

Global equity market perspective

By Tom Carroll, Head of investment & risk

The Fed's momentous U-Turn on monetary policy which began in December sparked a New Year equity rally, reversing some of the losses from the final quarter of 2018. Jerome Powell's optimistic outlook on the US economy last October had precipitated market turbulence as investors anticipated further rate rises. However, whilst this decision to reverse course may have provided a welcome boost in the short term there is a danger that investors are even more complacent about the risk of rising rates. In addition, by reducing their scope to raise rates, they may find themselves playing catch-up if inflation increases.

The biggest risks facing investors

As investors we are always facing risks and trying to understand the range of outcomes and potential impact on markets is a normal part of what we do. It does, however, feel that we have reached a stage of heightened uncertainty and there are a number of events which could precipitate further market volatility. These include the known unknowns such as Brexit, European politics (particularly in Germany as the Merkel period draws to a close) and international trade disputes. Although these have to some extent been priced in, further weakness is possible if the outcome of any of these events took a significant turn for the worse, but there is also upside potential in the event of a resolution to these issues.

The biggest risk, which perhaps investors are not fully appreciating, is the impact of the end of this cheap money era which has resulted in significant distortions. We continue to live in a period of low nominal GDP growth, ageing populations and low productivity growth, and without the stimulus of the past decade, returns are likely to be more muted.

Considering equity market valuations

Current equity market valuations appear reasonable in our view, and, in many markets, are not far off long-term averages. That means the driver for markets is likely to be earnings growth and the problem is that we are probably past the peak in this economic cycle.

That is not to say we are facing a recession, and indeed this prolonged period of economic expansion has been characterised by a series of gentle slowdowns and accelerations. The world economy is decelerating though, with virtually every major economy exhibiting weaker lead indicators over the past 6 months. The anticipated profit growth for 2019 of 10% has already been downgraded to 7.5% with many top down strategists forecasting a further slide to 4%.^{*} With profit margins also close to historic highs, it feels as though the recent trend of profit growth expectations being reined in will continue.

Market focus

With a slowing economy and pressures on profitability, we would continue to focus on companies with strong pricing power and an ability to sustain returns even in a more difficult environment. Cyclical stocks have already seen heavy selling but remain vulnerable to profit downgrades. I believe that valuations will become more important to investors as the year progresses. If returns become more difficult to eke out, then the price initially paid for a share will become ever more important in determining whether you make a profit.

With sentiment on the floor and valuations close to five year lows, perhaps Europe could start to perform better in spite of the political uncertainty. The IMF is forecasting that growth rates in the US and Europe are likely to converge over the next few years. Similarly, valuations in emerging markets look appealing, although my preference would be to play that through consumer-focused companies rather than a broad exposure to these volatile economies.

In terms of providing diversification for our clients, I am cautious when looking at historic correlations and assuming they will hold in the future. As last October showed, rising US interest rates sparked a sell-off in equities and bonds. As such, I believe there is an increasingly important role for alternative investments in portfolios. In particular, real assets (infrastructure, renewable energy and specialist property) possess an attractive mix of attributes including strong long term fundamental demand growth, inflation protection, cash generation and consequently a reliable

income stream. Overall, investors should expect a volatile stock market over the next 12 months. That's never easy to deal with but for truly active investors with a strong philosophy and a long-term horizon, this also throws up great opportunities.