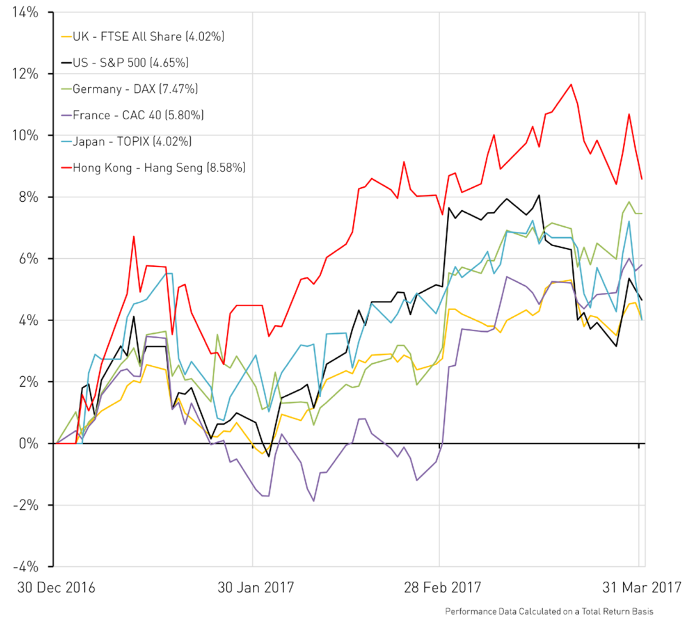
SPRING OUTLOOK

REVIEW OF THE PAST QUARTER:

Political events continued to drive markets in the first quarter of 2017; optimism surrounding the new US administration's pro-growth policies looked to be wearing thin after President Trump lost a battle in the form of the repeal and replacement of the Patient Protection and Affordable Care Act (commonly known as Obamacare), casting doubt on his ability to deliver any of his campaign promises. Strong US economic data led the Federal Reserve to an interest rate hike in March, encouraging analysts to take the Fed's projections of two further hikes more seriously.

Inflation continued to grind higher across most developed economies. Although the initial boost was largely due to climbing oil prices, UK core consumer price inflation (which strips out the effect of food and energy prices) climbed to the Bank of England's 2 per cent target in February. Despite oil propping up inflation, the increasing number of US drilling rigs is adding some downward pressure to the commodity's price.

In the UK, the activation of article 50 took place, signifying the beginning of divorce proceedings with the EU. The Netherlands election had been considered a benchmark for the remaining European elections this year and the result left fans of the EU feeling warm and fuzzy. The French election continues to keep investors on their toes as François Fillon's scandal could bolster support for far-right leader Marine Le Pen.



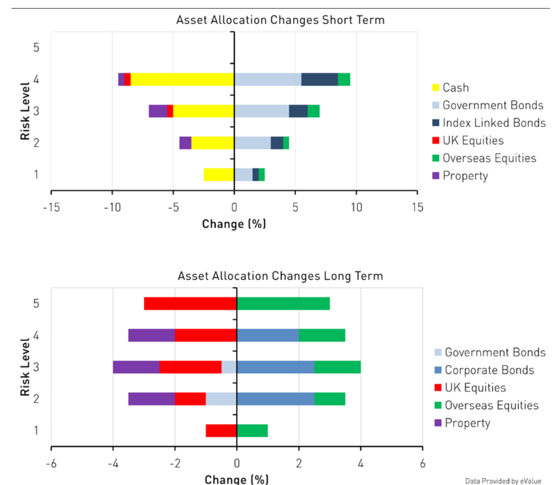
ASSET CLASS RETURNS

UK	US	Japan	Europe	Emerging Markets	Commodities	Property	Corporate Bond	Gilts	Cash
+4.02%	+4.65%	+4.02%	+7.33%	+10.13%	-6.18%	+0.71%	+1.72%	+1.62%	+0.02%

THE ACTUARIAL VIEW:

It has been an eventful three months both politically and economically, yet so far the full effects are still unknown. It was another good quarter for equities, although the UK lagged other developed markets. The most significant change, though, has been the increase in long-term interest rates across the board, although there have been different stories globally. In the US, rising wages and unemployment at record lows have led to the Federal Reserve raising short-term rates. Conversely in the EU, with unemployment falling (although not as dramatically as in the US), short-term rates have drifted down. UK rates have tracked the EU rather than the US.

The impact on the asset models has been that higher long-term rates improve the prospects for bonds in the short- and medium-term, leading to an increase in allocation and a reduction in cash. Other asset classes have seen limited moves. Prospects for emerging markets are still low, as a strong US dollar produces weak commodity demand and could cause problems in the servicing of US dollar-denominated debt. UK property prospects have deteriorated with new capacity, concerns about Brexit-related demand and the prospect of higher financing rates.



WHAT TO LOOK FOR IN Q2:

- **Bank of England Monetary Policy Committee (MPC) meetings:** At the MPC meetings on May 11 and June 15, interest rates are likely to remain flat, provided inflation doesn't stray too far above the 2 per cent target.
- **Federal Reserve meetings:** The Fed is due to meet on May 2-3 and June 13-14, where a further rate hike is likely if the US economy remains strong.
- **European Central Bank (ECB) meetings:** The ECB is due to have monetary-policy meetings on April 27 and June 8. The bank took a slightly more hawkish tone at the last meeting, declaring victory against deflation.
- **Eurozone elections:** Markets will continue to keep a close eye on the upcoming French election in May to see to what degree anti-establishment sentiment has spread in Europe.

