Economic Background – August 2019

Hot in the City[1]

Reflecting the uncertainty in the global economy and markets, the UK's weather provided great volatility this month, with Cambridge recording the highest ever temperature in the UK at 38.7C and Cheshire receiving more than twice the average rainfall during the month.

The conclusion from the recent G20 meeting and from central banker's analysis more recently is that risks in the global economy are increasing from protectionist policies. Global growth has slowed with manufacturing and export data falling. The manufacturing slowdown is broader and deteriorating further than the contraction in 2015/16. Global trade remains weak, with inflation and business confidence subdued as uncertainty pervades markets. Equity markets have shown resilience in the wake of macro headwinds with the help of loosening and accommodative monetary policies.

In its latest World Economic Outlook the International Monetary Fund noted that global growth is "sluggish". Emphasising subdued momentum caused by weak demand, soft global trade, muted inflation and mixed policy cues.

Fig.1 ***GDP Growth***

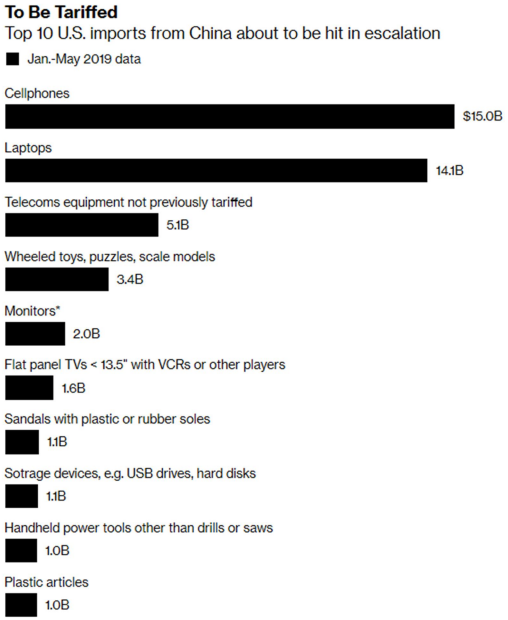
Source: International Monetary Fund

Exporting trade tensions

Influencing much of the uncertainty and global market sentiment over the past 12 months has been the promised "America First" trade stance of President Trump. Following the on off trade talks and tit for tat tariffs, President's Donald Trump and Xi Jinping agreed a truce and to restart the trade talks. Expectations for the meeting in July were low and US trade representative Robert Lightizer, Treasury secretary Steven Mnuchin and vice-premier Liu He didn't disappoint. The US's core 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. Worryingly some of the elements agreed in June came back under scrutiny, with debate surrounding whether China had started to increase purchases of US agricultural products.

As the protagonists started their talks, President Trump took to Twitter suggesting that China was not negotiating in good faith. The Chinese fired back with comments around "arrogance" and "selfishness". In retaliation the US President decided to escalate matters by raising tariffs on $300bn of additional Chinese goods by 10%, with the promise of more to come. The proposed tariff will start in September alongside the raise on the other $250bn of goods and products from 10% to 25%. If the US proceeds with the proposed tariffs, China has promised counter measures, their response will be an indication as to how quickly they want this resolved. The decision to allow the renminbi to depreciate against the US dollar, past 7 (Rmb/USD), immediately after the latest tariff announcements demonstrates the power China has to offset the tariffs. It is the first time in 11 years the managed exchange rate has reached these levels. The truce was short lived and it is difficult to see how the two sides can re-establish trust to even re-start negotiations effectively.

Fig.2 ***Latest China imports to be hit by tariffs***



Source: US International Trade Commission, Bloomberg

Chinese officials appear sanguine about how long this will all take and official statistics provide some reassurance that the mix of fiscal and monetary easing is working. However one has to wonder whether all is well in the middle kingdom. Confidence in business and households are low as the Chinese economy faces domestic and external challenges. The

[1] Billy Idol, 1982

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National Bureau of Statistics has released data showing slowing growth in service and construction sectors, whilst the manufacturing sector remains in contraction. Manufacturers' expectations of future imports and exports were also negative. China's reported GDP grew at 6.2% in the second quarter its slowest pace of expansion since 1992 and in as many months 2 Chinese banks have been supported by State owned entities.

