TOREVELL &PARTNERS

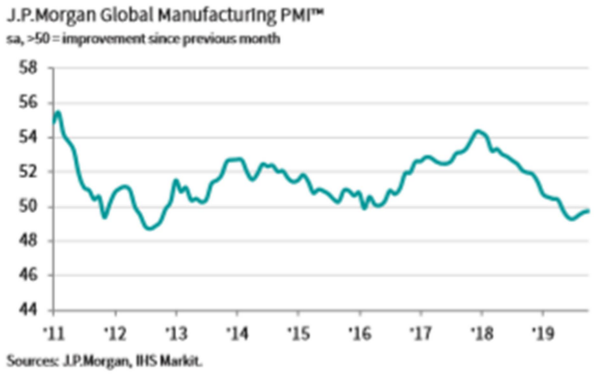
Economic Background – November 2019

Breaking up is hard to do[1]

The 2019 story so far has been one of political and geopolitical uncertainty leading to a dampening of investment, trade and confidence. Investor sentiment has oscillated between optimism and pessimism dependent upon the tweet, communiqué or vote in proceedings.

Faced with protectionist headwinds, the global economy is slowing and is predicted to grow by around 3% in 2019. Central to weakening growth is the broad based slowdown in manufacturing with the automobile industry in particular dented by new emission standards from the European Union and China. In comparison the services sector has remained robust, helping unemployment rates to remain close to their all-time lows in the UK and US and wage growth at or above inflation. The concern is that the divergence between manufacturing and services has persisted for so long, that it may infect the services sector.

Fig. 1 Global Manufacturing PMI



To counteract the slowing global economy, central banks across the developed and emerging markets have continued to provide monetary stimulus to ease credit conditions and prolong the current economic expansion. 16 central banks have cut rates in the 3rd quarter and 22 are likely to cut in the 4th quarter of 2019. Anaemic inflation expectations have provided central banks with the opportunity to take pre-emptive interest rate cuts, to reduce the downside risks despite low unemployment. Central bankers are keen to point out that there are limits to the effectiveness of monetary policy working in isolation. Fiscal support and government spending is an equally important factor for stimulating growth. Reducing trade barriers and geopolitical tensions would also help.

[1] Breaking up is hard to do, Neil Sedaka, 1962.

'Phase One'

There are positive signs that trade barriers and geopolitical tension may ease following statements from US trade representatives that the US and China were close to an interim agreement. Although what has been agreed so far appears limited, at least the direction of travel is positive. As a sign of goodwill proposed increases in tariffs that were due to take effect in October were suspended as China agreed to purchase more agricultural goods. Talks continue on dropping other tariffs, opening up Chinas financial services, protecting US firms' intellectual property rights and a currency pact. Presidents Donald Trump and Xi Jinping are due to meet mid-November to sign the partial trade deal. There remain massive differences between the two drivers of global growth, but if this partial deal gets over the line it provides Trump a 'win' for his re-election campaign. Coming at a time when he faces impeachment charges from the House of Representatives. For some investors, the trade truce provides support and confidence, which an escalating trade war would diminish. Others are more circumspect and want to see the detail of any deal, before coming to any conclusion. Talk of a deal comes at a time when China reported its economy is growing at an annual pace of 6%, its slowest pace for 3 decades and amidst unprecedented protests in Hong Kong. Perhaps there is motivation on both sides to achieve a truce at least in the short term.

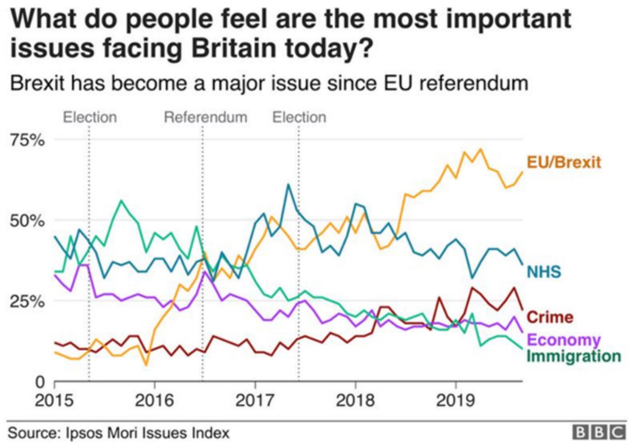
The US Federal Reserve (Fed) delivered its third interest rate cut in as many meetings in October, with the US overnight rate set at 1.5% - 1.75%. The US labour market remains strong and economic activity has been rising at a rate of 1.9% for the third quarter. The underlying gross domestic product data showed that US households though slowing were still consuming, however business investment contracted at 3%. Jerome Powell, the Fed Chairman, said that the rate cuts were a pre-emptive response to three developments; manufacturing slowing around the globe, trade uncertainty having an effect on US activity and inflation remaining below its target of 2%. Powell made it clear that the Fed

would only consider further rate cuts if economic data deteriorated further. In the short-medium term the outlook is still for no rate rises as the Fed would need to see inflation that remains persistently around their 2% target, before raising rates.

