Economic Background – June 2019

(Trade) War, what is it good for?

After fearing a global recession in the final quarter of 2018, following a raft of weakening economic data, optimism returned to markets in the first 4 months of 2019, as Central Banks eased monetary conditions with the US Federal Reserve (Fed) signalling it was expecting rates to remain unchanged for 2019. Rhetoric from both US and China had suggested a trade deal was close to being finalised and coupled with better than feared economic and corporate data, risk assets performed well.

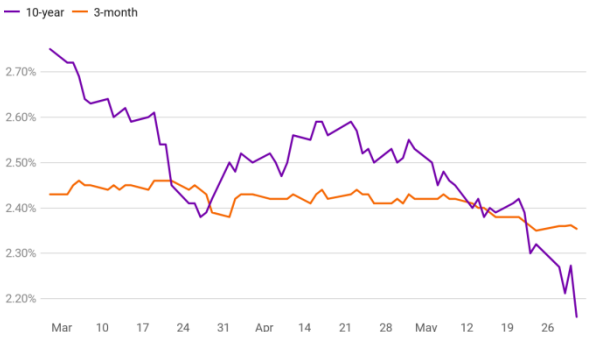
Consequently, the breakdown in talks between US and China at the start of May caught investors by surprise. President Trump used Twitter, to state that there was no rush to conclude the trade talks. The tweets came a few hours after the US increased tariffs on $200bn of Chinese products from 10% to 25% and mentioned that the process had begun to place additional tariffs of 25% on the remaining $300bn the US imports from China. China retaliated by increasing tariffs on $60bn of US imports. Since then relations between the two largest contributors to global GDP have deteriorated. President Trump ratcheted the conflict to a "tech war" increasing the technology restrictions on Chinese companies, with the blacklisting of Huawei. China retaliated by purchasing agricultural products from other areas of the globe and is reportedly looking to place controls on its exports of rare earths, elements that are critical to electronics and electric cars.

Source: Twitter

It's impossible to predict the outcome of this escalation but it is possible to analyse how each side wishes the end game to play out. President Trump has an election to win in 16 months' time and knows that if the US falls into recession during this period, the likelihood of his re-election is small. Chinese leaders have a much longer time frame to view economic declines, but a global recession would hit the regime hard at a time in their economic transition and when growth has fallen markedly. As we pass the 30th anniversary of the Tiananmen Square protests, it is a timely reminder of the differences between the political regimes.

As markets were absorbing the latest US-China actions, President Trump delivered a coup de grace towards the end of May by announcing that goods from Mexico would be subject to a 5% levy beginning on June 10. The move, which was reportedly opposed by his trade advisor Robert Lighthizer and US Secretary of Treasury Steven Mnuchin, would affect all imports and will rise 5% a month to 25% in October, unless action was taken on the migration "crisis" between Mexico and US. After 3 days of negotiation Mexico and US averted tariffs, after Mexico agreed to do more to curb the flow of migrants to the US border and to take back a higher number claiming asylum in the US. Alongside threatening to wipe out Iran and with India, Europe and Australia on President Trump's list of unfair trading partners this is a paradigm that is not going to be resolved soon and is likely to lead to more volatile markets in the following quarters.

US yield curve inversion



Source: CNBC

In US markets, after rising 18% through April, the S&P 500 fell 6.5% over May in US Dollar terms, with Energy and Information Technology sectors leading the decline. Given political uncertainty, the yield on US Treasury 10 Year bond collapsed to 2.09% at month end, from 2.51% at the end of April, as investors looked for safety and priced in US Federal Reserve rate cuts. In a move not seen since the summer of 2007, the US Treasury Yield curve inverted further with 1 month bonds yielding 2.35%, a +0.26% difference from the 10 year.

