Bulls versus Bears

Equity Journal Q2 2018

Equities rise despite growing geopolitical risk

The second quarter of 2018 was positive for broad equity markets despite the presence of geopolitical concerns. A snapshot of key issues and our overall views on equity markets are set out in this summary.

April

A reduction in trade policy concerns and continued improvement in US economic fundamentals boosted investor sentiment over April.

— The US economy added 175,000 jobs over the month and though this was below analyst expectations, the data was accompanied by the US unemployment rate falling to 3.9% – the lowest level since 2000.

— All regions added value over April, with UK equities the key standout performer (+6.4%), largely aided by Sterling depreciation and a rally in the oil price boosting a number of stocks within the index.

May

The US Federal Reserve ('the Fed') chose to keep interest rates unchanged at the start of the month, but strengthened expectations of a rate hike in June. This contrasted with the UK, where expectations of monetary tightening fell after the release of sluggish economic data, which weakened Sterling further.

Equity performance across regions was mixed, as fears around a global trade war reignited, the dollar continued to strengthen and political turmoil within Europe influenced trading patterns.

— The release of strong Q1 corporate earnings data across the US and Europe buoyed markets over the first half of the month. US economic data also continued to support equity markets, with the US adding 244,000 new jobs over the month (ahead of analyst expectations of 188,000) and the unemployment rate marginally falling to 3.8%.

— Nevertheless, following the political stance on Chinese imports in Q1, the US administration declared it would also proceed with levying tariffs on aluminum and steel imports from the EU, Canada and Mexico, leading to fears of retaliation and a global slowdown in growth.

— This development led investors to shift in to safe haven assets for a short period of time. A political crisis in Italy, where the populist coalition was at risk following election in March, also led to a sharp sell-off in late May. Markets did rebound from this at the end of the month, following a deal being reached to form the government.

— Whilst the US and UK markets were robust in response to these geological headwinds (returning 6% and 2.8% respectively), Europe (-0.9%) and EM (-0.1%) detracted value in GBP terms.

June

The theme of encouraging fundamentals versus geopolitical risk remained largely intact for the remainder of the quarter.

— Equity returns were muted over June, as trade concerns and other macro issues such as Brexit weighed in on investor sentiment.

Despite the political backdrop:

— US job growth continued to exceed expectations. The unemployment rate did tick up marginally, but this was mainly due to a change in the labour participation rate. Corporate earnings also remained healthy over the period.

— The Fed increased interest rates by 0.25% in June and indicated two further hikes over 2018. The European Central Bank ('ECB') also announced that it would cease its €2.4 trillion bond purchase programme in December 2018 and consider raising rates over 2019.

Overall, global equity markets largely shrugged off political concerns over Q2, delivering 7% in GBP terms (3% in hedged terms), driven by the performance of the US and UK.

'Bulls of the quarter' – Positive economic and corporate earnings data → Meaningful impact

'Bears of the quarter' – Geopolitical risk → Minor impact

The Bulls win!

The Ones to watch – KPMG Investment Advisory view

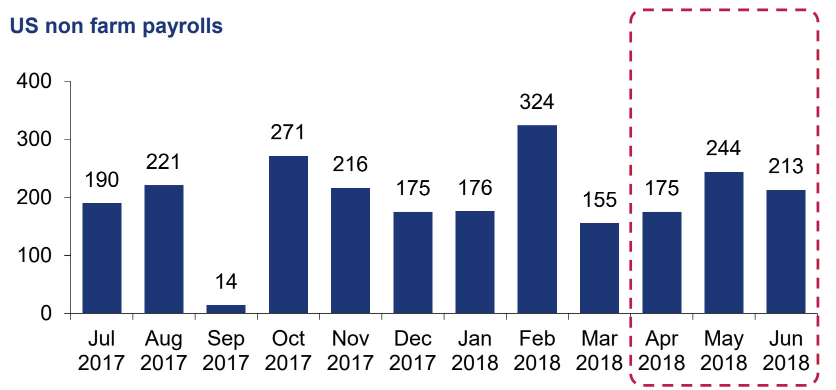
We continue to believe that the economic cycle is transitioning to increased volatility. Investors should be mindful of the current geo political environment, different drivers of volatility and other factors which impact equity returns, such as currency fluctuations.