Trick or Treat?

After much debate and chicanery, parliament failed to agree to exit the EU with or without the revised withdrawal agreement on 31 October and the Prime Minister, Boris Johnson was legally obliged to ask the EU for an extension. This has been granted by the EU to 31 January 2020. Following three failed attempts to secure an early election under the Fixed-Term Parliaments Act, Labour acquiesced and agreed to a general election on 12 December. Central to the debate for the next leader of the country will be Brexit, although all major parties appear keen to promise huge increases in spending on the NHS and infrastructure. The respective parties have a further opportunity to explain their vision for the future relationship with the European Union and the rest of the world.

Fig. 2 Major issues in forthcoming UK election



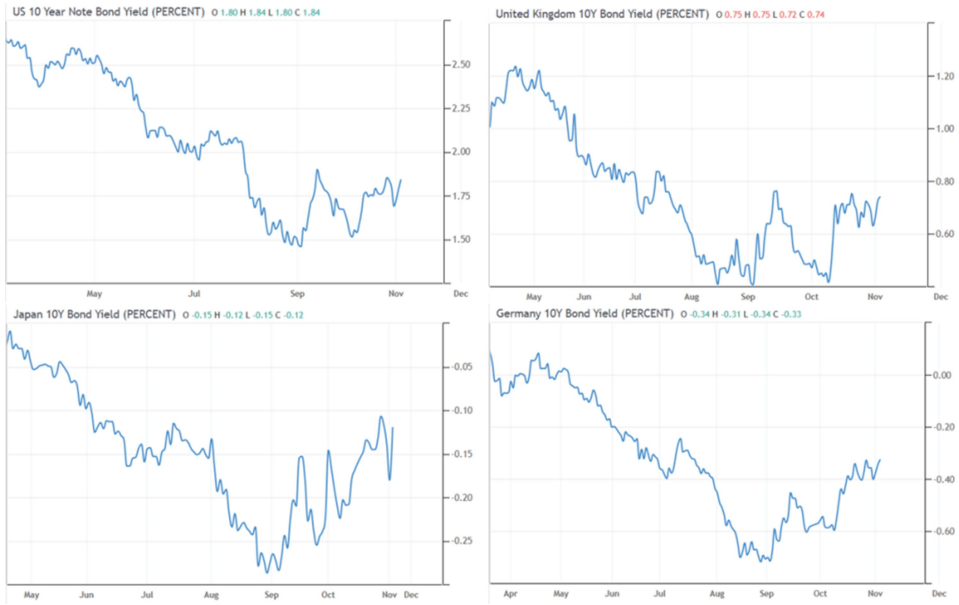
With the risk of a 'no deal' scenario reduced, Sterling rose 5% in October against the US Dollar. The latest developments and the advent of a general election have introduced a number of differing variables; consequently the path for the UK economy and markets remains uncertain, dependent upon the outcome.

Whilst Brexit rumbles on the EU is dealing with a manufacturing recession, driven by Germany. Post the financial crisis, Germany began aligning itself more towards China. As China has slowed it has disproportionately affected Germany and consequently Europe. Christine Lagarde as the new European Central Bank President has the responsibility to convince Germany that the European Central Bank (ECB) is on their side. Lagarde has reiterated Draghi's call for a common Eurozone budget, calling for Germany and Netherlands to use their budget surpluses to fund investments that would help stimulate the economy. Lagarde inherits a divided ECB council, quantitative easing and negative interest rate strategy. In what is regarded as a political appointment, Lagardes' political skills will need to be put to great use.

New leaders

The net effect of macro events, in particular the hopes of a US-China and Brexit deals have resulted in a rise in bond yields around the globe.

