PROSPECT
WEALTH MANAGEMENT

INVESTMENT PROSPECTS

- **UK political upheaval has little impact on markets.**
- **European growth is accelerating as Germany finally rebalances towards consumption.**
- **We are shifting investments towards the more stable growth area of the Eurozone from the UK.**
- **Risks from interest rate rises and Chinese debt appear to be in abeyance for now at least.**

Bond and Equity Markets Trending Up

Against a background of trend levels of economic growth in the US, China and the Eurozone, the UK has suffered the second political upheaval in 12 months. Although the UK now faces a protracted period of political instability, the bond and equity markets have not moved materially from the levels seen at the end of May and have produced positive returns in the last two and twelve months. It is notable that although foreign currencies have appreciated against sterling over the past 12 months, the dollar and yen have depreciated recently. The table opposite shows that returns from most international equity markets were positive. Europe, where Prospect portfolios are overweight, was especially strong, with currency gains adding to equity returns. Over the last 12 months returns from all asset classes except commodities have been particularly strong.

The UK Economy and the Markets

The recession that was forecast following the referendum a year ago has not materialised thanks to the 15% depreciation in sterling and the strong momentum in consumer spending that continued into early 2017. Now, however, we are seeing the initial effects of the Brexit vote. Inflation has risen to 2.9% whilst wages are growing at only 1.7%, despite unemployment being close to a cyclical low. The lack of wage growth reflects low business confidence, which can also be seen in the lack of growth in capital expenditure. As real personal incomes are squeezed, so confidence is falling and retail sales slowing (see overleaf).

The good news is that the fall in sterling has increased exports modestly and the CBI export orders are now at a 30 year high. At the same time, a hung parliament and rising popular anger over social policy means government spending is likely to rise over the next 12 months. The net effect is that overall economic growth is forecast to slow to 1.6% for this year and 1.3% for 2018. By comparison, the US is expected to grow at 2.0% and Germany by 4% this year.

The fragile nature of the UK economy in this uncertain environment is best seen in the bond market, where 10 year government bond yields have fallen over the past year from 1.4% to the current 1.0% despite a rise in inflation. Clearly, the market is telling us that weaker growth in

Total Returns in Local Currency

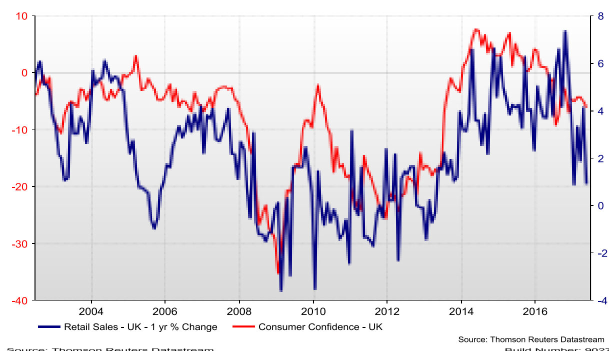
Last 2 Months and Last 12 Months

		Total Return for Market	
		2 mths to 31 May '17 %	12 mths to 31 May '17 %
Currencies v £	Rate		
US dollar	1.29	-2.7	12.3
Euro	1.15	2.7	13.5
Yen	143	-2.1	12.3
Cash (3m)	Yield %		
UK	0.27	0.1	0.6
USA	1.08	0.2	0.6
Euro	-0.36	-0.1	-0.4
Japan	-0.22	-0.1	-0.2
Bonds (10yr)	Yield %		
UK	1.05	1.1	5.1
USA	2.20	2.2	-1.4
Germany	0.30	0.4	-1.4
Japan	0.05	0.3	-1.7
Equities	Index		
UK	MSCI 100	3.5	25.5
USA	S&P Comp	2.5	17.6
Germany	DAX	2.9	26.0
France	CAC	3.7	21.2
Spain	SMSI	4.2	23.9
Italy	BCI Gen	1.8	18.9
Japan	Topix	4.0	15.8
Australia	All Ord	-1.5	11.6
China	Shanghai	-3.3	6.9
Alternatives	Index		
Property	IPD	1.4	4.1
Commodities	DJ UBS	-2.8	-2.4
Hedge Funds	HFR	-2.6	10.5

Source: Reuters

June 2017

UK Consumer Confidence on a Downward Trend



the future will place downward pressure on inflation in due course. Our bond portfolios have benefited with a gross total return of 11.4% over the past 12 months. UK equities have seen a wide range of returns from different sectors. The fall in sterling has boosted companies with overseas earnings but damaged consumer stocks through a rise in input costs. We have shifted the balance of equity holdings modestly but many consumer and financial stocks are now too cheap to sell.

International Markets Remain Attractive

International equity markets are experiencing a favourable mix of trend levels of growth with low inflation, the perfect background for equities. The US cycle is well advanced with unemployment at just 4.3%, but with strong business investment, low inventories and a cautious approach from the central bank to raising interest rates, we expect the US to continue to grow at around 2.0%. This is without the Trump administration throwing petrol on the flames with tax cuts and infrastructure spending. It is not surprising that the US stock market is hitting new highs in this benign environment.

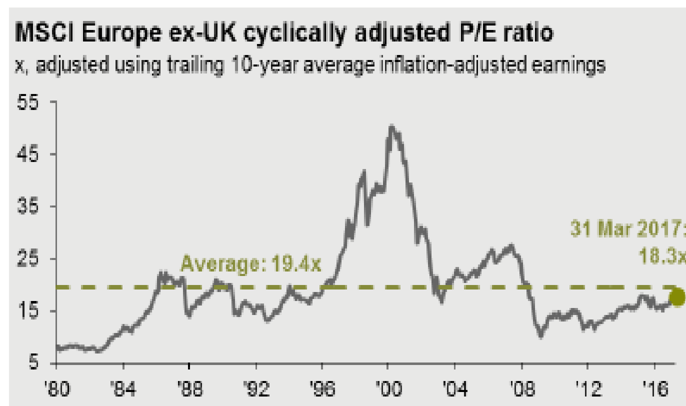
Europe also is seeing an acceleration in economic growth, with forecasts for 2017 being upgraded to 2.0%. The driver for this turnaround is a strong recovery in German consumer spending and investment in response to large scale immigration and low interest rates. The shift of growth away from exports to consumption raises the possibility of Germany becoming an engine of growth for the rest of Europe at the same time as President Macron introduces a new pro-business economic strategy for France. Eurozone equity market valuations remain attractive if company earnings are adjusted for the economic cycle, as the graph below shows. As a result we have increased the exposure of portfolios to European equity markets at the expense of UK holdings, where the outlook is more uncertain.

Where are the Risks Now?

The political and social upheavals of the past 6 months create an atmosphere of fragility but the underlying growth of both the economy and company earnings has been robust. We see three potential risks ahead. First, there is widespread consensus over this rosy outlook for markets and so there is the risk that equities rise too far, too fast and growth unexpectedly disappoints. Second, this could happen if one of the major central banks raises interest rates too quickly. To date though, tightening of monetary policy has been modest and there is no sign this is about to change. Finally, there are fears that excessive Chinese debt will lead to a crash. However, growth in China has been strong in Q1 this year and debt growth is being scaled back in recognition of the risks. For now, we see further upside for international equities.

Matthew Hunt
Principal

Eurozone Equity Markets Still Undervalued



Source: J P Morgan

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