JANUARY 2019

MACRO BRIEF

In association with Cormorant Capital.

TOWN CLOSE
Financial Planning

LAST MONTH IN MACRO

MANUFACTURING OUTPUT (CHINA)

An icy blast from the US

There's a reason Chinese stocks have fallen into a bear market; the broader Chinese economy is slowing. Evidence for that is contained in the most recent Purchasing Managers' Index reports for the manufacturing sector.

December's PMI from official sources, released a few days ago, stands at 49.4. Coming in below the neutral 50.0 mark, the survey's respondents are indicating that manufacturing output is contracting a little. At the same time the unofficial report, compiled by Markit/Caixin, fell to 49.7. Taken together we can conclude, loosely, that output is falling at both large, state-owned firms (the focus of the official report) and smaller, private enterprises(as reflected in the unofficial report).

I take it that both external and domestic demand for Chinese goods are subdued as is consistent with a slowing global economy. A Sino-US trade dispute is at least partly responsible for all of this, but there is good reason to believe a slowdown in Chinese output growth is inevitable. Policymakers face a choice – they can continue with moves to deleverage a debt-ridden economy and accept an orderly slowdown as output moves to more sustainable levels, or they can encourage further borrowing to underpin high rates of growth today and risk a more spectacular, disorderly slowdown in future. In so far as I can tell, China is responding to the US challenge by encouraging even more lending.

That is not a good response over any timeframe barring the immediate.

EMPLOYMENT SITUATION (USA)

Tasty

The consensus called for something like 166,000 new jobs to be listed in the December Nonfarm Payroll report. The highest forecast I can see came in at 215,000. In the event the Bureau of Labor Statistics counted a whopping 312,000 new posts. Not only that, a further 58,000 came by way of revisions to the October and November estimates. December was the 99th consecutive monthly gain. Feast on that, stock market. The next two jobs reports – out early in February and March – will provide a reasonably reliable impression of how the US economy is doing as we move into the new year. I suspect those are going to be market movers too.

MONETARY POLICY (USA)

One statement, two interpretations

'Overall, I would say that the picture for the rest of the world remains consistent with continued growth here in the United States… financial markets have been sending different signals'. That is how Jerome Powell, Chairman of the Federal Reserve Board of Governors began a series of comments reminding investors that interest rates are not on a pre-set path and that the Federal Open Market Committee was 'prepared to adjust policy quickly and flexibly'. That was exactly what some market participants wanted to hear and financial instruments are now priced to reflect the greater possibility of a rate cut than of rate hike in 2019. I'm deeply sceptical of that.

Data source: US Treasury, OECD.

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MONETARY POLICY (USA)

A likely pause

The Wall St Journal's monthly poll of economists reveals that the majority expect the Federal Reserve to hold the upper limit on the Fed Funds rate at 2.5 percent until midway through this year. That feels about right to me. Mind you, I can't say I'm happy with the odds that are currently priced into the market.

The CME Group calculates an implied probability of close to 25 percent for a rate rise by the June meeting. I'd feel more comfortable at something like 50 percent, but hey, there's time yet. Beyond that, I'm still clinging to an expectation for two 0.25 percent hikes.

EMPLOYMENT SITUATION (EUROZONE)

Definite progress

Eurostat estimates the average rate of unemployment across the eurozone at something like 7.9 percent. That's the lowest rate since October 2008; good news, of course, though youth unemployment remains uncomfortably high at 16.9 percent.

As usual, the average hides a lot of variation across the 19 monetary union members. Not surprisingly, the highest rates of joblessness can be found in Greece and Spain at 18.6 percent and 14.7 percent. The lowest rates are found in the Czech Republic and Germany where rates are as low as 1.9 percent and 3.3 percent respectively.

ECONOMIC OUTPUT (UK)

Not bad at all

The Office for National Statistics reports growth in UK gross domestic production at 0.2 percent for November. 0.2 percent isn't what you might call a blistering pace, but it's much better than the 0.1 percent rate that some were predicting and, in any case, represents a significant improvement on 0.0 percent in September and a 0.1 percent increase in October.

