REGIONAL OUTLOOKS 2019

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UK – Situation Normal(ish)

It feels like there are a lot of extraordinary goings-on to be concerned with in the first quarter of this year. Added to Brexit known knowns, Brexit known unknowns and Brexit unknown unknowns are similarly enigmatic scenarios rooted in the shape of the US yield curve and Sino-US trade talks.

Within each of those themes, varying aspects will appear more or less pivotal in the following weeks and months. And, of course, exchange rates, interest rates and stock prices will wax and wane in their fashion, as events bump our understanding of what might be. That much is certain.

Equally likely is that you will hear, or you will read, that 'markets dislike uncertainty'. When you do, roll your eyes for me.

Insofar as markets could manifest approval or disapproval, I'm pretty sure they wouldn't dislike uncertainty. Markets owe their very existence to uncertainty. Without it, we wouldn't need markets.

I'm not a free market acolyte – I will concede that markets cannot help to solve all of the world's ills – but I do know that markets represent the most successful system we've devised for coping with conditions of uncertainty in a great many walks of life. Of course markets don't always deliver a happy outcome for all parties at all times (prices can go down as well as up) but the broader picture is one of huge economic benefit.

One of the key benefits that a free (or free-ish) market economy offers is resilience.

The UK has a market economy that is nearly unparalleled in it's development. Important capital indicators – like the aforementioned exchange rate, interest rates and stock prices – are constantly in flux, influenced by events in real time.

Those fluctuations might appear to be part of the problem, but they are really part of the solution. If, for example, savers the world over fear for the future of the British economy our exchange rate will fall. In turn, a lower exchange rate offers overseas investors a discount on UK assets, reduced relative labour costs, an improved current account and it makes British manufactured goods and services more competitive. All of that happens very quickly and does not require intervention from policymakers.

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There are other aspects of the British economic landscape that contribute to its resilience. We have a legal system enshrining rights to ownership of property with the full weight of 1,000 years behind it. We have a vigorous political system, a free press, some of the best educational institutions in the world, more Nobel Laureates than any country barring the USA (and nearly twice that of the French), enviable cultural clout and, in the main, a healthy long-living populace with a predilection to work hard and shop hard.

It is quite reasonable to debate whether the UK will be the best place to invest money over the next few years – just as we could argue the same for the USA, Germany or Japan. But what is more certain is that the UK is a good place to invest.

Brexit, whatever the outcome, won't change that.

Actually, while we are on the subject of investment in the next few years, I will confess that I am now really quite keen to hold domestic stocks.

For a start, they're cheaper than they were last year – value stocks are down 9.5 percent, blue chip stocks are down 7.5 percent and the middle- and smaller-sized company stocks are down 13.1 percent and 15.6 percent respectively. In addition, domestic stocks are yielding 4.6 percent in the aggregate.

More than that, it looks to me that UK stocks (alongside selected eurozone investment, and German stocks in particular) offer a significant risk premium at current prices.

Actually, some of you might be thinking that the neo-Malthusian perma-bear in me must be hibernating. It is isn't. It would be foolish not to acknowledge what are significant risks to the downside in the near term. The broader backdrop too is one of elevated market valuation. That is why I still advocate a position which lies on the 'defensive side of neutral'. If your natural weighting would be, say, 60 percent in stocks and 40 percent in bonds the defensive side of neutral might sit at 50-50 for example.

In any case, ensure that your clients maintain a properly diversified position (comprising equities and government bonds) and that they are investing only the capital that they could sustain in the markets through the duration of a downturn.

But that doesn't mean you should not be assertive within your stock portfolio.

Now might be a good time to go out and buy a UK equity fund which you consider to be a good one but which has not performed well of late.

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US – Blasphemy

I have to confess that my faith in the yield curve – and more specifically that a recession will be heralded by an inversion of the 10-year/2-year or 10-year/3-month rate – is not unquestioning.

There are those that are utterly convinced that the US yield curve will invert in a matter of weeks or months. Taking it one step further, there are those that are similarly convinced that an inverted yield curve will be unfailingly followed by a recession. Further still, a recession will occur not more than 18 months hence.

Now, I'm not minded to dismiss that view. I think it entirely plausible that such a sequence of events may come to pass. But what does mark me out, is that I am not wholly persuaded by a narrative which is, by now, very widely held. I see other scenarios which are plausible to a greater or lesser extent than that.

For instance, the yield curve might not invert; in which case we may or may not see a recession. Or, the yield curve might invert; in which case, again, we may or may not see a recession.

I have to admit that I am wondering if the yield curve, as an indicator of near-term recessions, maintains its predictive power to such an extent I have become a yield curve agnostic. There are a couple of reasons for my scepticism.

First, and in spite of what you may read, the yield curve doesn't demonstrate a flawless track record.

