FE RESEARCH

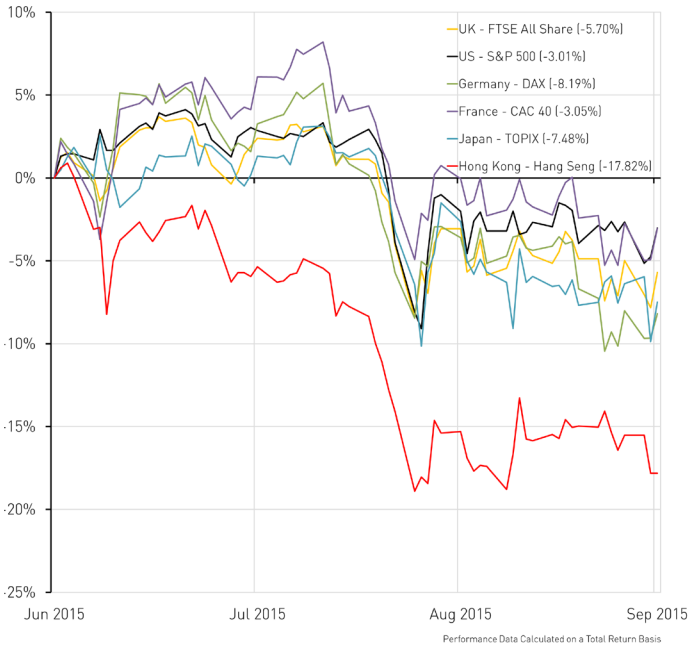
BE BETTER INFORMED

# AUTUMN OUTLOOK

## REVIEW OF THE PAST QUARTER:

The summer was dominated by fears of a China led financial crisis which caused markets to shudder August. The worst day, described as 'Black Monday', saw FTSE 100 close down 4.6 per cent, its largest decline since March 2009. The decision by the Chinese central bank to devalue the yuan sparked a huge global sell-off reminding investors that markets are far more correlated than they would like them to be. Meanwhile, inflation remained persistently low in the UK; owing to a fresh fall in the price of oil to as low as $43 per barrel. Jeremy Corbyn's victory in the Labour leadership election was a surprise, but had little impact on markets.

While Europe has been struggling with the migrant crisis; economics still managed to come to the fore when European Central Bank president Mario Draghi announced the real possibility for further quantitative easing, to inject life into what is a shallow recovery. A third bailout for Greece was struck between parliament and various creditors to avert any further deterioration in the country's Eurozone membership in the short-term. Elsewhere, the US continued along its path to modest recovery as unemployment fell to its lowest level since April 2008. However this was still not enough to convince the Federal Reserve, as interest rates were kept on hold again.



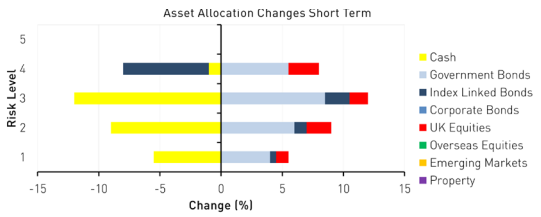

## ASSET CLASS RETURNS

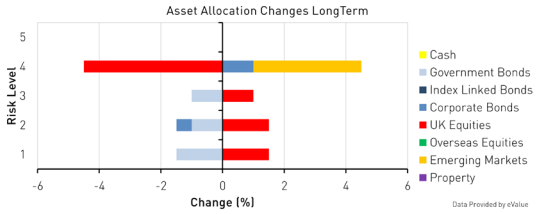
| UK | US | Japan | Europe | Emerging Markets | Commodities | Property | Corporate Bond | Gilts | Cash |
|---|---|---|---|---|---|---|---|---|---|
| -5.70% | -3.01% | -8.43% | -4.90% | -14.76% | -15.43% | +2.11% | +0.71% | +3.12% | +0.12% |

## THE ACTUARIAL VIEW:

Fear, uncertainty and doubt have dominated market behaviour for the last quarter. This has generally led to a poor time for most asset classes; market interest rates crept higher, while equities fell heavily. In particular a rise in European yields has improved the prospects for high yield and global government bonds. In equities; the prospects for emerging markets and Europe have improved the most, whereas Japan has improved the least. The only asset class whose prospects have not improved is property, where prices have remained stubbornly high.

