Political concerns tempered by a good IMF growth report

Markets were mostly steady last week, digesting coverage of the run-up to the first round of the French elections, and initial reactions to the snap general election called for the 8th June in the UK. As the week progressed it also became more apparent that the US Administration is making a renewed effort to deliver a revised replacement for Obamacare, and to bring proposals for tax reform and spending forward as much as possible, having pushed out the timeframe for these a few weeks ago. Some commentators had begun to write off what had become known as the 'Trump trade', linked to anticipated US fiscal stimulation and business-friendly regulatory reforms. The bellweather S&P 500 index rose 0.85% over the week. The Euro STOXX 600 index closed 0.65% lower on the week, slightly unsettled by the prospect of the first round of the French presidential elections; the euro stood its ground, however, just over 1% firmer against the dollar over the week. The French CAC 40 index slipped 0.23%, a resilient performance under the circumstances. The main election contenders (Le Pen, Macron, Mélenchon and Fillon) are all within a few percent of each other in the polls. The possibility of even a small portion of the large 'undecided'/abstention element coming off the fence has made for a real 'cliff-hanger'. Many observers are quietly fearing the possibility of a 'devil or the deep blue sea', far-left vs. far-right choice going into the final round. Driven by politics on the other side of the English Channel, the UK's FTSE 100 closed almost 3% lower over the week, at 7,114.55, following the surprise decision by Prime Minister Theresa May to call a general election (discussed in detail below); sterling rose by 2.35% against the dollar over week, to $1.2817, after a high of above 1.29 intra-day. Sterling's move was partly responsible for the Footsie's weakness, impacting earnings expectations, given the high percentage of export earnings in that index. In US Treasury bonds, the key yield on the 10-year was just half a basis point lower over the week, at 2.2480%, having bounced from an oversold closing low of 2.1682%; we believe the rally in bonds (with other safe-havens) that has occurred with the fall in the 10-year yield from above 2.60% now fully reflects any delay to Trump's policy rollout and related softening in near-term US growth expectations. Gold closed at $1,284.44/oz, almost unchanged over the week, consolidating its recent gain in the absence of further immediate geopolitical stimulus. Oil was weak, with West Texas Intermediate 7.3% lower (at $49.27), with analysts confused by the divergent views of the International Energy Agency and OPEC regarding trends in global oil inventories, as well as an unexpected rise in US gasoline inventories. **Lastly, good first quarter Chinese GDP growth numbers were published (an annualized 6.9%, and the first consecutive two-month gain for some time), followed by the publication by the IMF of a fairly bullish assessment of the outlook for growth in the world economy – in line with our own assumptions contained in our Global Investment Outlook 2017.**

"The decision to call a general election by Mrs May should result in a better Brexit for the UK"

The snap UK general election called by British Prime Minister, Theresa May, caught just about everyone by surprise. Going to the country would give her a renewed - and direct, in the sense that she would be installed as Prime Minister by the electorate, rather than by her own party - mandate to take the UK through Brexit with less interference from political forces currently aligned against her. Her reasoning is that the end result i.e. the *quality* of the Brexit eventually negotiated with the EU, is likely to be higher. The markets had known that she and her team were already beginning to have a tough time, from almost all angles, including the unelected House of Lords. The formal Brexit has only just begun, so a few months apparent delay can be accommodated now, and potentially offset by having a more powerful negotiating position after the election. Thereafter, and through to the final divorce, the UK's political stability should be better assured. The next general election wasn't to have been held until