Alongside China's slower growth, the ongoing dispute between Japan and Korea is taking its toll. Japan's export restrictions on a wide range of chemicals and electronic goods to South Korea have added to the downside risks facing the economy. Heavily reliant on the export of electronic goods, South Korea already has to contend with the US-China and the cyclical downturn in global electronics.

China is not the only country in Donald Trump's sights. Frustrated with the lack of progress on common digital taxation scheme, France has imposed a charge of 3% on the turnover of large digital companies. In response Trump said "We will announce a substantial reciprocal action on Macron's foolishness shortly. I've always said American wine is better than French wine!"

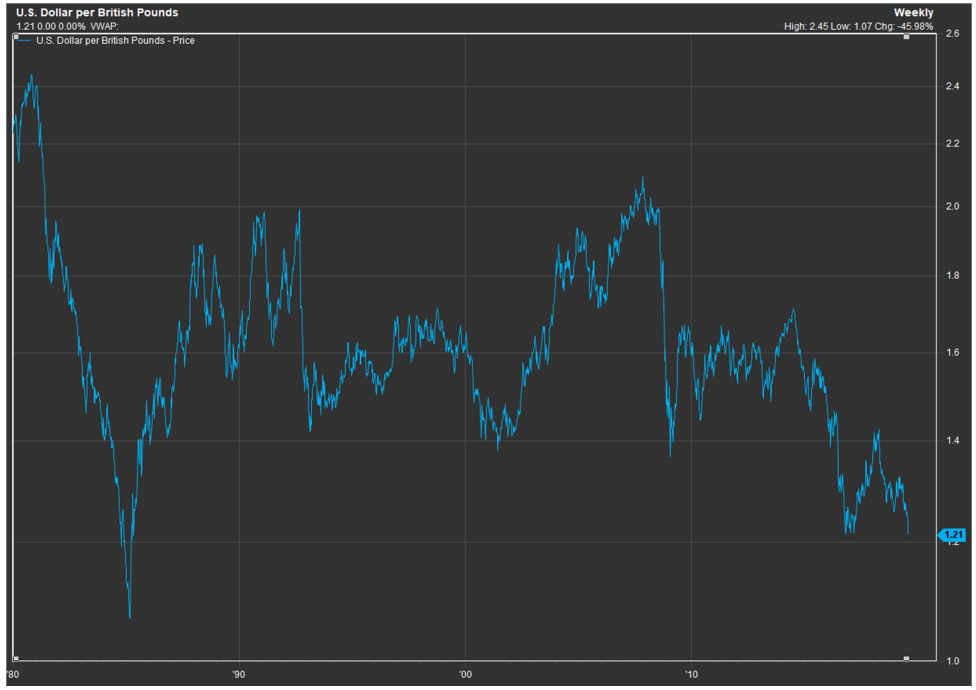
The EU and the US meanwhile continue their long running dispute over aircraft subsidies given to Boeing and European rival Airbus. The US has tried to increase pressure in recent months threatening an increase to tariffs on auto imports, cheese, wine and whisky. In response, the EU is trying a different tack by seeking an alliance with the US to counter Chinese technology companies. The European commission (EC) has suggested that good progress in areas such as robotics and self-driving cars can be made and highlighting that it has been purchasing more soya beans and liquefied natural gas from the US. The EC's hope is that this may dissuade the US from the proposed tariffs for now.

Prime Minister Johnson

Conservative party members voted 2:1 in favour of Boris Johnson to be their new leader and de facto UK Prime Minister. He inherits a divided country, party and a slim majority in the House of Commons with the support of the Democratic Unionist Party. Mr Johnson spent little time in selecting those he wished to help him deliver on his promises. 17 ministers left Cabinet, with those remaining and newly selected based on the premise they agree that a 'no deal' scenario is a viable one.

