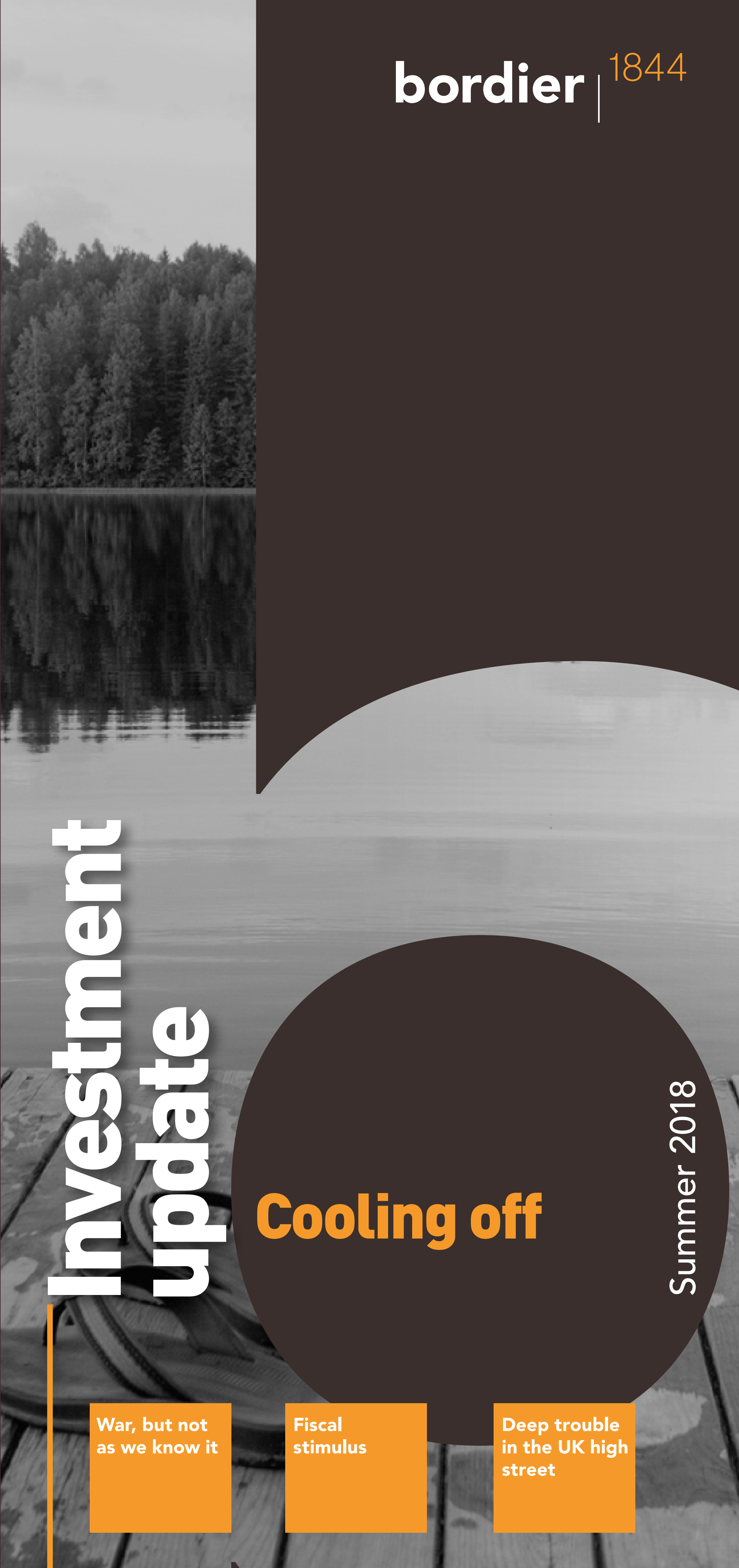

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Investment update

Cooling off

Summer 2018

War, but not as we know it

Fiscal stimulus

Deep trouble in the UK high street

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Overview

Following the moderate correction seen in the first quarter of 2018, global stockmarkets have generally recovered quite well in the last quarter, largely on the back of continued monetary stimulus and a tax-led injection to US corporate profitability.

But, in recent weeks market confidence has begun to wane again as some new challenges to growth and financial stability have emerged. Markets have become slightly spooked by the imposition of trade tariffs that go well beyond China, as well as some of the unintended consequences of the US President's initiatives. The unfolding trade war is highly complex in nature and has probably now overtaken the threat of monetary policy change as the number one near-term risk to the global economy and market stability. It also comes at a time when some other headwinds have either emerged or become more prominent. In Europe, for example, Italy's deep political divisions and questionable financial strength have led to heightened risk aversion and raised concerns of wider eurozone contagion; Europe's core economies have also lost some of their lustre, with a strong euro restricting overseas demand and negatively impacting growth. China also seems to have lost some economic momentum, as does Japan, despite continued stimulus and economic reforms.