A period of higher rates and cheaper shares would generally be expected to translate to an improved outlook for most asset classes, and in that sense there is a bright side to recent market events. This allows for a more aggressive asset allocation. In light of this, the short term, low risk portfolios have seen a shift away from cash to fixed interest. For the longer term, higher risk portfolios there has been less of a dramatic shift, with a slight move away from fixed income coupled with greater UK exposure at the lower risk levels and more emerging markets at the highest.




## WHAT TO LOOK FOR IN Q4:

- **Fed Meetings:** The next Fed meetings are scheduled for 27-28 October and 15-16 December. September's decision was understood to be a close call, however lingering concerns over the global fallout from the slowdown in China, and sustained commodity pressures keeping inflation low, mean that a rise by the end of the year may not be a guarantee. The Federal Open Market Committee still advocate that rates will only be increased gradually, so as not to stall the moderate recovery.
- **BoE Monetary Policy Committee Announcements:** Due on 8 October, 5 November and 10 December. The renewed fall in oil prices over the second quarter is likely to keep inflation low until at least the end of the year. The Bank of England's base rate historically follows the trajectory of the Federal Funds Rate, so emerging market headwinds should be more of prevailing factor for UK growth rather than any domestic issues on employment or spare capacity.
- **ECB Governing Council Meeting Decision on Rates:** The next announcements are due on 22 October and 3 December. At the last meeting, European Central Bank President Mario Draghi hinted that the existing stimulus programme may be expanded to aid inflation growth. On the other hand, the cheaper euro combined with a hesitant recovery are unlikely to yield a rise anytime soon.
- **China Slowdown:** The world's second largest economy has not been enjoying an easy ride of late, as Beijing attempts to manoeuvre the country away from one that relies on industry, to one led by consumption. Year to date gains on the Shanghai Composite index have been erased whilst there remains outright scepticism over the validity of economic data being reported.

# ASSET CLASS SCENARIOS:

## UK EQUITY

**Most Likely:** The FTSE 100 Index is likely to be held back by its high exposure to mining and energy companies and will probably be at a similar level in three months' time. A broader play on the domestic UK economy can be found with the FTSE 250 Index, which looks more promising; low inflation will be aided by another decline in oil prices, which means that real wage growth should continue to perform strongly. The services sector will remain a key driver of UK growth.

**Worst Case:** Construction and manufacturing could slow considerably and hinder overall growth. Manufacturing sentiment could drop further as a strong pound and slowing China cause orders to fall. Productivity growth remains weak which means wage growth is unsustainable and further economic expansion is impossible. Concerns over the implementation of the UK living wage may also put firms off hiring.

**Best Case:** Strong wage growth, low inflation and increasing consumer spending should provide positive economic growth. A resilient Eurozone and the US will provide additional tailwinds for consumer and business confidence, as UK equities surprise on the upside. As a result, this should boost business investment and activity whilst interest rates stay low.

## GLOBAL EQUITY

**Most Likely:** The US economy will grow at a moderate pace as indicators suggest that it is getting close to full employment. The ECB's quantitative easing programme should continue to support the region's recovery whilst the Greek situation is quelled to keep market volatility low. The outlook for European and Japanese equities remains bullish with the respective stimulus programme and corporate reforms currently playing out.

**Worst Case:** Market volatility, which is already high, could move higher now that Alexander Tsipras has been re-elected as Greek Prime Minister and is demanding debt relief, with Germany still vehemently opposed to the idea. The Federal Reserve could still raise interest rates by the end of the year, whilst the strength of the dollar is another cause for concern for already weak US corporate earnings.