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2020. The FT quoted a recent poll placing May's Conservative Party 21% ahead of Labour, although another put this at 18%; either way, such a lead should be translated into a further increased parliamentary majority above the current 17. Mrs May took power in July last year after the Brexiteers won the referendum, leading to David Cameron stepping down and Conservative members voting her in. The Labour Party is in deep disarray, led by an old-fashioned left-wing politician unpopular within his own party. It would be a bonus for Mrs May to be able to deliver a knock-out blow to Labour, after which Mr Corbyn would have to resign, and way ahead of what would have been the next scheduled election. With a stronger mandate to act, and with less interference from troublesome elements (including some hard-line Euro-skeptics in her own party), Mrs May and her team should be in a much better position to conclude a UK-EU free-trade deal, and they will of course also refresh the whole Conservative Manifesto. After the 8th June election, the next general election wouldn't have to be until June, 2022, way after the finalization of Brexit negotiations in 2019 and the start of any transition period – so the UK Brexit team would be able to concentrate on the job at hand, rather than beginning to worry about elections in 2020. If Mrs May has a larger majority she will not be at the mercy of Euro-skeptics seeking a relatively 'Hard' Brexit.

One of the prediction websites has suggested the Conservatives could win an extra 50 or so seats, based on their current substantial lead in the polls - although it could be much more. The June election is troublesome for the Scottish National party, which had called for a second independence referendum by mid-2019, although their mandate for such a vote would be renewed. **So what does this all mean for UK asset markets?**

"The likelihood of our $1.35-1.40 year-end sterling recommendation working just went up"

Sterling rose quite sharply after the election announcement, on the basis that the Conservatives are very likely to win the election, and by what could be a very good margin, possibly delivering a much higher majority in the House of Commons as discussed above. For the last couple of years our Asset Allocation Committee has had difficulty formalizing a view on UK assets. First there was the Scottish Referendum, then a UK general election, followed by the Brexit vote - and then the surprise result of that, so the uncertainty has been considerable - and even if the UK equity market did very well on the back of the boost to export earnings from very weak sterling last year, overseas investors had to successfully navigate the currency. From this point we expect (assuming a Conservative win) UK investment risk to begin to subside, and as the visibility of Brexit improves. Accordingly we will place UK assets in the 'studying much more carefully' category, given our expectation that the end result of Brexit should be better than many originally expected. **We are standing by the Outlook 2017 prediction that by year-end sterling should be in the $1.35-1.40 range, vs. $1.2817 as we go to print, and we believe that outcome now looks much more certain.**

"Investors are most worried by the chance that no Centrist reaches the French second round"

Will France become the latest country to succumb to populism? - be it the far-right, or the far-left, either of which would have serious implications for the nature of France's continued membership of the EU, and for the EU itself. By the time you have read this, we may have much of the answer. By way of background, the socialist, Benoît Hamon, appears to be lagging, while the Republican, François Fillon, may still have been mortally wounded by the 'fake jobs' scandal involving his family. According to the polls, the front-runners were Marine Le Pen (Front National) and Emmanuel Macron (independent, centrist), closely followed by Jean-Luc Mélenchon (far-left). Youth unemployment is a key issue, within the context of a rigid and often inefficient economy in need of structural reforms. Otherwise, the electorate is concerned about security issues, as well as by the ongoing discussion regarding immigration. Le Pen and Mélenchon want to either leave the EU, a return to the French franc, and/or to renegotiate key treaties within the EU. Many following the campaign have expressed the view that it would be a great relief if either Macron or Fillon make it into the second round, due on 7th May. In summary, this is all a huge change from the centre-right and centre-left parties that have dominated French politics for many decades. Mr Macron is very pro-EU, whereas a tangible lead for Le Pen - or especially Macon and Fillon *both* leaving the contest - would hurt European markets next week. Le Pen has been called the choice of 'unhappy France', vs. the 'optimistic' France of Macron. **We do remain overweight in European equities (although tactically reduced from a few months ago), and our euro exposure is partially hedged; fundamentally we like European equities as a class, and absent a total disaster in French politics the Asset Allocation Committee would like to rebuild the overweight.**

"We currently have a 'neutral' investment view on Turkish assets"