Fig. 3 Global benchmark bond yields

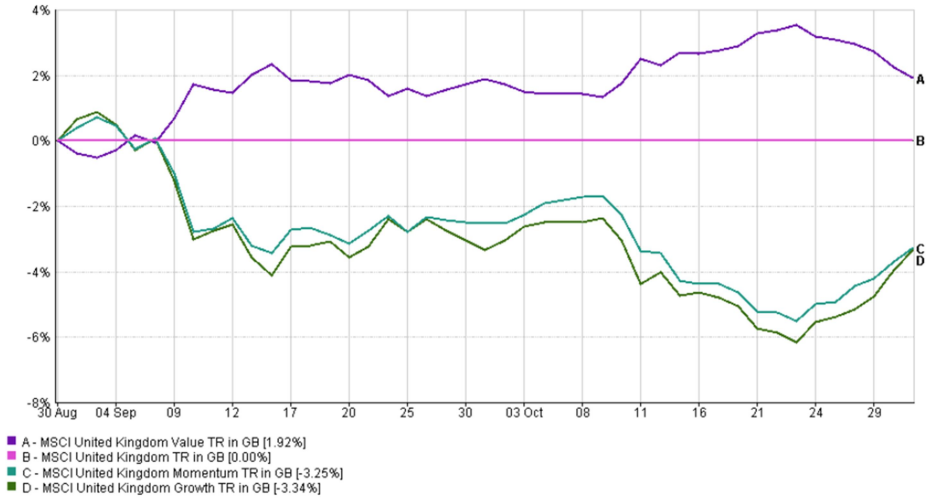


Source: TradingEconomics

Accommodative monetary policy and declining geopolitical risks have provided a positive backdrop for risk assets. However we have seen a change in leadership in

markets, with a rotation towards 'value' and cyclical sectors since the start of September at the expense of 'growth' and 'momentum' styles.

Fig. 4 MSCI UK Styles relative performance to MSCI UK since 31 Aug – 31 Oct 2019. Financial Express.



In the US earnings declined in the third quarter, but over ¾ of firms reported earnings were better than analysts' estimates, pushing equity markets to new all-time highs. According to FactSet, analysts' expectations are for further declines in the fourth quarter.

Give me Credit?

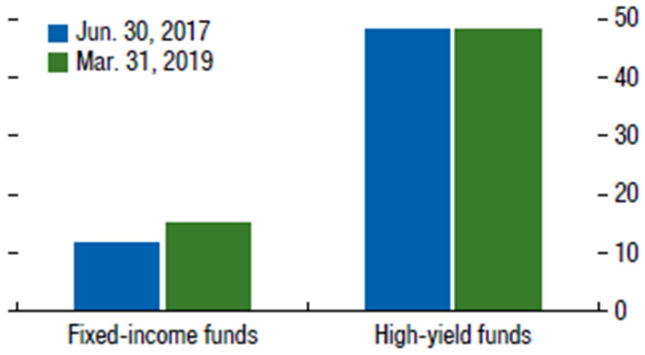
The International Monetary Fund (IMF) warned this month that fixed income funds are vulnerable to liquidity shocks, and these fears have been amplified by recent liquidity problems at H20, GAM and Woodford. They have identified that the prolonged period of low interest rates has driven institutional investors, especially those with nominal return targets or investment mandate constraints, to seek higher returns with potentially higher risks. They have achieved this by using a combination of increased leverage, moving down the credit quality, longer duration and purchasing less liquid assets. Having analysed the holdings of over 1,700 funds, their conclusion is that;

"Almost half of all high yield fund assets could face a liquidity shortfall, if the manager was confronted with a repeat of their biggest monthly withdrawal since 2000".

Fund flow information suggests that investors have stopped selling equities, however the allocation to credit markets and cash continue. Credit markets however are not a homogenous group and consist of widely differing quality and pricing.

The demand for credit and search for yield generally has been driven by quantitative easing and negative yields. Government bonds have become ever more expensive with negative yielding assets growing from $1tn in 2014 to $17tn, earlier this year.

Fig. 5 % of Bond funds with liquidity mismatch



Source: International Monetary Fund

Valuations in credit have become fuller in both investment grade and high yield debt, at a time when corporate net debt to earnings has risen. Unfortunately there are a number of credit "tourists" who have moved up the credit spectrum to find yield. They are typically not discerning buyers and we have witnessed huge flows into index tracking funds. These tracking funds are weighted by market capitalisation. Therefore trackers have a larger proportion of their assets with companies with the most debt and more exposed to sectors or credit qualities that are providing most issuance. This will not necessarily provide a favourable outcome.

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Summary

The global economy has slowed due to heightened political and geopolitical uncertainty causing trade, manufacturing and investment to weaken. However, there are tentative signs that certain barriers that have been in place are to be lifted in the coming months. Further delay, policy mistake or an escalation has the potential to tip the global economy into recession.

Presently employment data remains strong and consumer spending robust. The concern is that the prolonged manufacturing and industrial slowdown may have an effect on this and the service sector before long.

Given the risks and lack of inflationary pressures, monetary policy is accommodative and is likely to remain so for the near term, providing support to risk assets. However it remains prudent to be selective about asset type and quality.

Chris Davis
Chief Investment Officer