I count 15 recessions in the USA over the last 100 years. Only 9 of those were preceded by an inversion of the 10-year/2-year rate. The full set of signs reads; 10 inversions with 9 subsequent recessions and 6 'missed' recessions meaning that the yield curve scores 56 percent. Mind you, if we restrict our analysis to just the last 50 years that score rises to 100 percent because all 7 recessions in that timeframe were indeed preceded by an inversion.

The other reason for my sceptical mode of thought is that the bond market just ain't what it used to be. Recessions aren't caused by an inverted yield curve, inversions do little more than predict recessions. That predictive power – comprising the 'wisdom of crowds' – comes from the aggregated behaviour of those that participate in the bond market.

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US – Blasphemy

Some of those participants are more active than others, contributing 'wisdom' disproportionately. Today, the Federal Reserve is a significant participant. The Federal Reserve Bank of Dallas calculates a market value for US treasuries at something like $15.4 trillion while the Federal Reserve Board of Governors values the debt it holds at $2.2 trillion. That's around 15 percent of the market. Importantly, the Fed is what I would call a passive participant and it could be that the Federal Reserve, in rightly engaging a policy of quantitative easing, has inadvertently diminished the effectiveness of one of the more reliable economic indicators.

The dominant narrative might not be correct.

Setting the complexities of the yield curve aside, it seems likely that the US economy is indeed slowing. The third quarter of last year was witness to growth in the region of 3.5 percent. It looks likely that the fourth quarter will come in at 2.5 percent. And, looking ahead there's a good chance that the first quarter of 2019 comes in at a surprising low level - the consensus comes in at something like 2.3 percent but I think the risks are weighted to the downside of that.

I'm a little concerned for growth in the first quarter but less concerned for the rest of the year. As it stands, and for what it's worth, I am not forecasting a recession. Mind you, the prospects for the US economy for the full year are muddied by a great deal of uncertainty attached to the current round of Sino-US trade negotiations, and in particular whether or not the full threatened 25 percent tariff on Chinese imports comes into force.

In any case, trade talks are a sub-set of what I think is the geopolitical struggle of this generation – that between China and the USA. Hitherto, China's rising economic and military power has been unchecked by the USA. That is changing. A new arms race – focussed on emergent technologies – is apparent. In the main, it will manifest in the form of tariffs, sanctions and other regulatory exclusions designed to ringfence US innovations. The US will not shy away from conventional projections of might too. Closer diplomatic support for Taiwan and ongoing cooperation with Japan will play a pivotal role in that regard.

None of this is good news for China.

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US – Blasphemy

Back on Wall Street, it seems to me that the stock market is betting that economic growth over the course of the year will come in lower than the 2.3 percent expected by the Federal Reserve. That is the only justification I can see for prices which reflect a near 90 percent probability that the Fed Funds rate stays where it is, at 2.5 percent, for the whole year. In the short term, that is a position that makes me nervous because I can see little upside if the market is right, and little upside if the market is wrong.

Beyond the short term, I still think equity valuations are elevated generally and in the US in particular. My position lies on the defensive side of neutral.

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Eurozone – Happy Birthday

Twenty years ago, on 01 January 1999, the euro was introduced in electronic form for 11 of the 15 countries that, back then, made up the European Union. I'd say it has been a success. I mean, it's still here isn't it. That wasn't guaranteed.

Quite how far I'd go in describing the euro as a success is another thing. I certainly wouldn't travel quite the same distance as Sabine Lautenschläger, Member of the Executive Board of the European Central Bank (ECB) and Vice-Chair of the Supervisory Board of the ECB. In an interview with Deutschlandfunk, she asserts that monetary union has 'definitely been a success'. 'We should not forget…' she preaches '…that the EU, and therefore the euro, has also been immensely important in preserving the peace that we have enjoyed in the euro area, in the EU, for the past 70 years'.

Now, I enjoy living in an era without continent-wide conflict as much as the next man or woman, but I'm just not sure the euro is one of the key determinants of that peace. Mind you, if I'm wrong and the euro really is the key to avoiding catastrophe, then rising euro scepticism – in France, Italy and even to some extent in Germany too – ought not to be taken too lightly. It is lucky, then, that Sabine Lautenschläger believes that euro scepticism can be soundly defeated. All we need do is '…explain that the euro simplifies trade between euro area countries and brings economic prosperity and jobs'. Well, that ought to be enough for the Germans where the euro area very likely has brought a new level of economic prosperity. But the problem is that the Italians have some experience of the counterfactual, as do the Greeks. Others have noticed too.

Still, I'm not one of those that believes the euro will perish. I was confident it would persist even during 2011 and 2012, when the 'euro crisis' threatened a spectacular round of sovereign defaults, though I do acknowledge that the threat was real enough. Remember the PIIGS? The crisis hit hardest in Portugal, Ireland, Italy, Greece and Spain. (Cyprus was hit similarly hard but that ruins the acronym).

