TORELL & PARTNERS

Economic Background – September 2019

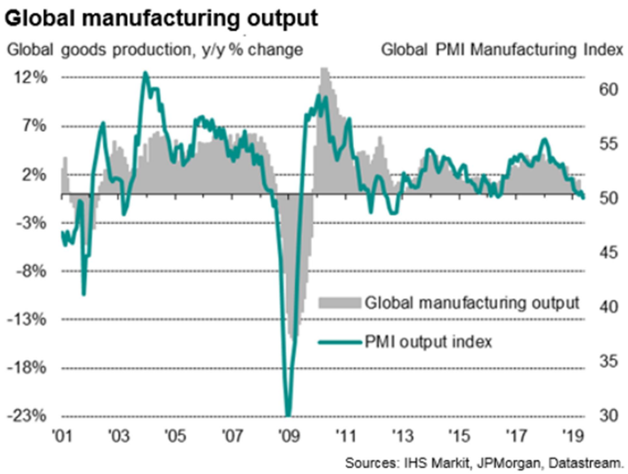
There may be trouble ahead[1]

Traditionally the summer months have little economic and political news flow, not so in 2019. As Hurricane Dorian heads towards mainland US, markets are increasingly becoming more volatile as economic data weakens, geopolitical risks intensify and global trade deteriorates.

As a consequence the growth outlook for the global economy has slowed. In July the International Monetary Fund cut its forecast for global growth, since then the relationship between US and China has deteriorated; the probability of the UK leaving the EU without an agreement has increased; a dispute in trade between Japan and South Korea has started; the Iran-US relations have deteriorated; Hong Kong is in crisis; and Argentina is in meltdown. There is much to worry about in the world as global trade and supply chains that have been developed over the last 70 years are adapted to new scenarios. Whether the global economy slows further will depend upon the willingness of political leaders to adjust their current fiscal and trade strategies.

The continued geopolitical uncertainty and protectionist policies have affected the manufacturing sector with services and consumer spending currently bolstering the global economy. In general the consumer, experiencing high employment, rising income and tepid inflation, appears resilient. As governments around the world have shown an inability or hesitancy to increase fiscal stimulus, it falls to the Central Banks to try to prolong the economic expansion.

Fig. 1



[1] Irving Berlin, 1936

Eroding confidence

Trade tensions, derived from protectionist values, have had the secondary effect of eroding business confidence and capital investment, with uncertainty becoming pervasive. The collapse in trade talks between US and China illustrating the fundamental differences between both sides and the escalation of tariffs mean there is no end in sight. The tit-for-tat tactics and rhetoric from either side suggest that we are not near the end of this saga. Following President Trump's announcement that tariffs would be placed on the remaining $300bn of imports from China, the Chinese allowed the Renminbi (RMB) to fall against the US Dollar. The decline will make Chinese exports more competitive, partially blunting the effect of the tariffs.

Subsequently the delay to the latest round of increased tariffs was rationalised by President Trump as a strategy to help US retailers and consumers in the run up to Christmas; it was purely coincidental that the S&P500 had dropped 10% prior to the announcement. Tweets by the President would suggest he may reverse this course sooner rather than later, announcing that US companies should "start looking for an alternative to China" and quoting the International Emergency Economic Powers Act (IEEPA) 1977. The IEEPA allows the President to halt financial transactions with any country in the presence of an "extraordinary threat" to America. President Trump's challenge is to appear strong against China and thereby appealing to his core base, whilst not damaging the US economy (and stock market), lowering the odds for a second term.

In Europe, trade continues to weaken and is especially soft in Germany with the economy contracting in the second quarter. German export dependent manufacturers are suffering from Brexit uncertainty, global trade tensions and structural changes to the car industry, as shown in Fig.2.

Fig. 2

Source: Twitter, Yardeni

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Recent economic sentiment and business surveys suggest that the declining trend in exports, industrial production and factory orders are likely to continue into the third quarter.

Deteriorating economic conditions have increased the likelihood of a technical recession in Germany. Even if the German government increase their fiscal spending, the damage may already be done. The risk of recession in the UK has also increased as the UK parliament resumes following the summer recess. The economy contracted 0.2% in the second quarter and, since then, manufacturing PMI, factory orders, business and consumer confidence have declined further.