Early last week, Turkey's President Erdogan declared victory in a referendum granting him sweeping powers, getting rid of the role of Prime Minister, and based on about 51.2% of the vote. Most of the changes will only take effect after the next elections, due in 2019, once the AK Party has presumably won. Many European politicians are concerned by this further concentration of political power in the country, with the probability that any discussion regarding its EU membership is now on ice. The new-style presidency will cease to be a non-partisan job, so Mr Erdogan will be able to restore ties with the ruling AK Party he co-founded. The winner of the next scheduled presidential election, in November 2019 (or any snap election called earlier) will be able to issue decrees with the force of law. Economic activity has been hurt by political events and violence in recent years, with FDI and previously important tourism revenues hit hard. It is to be hoped that this election result will result in some political calm, and a more stable economic performance; it is clearly far too soon to tell, although certainly the Turkish lira has shown reduced volatility in recent days. **We had turned positive on Turkish assets in the wake of the coup last year, and after the vote last week now have a 'neutral' view.**

"Off a small base, Chinese equities are now destined to become a more important global asset class"

As mentioned in the opening paragraph, it was announced that China's economy grew 6.9% in the first quarter from a year earlier, vs. expectations of 6.8%. This was due to an increase in investment, very good retail sales growth, and an acceleration in industrial production. Government infrastructure spending has been a driving force, and also still buoyant (- or over-heated) housing markets. The official target is for growth of about 6.5% this year, down from last year's range of 6.5-7.0%. Within the first quarter result, fixed-asset investment grew by 9.2%, up from 8.1% last year, retail sales increased 10.9% from the comparable quarter a year ago (vs. Bloomberg expectations of 9.7%), and industrial output rose 7.6% vs. the comparable quarter (vs. expectations of 6.3%). The majority of analysts have been expecting GDP growth to slow, and also as a credit squeeze designed to take the heat out of real estate prices bites. **Despite the transition pains inherent in the transition towards a more consumption-led economy - and by their own admission, some difficulties in measuring GDP data - we are now viewing selected Chinese asset classes more favourably, as will be seen in the Investment Summary below. These are admittedly baby steps, but then the Chinese 'investable' index percentages in global indices are still small.**

"The latest global growth update from the IMF is very heartening, and supports our optimistic 'Outlook 2017' investment stance"

The world economy is improving, according to the IMF's latest World Economic Outlook. The report forecasts global growth this year of 3.5%, up slightly from their earlier January forecast of 3.4%, and vs. the 3.1% estimated for 2016, followed by 3.6% for 2018 (unchanged from January). While this is only a small improvement, it is the direction that counts, as well as the fact that for some years investors have grown accustomed to consensus growth forecasts being reduced from the second quarter onwards. The IMF has once again warned of factors that could adversely affect its forecasts, especially protectionism, referred to as 'trade warfare' during a presentation of their findings. They did not specifically mention Donald Trump's promise to always put "America first", but US Commerce Secretary Ross was quoted as having railed against the IMF's protectionist concerns. The overall tenor of their report is - at least by comparison to recent years - actually quite optimistic. Maurice Obstfeldt, their Chief Economist, wrote: "The global economy seems to be gaining momentum - we could be at a turning point". Investors have been aware that for some years (since the Great Recession of 2008-2009) the world economy has collectively been unable to reach 'escape velocity', seemingly being in a state of constant hoped-for recovery, but never coming close to its growth potential. However, the IMF now sees helpful buoyant financial markets, and "a long-awaited cyclical recovery in manufacturing and trade", adding that "The economic upswing that we have expected for some time seems to be materializing…". **For the IMF, these are relatively strong words.** Amongst the larger economies, none are expected to experience a reduction of economic activity this year or next. The emerging world should grow at an average of 4.5% this year, followed by 4.8% in 2018, after 4.1% in 2016, and a degree of commodity price recovery has helped (although some of this has recently been given back). Positives such as better Asian export growth are an important part of a story of improving global trade, and increasing demand for container ships is a marker for this. Estimated to have grown by 2.2% last year, the IMF expects global trade volume to grow by 3.8% this year, and by 3.9% in 2018. We always watch the rate at which economies are sucking in imports (especially in the case of China), to gauge domestic demand, so recent growth in Chinese imports of up to 20% underlines that growth there is good, albeit with some excesses. The IMF expects Chinese growth of 6.6% this year and 6.2% for 2018, after 6.7% in 2016, at the same time repeating commentators' usual warnings regarding the over-use of credit, including 'shadow banking'. **Growth rates in the emerging world are out-stripping those in the developed nations - and now that the evidence is increasingly supportive of this we have begun to more fully reflect this in investment policy.**

