SEPTEMBER 2018

MACRO BRIEF

In association with Cormorant Capital.

TOWN CLOSE
Financial Planning

LAST MONTH IN MACRO

Inflation (USA)

A little above target

Run for the hills, US inflation is close to 3.0 percent. Bonds are doomed.

Actually, the Federal Reserve are less interested in the Consumer Price Index (CPI) than they are in the 'core' reading of the Personal Consumption Expenditure Price Index (core PCE). That's an important observation since the year-on-year increase in the CPI stands at 2.9 percent while the same increase in the core PCE is exactly in line with the Fed's 2.0 percent target for inflation.

As it happens, I'm relaxed about the outlook for inflation in the US and, by extension, I'm relaxed about the outlook for the bond market. (Note: I use the word 'relaxed' to describe my attitude toward the outlook for US treasuries, I do not use the word 'enthusiastic').

In fact, I will remain relaxed even if the core PCE rate drifts a little higher in months to come. After all, inflation has been sustained at a little below target for almost all of the last six years and I see little harm in a mirrored period which sees inflation edge slightly higher than the target rate. No real harm at least.

Mind you, the Fed don't currently expect the core rate of increase in the PCE to move much higher than 2.1 percent. Nor, so far as I can tell, do market participants. So, if indeed we do see an increase far beyond 2.1 percent, the result is likely to be a pick up in asset price volatility as the market adjusts for a steeper incline in the outlook for interest rates.

It's difficult to say right now, but I'm guessing that I'd remain relaxed then too. That's because I think it very unlikely that inflation will accelerate to the point that the Fed will need to raise rates at a pace faster than 1.0 percent a year. And 1.0 percent a year ought to be easy to absorb so long as the broader economy sustains at least a moderate pace of increase.

Expect the Fed to raise the target for the Fed Funds rate to <2.25 percent later this month.

Manufacturing output (China)

Still OK, for now

There are two sets of Purchasing Managers' Index data covering Chinese manufacturing output. The official version, compiled by the National Bureau of Statistics of China, has a bias toward larger, state-owned businesses while the 'unofficial' one is compiled by Markit/Caixin and surveys smaller, privately-owned enterprises.

The official figures for August see the index reading at 51.3, up a touch from 51.2 in July. That flies in the face of expectations for a decline to 51.0.

Happily, 51.3 is right in the not-too-hot, not-too-cold zone. That's good news, since I think that a deterioration in the outlook for Chinese manufacturing – to the point where the PMIs register a reading below the neutral 50.0 mark – would represent a significant headwind for the stock market.

A note of caution is warranted, mind. The headline number was boosted by a pickup in production (more stuff is being made) but underlying that was an increase in inventories (more stuff is not necessarily being sold). Export orders were weak too, suggesting that the US-China trade spat is having an effect of some kind.

Having said that, economic growth in China is being sustained at something like 6.7 percent currently. That's comfortably ahead of the 6.5 percent target.

Data from the Commerce Department (US), Federal Reserve, Caixin and the National bureau of Statistics China.

Employment situation (USA)

Hikes in September and December

The Wall St Journal's survey of forecasts reveals that 'economists unanimously believe the Fed will raise rates in September'. The futures market is in accord with that sentiment – prices currently reflect a near 100 percent probability that the Federal Open Market Committee will raise the upper limit on the target for the Fed Funds Rate to 2.25 percent during the 25/26 September meeting.

Everything points toward further tightening, and – in the short term at least – I can see no compelling reason for the Fed to deviate from that course.

Last week's Non-Farm Payroll report is case in point. A further 201,000 shiny new jobs were added during August and in doing so set the record for the longest consecutive streak of job gains on record (95 months). 201,00 is a little higher than the 192,000 that formed the consensus expectation but a downward revision to the June and July releases dulls the sheen a little. Mind you, we also learned that the rate of unemployment remains as low as 3.8 percent and hourly wages are rising at something like 2.9 percent.

Actually, wage rises approaching 2.9 percent are enough to spook investors a little because of the implications for broader measures of inflation. There are credible reports too which suggest that wage growth is currently understated – retiring baby boomers on higher wages are being replaced with younger workers on lower wages and sensible adjustments for that effect push wage growth to something like 3.2 percent.