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The US Federal Reserve (Fed) is due to meet again in June and the bond market is expecting a downward shift in rate forecasts. At the beginning of the year two rate increases of 0.25% were expected, but markets are now discounting at least two interest rate decreases later this year. The members of the Fed committee, in public at least, remain steadfast that it would take a sustained period of inflation undershooting their target before an interest rate cut became necessary. With economic growth in evidence as of Q1of this year, it is difficult to identify the rationale for the Fed to cut in the short term unless there is a pronounced slowdown, and so a wait and see approach is more probable.

The 'known unknown'

On 6 June we passed the anniversary of the WWII Normandy landings. Prime Minister Theresa May, at one of her final engagements laid a memorial to commemorate the British troops that died in the summer of 1944. In the Prime Minister's announcement of her resignation, Mrs May remarked that her successor will face the same challenge of achieving a consensus over Brexit within Parliament that she had. Her potential successor's task is to persuade the Conservative MPs and the Conservative membership that they can. Following the success of the Brexit Party, in the European elections and the by-election in Peterborough it seems inevitable the Conservative party will turn to a 'hard' Brexit candidate. The first round of voting of Conservative MPs reduced the number of candidates from 10 to 7 and with Matt Hancock withdrawing after the ballot we now have 6. The current favourite to win the leadership contest is Boris Johnson after receiving 114 MPs votes in the ballot, more than twice the amount of his next competitor. Mr Johnson has stated that if he were to become the next Prime Minister he intends to see through Brexit by 31 October, with or without a deal. He has ruled out a snap election, a second referendum or a further delay. Currency markets seemed to agree with the prognosis that the perceived risk of a 'No Deal' Brexit has increased, as Sterling fell 3% against the US Dollar to 1.26 ($ to GBP) at the end of May, within 5% of its low in 2017. Of course what a candidate says prior to election and what they do when they are in the hot seat can be very different. Some commentators believe that if the new Prime Minister is intent on a no deal Brexit it can't be stopped, others that it can. It is the 'known unknown', with the uncertainty causing international investors to continue to be underinvested in the UK market, despite valuations at extremes.

Despite Jeremy Corbyn experiencing approval ratings worse than the incumbent Prime Minister, markets continue to worry about a Corbyn led government. Labour's desire to renationalise key utility companies and energy networks, including National Grid has caused the companies to re-rate. Labour has yet to spell out how they intend to compensate existing shareholders or how they intend to pay for it, it does not matter the damage has been done. In a possible bad case scenario, Labour could pay investors book value (assets – liabilities), for the companies rather than market value, which in some cases could be at a discount of 80% of the current price.

Inflation continues to be an issue for the European Central Bank (ECB), as it fell to 1.2% in May from 1.7% in April, well below the ECB's target and below consensus expectations. The ECB will meet in early June to discuss the options left to stimulate its various economies, with market expectations that the Bank will have to launch another round of monetary stimulus. The US-China trade conflict has impacted the Eurozone and Germany in particular with manufacturing data continuing to disappoint. In Germany, May's Manufacturing PMI data showed a fifth month of contraction and German industrial production has declined 1.9% in April resulting in a 1.8% fall over the past year. The fall in industrial production outside of construction is another sign of slowing global demand as Germany faces cyclical headwinds. In France, overall business confidence improved slightly in April as industrial production rose and manufacturing stabilised. French exporters didn't enjoy the global upswing of 2017 and 2018, compared to Germany and so the global headwinds pose comparably less of a problem.

As the ECB prepares to publish details of its programme of cheap loans for Eurozone banks (TLTRO III), markets are considering how cheap the ECB's cash rate will go. This has driven the German 10 year government bond to a negative yield of -0.23%, from 0.01% at the start of the month and the Danish and Dutch 10yr bonds have gone negative. Conversely the Italian 10 year bond yield rose to 2.61% from 2.55% and now yields more than Greek debt, reflecting the concerns investors have over Italy's coalition government negotiation with the European Commission over its debt levels and the threatened introduction of a parallel currency.