The new Prime Minister has promised his supporters the UK will leave the EU on 31 October, with or without a deal, "no ifs or buts". Describing the likelihood of leaving without a deal as a million to one chance and preferring a deal, he is intent on leaving on Halloween. Mr. Johnson cannot be accused of being unclear; stating any deal struck will be without the current Northern Ireland back stop. The EU remains fixed in their view that the agreement cannot be re-opened. As the current deal will not go before Parliament again in its current form, having been voted on 3 times, the probability of the UK leaving the EU without a deal has increased. Currency markets agree, with Sterling declining against other major currencies. GBP/USD has declined to levels last seen in the immediate aftermath of the referendum result. If the UK leaves the EU without a deal on 31 October, Sterling could challenge or surpass the 40 year lows.

Fig.3 ***Sterling / US Dollar Exchange Rate***



Source: FactSet

For opponents of the current strategy, Parliamentary time is limited before 31 October. There are 3 possible routes to avert exiting without deal.

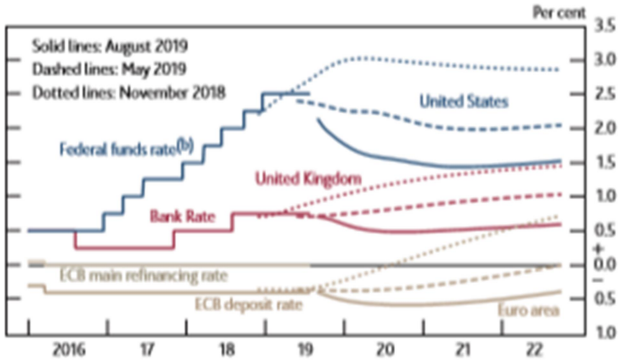
1. Getting a new deal with the EU and having that agreed by parliament;
2. Passing a simple majority of 'no confidence' in the Government, thereby imposing an early General Election in which they hope the Conservatives/DUP would not win a majority. Given the schedule of a General Election, a vote of 'no confidence' would need to be tabled and passed by early September;
3. Or by passing primary legislation to change the current default position of leaving on 31 October. Currently MPs have no mechanism to introduce legislation, however some believe the Commons Speaker will find a way.

The forthcoming months are likely to be a period of continued uncertainty.

Easing monetary policies

Against the backdrop of slowing growth, contracting trade and declining inflation expectations, central banks have moved toward monetary policy easing.

Fig.4 ***Expected paths of policy rates have shifted sharply downwards***



Sources: Bloomberg Finance L.P. and Bank calculations.

At its latest meeting the European Central Bank (ECB) forewarned that a further loosening of monetary policy was likely in the near future. Ahead of his October hand over to Christine Lagarde, Mario Draghi is to set give the flagging Eurozone economy one last stimulus boost in September. Interest rate cuts, asset purchases, bond buying, tiered interest rates will all be on the table.

The Bank of England (BoE) kept rates on hold at 0.75% in July, highlighting that the outlook for global growth had deteriorated in part due to trade tensions that price pressures in the Eurozone and US had been subdued and the probability of a no-deal Brexit had increased. Although growth in the UK economy had slowed, with inflation around their 2% target and the uncertainty surrounding Brexit, the BoE decided to keep their powder dry for another day.

The first move by the major central banks was by US Federal Reserve (Fed), which cut the federal funds rate by 0.25% to a target of 2%-2.2.5%. After increasing the federal funds rate 9 times over the past 4 years this is the first rate cut by the Fed since December 2008. Described as a "mid cycle adjustment", Fed Chairman Jerome Powell rationalised the cut as a way to tackle low inflation, protecting the US from weaker conditions in the global economy brought on by trade tensions. Some had hoped for more and in his press conference Mr. Powell wasn't clear that in the near term future there would be more cuts. He maintained however that the Fed would "act as appropriate to sustain the expansion".

Uncertain and divergent markets

Leading up to the central bank meetings, with dovish central bank rhetoric and contracting macroeconomic data, government bond yields declined and equities rallied. Since the end of July we have seen markets rise and fall in response to the Fed's decision to reduce interest rates and President Trump's announcement of further tariffs on Chinese trade.

