TORELL & PARTNERS

Economic Background – July 2019

Starting All Over Again[1]

In Osaka, Japan the G20 (an international forum of government leaders, central banks and international organisations, accounting for at least 75% of world trade) met at the end of June to discuss amongst other things the major economic challenges. Shinzo Abe, the Japanese prime minister and G20 president for this year, had set an ambitious agenda of free and fair trade, taxation of the digital economy and how to tackle the global environmental challenge. The result of the talks was a warning that trade and geopolitical tension had increased and risks to the global economy "remain tilted to the downside". There was a bland statement on cooperation for a globally fair, sustainable and modern international tax system and only 19 countries signed up to the Paris Agreement on climate change, with the US rejecting the deal.

Since last year's G20, there had been increased concern then optimism that the trade dispute between the two largest economies in the world would be resolved. However the breakdown in talks in May this year caught many by surprise. The US chose to increase tariffs on $200bn of Chinese products and placed Huawei, the Chinese tech champion, under effective blacklisting. China in retaliation, increased tariffs on $60bn of US product and started purchasing agricultural products from other areas of the globe.

Global markets welcomed the G20 meeting of Presidents Donald Trump and Xi Jinping concluding that they would re-start negotiations. Although the immediate risk of an all-out trade war has been averted, they are in effect back to square one. The fundamental issues remain to be resolved, namely that there is a trade imbalance between the two countries, China does and will continue to have a subsidy policy, and the alleged intellectual property theft by China's companies. As President Trump conveyed the agreement via Twitter he also mentioned "the quality of the transaction is far more important to me than speed. I am in no hurry".

As Donald Trump launched his 2020 presidential campaign this month, perhaps China understands his timeline very well.

A bright spot from the summit was an announcement that the EU and Mercosur (a South American trading bloc) struck a trade deal. It has taken 2 decades to achieve. As the Financial Times notes, there is still caution as "the agreement still needs to be ratified by the national parliaments of all member countries of both blocs, as well as by the European Parliament and EU Council". A huge victory for the South American agribusiness sector; EU farmers, unsurprisingly, have not welcomed the deal. French President Macron might have some angry farmers on the roads this summer.

With the US-China negotiations continuing and the dispute with Mexico resolved after some rapid diplomacy and Mexican promises, Europe is next on the US president's agenda. Mario Draghi, the retiring European Central Bank (ECB) president has been accused of conducting a currency war by President Trump. In Mr Draghi's latest speech he outlined how the ECB could launch a new round of easing measures if the inflation outlook didn't improve. In response the US Trade Representative's office released a list of additional products that could be hit with further tariffs if the long running dispute over aircraft subsidies given to Boeing and European rival Airbus, is not resolved. The new list of additional products includes olives, Italian cheese and Scotch whisky, with the threat to increase tariffs on auto imports remaining.

Trade data continues to disappoint

The fear is that protectionist policies are occurring at a time when the global economy and trade is weak and becoming weaker. In the Bank of England's (BoE) analysis the direct effect on global GDP if all the tariffs proposed are implemented is -0.8%. However, as they point out, this does not account for negative indirect effects on business confidence and investment.

Fig.1 ***Global manufacturing PMI survey***

[1] Daryl Hall and John Oates, 1998

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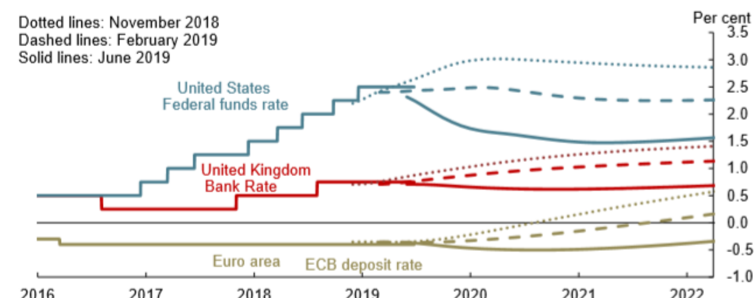
The latest global manufacturing Purchasing Managers' Index (PMI) survey is the lowest since October 2012 and is indicating falling global production for the first time since 2012. The Eurozone and the UK saw the steepest declines, with China and Japan also in contraction. China is a major driver of global growth and the 8.5% annual decline in imports in the latest data release is a major concern, even though it has received relatively little attention. The underlying data suggests that both Chinese domestic and global demand is slowing further, with business optimism falling, contraction in manufacturing and the service sector growth easing. China has recently provided new fiscal stimulus, with local government told to increase the use of bond issuance for large infrastructure projects. Beijing may need to do more in the short term. Likewise, G7 central banks are recognising the material slowdown and have changed the tone of their communications.

