KINGSWOOD

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Q1 | 2020

INVESTMENT OUTLOOK

SUMMARY

- The easing of US-China trade tensions coupled with monetary easing should lead to a pick-up in global growth
- The coronavirus will hit activity near term but is not expected to derail the global economic upturn
- Growth in corporate earnings, rather than a further re-rating, should drive additional gains in equities
- Prospective returns in 2020 are high single digits for equities, significantly higher than for bonds or cash
- However, we are cognisant of the risks and our portfolios are positioned accordingly
- We are positive on UK equities as economic and political risks have diminished and valuations remain cheap
- We are cautious on US equities due to their high valuation and the risks surrounding the November elections
- We have added environmental change as a new thematic allocation within equities

ECONOMIC AND MARKET OUTLOOK

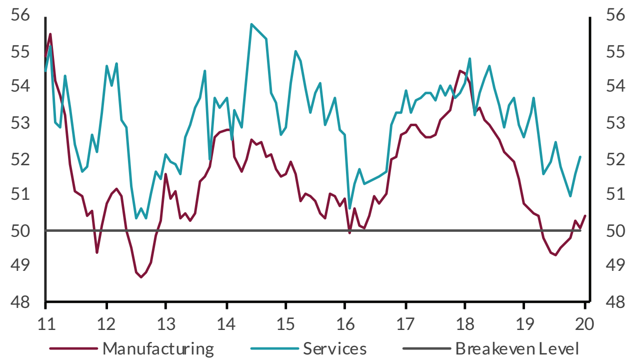
Global equities posted strong gains in the fourth quarter and returned an exceptional 26.9% in local currency terms over 2019 as a whole. A rebound in the pound limited the gains seen last quarter for a UK investor, but equities still returned 22.3% in sterling terms over 2019.

Fixed income returns, by contrast, were minimal last quarter as government bond yields rebounded from the lows in September. Even so, fixed income still saw unusually high returns for the year as a whole.

The key drivers behind the recent strong equity performance and rise in bond yields were a bottoming in global business confidence and hopes of an upturn in economic activity this year. There are **two main reasons to expect a pick up in growth:**

The first is that the relaxation in global monetary policy seen last year was the most extensive since the global financial crisis. This easing, along with the rebound in financial markets, mean financial conditions over coming months should swing, from being a drag on growth, to becoming a boost.

Global business confidence has started to recover



Source: JPMorgan

Policy is generally now on hold. In the US, the Fed has lowered rates by 0.75% but has signalled the easing phase is now over. Meanwhile, in the Eurozone, the ECB looks set to continue its quantitative easing programme for the forseeable future.

The UK has bucked the general trend by keeping policy on hold. Speculation had grown that the MPC could cut rates at the latest meeting. But the Boris-related bounce in business confidence, along with the prospective fiscal boost, stayed its hand in the end.

If policy were to be changed anywhere, it will very likely comprise further easing. Inflation remains below target and looks set to remain subdued. Secular disinflationary forces, such as globalisation and the internet, should continue to offset upward pressure from tight labour markets. Moreover, the Fed and ECB have both launched wide-ranging policy reviews that should leave them more tolerant of any inflation overshoot, as it follows a significant undershoot in recent years.

Fiscal policy should also become supportive to growth at the margin. Here in the UK, the Conservatives are very keen to secure a revival in growth and the March Budget should confirm a sizeable rise in government spending. There is also pressure to boost spending elsewhere in Europe.

The second reason is that trade tensions, which caused a marked weakening in the manufacturing sector, **have eased significantly.** The US and China have now signed a 'phase one' trade deal, which commits China to boost purchases from the US in exchange for the US rolling back some of its tariffs.

This deal certainly does not mark the end of trade frictions. A 'phase two' US-China deal will involve intractable issues, such as state support and intellectual property rights, and is unlikely to be agreed this side of the US elections in November. US-EU trade relations also may remain somewhat fraught given the plans by France and the UK to impose taxes on the US internet giants. All the same, the **risk of a major trade war has receded significantly.**

In the UK, trade negotiations will be centre stage this year with the Government trying to secure free trade deals with both the EU and the US. With the EU Withdrawal Agreement now stating that there can be no extension to the transition period beyond December 2020, a hard Brexit cannot be ruled out altogether. But the most likely outcome is that a bare-bones agreement is reached with the EU by year-end.

