any boost from further falls given current levels may be less likely. As a result, we have a preference for floating-rate credit assets, where returns are less vulnerable to underlying rate moves.

Speculative-grade credit spreads, particularly the higher quality portion of the market, remain well below long-term median levels. We prefer private credit markets, both in corporate and commercial real estate lending, where investors benefit from better credit spreads and structural protections for lenders.

Chart 3: A-rated investment-grade corporate credit yield spreads



Source: ICE Index Platform

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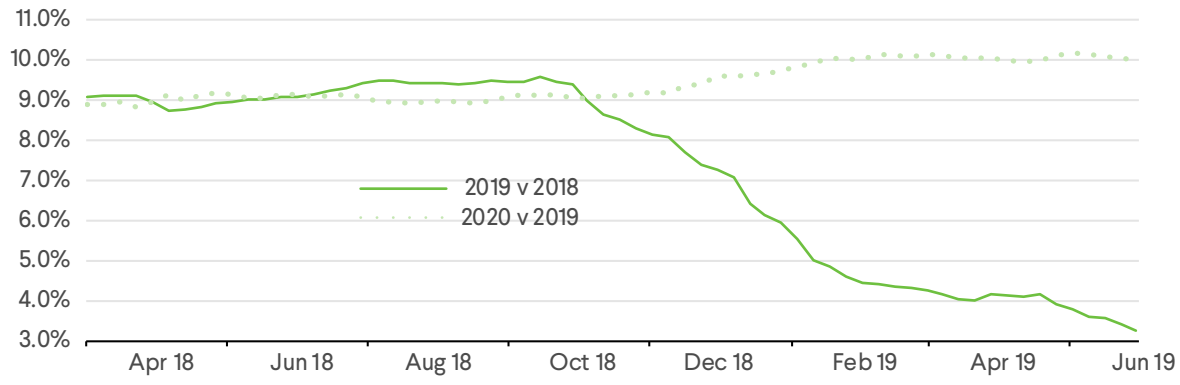
Equities

Equities performed strongly in the second quarter, looking through any short-term disruption and helped by Q1 earnings coming in ahead of expectations. Forecasts for 2019 earnings growth held firm and even rose slightly during the second quarter, although they have started to ease again in the last few weeks (Chart 4). We think there are short-term risks both from a further slide in earnings forecasts and, as before, disappointment about the support from monetary easing.

There is also evidence that the impending Brexit outcome is starting to make for a more difficult technical environment for UK property – investment volumes in the first quarter were the lowest they had been since the third quarter of 2016. Secondary market pricing of UK property funds is showing signs of a shift in the balance of interest from investors. Strong demand had kept the secondary market pricing of funds above net asset value, but prices have been falling in recent months towards, or in some cases, below, bid price.

Chart 4: MSCI World Index forecast earnings growth



Source: Datastream

For the longer-term, cyclically-adjusted price earnings ratios are not at extreme levels – the impact of an expensive US market is offset by relative cheapness elsewhere. Global valuations are starting to look a little stretched, but not entirely dependent on very low current levels of real yields. However, we do not expect real yields to return to pre-crisis levels because we do not believe global growth will return to pre-crisis levels. We are not convinced that market expectations of longer-term earnings growth have adjusted to reflect this, leaving a more sustained slow-down in earnings growth as the greatest long-term risk for equity market returns.

Property

Annual rental growth is as low as it has been for 5 years, although there are signs that it is stabilising. In May, the MSCI IPD UK Monthly Property Index fell for the first time year-on-year since 2017, when the impact of the Brexit referendum result was still being felt. Until now, the return from income has more than offset falls in capital values. The combination of these lower capital values and very modest rental growth has resulted in some very gradual yield expansion over the last 9 months, but initial yields and reversionary yields are extremely low versus long-term history.

Conclusions

We think the uncertain trade environment means the main risk is of a further slowdown in global growth. Muted inflationary pressures give central banks more room to cut rates, a side effect of which may be to calm risk markets, but 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 the 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-orientated portfolios and would advocate diversifying credit portfolios, potentially by trimming speculative-grade credit exposures.