Though fundamentals in the US (the largest component of market cap) look healthy at present, US fiscal policy is a potential concern, with a combination of low unemployment and higher wage growth creating a possible source of inflationary pressures. To date, US wages have remained sticky despite job creation, but should the current trend continue, we would anticipate upward pressure on wages as the year progresses.

We believe the current environment is an appropriate time for investors holding a meaningful allocation to equities to review existing portfolios and consider reducing risk.

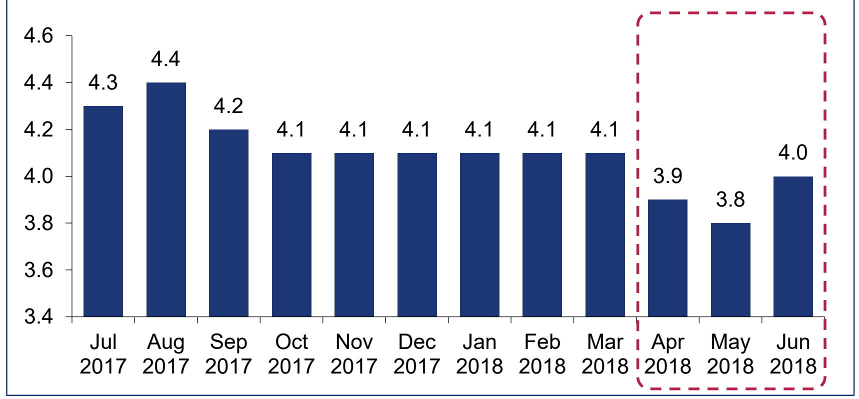
Topical charts

The US continued to add jobs – Beating expectations over May and June



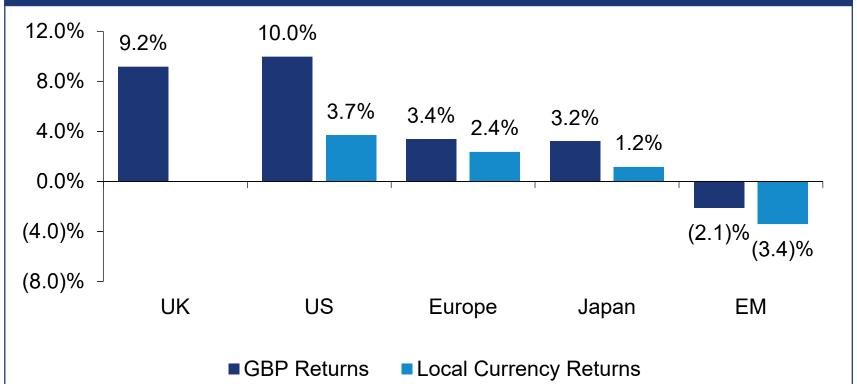
Source: Tradingeconomics.com

The US unemployment rate remains steady and below the historic average

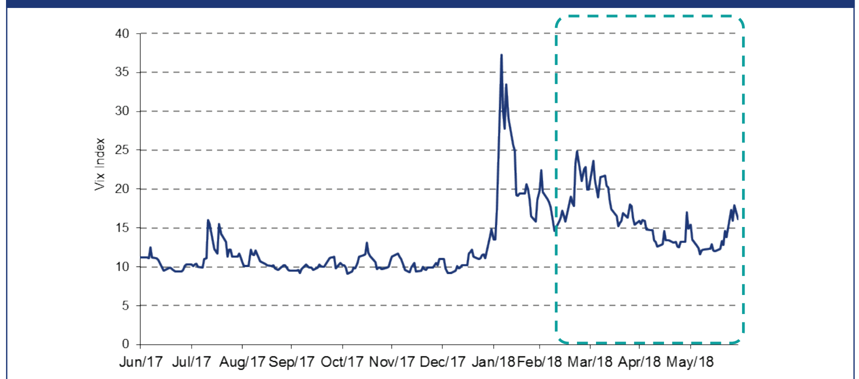


Source: Tradingeconomics.com

Regional attribution over Q2 2018 – Currency impact continues



VIX – Volatility remains



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