The amount of negative yielding debt in the world has increased to an all-time high of over $14 trillion[2]. At least 25% of all bonds in the world trade at negative interest rates. The German 10 year government bond is currently trading at -0.49%, with the equivalent Swiss bond at -0.85% and the entire Swiss bond curve in negative territory (including the 50 year bond). Whilst the US 10 year bond yield didn't move once the market had priced in the Fed cut in rates, it moved significantly following the recent trade tariff announcement. The US 10 year bond now yields 1.86%, having been at 2.5% at the start of May. Yields on UK government bonds continue to fall as the possibility of leaving the EU, without a deal becomes more likely. The UK government 10 year bond yields 0.56% down from 1.2% in May.

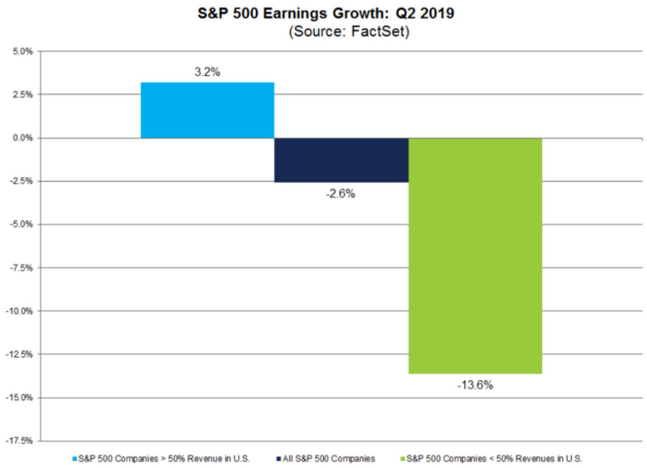
Equity markets have been buoyed by accommodative central banks, despite the macro and corporate outlook becoming more uncertain. In the US in particular the main

[2] Source: Bloomberg, 1 Aug 2019.

beneficiaries have been Technology companies. Evidence from the 2nd quarter reporting cycle suggests that companies with greater exposure to the domestic US economy have fared better. As global growth has slowed and dollar strengthened, companies in the S&P 500 with a higher proportion of international revenues have performed distinctly worse than more US focussed companies.

So far 40% of companies having reported results in the S&P500, the FactSet data in Fig. 5 show clearly the disparity between the two groups of companies. Overall the S&P500 companies are showing a decline in earnings for the quarter of 2.6%. With 60% of companies still to report we will watch this trend closely.

Fig.5 ***S&P 500 Earnings Growth***



In the UK market we have the opposite scenario, where the domestic earners, who are affected to a greater extent by Brexit sentiment, have underperformed international earners, who have benefitted from a declining Sterling. Until there is clarity about the UK leaving or achieving a deal with the EU, this will remain. The net effect is that UK share are on a >30% discount to the rest of the world, the cheapest it has ever been relative to the US.

Summary

Dark clouds gather over the global economy as geopolitical risks abound. Global growth is slowing exacerbated by trade fears and protectionist policies. So far supply chains appear to be remaining resilient; however as the rhetoric and tariffs increase, disruptions are more likely.

With the advent of the new Prime Minister and the current intransigence of the UK government and EU, the probability of leaving the EU without a withdrawal agreement has increased. Markets believe so, as Sterling and UK bond yields fall further.

A consequence of the uncertainty has been the withdrawal of capital investment, hitting manufacturing economies hard. In July global manufacturing production decreased for the second month in a row, with new export business declining in China, US, Euro area, Japan, Taiwan, South Korea, UK, Canada, Russia and Brazil. Central banks and markets have adjusted their forward looking expectations, with the former already in a synchronised accommodative mood.

The confluence of a search for safety and declining interest rates has led bond yields to fall further. Stock markets are showing wide disparities in valuation, reflecting global tensions and uncertainty. Investors in fixed income and equity markets appear willing to pay a large premium for perceived consistency and certainty. Brexit is providing additional uncertainty for investors and companies alike and provides ample excuse for global investors to stay away.

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