"The IMF underlined the positive outlook for growth and trade in the 'ASEAN-5' countries"

Staying with the IMF forecasts, even economies such as Brazil and Russia, problematic in recent years, are expected to see some growth this year. The IMF increased their growth forecast for India's fiscal 2016-17 to 6.8% (up from 6.6%), leaving 2017-18 unchanged at 7.2%. The 2017 growth forecast for what they call the 'ASEAN-5 countries' (Indonesia, Malaysia, the Philippines, Singapore and Thailand), was revised up to 4.9%. Turning to Japan, growth of 1.2% is now expected in the current year (up 0.4 of a percentage point from their January forecast), driven by improving net exports. In the eurozone, easy financial conditions and a weaker euro are supporting growth, which is now expected to be 1.7% this year, marginally up (0.1%) from January. The IMF expects US growth to be 2.3% this year and 2.5% next year (both unchanged from January), after 1.6% last year, although realistically they may edge this down slightly in the months to come given the delay following proposed healthcare reform (although this doesn't worry us). In our own region, their Saudi Arabian 2017 growth forecast stands at 0.4%, with a reduction to 1.3% for 2018 (from 2.3%), due to lower oil production and a tighter fiscal situation. Iraq's economy is now expected to contract by 3.1% in 2017, after recovering to 10.1% last year on higher oil exports. **One of the most notable changes made in forecasts was for the UAE for 2018: 4.4%, up from the previous forecast of 3.1%.** Readers won't be surprised to hear that their 2017 UAE growth forecast has been reduced to 1.5% (from 2.5% last October), after 2016's 2.7%. **In Outlook 2017 we wrote that we expected global growth to be revised upwards from the 3.4% (based on the IMF number at the time), and this has begun to happen. Remaining conservative, the IMF has so far left their assumption for 2018 unchanged, at 3.6%, although we are now more adamant that will be subject to upward revision, step-by-step. We really don't agree with bearish prognostications for risk assets, and we continue to expect an elongated global economic cycle, with important structural (rather than cyclical) elements to it.**

"The Asset Allocation Committee has for the first time overweighted Asia-Pacific Equities (ex-Japan)"

INVESTMENT SUMMARY: The Asset Allocation Committee met late last week and made the following decisions regarding investment policy: **(1) To increase the already underweight position in Government Bonds (developed markets)** - on the basis that (a) short-term adjustments to US growth and inflation expectations had been made, although with (b) the continued belief that the Trump Administration would still make highly beneficial policy adjustments, in time for growth to be boosted from 2018 onwards, and (c) that the publication of authoritative reports such as the IMF's last week underlines growth - and growth mitigates against even lower Government bond yields, and should in time result in moderately higher interest rates. Also, **(2) To move overweight in Asia Pacific Equities (ex-Japan), as defined by the relevant MSCI index.** This move is initially a small one, but the logic (underlined by the EM – and especially Asian - growth 'tilt' in the IMF report) is very significant. What are the components of the index (which is 3.5% of the Balanced, and 5.5% of the Growth benchmarks respectively), so we know which countries are included? Most important is **China (**20.9%), then **Australia (**20.3%), **South Korea (**13.8%), **Hong Kong (**13.5%), **Taiwan (**11.3%), **Singapore (3.6%), Malaysia, Indonesia & India** (each approximately 2.3%), and **Thailand (**2.1%). The weighted earnings growth for this index is expected to be an impressive 17.4% in the current year, comparing very favourably with the prospective P/E of 13.6x, with growth of 8.8% expected for 2018 that is very likely to be revised upwards. Japanese equities as an asset class are under review. **Despite the various potential geopolitical flashpoints, the work of asset allocation must continue, and the AA Committee has increased its overall medium-term 'risk-on' stance.**

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