There is still hope that we are facing more of a mid-cycle slowdown, with its associated challenges, rather than anything more sinister, but we are also mindful that the current 'Goldilocks' period of low interest rates and the flattering of all asset prices (except cash) has been extended for much longer than was probably originally intended. Therefore, having taken advantage of the first quarter's sell-off in markets, we are currently happy to err on the side of caution. This means remaining slightly below our longer term neutral positioning in stockmarkets and steering clear of areas that have been big recipients in recent years of cheap and flighty capital, such as emerging and high yield debt markets, where the heat is now turning up. To adopt a line from Rudyard Kipling, keeping a cool head whilst others (including Trump) are losing theirs is more likely to be rewarded as markets grapple with a highly confusing confluence of trade tensions, rising inflation, stimulus reduction and slowing economic momentum.

2 July 2018

War, but not as we know it

There is little doubt that the escalation of President Trump's protectionist agenda has probably thrown the biggest spanner in the economic works in recent months, and leading economic indicators, which had begun the year in quite good shape, are now exhibiting signs of cooling.

These early warning signals are asking questions about growth in the global economy which, after ten years of coordinated post-financial crisis stimulus, has now become less broad based and synchronised, and is probably now past peak cycle. Central bank policies are now becoming more divergent and policymakers' decisions seem increasingly prone to more error as a result. The US Federal Reserve has already noted that changes to trade policy could cause it to question the outlook and how it handles policy change. These issues pose some modified risks for financial markets to factor in as we move forward, so some care is very much still required.

Global supply chains are complicated in nature, and if Trump thinks that his overt trade attack on China starts and ends there he is grossly mistaken. Viewing things clinically, the announced US trade tariffs against China (and now threatening the European Union too), as well as counter-initiatives, actually represent a relatively modest part of the global trade picture. Consequently, most high-level analysis points to a similarly moderate reduction in global gross domestic product growth. But, it is the knock-on effects on wider trade relationships and business disruption that should probably concern us. All this trade uncertainty comes at a time when economies and markets are already treading a somewhat wobbly tightrope as they transition from loose and tighter monetary conditions. Coming, as we are, from a position of post-financial crisis recovery and relative strength across the developed economies, any tariff-explained reductions in economic growth, no matter how small, are likely to be viewed nervously by market participants. Add to this some of the pre-trade war slackening of activity in various economies as they roll over from a period of peak stimulus, and we potentially have the ingredients for quite a challenging patch for markets going into the remainder of this year and into next.

Fiscal stimulus

We hear lots of talk about the impact monetary stimulus has had on keeping the global growth plate spinning, but we should also bear in mind the widespread fiscal boost which has also provided good support.

Three quarters of the countries within the Organisation for Economic Co-operation and Development (OECD), for example, are undergoing some form of fiscal easing, which has helped trade and investment to rebound in recent years. The most high-profile fiscal stimulus in recent months has emanated from the US, where the reduction in the corporate tax rate from 35% to 21%, taking it to a level last seen just after World War II, has been a big shot in the arm for US corporate profitability. Earlier analysis suggested that this might provide a relatively short term fiscal boost, but there are signs that it might be somewhat more durable, particularly as repatriated overseas cash from US multinational corporations finds its way into the wider US economy.

It is tempting to consider an increased allocation to the US stockmarket, particularly to sectors or businesses seen as benefitting most from tax changes, or to those which are least affected by the unintended consequences of US trade protectionism. But some care is needed: several companies are clearly concerned about the broader and longer-term impact of Trump's executive orders. Harley-Davidson, for example, has effectively said 'on your bike' to Trump by announcing it will need to spend around US$100m on relocating manufacturing facilities out of the US to avoid EU tariffs - this certainly does nothing to strengthen the US economy or improve its trade deficit.

When one puts the fancy valuations of several dominant technology stocks to one side, the US stockmarket is not as expensive as meets the eye, and potentially worth a more generous allocation at some point. We will probably get a better opportunity to do this once the market consequences of the transition from easy to tighter monetary conditions, as well as deteriorating trade relations, are a little more understood and priced in than they are at present, so we are in no rush to take action.

Deep trouble in the UK high street

Leaving aside any number of Brexit related issues, the UK high street continues to show signs of significant stress: the list of retailers issuing warnings or struggling to keep their heads above water in the face of relentless online threats and consumers' changing habits, grows week by week.

Oddly though, consumer confidence, whilst still negative, has improved a little since the start of the year, and retail sales figures have shown a surprising boost. Analysts attribute much of this rebound to better weather conditions after a very bleak winter, warm bank holidays and even the positive consumption effects surrounding the recent royal wedding. Depending on England's fortunes in the World Cup, the drinks, food and leisure sectors may receive a similar temporary boost. However, the underlying weaknesses in the UK economy are unlikely to alter soon, particularly with the Brexit shadow still looming large and monetary policy on the cusp of tightening. The combination of high debt levels, a low savings ratio, weak productivity growth and a fragile property market (and several more uncomfortable metrics) mean that we have quite a vulnerable UK economy. Even the International Monetary Fund has warned that the UK economy needs to find ways to become more efficient in the face of Brexit uncertainty and other issues, but any solution to this, if found, cannot happen overnight. Having seen several downward revisions to economic growth in recent months, it may not take much for the dreaded 'R' word to become more widespread in the media. Once that happens we may already be past the economy's nadir, but for now it seems sensible to maintain a bias to overseas economies and markets where there appears to be greater growth potential.

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