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Economic Background – October 2019

Ever Changing World[1]

As we head into the final quarter of the year we find the global economy slowing, inflation conspicuous by its absence and central banks delivering accommodative monetary policies. Increased volatility in markets reflects the ongoing trade tensions around the world confluence with heightened domestic and geopolitical risks. This uncertainty is having a profound effect on business confidence, trade and investment.

Industrial production and the manufacturing sector are being effected the most by the rise in protectionism, slowing global growth. In particular, the export economies of Europe, Japan and China have contracted, as supply chains that have been developed over decades are adapted to new scenarios. The service sector has, so far, remained resilient. Consumers appear relatively healthy with good employment, wage growth and benign inflation. This is especially true in the US where unemployment is at a 50 year low. Whether the global economy slows further will depend upon the willingness of political leaders to adjust their current fiscal and trade strategies.

More talks

The trade war between the US and China intensified over the summer, with Donald Trump exploring the possibility of limiting Chinese companies ability to list on American exchanges and preventing US government pension funds buying Chinese equities. As Chinese negotiators head to Washington for talks we are currently in a period of détente, before increased tariffs are due to start on $250bn of Chinese imports to the US on 15 October. To complicate matters, the US has recently put sanctions on Chinese oil companies and officials for allegedly shipping Iranian oil, providing another avenue of discussion and leverage. Hopes of a breakthrough are low.

After adjudging that the EU has failed to abide by the world trade organisation (WTO) rules in supporting Airbus, the WTO authorised the US to impose 100% levies on $7.5bn of goods. The US has limited this to a 10% levy on aeroplanes, whilst certain agricultural and industrial products will face 25% tariffs.

The US manufacturing sector contracted for the second consecutive month in September. President Trump chose to blame the Federal Reserve (Fed) for the US manufacturing decline, by having too strong a US$. At its September meeting the Fed cut the target range for the federal funds rate by 0.25% to 1.75%-2%. The cut, which was not unanimous, was the second cut this year and was justified due to global growth concerns and muted inflation. The projections are for no further rate cuts in 2019; however 7 of the 17 policymakers believe one more rate cut may be appropriate. Despite these factors US domestic growth increased at 2.0% in the second quarter, supported by consumer spending which grew 4.5% over the period.

With 13 months to go before US presidential elections, Donald Trump may become the fourth US president ever to face impeachment proceedings after being accused of betraying his oath of office and US national security in September. The President is accused of pressuring Ukraine to investigate the leading Democrat candidate Joe Biden's son, Hunter, who was a board member at a Ukrainian gas company. A potential winner in the fall out is Elizabeth Warren, an early caller for impeachment and No.2 in the race to be Democratic candidate in 2020. This is of particular concern to the large tech companies like Facebook, Amazon and Google whom she has promised to 'break up' and impose increased regulation if she became president

中国生日快乐 (Happy birthday China)

China starts a week of celebrations to commemorate the 70th anniversary of Communist Party rule at the end of September. Following a series of economic reforms, the past 2 decades have seen China transition from an isolated state, to a core part of the global economy as the Communist Party sought to find the right development model. China's boom has been assisted by a large willing young labour force, increased urbanisation, enormous infrastructure investment, economic reform and globalisation. The US argues that they have also been helped by state sponsored intellectual property theft and currency manipulation.

[1] Live and Let Die, Wings, 1973.

There are growing doubts as to the sustainability of this economic boom with China now facing a shrinking workforce and aging population. China's annual growth rate has slowed to its weakest in 27 years, amid global trade tensions and weakening global demand. The previous rapid growth had been accompanied by an unprecedented rise in credit. At its height in 2015/16, data suggests that private sector credit creation was over $4.5 trillion a year. Policymakers have been trying to rein in the debt boom in recent years, however due to the friction with the US slowing growth and investment, the rules have been relaxed. This comes at a time where analysts suggests that there have been 13 cases in the first 4 months of 2019 of local government financing vehicles defaulting on shadow banking instruments. With $560bn of local government debt estimated to come to maturity in the next 30 months, central government has much to contend with.

China's National Day on 1 October provided the backdrop for protestors in Hong Kong to continue their pro-democracy demonstrations, in the world's third largest financial centre. In one of the worst days of violence since the demonstrations started 4 months ago, police revealed that they had fired six live rounds, shooting an 18 year old point blank in the chest, and arrested 269. The formula of "one country, two systems" appears under threat. Taiwan too has reiterated its opposition to coming under control of Beijing, demonstrating that much work has to be done for China's doctrine of the "great rejuvenation" by 2049 to be achieved.