No matter. In my view, 3.2 percent is not a fast enough pace of increase to concern the Fed. Not now at least. And so, I remain of the opinion that the Fed will raise rates in September and in December to bring about a 1.0 percent increase in the Fed Funds Rate this year. As it stands I'm projecting two or three rate rises next year. If I'm right, investors have little reason to fear the Fed.

Economy (Australia)

Remarkable

The Australian economy was expected to grow at around 2.8 percent year-on-year during the second quarter of this year. In the event the numbers came in at a whopping 3.4 percent. That's the fastest pace of growth for six years and, remarkably, it marks the 27th year without a recession for those living Down Under.

Come to think of it, that's even more remarkable when you count 5 different Prime Ministers in the last 8 years or so.

Of course, it helps if you're a resource rich nation next door to a mighty neighbour with a seemingly insatiable appetite for said resources.

Economy (Eurozone)

We'll always have Italy

Eurostat has confirmed growth in the second quarter at 0.4 percent – the same rate contained in it's earlier 'flash' estimate. Year-on-year growth comes in at 2.1 percent.

Growth was fastest in Malta (5.7 percent), Poland (5.0 percent) and Hungary (4.6 percent). It was slowest in Belgium (1.4 percent), Italy (1.2 percent) and Denmark (0.6 percent).

Thank goodness for Italy (and Denmark). Growth in the UK during Q2 was measured at 1.3 percent.

Meanwhile Germany's economy increased 1.9 percent and France grew by 1.7 percent.

Employment, output and monetary policy (UK)

Not before March

It's difficult to reconcile an increase in Bank Rate (two hikes in the last year – just one hike behind the Federal Reserve) with Mark Carney's Doomsday scenario as painted by the press during last week. That's because the Doomsday scenario is not in the foreground for the Bank of England. Instead, the 35 percent decline in house prices, widely reported as something likely to be brought about by a 'no deal' Brexit, forms a part of the Bank of England's regular stress tests.

Those tests – which also apply a quadrupling of interest rates and a doubling in unemployment – are integral to work carried out by the Bank's Financial Policy and Prudential Regulation committees and are not associated in any special way with Brexit.

Indeed, the Bank's central forecast calls for a gentle rise in Bank Rate – perhaps 'two or more times over the next few years' – which really is the antithesis of a house price crash.

Having said that, I think it would be barmy for the Bank to tinker with rates between now and the March 2019 exit; that is how I see Brexit impacting policy in the short term.

I think we can expect Bank Rate to remain at it's current level (0.75 percent) for at least the next six months.

Actually, our economy is in much better shape than I could have imagined in the wake of the referendum vote.

The most recent figures from the Office for National Statistics put unemployment at 4.0 percent, wage growth at a comparatively healthy 2.9 percent and output (gross domestic policy) increasing at an annualised rate of 2.4 percent.

Monetary policy (Eurozone)

No surprises

The European Central Bank (ECB) remains on script. Net purchases of euro denominated bonds will persist at the new rate of €15 billion per month (starting next month and down from €30 billion currently) until the end of the year. Assuming nothing too dramatic occurs in the interim, that is when net asset purchases will cease.

But don't expect a great deal to change at that point. The ECB's main policy rate of interest will remain at it's current level 'at least through the summer of 2019'. Indeed, the Bank will sustain bond purchase at a rate of something like €20 billion per month to maintain the current stock of bonds on its balance sheet (it is net purchases that are ending, not all purchases).

And so, the death of ultra loose monetary policy has been greatly exaggerated.

Output (global)

Neither here nor there

The Organisation for Economic Cooperation and Development's (OECD) Composite Leading Indicator is evidencing slowing global growth.

The index, coming in at 99.7 for July (down from 99.8 in June) now sits below the long-term average. Conditions are deteriorating in the UK, Europe, Brazil and Russia. Meanwhile, conditions are stable or improving in the US, Japan, Canada, China and India.