Lower for longer

Fig.2 ***Expected paths of policy rates have shifted sharply downwards***



Sources: Bank of England, Bloomberg Finance L.P., ECB, Federal Reserve, Eikon from Refinitiv, Tradeweb and Bank calculations.
Notes: The June 2019 and February 2019 and November 2018 curves are estimated using instantaneous forward overnight index swap rates in the 15 working days to 19 June 2019, 30 January 2019 and 24 October 2018 respectively. The federal funds rate shows the top of the target range.

June's decision by the US Federal Reserve (Fed) to hold rates at 2.25% - 2.5%, described as "insane" by President Trump, was accompanied with a change in language to their policy statement.

> *"Since the beginning of the year, we had been taking a patient stance toward assessing the need for any policy change. We now state that the Committee will closely monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion, with a strong labor market and inflation near its symmetric 2 percent objective."*

Fed Chair Jerome Powell, 25 June 2019, at the Council on Foreign Relations, New York.

The Fed has given itself room to manoeuvre on interest rates. US GDP growth is at 3.2%, unemployment at 3.6% and headline inflation at 1.8%, only slightly below their long term target of 2%. One would think there would have to be a serious deterioration in the near term outlook of data to support a cut. The Fed may well point to a lack of inflation and slowing economic and company data, as indicated in the slew of recent indicators. Supporting that view is the reiteration from Mr Powell recently that "an ounce of prevention is worth more than a pound of cure". The market is convinced that the Fed will cut rates on 31 July. In response the yield on the US 10 Year bond fell below 2% and equity markets have retaken their all-time highs, even though the US was 10 minutes away from war with Iran.

Following weakening global economic data, Mario Draghi indicated that he is prepared to do more to simulate the sluggish Eurozone economy. Unsurprisingly the Euro fell and the price of Eurozone sovereign debt rose. The amount of negative yielding debt has increased to an all-time high of $13 trillion. Austrian, French and Swedish 10 year yields went below zero, joining Japan, Germany, Netherlands, Switzerland, Denmark and Finland. The majority of 2 year sovereign debt in the Eurozone is currently trading with a negative yield. This does not augur well for the strength of the European economy.

European government bonds soar after ECB signals

French yields turn negative for the first time

Austria sells 'century bond' with yield of just 1.2%

Vienna's €1bn extension oversubscribed as investors clamber for returns

Portugal sells €1.25bn of long-term bonds at record low yields

German bond yield hits new low as investors pile into safe assets

Weak data from China add to worries over geopolitical tension in the Middle East

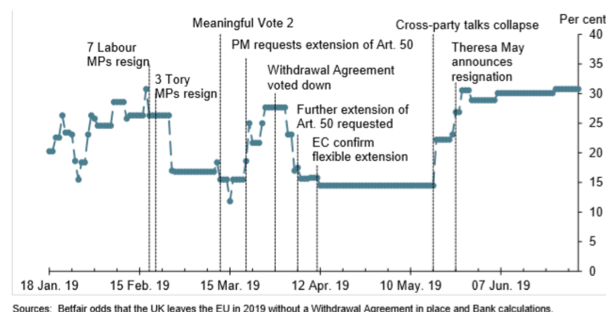
Buyers of negative yielding debt pay to hold the asset, rather than receive an income. Why would anyone do it?

1. Central banks, insurance companies and pension funds have to own safe, liquid assets to meet their current and future liabilities;

2. Investors operating in a different base currency might believe a foreign currency might rise and compensate for the negative yield;
3. Or an investor may choose the certainty of a known loss to the possibility of a larger one if they expect markets to be volatile.

With Draghi due to leave the ECB in October, European leaders have selected Christine Lagarde, the current Chair of the IMF and former French Economic Minister, as their nomination to be the new President of the ECB. Whilst the proposed appointment appears politically expedient, Lagarde is not an economist and has no experience of developing monetary policy. Nevertheless the market believes this is someone who will maintain the prolonged accommodative stance within the Eurozone. In our view the era of negative yields in Europe is unlikely to be changed in the short term, but perhaps the possibility of a policy mistake has increased.

Fig.3 ***Perceived probability of No Deal Brexit***



In its June meeting BoE's Monetary Policy Committee (MPC) voted unanimously to keep interest rates at 0.75%. Mark Carney, the Governor of the BoE, noted that the perceived likelihood of a no deal Brexit had increased with uncertainties putting pressure on UK forward interest rates (Fig.2). This has led to a decline in Sterling. GDP is expected to be 0.0% in Q2, with inflation at 2.0%. The MPC continues to assume if a 'smooth Brexit' outcome is achieved then a tightening of monetary policy would be appropriate. However, as Carney outlined in his 'Sea Change' speech recently, in recent months he has witnessed a "profound transformation in global financial markets". Alongside discussing how global protectionist policies could affect inflation and growth, he said the risks to the UK economy had increased, and so "the MPC would use the flexibility of its remit to support our economy's transition as much as possible". Gilt yields fell sharply on the news, with the 10 year bond trading below 0.70% having been above 1.20% at the beginning of May.

