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Second Quarter 2019

The second quarter of 2019 looks like a repeat of the previous three quarters rolled together into one. In April, as in the third quarter of 2018, stocks and bond yields both rose, with the S&P 500 closing the month at an all-time high. Trade concerns then kicked in again in May as continued fears over US-China tariffs stole the show and equities sold off sharply. The MSCI World index fell over 6% in the month. In a flight to safety market, government bonds were a safe haven with the US 10yr Treasury yield falling from 2.5% to 2.12% and the equivalent UK Gilt yield falling from 1.18% to 0.89%. June arrived and as quickly as equities had fallen, they rallied into quarter end. Continued dovish tones from major central banks helped yield to fall in June, although to a much lesser extent than seen in May.

Having been spooked in the past by concerns of bad economic data being bad news for equity markets, the US Federal Reserve and European Central Bank once again eased investor's nerves at the back end of the quarter with indications that further monetary stimulus would take place if economic data continued to weaken. Bad news is good news once again.

In the recent quarter, the European EuroStoxx 50 returned +6.2%, the US S&P 500 +4.3% and the UK's FTSE 100 +3.3%. Emerging Markets suffered from trade tensions and gained merely 0.7%. Unsurprisingly May hurt emerging Markets particularly badly. Japan caught a cold from the Asian trade tensions and despite tracking other developed markets for much of the quarter, failed to capture the rally in June and ultimately just about broke even. All in all, the MSCI World index finished the first half of 2019 up 15.6%, the largest first half gain since 1998.

Fixed income returns were less diverse, with investment grade credit leading the way at +3.9%, European and US sovereign bonds making just over 3% and high yield gaining the least at +2.5%. For the quarter, and year to date, peripheral European government bonds have done best as their yields continue to fall in line with the more core nations. US Treasuries have gained over 5% year to date as the market has moved from expecting one or two hikes in 2019 to currently pricing in two cuts by year end.

As we noted in the last quarterly commentary, manufacturing data remains weak. Having fallen below 50 in the Eurozone during the first quarter, the Purchasing Manager's Index continue that trend in the second quarter. Germany remains especially weak as trade concerns hit exports to China in particular. With an election year in 2020 looming, President Trump's enthusiasm to come to a deal on trade with China is likely to increase to provide him with a cornerstone for a re-election campaign which could eventually provide the stimulus for a recovery in this data.

Economic data in the UK fell sharply during the quarter, with Manufacturing and Construction numbers falling below 50 in May and continued their descent in June despite economists predicting a small recovery. During April and despite the 1922 Committee ruling out changing leadership rules, 70 Conservative Associations signed a petition calling for a vote of no confidence in Theresa May's leadership. Eventually the PM announced her resignation on 24th May. Boris Johnson and Jeremy Hunt are the two remaining candidates to lead both party and country, offering differing Brexit approaches that the Conservative Party membership will decide between.

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Outlook

Bond and equity markets are currently showing conflicted signs to markets. Equities appreciate China stimulating their economy, a likely trade deal in the near future, and the US Fed about to embark on easing as positive signs and continue to set new highs and look even higher. On the other hand, bond markets are decidedly more negative. Global data has weakened recently, inflation appears under control and in the US, EU, and UK, is at or below targeted levels.

Until this dichotomy is resolved, it is difficult to take a strong view on which asset classes will perform best. As we noted last quarter, the cuts to interest rates in the US that the market is currently pricing in over the next 18 months appears aggressive to us, unless data worsens significantly.

Lower rates would provide a cooling of US Dollar strength which classically provides impetus for emerging markets to continue their recent strong run. US-China trade wars could always derail this support but we believe President Trump's enthusiasm to start a re-election campaign on the strong foot will see this problem solved before long. Combined with stimulus in the form of infrastructure spending and possibly even the easing of monetary policy, emerging markets remain at the cheaper end of the global market in our view.

The UK seems most isolated from trade war concerns, albeit only because Brexit could be a bigger problem if the outcome is market unfriendly. Politics in Europe remain a source of acute concern as the increasing support for populist parties in Italy and the 'gilets jaunes' in France, combined with the threat of the EU being next in President Trump's eye line for a tariff 'negotiation' make the picture quite hazy. Having sold our only direct European equity exposure in the fourth quarter of 2018, market weakness there could offer the opportunity to buy in at more attractive levels.

In equity market terms, 2019 was the strongest start to the year since 1998 (as measured by the return of the broad MSCI World index). It's not impossible, but we think it quite unlikely, that the second half will see returns as strong as the first half. Maintaining a balanced portfolio, according to an investor's risk preference, remains key for long term successful investing in our view.