In the event, it was the service sector that provided the oomph, assisted by that Black Friday nonsense it seems.

PARLIAMENTARY VOTE (UK)

A little bit bad

Gosh, Brexit is getting exciting isn't it.

It's not impossible for Theresa May to somehow scrape her deal through parliament on Tuesday. If she does, I reckon the pound will soar and UK based mid- and small-cap equities will skyrocket.

Of course, it seems more likely that her laudable efforts will fail. And the zombie apocalypse will be upon us. At least that's what you'd be forgiven for thinking.

LAST MONTH IN MACRO

OUTPUT GROWTH (GLOBAL)

A slowdown here, a slowdown there, here, there, everywhere a slowdown

The Organisation for Economic Cooperation and Development (OECD) sounds like trouble to me1. Really though, the OECD is sounding trouble for all of us. Sat in their French headquarters, OECD boffins compile what they consider to be a composite leading indicator (or CLI) and which is intended to anticipate economic activity 6 to 9 months hence. Now, I'm sceptical about the veracity of that particular claim but I'm not cynical; it is worth noting what they have to say. And here, in fact, is what they had to say last week…

'In the United States and Germany, the tentative signs of easing growth momentum, that were flagged in last month's assessment, have been confirmed with easing growth momentum remaining the assessment for Canada, the United Kingdom and the euro area as a whole, including France and Italy . In Japan, the CLI continues to point to stable growth momentum.

Among major emerging economies, stable growth momentum remains the assessment for the industrial sector in China and now also for India, while in Brazil and Russia the CLIs continue to anticipate easing growth momentum'.

Actually, there's not a lot in there that we don't already know, though it is comforting to see 'stable growth' sustained in China. Let's hope it stays that way for a while longer.

(1)There's something about grand-sounding, Paris-based bodies that set my nerves on a edge a little. I blame the 1790s. Back then, during the French Revelation, the ill-named Committee of Public Safety presided over the apt-named Reign of Terror.

INFLATION (UK)

Mystic Steve

I don't know if you've noticed but there are some things I get right.

This time last year I suggested that the 3.1 percent increase in the Consumer Price Index represented the peak and that, from there, inflation would fall to target much sooner than was widely anticipated. At that time the International Monetary Fund expected inflation to come in at 2.6 percent during 2018. Indeed, the British Chamber of Commerce pencilled-in a rate as high as 2.7 percent and Morgan Stanley called for an increase at 2.9 percent.

Fast forward to today and the Office for National Statistics (ONS) estimates year-on-year inflation for December (and 2018 by extension) to be 2.1 percent; just 0.1 percent above the target set for the Monetary Policy Committee (MPC) by the Chancellor of the Exchequer.

Core inflation (which excludes the effect of volatile price changes in food, energy, alcohol and tobacco) is similarly close at 1.9 percent.

Beyond my trivial triumph, the ONS report is very good news indeed. Inflation which is near to target represents one less constraint for the Bank of England.

It gives the Old Lady of Threadneedle Street a little more room for manoeuvre in these uncertain times. Inflation can be allowed to move close to 1.0 percent in either direction (remaining inside the 1.0 to 3.0 percent target range) before the MPC has to be seen to be doing something. That amounts to a good deal of policy flexibility.

Data source: OECD, Office for National Statistics.

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EMPLOYMENT SITUATION (UK)

It's all good

If you're looking for evidence of the mal effects of Brexit-inspired uncertainty, you wont find it on the pages of the most recent UK labour market report.

Figures from the Office for National Statistics, covering the three months to November 2018, suggest that the number in work increased 328,000 to 32.5 million over the preceding 12 months or so. Additionally, the employment rate – at 75.8 percent – stands at it's highest level in a record that stretches back to 1971 and the unemployment rate – at 4.0 percent– has not been lower since before I was born in March 1975.