Actually, that reads like a statement from the Department of the Bleeding Obvious but there is some useful information in there. So long as the outlook remains stable for the US and Japan, I think gains in India and China will be enough offset slowing growth in the UK and Eurozone. That is to say a sharp slowdown seems unlikely. That's good news for equity investors generally.

Data from the Bank of England, ONS, ECB and OECD.

Inflation (UK)

Quite dramatic

The consensus called for a 0.1 percent dip in the headline rate of year-on-year inflation during August. In the event, and to the surprise of market participants, the Office for National Statistics revealed their estimate to be 2.7 percent, 0.2 percent higher than July's 2.5 percent increase. Similarly, core inflation increased from 1.9 percent to 2.1 percent. So far as I can tell, those reacting to the news form to neat camps.

The first comprise those that think this is an anomaly, a surprise increase that won't be sustained and which is explained by price rises for a small number of products which are themselves notoriously volatile – things like computer games, theatre tickets and clothing. Indeed, the Financial Times notes research by Jason Lennard, an economist at The National Institute of Economic and Social Research, which suggests underlying inflation barely moved in August on a measure which removes the top and bottom 5.0 percent of price changes. That suggests that price rises are not at all widespread.

The second camp worries that rising inflation will bring about a quickened pace of rate hikes. Indeed, the Bank of England has, in recent months, voiced its concern about limited spare capacity and likely price pressures arising from an imbalance in supply and demand across the British economy.

I'm allied with the first camp – I'm more dove than hawk, for now at least. I still think we are some way off another hike in rates though I acknowledge that the latest data release increases the likelihood of 25 basis point lift inside the next six months – a likelihood that I still judge to be less than 50/50. I mean, there's Brexit. That's happening in the next six months or so. The outlooks is a little clouded, isn't it.

Actually, the more immediate impact of a surprise increase is to fatally hole my early call for inflation to fall close to the 2.0 percent target by the end of this year. That seems unlikely now.

Brexit (UK, Eurozone)

You pays your money, you takes your chance

Is it just me, or did news of Donald Tusk's 'sorry, no cherries' Instagram post have you too hurling whatever you had to hand at the television? Anyway.

I do not know what is going to happen next.

What does seem clear is that the European Union want concessions over and above those contained in the Chequers plan. And what seems similarly clear is that further concessions will infuriate a large number of Conservative MPs and a small number of Labour MPs – enough to effectively kill Chequers off.

If Theresa May really thinks that Chequers is the only viable model, then a no-deal scenario is the inevitable conclusion. If that comes to pass, I expect the pound to take the strain with a decline in the order of at least 10 percent on a trade-weighted basis. Consequently, the FTSE 100 index and various overseas indexes will gain the reciprocal so I don't view a no-deal scenario as particularly damaging to investors with a diversified portfolio.

Of course, the immediate effect of a decline in the pound will be to encourage inflation still higher – perhaps back over the 3.0 percent threshold and beyond. In that case I would expect the Bank of England's Monetary Policy Committee to hold their fire, opting instead to see through another 'one-off' cause just as the did following the pounds dramatic decline in mid-2016.

Actually, I don't think the no-deal scenario is the most likely. I have the feeling that the EU overplayed its hand in Salzburg. Policymakers in Europe are keen to avoid a no-deal outcome and that will focus minds on overcoming the problem of the Irish border.

Indeed, I think there is another viable option – the so-called Canada Plus model. That puts the UK outside of the customs union but secures free trade in goods.

Data from the Bank of England, ONS and FT.

Monetary policy meeting (USA)

The Donald doesn't like it

Last week, the Federal Open Market Committee increased the target for the Fed Funds rate by a quarter of one percent for the eighth time in the current cycle. Accordingly, the upper limit on the main policy rate now stands at 2.25 percent.

Policymakers noted that, since the prior meeting, the labour market had continued to strengthen and broader economic activity had been rising at a 'strong rate'.

Donald Trump doesn't like it. And he said so. He doesn't want the Fed slowing the economy on his watch.