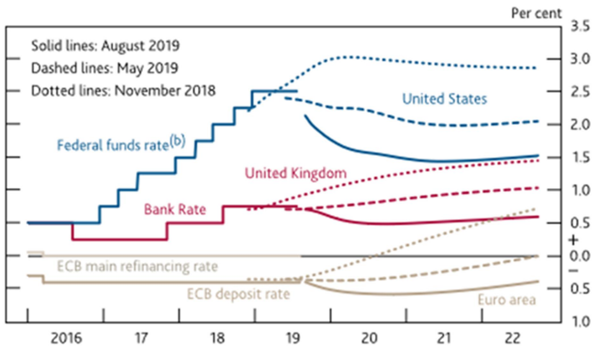
The resolution of Brexit is central to both European and UK economies. With 7 weeks to go before the 31 October deadline, nothing is certain. Following the selection of Boris Johnson to be Prime Minister (PM), he has laid out his agenda of the UK leaving the EU on Halloween with or without a deal, with a preference for a deal without the Northern Ireland backstop. With both sides of the debate hardening their stance, a resolution with the current Parliament is increasingly unlikely.

However, the situation is without precedent and ever changing. As I write, Boris Johnson has lost his majority (of one) in the House of Commons (HoC) and MPs have voted to take control of the HoC timetable. The PM's opponents have coalesced around the concept of stopping a no deal Brexit, but without proposing an alternative. They have been successful in voting in a new law requiring the PM to seek a further extension to the deadline if a deal with the EU is not in place by 19 October. There is no guarantee that the EU will allow an extension. The PM has had one attempt to trigger a General Election rejected by Parliament and has vowed to try again. If this route fails he could propose a new law specifying the date of a general election, which would require a simple majority of one to pass. The uncertainty is having a direct effect on markets and investment. Sterling fell to below 1.20 (US$ to GBP) at the start of September, UK 10 year government bonds yield less than 0.5% and the UK equity market is the cheapest relative to the US than it has ever been.

Bankers in a Hole

In August Central Bankers, academics, policy makers and economists met in Jackson Hole, Wyoming to discuss the current challenges for monetary policy. The conclusion was that given the fundamental changes to global trade policies there is no simple response via monetary policy.

Fig 3. Forward interest rates expectations



Source: Bank of England, Inflation report, August 2019

Against the backdrop of slowing growth, contracting trade and declining inflation expectations, central banks have moved toward easing monetary policy. In recent months the US and China have both reduced interest rates and expectations are that the European Central Bank (ECB) and the Bank of Japan will ease further when they meet in September. The Bank of England (BoE) would like to keep interest rates on hold at 0.75% until Brexit is resolved either way, however with the rest of the world in a loosening pattern, the BoE may be out of step.

Despite easing interest rates in July, Jerome Powell the Federal Reserve (Fed) Chair has come under fire from President Trump for not doing enough. Disappointing many, Mr Powell refrained from outlining the route for monetary easing in his Jackson Hole speech, reiterating that the Fed would "act as appropriate to sustain the expansion". After increasing the federal funds rate 9 times over the past 4 years, in July the Fed cut the federal funds rate by 0.25% to a target of 2%-2.25%. 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. Given the data flow since that meeting, the Fed has grown increasingly worried about the global growth outlook and the heavy impact policy uncertainty is having on business decisions. Expectations are that the Fed will cut rates by 0.25% in September and in October or December), even though employment figures are positive and inflation appears to be under control.

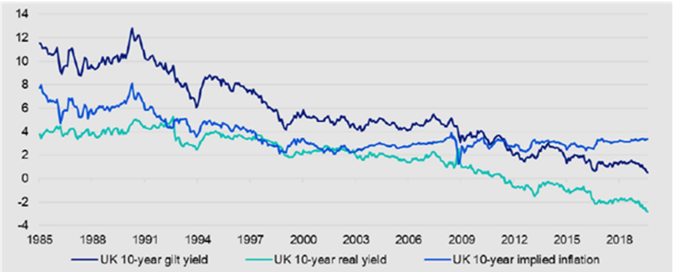
How low can you go?

Slowing growth, low inflation, trade tensions and geopolitical risks have all contributed towards a collapse in government bond yields and increased volatility in equity markets. August set another record in respect to the amount of bonds which are now trading with negative yields. A reported $17 trillion[2] of bonds are guaranteed to lose the holder money if they are held to maturity, including $1 trillion in corporate debt.