Ciao, Mario

Whilst the US and Chinese growth is slowing but positive, European growth remains subdued. Mario Draghi the European Central Bank (ECB) president presided over his last governing council meeting in September. Afterwards he announced that the ECB forecasts are now for real GDP growth of 1.1% in 2019, 1.2 % in 2020 and 1.4 % in 2021, with risks tilted to the downside. Inflation remains subdued and expectations have fallen further. ECB forecasts now foresee annual inflation at 1.2% this year, 1.1% in 2020, 1.5% in 2021, below their 2% target. Furthermore a 'no deal' Brexit scenario is not in the forecasts.

In response the ECB have decided to cut the deposit rates by 0.1% to -0.5% and introduced a two tier structure to support banks. However the restarting of the quantitative easing, or APP (asset purchase programme), on an open ended basis was a surprise. APP at €20bn per month will be undertaken on an open ended basis "for as long as necessary", Draghi explained. The assets will be largely the same as last time – bond purchases will commence on 1 November. The market was not expecting the open ended nature and this is seen as very dovish. In his Q&A post meeting he said that the APP will continue even beyond the first rate hike.

The ECB President outlined three reasons for the action they have undertaken for their mission of price stability.

1. The "protracted slowdown" in the Eurozone economy, which he says is "more marked than expected".
2. The "persistence of downside risks" of both a trade and geopolitical nature.
3. The downward revision in projected inflation levels and the fact that current inflation remains muted

Mr. Draghi used this opportunity and in a subsequent interview to encourage European countries to use their fiscal headroom (where they have it) to increase spending. In his experience monetary policy has its limitations if not complemented by fiscal policy, backing Emmanuel Macron's call for a European budget and further integration.

Not all of the Eurozone is convinced of the latest ECB measures, or of a fiscal union least of all Germany. In days after the meeting, Germany's representative on the ECB's executive board was the third German representative to resign from the governing council. German bankers and politicians lined up to express unease over the ECB's policies, with Bild Zeitung reflecting the public mood by characterising Mr. Draghi to a vampire, sucking the life out of German savers.

Anger over Draghila's zero interest.
"They want to pump us with the credit drug"

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Searching for a deal

'Get Brexit Done' was the strap line at the Conservative Party conference in Manchester this month, as Prime Minister Boris Johnson unveiled his "broad landing zone" of a compromise with the European Union (EU). The event caps a tumultuous 10 weeks as Prime Minister for Mr. Johnson. An already volatile Sterling exchange rate followed the political turmoil within Westminster and the Courts.

This uncertainty is affecting markets and investment as noted by Mark Carney, Governor of the Bank of England (BoE).

> *"Brexit-related developments are making UK economic data more volatile, with GDP falling by 0.2% in 2019 Q2 and now expected to rise by 0.2% in Q3. The Committee judges that underlying growth has slowed, but remains slightly positive, and that a degree of excess supply appears to have opened up within companies. Brexit uncertainties have continued to weigh on business investment, although consumption growth has remained resilient, supported by continued growth in real household income. The weaker global backdrop is weighing on exports. The Government has announced a significant increase in departmental spending for 2020-21, which could raise GDP by around 0.4% over the MPC's forecast period, all else equal."*

As expected the BoE kept interest rates on hold at 0.75%. Inflation fell back in August to 1.7% from 2.1%, in July and with the unemployment rate having been just under 4% since the beginning of this year.

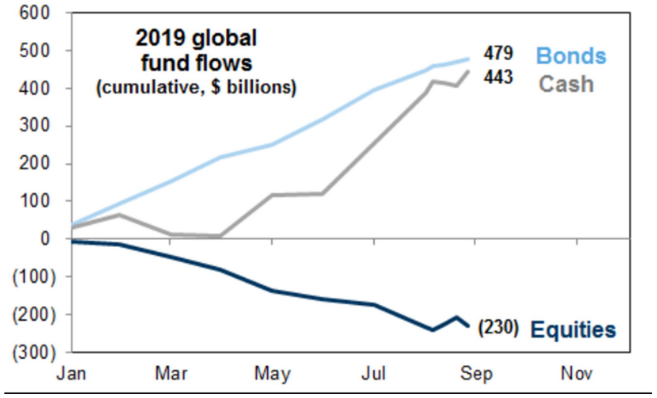
Brexit uncertainty and slower global growth have led to deterioration in business confidence and economic data. Manufacturing PMI data has shown the UK to be in contraction since April this year, primarily due to lower demand and the latest services data shows contraction for the first time since March. Businesses are reporting that the heightened uncertainty around Brexit has led to the postponement of orders, with input prices rising.