No matter, the Fed is fiercely independent. As if to emphasise that, the Fed will increase rates again in December to bring the increase in 2018 to 1.0 percent, in line with the Fed's projections around this time last year. Their current set of projections call for another 1.0 percent increase during 2019 with, perhaps, a quarter point increase likely in 2020.

The Fed is projecting full year GDP growth at something like 3.1 percent this year, in line with my own expectations and, now, the consensus forecast as described in the Wall Street Journal's monthly survey. Perhaps more importantly, the Fed expects core inflation to remain at – or very close to – the 2.0 percent target during this year and next.

Two questions buzz in my bonnet. 1, will core inflation peak at a rate higher than 2.0 or 2.1 percent? And 2, what is the 'neutral' rate of interest, is it 2.75 percent, is it 3.5 percent or is it higher?

If the answer to the first question is 'yes', we can expect a period of volatility not unlike that in the early part of this year when the MSCI World Index shed close to 10.0 percent. Back then the market was priced for a full year rate rise in the order of 0.5 percent, rather than the 1.0 signalled by the US central bank. It seems to me that there is a similar disconnect today.

(…continued)

Indeed, we might expect a little more volatility this time around if core inflation peaks much higher than 2.1 percent since that might force the Fed to move faster than 1.0 percent. That, in turn, infers that asset prices would have to move by a larger degree to accommodate the changed outlook.

As it happens, I don't think that core inflation will move much beyond 2.1 percent for long, if at all. I don't have a great deal of conviction in that regard, mind. It's more guesswork than calculation.

The second question is a little obscure, nevertheless it is important. The 'natural' rate of interest neither aids, nor hinders economic growth. And it very likely doesn't exist – not in any stable kind of way at least. But if the Fed gets the main rate of interest in line with the 'natural' rate then investors are safe. Inflation and growth will get neither too hot, nor too cold and businesses can go about their business without significant intervention from the central bank. Actually, if the natural rate is something like 3.5 percent I reckon the Fed will get their without too much trouble by mid 2020. If on the other hand, the natural rate of interest is much lower, at say 2.75 percent and bearing in mind that rates will be at 2.5 percent by the end of this year, then the Fed will likely be applying the brakes to the US economy much, much sooner than they intend. Around about the time, in fact, that the Trump stimulus begins to wane.

There are, then, risks to the outlook.

Here's the odd thing though, the neo-Malthusian perma-bear inside of me just cant seem to rouse. I mean, I'm not particularly optimistic – there's no surprise there – but neither am I particularly pessimistic. I'm just not seeing the kind of financial market excesses that precipitate the deeper downturns. I'm not an unhappy bear. The current expansion might well go on for a while yet.

LAST MONTH IN WORDS

Argentina's peso tumbled again on Thursday as President Mauricio Macri grapples with a crisis of confidence sparked by growing social unrest and skepticism about his ability to contain runaway inflation, cut spending and meet financing needs.

The Central Bank of Argentina sharply raised its key interest rate to 60% from 45% at an unscheduled meeting early Thursday in an effort to shore up the plunging peso. The currency fell to new lows days after the government asked the International Monetary Fund to speed up loans under its bailout package.

"This is beyond a currency crisis. It is a crisis of confidence. So whatever the administration does, even if they are correct measures technically, have no impact whatsoever," said Sergio Berensztein, a political analyst in Buenos Aires.

Source: Wall St Journal, 30 August.

‘The good news about technical/liquidity EM disruptions is that, provided the general contamination to economic fundamentals is contained, they tend to fade. They offer investors the opportunity to gain exposure not just to extreme overshoots but also to other fundamentally stronger names selling at bargain-floor prices. But timing is critical, and especially for investors that lack the structural ability to underwrite significant market volatility. The current EM sell-off, while subject to temporary snapbacks, does not appear over yet’.

Source: Mohamed El-Erian, FT, 03 September.

‘Today, neither stocks nor bonds are cheap overall, but they aren’t so drastically overvalued “that this is the time for maximum defense,” says Mr. Marks. “Nor are prices so low and the outlook so good that you should be aggressive.” You should expect returns over the next five years or so to be “low or negative in most asset classes.”