On 1 May, as Emperor Naruhito ascended to the Japanese throne as its 126th Emperor, a new era began called 'Reiwa', translated as 'beautiful harmony'. The Japanese economy advanced unexpectedly by 0.5% in the three months to March of 2019, easily beating market expectations of a 0.1% contraction and after a downwardly revised 0.4% growth in the previous period. Inflation remains well below Japan's 2% target. The Bank of Japan has limited tools left after leaving interest rates unchanged to at least until spring 2020, so it falls to Prime Minister Shinzo Abe to provide stimulus. However Abe has a

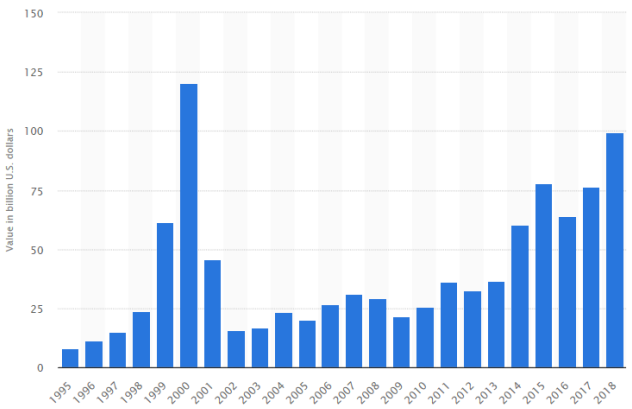
course of fiscal tightening on the agenda, with a plan to raise consumption tax from 8% to 10% in October. Given the state of the local and global trade he may have to postpone these ideas.

Anyone want a Unicorn?

Quantitative easing (QE) in the US first started in November 2008, when the Fed announced it would purchase $800bn in US debt. Two further rounds of QE followed and the Fed eventually held $4.5 trillion in assets by 2014, a six fold increase in US Treasuries it held prior to November 2008. The purpose of QE was multi-faceted, it provided liquidity to the banking sector, it increased money supply and it lowered yields on sovereign bonds, allowing governments to borrow at cheaper rates, which would in turn allow them to provide fiscal stimulus. Intended or not, by reducing the number of government bonds in use it pushed investors up the risk spectrum in the search for return.

This has led to the growth in global stock and fixed income markets, providing attractive returns over the past decade. Scarce assets, such as classic cars, fine art and wine saw similar increases, with venture and private equity investments also providing early investors with astronomical returns and attracting new entrants. The chart below shows investment into US Venture Capital firms has risen from $29.3 billion in 2008 to $99.5 billion in 2018. In levels not seen since the tech bubble of 1999/2000.

US Venture Capital investment, in $billions



Source: Statista

In investment parlance a unicorn is a privately held start-up company with a value of over $1 billion, the use of a mythical creature for these firms was intended to highlight the rarity of these firms, but over recent years the number of these rare beasts has risen from 38 in 2013 to 156[1] in America alone today.

Uber and Lyft are the latest of these firms to test the appetite of public investors. Lyft's (an online social car share service) IPO was on April 11th achieved a valuation of $24 billion or $72 per share, on 2018 revenues of $2.2 billion and net losses of $911.3 million. The stock price fell to $48 and has recovered to $61 as of mid-June.

Uber raised $8.1bn in capital on 9 May, offering at $45 a share, towards the low end of its indicative range, and below $48.77 which Uber sold to private investors three years ago. The stock price fell initially to $37, before recovering to $44 in mid-June.

The share price volatility of these unprofitable companies is driven by the highly speculative nature of their future cash flows, given their capital intensive nature and business model at this part of the business cycle. Many sectors such as taxi apps and robo-advisors, are still at a high risk stage of their development. Positive earnings and even good standards of governance seem like an anathema to them, as long as sales are growing.

