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2018 Global Investment Outlook

3rd quarter insights

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The outlook for global markets has darkened somewhat over the last few months as the synchronised global growth that economies enjoyed last year now looks under threat from a potential global trade war. There are still opportunities, but risks are growing and much depends on a highly unpredictable US President.

Trump, QE headwinds, valuations

In this unpredictable environment, we see three reasons for caution:

- Firstly, Trump is playing a high stakes poker game that risks derailing the global economy.
- Secondly, the tailwind of QE is turning into a headwind, as central banks around the world tighten monetary policy as inflationary pressures build.
- Finally, valuations in some parts of the equity market provide an insufficient margin of safety should the trade war escalate.

This is a highly fluid situation which could be resolved by a "win" for Trump well ahead of the US mid-term elections in November or could escalate into something much more sinister for the global economy.

Let's consider the risks:

Risk 1: TRADE WARS

Global tariffs have been falling for decades and as they have done so, global trade as a percentage of GDP has soared. In the US, the trade-weighted tariff has fallen from around 5% in the 1960s to 1.7% before this trade spat began.

At the time of writing, tariffs on $58bn of steel, aluminium, washing machines and solar panels have pushed that rate up to 2%. Trump's administration has laid out a roadmap of how the US might ramp up tariffs if China enact tit-for-tat policies.

JP Morgan estimate that this would see the tariff rate increase to anywhere from 2.5% to 6.5% if all threats are carried out. In one fell swoop, Trump would roll back 50 years of tariff reductions and with it, risk a severe disruption to global trade.

What might be the effect on global growth? The Bank of England estimate that if US tariffs are pushed up to 10% between the US and all its trading partners, then the direct impact on US growth would be 2.5% and 1% on global growth. Furthermore, it estimates that their influence on business confidence and financial conditions could double the effect on growth, both for the US and the rest of the global economy.

Photo by Gage Skidmore

Risk 2: CENTRAL BANKS

One thing that hasn't changed this year has been the determination of the Federal Reserve to push up interest rates after years of support for global markets. In June the Fed raised interest rates for the second time this year and increased their forecast to four rate rises for the full year, from the three that were indicated in March.

Meanwhile the European Central Bank confirmed that it would phase out its QE programme by the end of the year. This fading support for markets increases the market risk of escalating trade tensions.

Risk 3: VALUATIONS

In the last couple of months, the US has been regarded as a haven: the fastest growing major developed market with growth boosted by the tax cuts with the economic momentum to withstand trade wars better than most countries. However, the problem with the US stock market is that it is expensive on almost every measure.

Overleaf we compare global markets on two classic valuation metrics: price to book and cyclically adjusted price/earnings. On both measures the US market is expensive both in comparison to the rest of the world and versus its own history.

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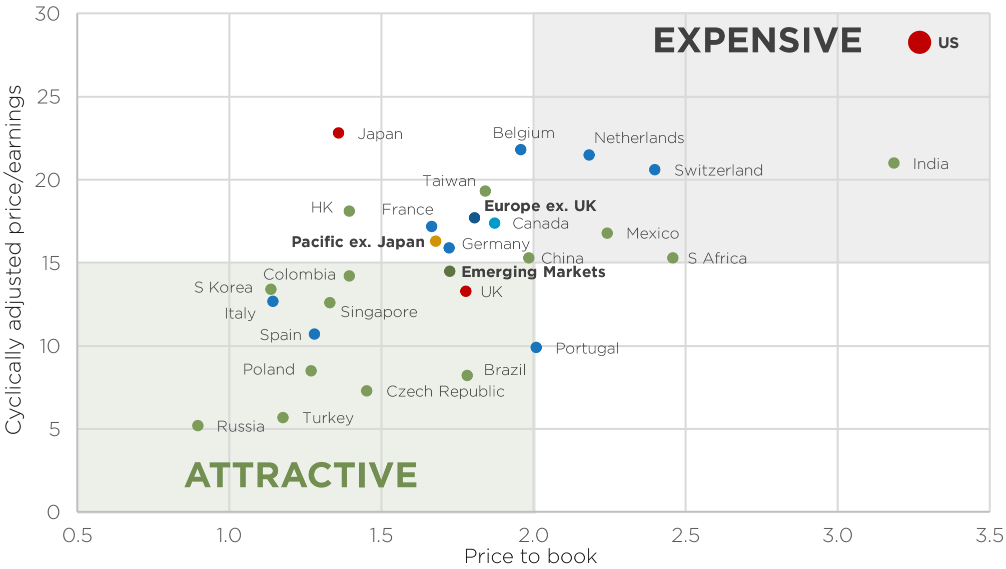

Source: Bloomberg as at July 2018.

Dry powder

Against this backdrop we think it's important to have a significant amount of dry powder to take advantage of opportunities when they present themselves. This allows us to move fast if markets overreact to geopolitical noise and provide a cushion should the trade wars escalate. In the meantime, we still think that there are opportunities in global markets. One new investment that we have made over the last quarter is into global energy stocks.

Energy Stocks

Energy companies have been in the doldrums for a decade, generating no returns for investors despite generous dividends, whilst global equities have returned nearly 80%. The obvious culprit has been the oil price which is down by a quarter over the same period as the phrase "commodity super cycle" crashed out of the investment lexicon. With the usual enthusiasm to build capacity in the good times, oil companies kept on spending for a full five years after the peak in the oil price. The additional capacity pushed the market into over-supply and the oil price crashed a year later.

Another five years on and the cycle turns again. Capital expenditure has more than halved from its peak and the oil price has rallied by 200% from its low in 2016. The combination of higher prices and lower costs has boosted the free cash flow generation of the largest oil companies to levels last seen in 2012 when oil averaged over $110 per barrel. Brent crude oil is currently just under $80 barrel and looks set to move higher on the back of OPEC production cuts, falling inventories and increasing tensions between the US and Iran.

Until very recently the equity market's response has been sceptical, to say the least. The energy sector as a percentage of the total market hasn't increased despite the powerful rally in the oil price. This is quite normal. Energy stocks typically don't start to outperform for nearly two years after a major low in oil prices. But the good news is that energy stocks then typically outperform for several years.

Conclusion

We don't think that it's an exaggeration to say that the outlook for the global economy and markets is highly dependent on the actions of one man, Donald Trump. This is uncomfortable, to say the least, given how unpredictable his actions are. If he gets a "deal" in his eyes, then the global economy has sufficient momentum to shrug off the impact that his actions have already had on global trade. However, if trade wars start in earnest then the impact will be felt around the world. In this highly uncertain environment we think that prudence is important, whilst being able to respond to the opportunities that arise from this uncertainty.

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