Given the economic backdrop, US Treasuries have performed particularly well. The 30 year US bond now yields less than 2%, an all-time historical low. The 10 year US bond yield has fallen by more than half to 1.5% from 3.2% in October last year. In August it fell below the yield of the 2 year bond, resulting in an inversion of the US yield curve. Yield curve inversions have predated each US recession over the last 50 years and are closely watched by analysts and investors as a leading indicator. However one should also note the attractiveness of the US 10 Year bond for a global investor relative to a German 10 year Bund yielding -0.7% and a Swiss 10 year bond yielding -1.0%.

Yields on UK government bonds continue to fall as the possibility of leaving the EU without a deal increased in probability. The UK government 10 year bond yield fell below 0.5% in August, down from 1.2% in May. In nominal terms UK yields still have room to fall further to catch up with the European bonds, however as Fig 4 shows the real 10 year gilt yields is already at -2.8%!

Fig 4. Gilt Yields



Note: Note: monthly data from January 1985 to August 2019 (the latter is as of 8 August). Past performance is no guarantee of future results.
Source: Refinitiv Datastream and Invesco

Eurozone bond yields continue to fall further into negative territory. During August Germany sold 30 year debt at a negative yield for the first time ever. The sale, which provides investors with a negative yield of -0.11% for 3 decades, attracted bids for only 43% of the €2bn on offer. This investor antipathy towards the negative yielding asset is perhaps symptomatic of a distorted market, which is driving yields even lower. The amount of freely tradeable Bunds in circulation is estimated to be less than €150bn, down from €600bn in 2014 and is projected to be below €70bn in 2024. With the ECB set to announce a new round of monetary stimulus in September, the distortion is likely to be exacerbated further.

This distorted fixed income market has caused investors to change their behaviour. In the prolonged period of low interest rates and a lack of default, fixed income investors have rationalised investing in riskier credit, longer duration and lower liquidity as they search for yield. An example of this was in 2017, as investors oversubscribed an issue of 100 year Argentine debt at a yield of 7.9%, despite the precedent of the Argentinian government defaulting eight times since 1816. In August, following a primary election, the incumbent free market president was beaten by a socialist politician and the Argentinian 100 year debt fell to just 41c on the dollar. The president has asked for more time to repay short term debt which S&P have labelled as another default.

“Elevating the World’s consciousness”

Low interest rates and record low bond yields are creating dislocations across all asset markets. None more so than in US Venture Capital, where capital is chasing the next global disruptive company.

One such company seeking money for growth via an initial public offering (IPO) in September is the We Company. The We Company’s mission statement is to “elevate the World’s consciousness”. Lofty aspirations for a property landlord, but the group want to “elevate how people work, live and grow”. However, The We Company is no ordinary property landlord; it currently loses $2 for every $1 of revenue. It is also liable for $47bn of long term leases whilst providing a service that can be turned off by its customers at short notice, resulting in a large discrepancy in cash flow duration; the corporate management structure appears overtly complex; and the CEO (and family) have benefitted greatly as tenant, property owner, debtor and shareholder.

[2] Financial Times, 30 August 2019

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Undeterred SoftBank, the Japanese global venture capital investor valued WeWork at $47bn at the start of the year. With full year losses of $1.9bn in 2018, analysts expect the IPO price will be lower as it seeks to raise $3-$4bn.

The We Company is symptomatic of the current state of the asset markets. It is truly remarkable that such a highly leveraged company, with a prospectus that provides no indication or a way to tell when it is likely to be profitable, has been able to raise $1, never mind billions.

Summary

The global economy is slowing, with manufacturing shrinking as trade tensions and protectionism increase and business and consumer sentiment is in decline. There appears to be no end in sight to the global trade wars and positions are becoming more entrenched.

Central Banks around the world continue to pursue looser monetary conditions in order to bolster confidence and create better credit conditions. With interest rates already at historically low levels there is a debate around their effectiveness in a world which is changing the way it operates.

With 7 weeks to go, before the current Brexit deadline of 31 October, the UK's parliament appears no nearer to making its mind up, suggesting a General Election is near.

Capital markets are at extremes. If precedence and fixed income markets are to be believed, in the words of Irving Berlin "there may be trouble ahead". The search for safety and expectations of declining interest rates has led to bond yields falling to record lows and an inversion of the US yield curve. This leading indicator historically has been a precursor to a recession, but current fixed income markets are very different from previous inversions.

Stock markets are showing wide disparities in valuation, with some loss making entrants priced at significant premiums to more established and profitable incumbents. UK shares appear extraordinarily inexpensive but Brexit is providing additional uncertainty for investors and companies alike and provides ample excuse for global investors to stay away.

Chris Davis
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