Imagine a continuum from 0 to 100, he says, with 0 being completely out of the market and 100 being completely in using aggressive techniques like investing with borrowed money.

“Each of us, based on our understanding of ourselves, should have a normal position between 0 and 100. So, vis-à-vis our normal position, where should we be now? I think today we should be moderately tilted toward defense.”

Source: Howard Marks, Oaktree Capital Management, quoted in the Wall St Journal, 14 September.

‘We still expect the curve to resume flattening over the next few months. And while it is difficult to predict precisely, we would not be surprised to see the 10-year/2-year measure of the yield curve invert at some point early in 2019. We think that the US economy will slow sharply in 2019, as the fiscal stimulus fades and Fed tightening bites’.

Source: Capital Economics quoted by John Authers in the FT, 21 September.

‘S&P Dow Jones Indices estimates that fully passive index funds, including ETFs, own about a fifth of the stocks in the US equity market that are freely available to trade.

ETFs also regularly account for a third of all US stock market transactions and an even higher share in periods of elevated volatility.’

NOTES

While a reasonable course of action regarding investments may be formulated from the application of our research, at no time will specific recommendations or customised advice be given, and at no time may a reader be justified in inferring that any such advice is intended. Although the information contained in this document is expressed in good faith, it is not guaranteed. Cormorant Capital Strategies Limited will not accept liability for any errors or loss arising from the use of this document. Readers are directed to our terms and conditions.

Cormorant Capital Strategies Limited, registered in England, number 05346579. Our registered address is 84 Bromefield, Stanmore, HA7 1AQ.

Crown copyright material is reproduced with the permission of the Controller Office of Public Sector Information (OPSI). Bank of England data reproduced with kind permission of the Bank of England.

(1) MSCI United Kingdom Value, Bats 100, Bats 250, Bats UK Small Companies, S&P 500, Euro Stoxx 50, Nikkei 225, MSCI Brazil, MSCI Russia, MSCI India, MSCI China, Financial Analytics (2) MSCI United Kingdom, MSCI World ex Value, MSCI Emerging Markets, MSCI United Kingdom Value, Bats 100, Bats 250, Bats UK Small Companies, Barclays Gilt 1 – 5 Years, Barclays Sterling Gilts, Barclays Sterling Gilts 15+, Barclays UK Government Inflation Linked Bond, Financial Analytics (3) MSCI World, Barclays Global Convertibles, Barclays Global Treasury, MSCI World ex UK Large Cap, MSCI World ex UK Small Cap, MSCI World ex UK Value, MSCI World ex UK Growth, MSCI World, MSCI World Equal Weighted, MSCI World High Dividend, MSCI World Minimum Volatility, MSCI World Momentum, Financial Analytics (4) MSCI World Consumer Discretionary, MSCI World Consumer Staples, MSCI World Financials, MSCI World Health Care, MSCI Industrials, MSCI World Materials, MSCI World REITs, MSCI World Technology Hardware & Equipment, MSCI Telecommunications Services, MSCI World Utilities, Financial Analytics (5) SPDR FTSE UK All Share ETF, SPDR S&P 500 ETF, SPDR MSCI EMU ETF, SPDR MSCI Japan ETF, SPDR MSCI Emerging Markets ETF, SPDR Barclays Gilt, iShares Index-Linked Gilts, iShares Global Corporate Bond ETF, iShares Global High Yield Corporate Bond ETF, Mixed Assets assume separate equal weighted parcels of equity and bond exposure (6) Financial Analytics, overseas exposure assumes equal weight in US, Europe, Japan and Asia (7) Reference National Life Tables, Office for National Statistics, sustainable income assumes life expectancy, a gross 5 percent growth rate, annual income paid out at the start of the period.

www.townclosefp.co.uk

Town Close Financial Planning Limited is authorised and regulated by the Financial Conduct Authority, reference number 608526. Registered Office: Suite 2, 258A High Road, Loughton IG10 1RB. Registered in England and Wales, Company Number 08390032.

Suite 2, 258a High Road

Loughton

IG10 1RB

Tel: 020 7993 4898

Email: advice@townclosefp.co.uk