MONETARY POLICY (JAPAN AND EUROZONE)

Only the weather has changed

Meeting last week, policymakers at the giant Japanese central bank opted for more of the same. Rates remain unchanged and asset purchase schedules remain unchanged. It is likely that I will repeat that statement after each of the seven Monetary Policy Meetings scheduled in the year ahead.

Much more exciting, by comparison at least, are meetings of the Governing Council at the European Central Bank (ECB). That outside chance I've mentioned – that the ECB might edge toward looser, rather than tighter, policy in the months ahead – looks less unlikely with each meeting. There's no change for now, but Mario Draghi's comments to the press following last week's meeting where certainly more dovish in tone..

OUTPUT GROWTH (CHINA)

Tanks versus students

A few days before the National Bureau of Statistics of China was due to release its estimate for output growth in 2018, it downgraded growth in 2017 from 6.9 percent to 6.8 percent. In the event, the 2018 increase in gross domestic product is thought to amount to 6.4 percent. That's more or less in line with the consensus.

As it happens, 6.4 percent is the slowest pace of growth since 1990 when China's expansion was hamstrung by international sanctions – sanctions which were applied in the aftermath of the Tiananmen Square massacre the year before.

It is not known how many of its people the People's Republic of China killed early in June 1989 – reports vary from 180 to more than 10,000. Back then, students had gathered in their masses, calling for less corruption, a commitment to democratic reforms and more freedom; including freedom of speech and freedom of the press – all things which Deng Xiaoping weirdly dismissed as some kind of veiled plan to turn China into a 'totally Western-dependent bourgeois republic'. The Chinese economy has delivered improved living-standards for a great many of its citizens in the 30 years since the 'June 4th Incident'. That has been enough to propel China toward 'middle-income' status and, allied with brutal repression, sustain the Communist Party of China in power.

But that was the easy bit. Progress from middle income to 'high income' is much more difficult. And all of the countries that occupy the high income bracket are democracies with all that entails; free speech, a free press and little corruption.

Data source: OECD, Office for National Statistics.

LAST MONTH IN WORDS

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"The economy undoubtedly faces greater downward pressure," says one… Beijing adviser. "How bad it will become, and how strongly we should stimulate the economy will largely depend on how soon we can settle the trade dispute with the US."

Source: Wall Street Journal,06/01/2019.

LAST MONTH IN WORDS

Lord (Peter) Hennessy says British politics will this week enter “a multiple crisis” over Brexit, the constitution, the party system, and voters’ faith in politics in general. “All of that adds up to a crisis with a capital C”. Cheery.

Source: Tom Newton Dunn, Political Editor of the Sun, Twitter, 13/01/2019.

LAST MONTH IN WORDS

‘Chinese lawmakers have announced that they will convene on Jan. 29-30 for a previously unscheduled legislative session that will allow them to speed the review process for a long-awaited law on foreign investment. The bill, initially introduced in 2014, has faced repeated delays and has undergone multiple drafts. In its latest draft, published in 2018 amid an escalating trade war with the United States and growing grievances from foreign businesses, the bill aims to take a stronger line on protecting foreign investment and intellectual property rights. Specifically, the 39article draft contains provisions to prevent the forcible transfer of intellectual property — addressing a core US concern.’

Source: Stratfor,17/01/19.

LAST MONTH IN WORDS

‘While the ECB refrained from taking new policy steps to address the slowdown, leaving its key interest rates and policy guidance unchanged, investors are betting that the slowdown will ultimately delay a move by the ECB to raise short-term interest rates, currently set at minus 0.4%. Many investors don’t expect an increase before mid-2020.

“The ECB is burying the last hope of an interest rate hike in 2019,” said Klaus Bauknecht, chief economist at Deutsche Industriebank AG in Cologne, Germany.

Indeed, Mr. Draghi’s comments suggest the ECB is leaning the opposite way: toward more easy-money policies.

“We have lots of instruments and we stand ready to adjust them or use them according to the contingency that is produced,” Mr. Draghi said, listing options such as forward guidance on interest rates, bond purchases and long-term loans to commercial banks.’

Source: Wall St Journal, 24/01/2019.

NOTES

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(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.

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