Standard Life

# Market review May 2018

## An outlook of worldwide markets

For financial advisers only

**With UK markets reaching record highs, supported by sterling weakness, in this month's market review Andrew Milligan, Head of Global Strategy at Aberdeen Standard Investments considers what's driving markets and where investors can find opportunities. He also takes a closer look at emerging markets, US interest rates and what political uncertainty in Italy could mean for global financial markets.**

### Sterling reaches new lows against the US dollar and euro

Once again sterling fell back against other currencies, more so against the US dollar, less against the euro throughout the month of May. This was partly related to renewed worries about the UK's Brexit negotiations, more so due to the dollar's rally as capital was attracted by higher US bond yields.

The important thing to remember though is that the stock market is more sensitive to currency moves than the economy. A very large part of the profits of companies in the FTSE® 100 index come from overseas, and when these are translated back into sterling the effect of currency moves is very apparent.

On the other hand, the effect which currency moves have on the economy can take several years to show. It takes time for consumers and businesses to respond to a more or less competitive currency. This is particularly true for the UK – a major provider of services to the rest of the world, which are often less price sensitive. For the time being, at Aberdeen Standard Investments we're broadly neutral on UK equities, preferring faster growing overseas economies.

### Equities and bonds - economics and politics

Equities and bonds are responding to similar forces this year. On the plus side there's a growing realisation that the world economy will grow quite well, despite a poor start to 2018. Currently companies are flush with cash, so are hiring and investing more. On top of that, unemployment is coming down, wages are edging higher, and the US central bank has warned about further interest rate increases. And while profits growth may have peaked in the spring, it still looks very robust going into 2019, especially if oil and commodity prices hold up.

However, it won't all be smooth-sailing. Alongside such economic fundamentals, we also have to assess the importance of political events, such as the trade conflicts between the US and China, what's happening in Italy and Spain, or developments in the Middle East. Much of that news is not helpful for business confidence. All in all, at Aberdeen Standard Investments, we're overweight in global equities, supported by that profits growth, and underweight in global bonds, as yields are expected to rise and prices fall while central banks slowly tighten policy.

### US earnings soar but worries about trade grow - does market stability lie ahead?

Investors are being pushed and pulled between strong company profit news and a spate of worrying political developments in different countries. As such, I'm often asked if market stability lies ahead. While I would welcome a period of calm, I think it's quite unlikely. As one commentator on the US-China trade negotiations put it "I do not see a trade war but neither do I see a trade peace".

It's key to remember that President Trump's announcements - for example his plans to examine overseas competitors to the US car industry - are intended to support his voter base in the run-up to the November mid-term elections. So there's no reason for negotiations to proceed quickly or smoothly.

On top of that there's a range of other issues that trouble nervous investors. Current examples include the state of Italian and Spanish politics, or how higher interest rates and a rising US dollar are putting pressure on some important emerging markets such as Turkey.

We've said for some months now that we see 2018 as a return to normal levels of market volatility. We still see good growth opportunities in a variety of global equity markets, but more so at a stock or sector level to avoid some of the volatility we see ahead.

## US on track for interest rate rise

According to the latest set of minutes from the Fed, they're very clearly telling us they'll raise rates again in June and probably every three months into 2019 – as long as the upward trend in the US dollar doesn't do its work for it.

As US growth continues and lower unemployment allows higher wages, we expect the Fed will continue to raise rates until it fears too much more will do harm. The good news is that the majority of these Fed decisions are already priced into markets.

## Emerging markets still offer opportunities

Several factors, including Argentina's application to the International Monetary Fund (IMF) for a bailout, have raised concerns about emerging markets. At Aberdeen Standard Investments, we still like emerging markets but diversification and selection are key.

A point I emphasise is that emerging markets cover a very wide range of countries and regions. Russia isn't the same as the Philippines, and the Middle East is very different to Eastern Europe.

There are some common drivers, for example consumer demand in the West, but many differences. While some countries benefit from oil at $80 a barrel, others suffer.

For some years we've been exploring the vulnerabilities and risks of emerging markets faced with tighter US monetary policy. The good news is that most emerging markets are in a good position, with debt levels under control. The bad news is that there's a short list of countries which can suffer from such risks as US sanctions, a rising US dollar, geopolitical risks and poor government. For example, Turkey and Venezuela are very much in the news today.

There's no doubt emerging markets still offer opportunities, but it's crucial to be selective when choosing which emerging market debt or equity funds you buy.

## Political instability in Italy and the global economy

The political crisis in Italy dominated headlines towards the end of the month, as did the sharp reaction in European markets. We think there's certainly reason to worry that the political situation in Italy might possibly spill over into the global economy.

The backdrop is that Italy as one of the world's largest economies has a very large debt burden, little improvement in living standards since 2000, and a steady rise in support for populist parties.

The likelihood of Italy leaving the EU or the euro is still very low, because of the major damage that would cause the economy. However, we're likely to see bitter arguments between Rome and Brussels over the way forward for the Eurozone in general and Italy in particular. The European Central Bank (ECB) can only do so much to hold financial markets together when political uncertainty is rising so quickly. On balance, all this is likely to discourage global investors from raising their positions in European assets for some time.

**For an in-depth look at what's happening in global markets, read the Aberdeen Standard Investments Global Outlook June 2018**

**The information in this blog should not be regarded as financial advice. Please remember that the value of your investment can go down as well as up and may be worth less than you paid in.**

**Information is based on our understanding in June 2018.**

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