While we believe global growth should improve over the coming year, **we are not looking for a rebound of the strength seen in 2016 and 2017.** Indeed, downside risks persist. Geo-political tensions – most obviously between the US and Iran – could flare up again and the coronavirus clearly poses a threat.

The extent of this threat is still far from clear. The draconian restrictions on travel mean growth in China will be hit significantly. But the experience of the SARS outbreak back in 2003 is that activity should recover fairly quickly once the virus is under control.

As for global growth, the impact in 2003 was minimal but China is now a much larger economy and more connected to the rest of the world. All the same, we still believe it is unlikely to derail a modest pick up in growth, not least because central banks would step in if it did pose a significant threat.

Equity valuations back up to highs of 2016 and 2018

Source: Refinitiv

Global equities in early October finally broke clear of the highs reached in early 2018 and, at their peak in January, were some 10% above. The strength of the gains had left markets somewhat vulnerable and the **coronavirus has provided the catalyst for a retracement.**

Corrections of 5-10% are quite common and markets could fall back further as the news may well worsen near term. Still, the lesson from previous health scares is that markets swiftly recover their losses once the outbreak is contained.

The strong gains of the last year have been entirely driven by a valuation re-rating. Global equities are now on a P/E ratio of 16.2 versus a long-term average of 15.7. However, low interest rates are supportive of higher than normal valuations, which are often seen in the latter stages of the business cycle.

We believe **corporate earnings – rather than a further re-rating – will drive additional equity gains.** Global earnings have contracted slightly over the past year but should benefit from a pick up in the global economy. We expect earnings growth of around 5% for the coming year.

Combined with their dividend yield of 2.4%, all this points to **global equities delivering high single digit returns in 2020.** This is a far cry from last year's returns of some 25%, but should still leave equities returning significantly more than bonds.

Government bond yields fell back in January, unwinding much of their rise in the fourth quarter. However, if a pick-up in global growth materialises, yields should trend higher again. That said, any increase is likely to be limited, with inflation under control and central banks firmly on hold.

The prospective rise in yields will impose a drag on prospective fixed income returns, which are already severely limited by the low starting point for yields. Government bonds as a result should deliver minimal returns and prospects for corporate bonds are not that much better. Corporate bond spreads are at close to historic lows and are unlikely to narrow any further.

POSITIONING

We added to our equity positions further in the fourth quarter and **our weighting is now back to neutral.** With the upside for equities tempered by the risks, we are minded to stay that way for now. If, however, there were a significant correction, we might use the opportunity to move overweight.

We added to our UK equity exposure in November, once the risk of a No-Deal Brexit and/or Labour Government had receded, leaving us overweight. The UK has outperformed a little recently but with the market still cheap and a pick-up in UK growth in prospect, we believe there is **scope for further UK outperformance.**

Small and mid cap stocks are our favoured areas because they have the greatest exposure to the domestic economy. Large caps have much of their revenue coming from overseas and would be held back by any move up in the pound.

We are also positive on Asia ex Japan, and to a lesser extent, Emerging Markets more generally. Asia is particularly vulnerable to a worsening of the coronavirus crisis. However, longer term, it should be a prime beneficiary of an upturn in global manufacturing activity and should more than recapture any short-term losses. Its relatively cheap valuations also remain a long term attraction.

We remain neutral on Japan. Its cheapness is an attraction as is its cyclicality – it is one of the markets which will benefit most from stronger global growth. However, the continuing weakness of the domestic recovery is a concern.

UK equities have scope to outperform further

Source: Refinitiv

By contrast, we are cautious on the US. Even though we recently added a little to our allocation, we retain a sizeable underweight. The P/E ratio of the US is now 30% above the rest of the world, close to the high touched in 2018. It is also a relatively defensive market and will not benefit as much as other more cyclical markets from stronger global growth.

In addition, there are the US November elections. These could be a source of volatility and would pose a clear downside risk if either of the two hardline Democrat candidates, Elizabeth Warren or Bernie Sanders, were to become President.