Liquidity

Weak macroeconomic data coupled with the reintroduction of quantitative easing and looser monetary policies have exerted further downwards pressure on global government bond yields. Currently, a quarter of all debt issued around the world is trading with a negative yield. As an example of the real world consequences a Danish bank has issued a 10 year mortgage bond at a rate of negative 0.5%, meaning house buyers are being paid to borrow!

The distorted fixed income market, with an extended period of low rates and a lack of default is changing investor behaviour. Investors are increasingly rationalising investing in riskier credit, longer duration and lower liquidity as they search for yield. The latest fund flow information in Fig.3 demonstrates this, with over $900bn flowing into fixed income and cash funds in 2019, whilst $230bn has been removed from equities. The flows into asset classes are interesting as it tells us how capital is being allocated which in turn provides an insight into behavioural nature of investors. A rapid rise in inflows or outflows into an asset class might give us cause concern as to the asset class's liquidity profile. The Chartered Financial Analyst institute defines market liquidity as "… a market's ability to facilitate the purchase or sale of an asset without causing a drastic change in the assets price". In September the European Securities and Markets Authority warned that as many as 40% of European high yield bond funds would not have enough liquid assets to meet investor withdrawals in the event of a market shock. The rise in passive funds into these areas has further exacerbated the concern about what price would be achieved if there was a rush to sell the assets. The Financial Conduct Authority has already set out new rules for "funds investing in inherently illiquid assets". Designed for property funds, given the obvious

Fig.3 Global fund flows, Goldman Sachs



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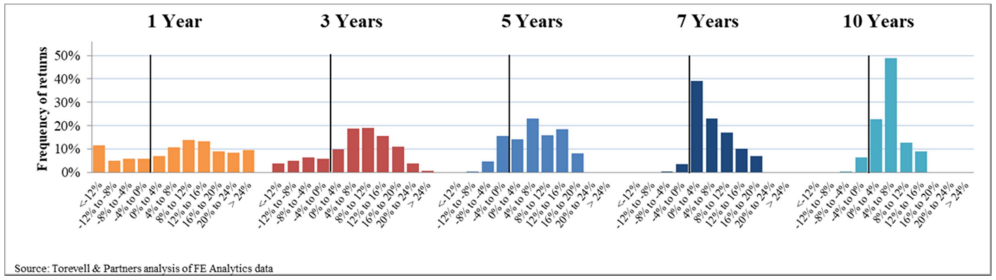
liquidity mismatch between a real estate and a daily dealing fund the rules are likely to be expanded following the Woodford fund suspension.

Equity Returns

Martyn Torevell and Alex Dean-Austin have produced their latest research on the distribution of UK equity returns over the last 30 years. The full version which I encourage you to read is on our Torevell & Partners website.

Fig.4 Narrowing of distribution of returns as holding period increases



The research analyses the historic performance of equity market returns over short, medium and long periods, exploring the historic risks and opportunities of holding equities over each time period. Analysing the data over 30 years incorporates several periods of heightened market volatility, through both bull and bear markets. The key observation being that …

> *"… for those who are able to live with the inherent volatility of equity investment it is possible to achieve significant, positive real returns above inflation over a longer term period."*

There is always a risk of losing money when investing; however for equities historically this risk is reduced the longer the holding period. We certainly believe, given the depressed yields in fixed income currently, that an adequately diversified portfolio of equities is likely to provide a greater return for investors over the longer term than that of fixed income.

Summary

Global growth has weakened as industrial production and manufacturing contract due to the shifting sands of global trade. This has weighed more heavily on the global manufacturing and export focused countries. Given the geopolitical risks, slowing growth and benign inflation, central banks have embarked on looser monetary policy.

However with interest rates already at historically low levels, debate surrounds the effectiveness of a further weakening of monetary policy with central bankers encouraging governments to use fiscal policy to stimulate growth.

Growth is likely to slow further as ongoing trade tensions and global political uncertainty effect trade and investment. Given the macro risks outlined, volatility in markets is likely to be high.

Chris Davis
Chief Investment Officer