WeWork is potentially the next high profile "unicorn" to IPO. With offices around the world (and Manchester) WeWork provides shared office space and services allowing businesses to shrink and grow the number of desks as they please. WeWork is already one of the biggest global corporate landlords, with ambitions to transform the way people work. It has added new business lines, some of which are tenuously related to office space, such as a private school and an indoor wave pool. The WeWork umbrella company reported annual losses of $1.93bn in 2018; with a reported a valuation of $47bn as it takes out long term leases on prime corporate buildings and provides flexibility for its users.

Whilst this is not a replica of the tech fuelled boom of 1999, it certainly has a lot of similarities.

[1] Source: Economist April 20th

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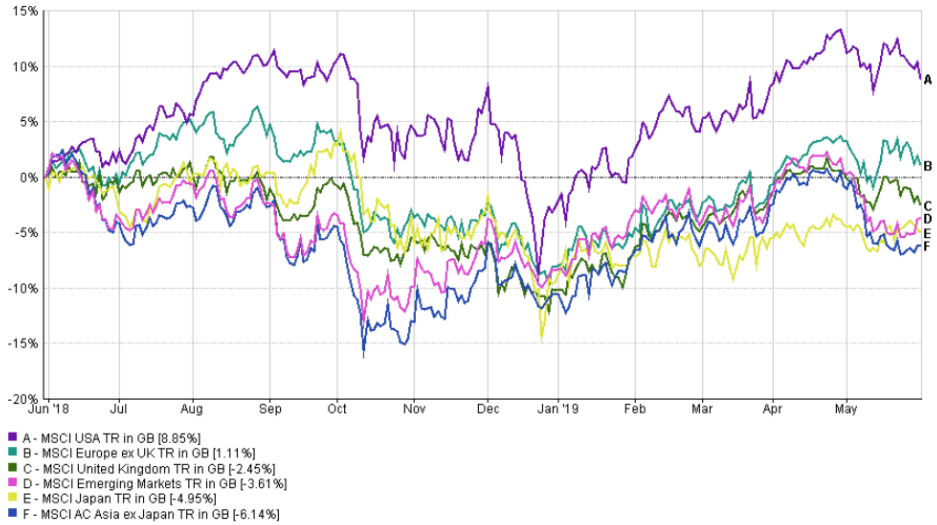
Market Summary

Global equity indices are heavily weighted (>60%) towards US companies. The US dominance of the global index is shown in the performance figures over the past year with the MSCI World index returning 5.3% compared to the MSCI World ex US index returning -0.2%, in Sterling terms.

1 Year MSCI Regional Indices, Total Return, Sterling[2]



Following excellent growth in the year through April, equity markets pulled back from their highs in May. The US market and in particular the high growth companies in the US, continue to lead the other regions over longer time periods, and it remains the most expensive region for equities. Within markets, investors continue to be willing to pay a premium for above average growth stories and for stocks that offer 'quality' and momentum. Meanwhile in the UK, value and cyclical stocks are unloved.

[2] Source: Financial Express.

As mentioned earlier, global Government bond yields collapsed in May, with the US yield curve pricing in rate cuts and whilst the Fed is reticent about using monetary policy now, if the trade war persists, growth will be hampered and they may be forced to act. Seen as the ultimate safe haven asset the German 10 year bund yield hit an all-time low in May.

Accompanying global concern of trade, UK markets continue to contend with an unstable political backdrop. Following the resignation of Prime Minister Theresa May, the perceived risk of a 'No deal' Brexit increased, consequently it is unsurprising that over the month Sterling declined 3% against the US Dollar to 1.26 ($ to GBP), within 5% of its low in 2017.

It is impossible to predict the next moves of the US-China trade war, although we don't believe Trump will risk a recession for it; however there is a possibility of a policy mistake. It does appear, however, that the trade dispute will take much longer to resolve than consensus had initially thought.

Market volatility has been dampened in recent years through a benign economic environment and accommodative central banks. Economic and market data in quarter 4 2018, May 2019 and the unconventional policies of populist leaders suggests that we should expect the current market volatility levels to be at least maintained.

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