

## For financial advisers only

Andrew Milligan, Head of Global Strategy at Standard Life Investments, looks at how markets both domestically and globally are responding to continuing political and economic tensions.

### Political tensions and markets

On the whole, markets are coping quite well with the various political events which are making the headlines. For example, the US stock market is up over 12% year to date, at the time of writing, while Europe and Asia are doing even better, with returns closer to 20%.

**“This reflects the fact that global economies and businesses generally haven’t been affected by political tensions. In fact, many economists are raising their forecasts for global economic growth in 2017, and that’s before the impact of any major tax cuts in the US is felt.”**

Of course, it’s important to remember that individual markets are often affected on a day-to-day basis - say Spain after the recent vote. Tensions on the Korean peninsula also need to be monitored carefully. At Standard Life Investments, we still believe that actual conflict in Korea will be avoided due to the extremely high costs for all parties concerned, although the risk of miscalculation has certainly risen.

### German coalition discussions continue

Newspapers headlines have highlighted that the hard right and hard left parties have gained a noticeable representation in the German parliament. However, in truth the ability of these parties to affect the central thrust of policy-making in Germany will remain rather limited. Angela Merkel can form a workable coalition involving the Free Democratic Party (FDP) and Greens, together with her Christian Democratic Union (CDU) party and the Christian Social Union (CSU).

The coalition may not run smoothly in view of some noticeable differences over matters such as energy policy, taxation and European integration, and it could take some time to reach an agreement that satisfies all three partners - perhaps not until Christmas. However, the implications may be more important for the rest of the European Union (EU) than for domestic German policy. For example, the FDP has been vocal about enforcing EU fiscal rules through sanctions and a two-speed eurozone, contrary to recently expressed views from French president, Emmanuel Macron. As far as Brexit is concerned, the time taken to form a workable coalition will limit Mrs Merkel’s involvement in negotiations between the UK and the EU.

## Brexit negotiations start to provide more certainty

**“Financial markets are ebbing and flowing with day-to-day announcements of the cut and thrust about UK/EU negotiations. The key issue recently has been the signals that there may be a transitional agreement perhaps lasting several years”**

This provided more certainty to many UK and overseas businesses, and was one reason - alongside hints about an interest rate increase by the Bank of England - explaining a sharp jump in the pound against the dollar and euro. Conversely, a stronger currency is a negative for the FTSE® 100 index, as it includes many overseas earners, meaning that the UK market has underperformed many of its competitors in recent weeks.

## European economic outlook remains strong

The European economy certainly looks strong into 2018 - strong enough to allow the European Central Bank to start tapering its QE bond purchases and even consider raising interest rates. Germany, France and Spain are leading the way, while even Italy is seeing improved growth, all reflecting a beneficial cycle of lower unemployment, better consumption and more trade.

Of course a lot of good news has already been priced into European stock markets, which are up about 20% in local currency terms due to the wave of money leaving the US and investing in European assets in 2017. Going forwards, if the euro begins to fall back against the US dollar that might provide some more support for exporters in European countries, and financial companies would benefit from higher interest rates.

**“Because of this, Europe remains one of our favoured equity markets globally as we think company profits can remain solid into 2018.”**

## Rise in UK interest rates on the cards

A rise in UK interest rates in November is very likely and the financial markets have already largely priced this news into sterling, gilts and equities. A series of Bank of England speeches have spelled out very clearly why they're considering taking this action - the global withdrawal of QE, the inflation threat ahead and the ability of the economy to withstand policy tightening.

## The importance of China to the global economy

Looking into 2018, China remains very important for the global economy, especially emerging markets. The government has done a good job of making sure that economic growth remains above 6% a year, supporting consumer and business confidence, but this has been at the expense of a very sharp rise in public and private debt in recent years. Along with the UK, China's credit rating was also downgraded in September.

A key issue is that the government can control the banking system while it ensures that capital remains inside the country. An important issue for 2018 is whether the Communist Party will allow much more reform in parts of the economy, or whether it will rely on the debt engine to do its work for some time to come.

## And finally, Trump's presidency and the markets

**“The US stock market is up over 12% year to date. Part of this reflects the underlying economic strength of the US and indeed global economy - the US is benefitting from stronger export growth to Asian and European countries, for example. However, part of this growth reflects what Trump has done and not done.”**

The Republicans have recently announced the outline of a large tax-cutting package. Whether and how this can get through Congress is still the subject of some debate, but the positive effects on some US firms would be quite pronounced. Other businesses, for example in the financial, health and coal industries, are benefitting from easier regulation under the Trump administration.

Despite a lot of bluster about trade protectionism during his election campaign, President Trump has been quite cautious, for example in relation to China, or has moved slowly rather than rapidly, for example over renegotiation of the North Atlantic Free Trade Agreement (NAFTA). Of course, other aspects of policy-making are worrying markets, such as the tensions with North Korea and the turnover of senior staff in the White House. This may partly explain why the US dollar hasn't been one of the more favoured currencies in 2017. Whether that changes may depend on the success of the tax-cutting plans.

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(01) 639 7000 [www.standardlife.ie](http://www.standardlife.ie) [customerservice@standardlife.ie](mailto:customerservice@standardlife.ie)

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