ASSET CLASS SCENARIOS:

UK EQUITY

Most Likely: UK equities to be driven by the UK exchange rate in the near term, as the outcome of Brexit will not become clear for a while yet. FTSE 100 to continue outperforming FTSE 250 with short-term choppy markets as negotiation rhetoric evolves. Further rotations between growth and value stocks are likely as data continues to be erratic. The BoE's expected tolerance of sustained inflation will play in favour of stocks over bonds, especially inflation-hedged stocks.

Worst Case: Unfavourable Brexit negotiations sends the UK economy into recession, breaking the once-resilient consumer and cyclicals. Depreciation of UK sterling would continue to import inflation, eroding incomes/ profits. For an unlikely perfect storm, further oil price strength, could exacerbate stagflation and encourage the BoE into raising rates, hurting equity further.

Best Case: Brexit negotiations allow for interim concessions that keeps the UK consumer positive, driving growth across cyclicals. Continued access to euro growth and new trade partners; relative UK sterling weakness would benefit both local and exporters. Fiscal stimulus, though unlikely, will add as another driver of growth, allowing even the FTSE 250 to join the party.

GLOBAL EQUITY

Most Likely: Global equities are likely to be increasingly focused on political and policy uncertainty. European equities appear attractive with improving earnings, a weaker currency and rising inflation expectations. US equities could stumble if President Trump cannot deliver on tax reform and fiscal stimulus. We may finally see European and Japanese equities outperform largely overvalued US equities.

Worst Case: Markets could collapse if Marine Le Pen wins the upcoming French elections, given her policies to abandon the euro and angle for a potential 'Frexit'. Stretched valuations in US equities provide little reassurance, with a potential for risk-off events to weaken investor sentiment. Japanese equities could face headwinds if the yen strengthens, should investors adopt a more risk-averse stance.

Best Case: US equities would benefit if President Trump implements tax reform and fiscal stimulus. An election win for Emmanuel Macron in France and Martin Schulz in Germany would be market-friendly, leading to structural reforms in France and fiscal stimulus in Germany. An improving European economy with stronger earnings growth should give rise to greater opportunities. Japanese equities could benefit from attractive valuations, cyclical strength and stronger earnings prospects.

EMERGING MARKET EQUITY

Most Likely: Fundamentals in large emerging market economies Russia and Brazil are improving, so there is scope for good returns from those markets, possibly accelerated by rate cuts. China's economy is fairly stable, with demand for commodities supporting many of the countries in its supply chain, so our base case would be good returns from emerging markets as a whole.

Worst Case: If President Trump implements restrictions on trade with China, Mexico or more broadly, it could lead to falls in exports from those countries or in their currencies, both of which would be bad for UK sterling investors' returns. There remains the risk that China's highly-indebted economy struggles under its interest repayments and the government fails to control outflows from the currency, which means there is a tail-risk of a crisis that would drag in much of the region.

Best Case: If commodity prices rise and there are economic surprises to the upside, then we could see strong rallies in emerging markets. A falling US dollar could encourage international investors back into the region and lessen the debt burden in their economies.

CASH

Most Likely: Rates will remain low, if not be lowered further, and inflation may further pick up, reducing the appeal of cash. However, with the large amount of political and economic uncertainty in global markets, cash will retain its safe-haven appeal.

Worst Case: The next interest rate move is a cut, as the Bank of England tries to discourage savings. As the oil price continues to recover, returns across equity markets should improve, which not only lowers the relative return on cash, but also erodes the real return as inflation picks up.

Best Case: A scenario featuring shrinking global growth, rising interest rates and increased political risks could see simultaneous declines in both equity and fixed-income markets. In relative terms, it would imply that the neutral positioning of cash would outperform.

FIXED INCOME

Most Likely: We expect the Bank of England to keep rates unchanged as there is likely to be increasing concern about the UK economy as the Brexit negotiations get underway, so gilt yields should remain low. US yields are likely to drift up as economic news is strong, but the Federal Reserve's cautious pace of tightening should mean there are no large moves. High yield should benefit in this environment, although spreads are narrow, meaning returns are unlikely to be as high as last year.

Worst Case: If the Federal Reserve raises rates faster than markets expect, then US Treasuries could sell off sharply, pulling US and EU prices with them. Corporate bonds would likely do better in such an environment, however, as it would portend a rapidly improving economy. A rate rise in the UK could hit bond prices, but concerns about Brexit should limit any effect.

Best Case: Chaotic Brexit negotiations could see increasing risk-aversion in the UK and a rally in gilts back to the level they reached after last June's vote, and corporate bonds could sell off. There is an outside chance of a Marine Le Pen victory in France, which could lead to a rally in safe havens including US Treasuries and German Bunds, although a sell-off in French and peripheral European debt.

PROPERTY

Most Likely: Globally, income will continue to drive returns. We do not expect much capital value growth in most markets, and prime cities are likely to perform better than secondary ones. Noise is highly anticipated in the UK and continental Europe.

Worst Case: In the US, the Federal Reserve raises the target range quicker than anticipated by market participants, prompting a real estate investment trust (REIT) sell-off. For UK investors this could be subdued by a stronger US dollar. In Europe and the UK, the early stage of the Brexit negotiations could be damaging to the sector and trigger sales, but this seems unlikely to be as violent as during the summer of 2016.

Best Case: The UK government takes a leading position in negotiating a new deal with the EU. Growth data could surprise on the upside, which is always positive for property. In the US, the fall in capital values stabilises and the overall market is supported by the residential sector, which benefits from increased purchasing power.

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