We are also not overly keen on continental Europe. The Eurozone recovery still looks fragile, valuations are not especially cheap and structural problems remain an issue.

In a world characterised by dull growth and muted cyclicality, long term themes remain a major focus for us. We have recently expanded our range of investments, **adding an exposure to environmental change.** Climate change is being taken increasingly seriously by companies. Investor focus on companies that will benefit from, and drive the move to, a low-carbon economy, can only continue to increase.

We retain our existing exposures to technology, artificial intelligence and frontier markets, all of which continue to have good long term growth potential. In addition, we have allocations to infrastructure and global brands, whose defensive characteristics are attractive.

In fixed income, our focus has been on short-maturity, high-quality bonds as we believe long-maturity bonds carry a significant risk of capital loss with yields so low. However, we are in the process of diversifying our exposure somewhat by **increasing our allocations to managers with more flexible mandates.** With our increased equity exposure, we also want our bond holdings to provide more protection if there were a renewed growth scare.

We also have a **weighting in alternative assets** which gives exposure to equities in a risk controlled manner. Finally, we have an allocation to gold. The rally in the gold price looks a bit overdone following a very strong run over the last year. But it should continue to garner support from the low level of rates. It also provides some protection against a major equity sell-off.

MARKET VIEWS

	PREVIOUS VIEW	CHANGE	CURRENT VIEW	
LOWER VOLATILITY ASSETS				
Cash	● (negative)	-	● (negative)	Cash remains very unattractive with interest rates so low
Government Bonds	● (negative)	-	● (negative)	Yields to trend higher from their very low levels, severely limiting returns
Corporate Bonds	● (positive)	⇩	● (neutral)	Spreads are tight and prospective returns are on the low side
Index-linked Bonds	● (negative)	-	● (negative)	Inflation remains becalmed, limiting appeal of index-linked bonds
Lower Volatility Alternatives	● (neutral)	-	● (neutral)	Low volatility alternative strategies offer only modest returns
HIGHER VOLATILITY ASSETS				
Equities	● (neutral)	-	● (neutral)	Stronger growth and renewed gains in earnings should drive equities higher
Higher Volatility Alternatives	● (positive)	-	● (positive)	Alternatives with downside protection are appealing given poor outlook for fixed income
Property	● (negative)	-	● (negative)	Illiquidity issues and woes on the UK high street keep us cautious on property
Gold	● (neutral)	-	● (neutral)	Upside potential limited but a good hedge against risk of major equity sell-off
EQUITIES				
REGIONS				
UK	● (negative)	⇧	● (positive)	Reduced economic/political risk and cheap valuations have turned us more positive
US	● (neutral)	⇩	● (negative)	Rise in valuations and US election risk have made us more cautious
Europe ex UK	● (negative)	-	● (negative)	Economic recovery is fragile and long-term structural problems remain
Japan	● (neutral)	-	● (neutral)	Good value and its cyclicality attractive but weakness of domestic economy a concern
Asia ex Japan	● (positive)	-	● (positive)	Prime beneficiary of easing in China-US trade tensions and pick up in global growth
Emerging Markets	● (positive)	-	● (positive)	Cheap valuations and relatively good long term growth prospects are attractions
THEMES				
Global Infrastructure	● (positive)	-	● (positive)	A defensive sector which should provide some protection in a sell-off
Global Technology & AI	●● (positive)	⇩	● (positive)	Rise in valuations and regulatory headwinds mean outlook not as bright as it was
Global Brands	● (positive)	-	● (positive)	Quality focus of strong global brand names is an attraction longer term
Frontier Markets	● (positive)	-	● (positive)	Attractive because of superior long term growth prospects and cheap valuations
Environmental Change	● (neutral)	⇧	● (positive)	Climate change is fast becoming a major focus for corporations and investors
Small & Mid Cap Stocks	● (positive)	-	● (positive)	Should outperform if global growth picks up as we expect

Our view reflects our assessment of the relative attractiveness of each asset class after taking into acccount its volatility

Change = change in view over the last quarter

● = POSITIVE ● = NEGATIVE ● = NEUTRAL

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