**Best Case:** Lowered expectations of a rate rise weaken the US Dollar and low commodity prices keep a lid on inflation; providing a boost to consumer confidence and spending, while also boosting export performance. An expansion of the stimulus programme put in place by the ECB will push equity prices higher across the Eurozone, with companies beginning to report improvements in corporate earnings growth as demand picks-up.

## EMERGING MARKET EQUITY

**Most Likely:** The fallout from the Chinese slowdown creates an overall negative outlook for the region. China and India will still continue to enjoy mid-single digit growth, however short-term market volatility is likely to be high. Market volatility could spike to levels last seen during the Asian Crisis of 1998, however fundamentals are significantly better today.

**Worst Case:** Brazil's credit-rating downgrade to junk status highlights the fragile nature of the economy going forward, whilst Russia will also remain in recession to provide a drag on EM equities. Exports have collapsed which is putting pressure on the growth prospects of commodity dependent economies, whilst many EM currencies could fall further and surpass their historic lows, especially if US interest rates rise.

**Best Case:** Upward pressure on wages and improving consumption in China will enable the economy to successfully steer itself away from stressed sectors such as housing and manufacturing. Significant valuation opportunities shrouded by dollar strength remain, with India especially compelling; as pro-market reforms continue to attract more investment into the country.

## CASH

**Most Likely:** Even if interest rates do rise in the final quarter, returns on cash will remain unaffected and extremely low in the short-term. Given the wider macroeconomic picture and the potential risk in bonds it can still be prudent to hold cash in a portfolio. Inflation risk should not be a concern until early next year at least, as the fall in commodity prices keeps prices down.

**Worst Case:** As ever, the worst case scenario for savers is a steady erosion of their already-low returns through inflation. If real wage growth continues without a corresponding increase in productivity this could be a real problem, especially as low levels of unemployment limit the spare capacity of many economies, putting further upward pressure on wages.

**Best Case:** An end-of-year rise in rates could result in an increase in the returns to savers, although these rises would only be minor and with a time lag, therefore it is unlikely that much of a difference would be seen.

## FIXED INCOME

**Most Likely:** As speculation ramps up over the timing of an interest rate rise, there will no doubt be further bond market volatility to deal with. Short-term European sovereign yields will continue to stay below zero as the ECB's asset purchase programme looks to stabilise the market. Liquidity remains the biggest concern right now in sovereign debt.

**Worst Case:** The slowdown in China and the shock in commodity prices will continue to severely affect credit markets, forcing credit spreads to widen. Deteriorating liquidity is stretching valuations and lowering yields in US treasuries, however these will still remain more attractive than European sovereign bond yields. Emerging market debt remains challenging on the back of an ever strengthening US dollar.

**Best Case:** A robust recovery in the US and Europe will bode well for credit markets, which should perform even if interest rates rise. Yields will also slowly normalise, with value opportunities available in the European and US High Yield markets. A rise in interest rates could help emerging markets to restore capital discipline and reduce overall bond market volatility.

## PROPERTY

**Most Likely:** The sluggish pace of new house building means that house prices are still rising, with growth still uneven across the regions. Commercial real estate should enjoy some good returns, owing to rising yields as the recovery continues. The European real estate market lags the rest of the world in terms of demand and growth, so continues to offer more value than the UK.

**Worst Case:** An increase in rates will impact residential property, making mortgages more expensive and reducing demand from buyers. With most investment funds focusing on commercial property the effects will be less severe, with property funds more able to pass on increased costs to tenants, however vacant rates may increase hurting returns.

**Best Case:** With sovereign yields remaining depressed, property offers a chance of higher rental income to investors. Interest rates remain static avoiding any upset in the market. Commercial property remains attractive in Europe as the ECB's stimulus programme means yield premiums offered by property are far more attractive the government bonds.