Equity market distortions

The effect of the change in policy rates around the world has driven bond yields lower and the lower discount rates have provided further support to equities despite the macro and corporate outlook becoming more uncertain. The lower for longer interest rate environment, tepid economic growth and a lack of inflation has resulted in investors' pursuit of companies with above average growth and 'disruptive' qualities. Investors are willing to pay a large premium for companies which can demonstrate growing revenues, cash flows and then reinvest those cash flows at good rates; in industries with a lack of strategic headwinds and undisturbed regulation. The rise of passive funds has intensified this trend, as momentum has driven the price of these assets higher. There are also 'disruptive' companies who choose turnover over profit and indeed are open that they may never make a profit. The valuations of these companies appear extreme.

Fig.4 ***The widening gap between highest and lowest valuation stock in S&P500, 20 June.***

Valuations are often described in broad market terms. For example, currently the S&P 500 has a forward price to earnings ratio (P/E) of 17x, slightly above its 10 year average of 15x. However markets are not a homogenous group and the gap in valuation between the top and bottom 20% of stocks has widened to the largest since the tech market collapse in 1999/00, as can be seen in Fig.4.

A number of fund managers, who select stocks based on the value, describe the market as an elastic band being stretched; eventually it has to snap back. It has been a painful investing environment for value managers over the past 10 years relative to other styles. The underperformance has persisted for a long time, however dislocations like this have happened before and the reversals tend to be swift. History suggests that over the long term valuations do matter. As the second quarter earnings season develops, the impact of

global trade tensions are having on earnings will become clearer. If there is deterioration in growth from the small cadre of 'consistent', 'quality' group of companies, perceived to be resilient to the market cycle, then the snap back could be sharp. If not, the elastic band will stretch further.

Brexit effect

The gap in valuation is not just a US event; it is also seen across developed and emerging markets. In the UK, the market also has to contend with the uncertainties of Brexit. Following Theresa May's resignation, the Conservative party members will appoint Boris Johnson or Jeremy Hunt as their new leader and prime minister on 22 July. As a leading 'Brexiteer', Boris Johnson is the overriding favourite. Pledging that the UK will leave the EU on 31 October, with or without the withdrawal agreement, Johnson has also ruled out a snap election, a second referendum or further delay. Whether leaving without an agreement is in his gift is up for debate, nevertheless the perceived probability the UK will leave without a deal has increased.

The permutations of a deal/no deal Brexit and the prospect of a General Election with the new Brexit Party riding high in opinion polls are wide. The uncertainty has persuaded global investors that the risk of investing in UK companies is too high. Global funds have an extreme underweight position to the UK, despite UK companies being materially undervalued relative to their international peers. Until a clear path is decided upon by Westminster or the electorate, this is likely to remain the case.

The UK market is split into 3 distinct groups, domestically focussed companies, more internationally focussed companies (excl. commodity companies) and international commodity companies. A narrow group of large commodity stocks have led the market growth in recent years, with sentiment towards UK focussed companies currently priced at recessionary levels. The net effect is that the UK is on a >30% discount to the rest of the world and the cheapest it has ever been relative to the US. At the same time the yield gap between UK equities and Gilts is as wide as it has been in 119 years; equities are at relative extremes and certain parts of the market in absolute terms.

Summary

Whilst equity and bond markets have rallied since the start of the year, the downside risks to the global economy are becoming more prominent. Growth remains muted and inflation subdued. If populist and protectionist policies are expanded, it is likely to harm global trade and economies further. With the US-China trade talks restarting, the risk of an all-out trade war has been averted for now, however the détente appears fragile and could disappear in a tweet.

Central banks recognise the issue and are seemingly willing to act sooner rather than later. Certainly markets expect them to do so, with bond yields declining rapidly. With discount rates falling, equity markets are rising even when earnings expectations have been reduced.

The variances in global stock markets are wide and are likely to go wider if central banks cut further and faster than expected. Conversely, if central banks don't deliver on expectations, the elastic band might not snap back but break.

Brexit has had a fundamental effect on the price global investors are willing to pay for UK companies. This is likely to last until there is clarity of some sort. Consequently we believe that investors should anticipate market volatility to be at elevated levels over the forthcoming months.

Chris Davis

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