Mario Draghi's promise, on the 27 July 2012, to do 'whatever it takes to preserve the euro' signalled the moment that policymakers began to take the threat seriously. In the event, the ECB, the European Commission and the International Monetary Fund (IMF) all had a part to play. (Britain, in spite of our own banking crisis, played a limited part too with a £3.2 billion bilateral loan arrangement with the Irish and increased support for the IMF). New loans and restructured old loans played their part but the euro was really saved by the ECB's gigantic programme of asset purchases. Beginning in March 2015, the ECB has allocated around €2.6 trillion of newly issue reserves for the purchase of euro zone bonds of one kind or another.

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Data source: European Central Bank, UK Government.

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Eurozone – Happy Birthday

Net purchases continued all the way through to December last year. One of the more immediate effects of the ECB's policy of quantitative easing has been to force government bond yields lower. The 10-year rate for Italian bonds was close to 7.5 percent during the crisis but held at less then 3.0 percent all the while the ECB was hoovering bonds. Portuguese, Spanish, Irish and Cypriot bonds are similarly yielding less than 3.0 percent today. A less immediate effect, and another important objective for the ECB in the aftermath of the 2008 financial crisis, has been to ward off deflation. Indeed, early in 2015, the headline rate for the Harmonised Index of Consumer Prices fell 0.6 percent year-on-year. The most recent data (a flash estimate for December) calculates inflation at a little over 1.5 percent.

As it happens, 1.5 percent is sharply lower than nearer 2.0 percent a month earlier.

Mind you, I'm not reading too much into December's sharp decline; oil prices have been on a rocky ride and lower energy and fuel costs will likely account for softer prices. Meanwhile, of course, lower oil prices don't explain why 'core-inflation' (CPI less energy and food costs) remains in the doldrums at close to half the ECB's target. That, I suspect, is a little more indicative of low underlying aggregate demand in Europe. Not that the ECB agree with me on that… here's what they had to say a couple of weeks ago in the December economic bulletin…

'While incoming information has been weaker than expected, reflecting softer external demand but also some country and sector-specific factors, the underlying strength of domestic demand continues to underpin the euro area expansion and gradually rising inflation pressures. This supports the Governing Council's confidence that the sustained convergence of inflation to its aim will proceed and will be maintained even after the end of the net asset purchases'.

Of course, monetary policy remains unusually accommodative in the euro zone. Net purchases may have ceased but the giant central bank will not be selling any of the bonds it has amassed and it will continue to buy new bonds with the proceeds of coupon and maturity payments, maintaining a steady balance sheet in the process. Additionally, the main policy rates of interest lie at zero or less than zero and, if the bank's promises are anything to go by, they aren't going to budge from there until at least the summer of this year.

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Data source: European Central Bank, UK Government.

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Eurozone – Happy Birthday

And while I am not particularly excited about the economic prospects for the euro zone, I do feel the tiniest tingle for euro zone stocks right now. For a start they are 10.0 percent cheaper in the aggregate than they were this time last year. German stocks – those I am most keen on presently – are down 16.8 percent. More than that, I think prices are comparatively attractive from a valuation perspective too.

Data source: European Central Bank, UK Government.

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Japan – Getting There

Barring the odd quarterly contraction, the Japanese economy is on track to match the country's longest post war recovery. The most recent data point to 71 recession-free months of output growth stretching back to December 2012. That compares with a record 73 months.

Of course, a sustained increase in gross domestic product is a good thing, but other key indicators – such as the Consumer Price Index and wage growth measures – cloud the view. First though, the good news…

Prime Minister Shinzo Abe's 'three arrows' package of reforms contained, amongst other things, a set of initiatives intended to transform the Japanese labour market. And while 'transform' may be pushing our definitions a little, it is easy to argue that there have been some very positive moves in that regard. For a start, unemployment currently stands as low as 2.5 percent; a 25-year low. And while Japan's working age population has shrunk by 4.7 million in the last six years or so, the Wall St Journal reports that the number of people in work has actually increased by 4.4 million over the same period.

Policymaker's efforts to encourage more women, more older folk and, to some extent, more foreigners into work is key to that success. A stronger labour market ought to encourage competition among employers and that, in turn, ought to encourage stronger wage growth. Stronger wage growth may, in time, help the Bank of Japan to achieve its 2.0 percent inflation target and at that point Japan can very likely close the book on two decades of economic malaise.

But we are not there yet.

Headline inflation over in Japan is currently measured at 1.4 percent year-on-year. Underlying that, core inflation (which excludes volatile food and energy prices) is estimated to have increased at just 0.4 percent. That is a mile off the target rate. Mind you, some inflation is better than none and the damage wrought by years of deflation might now be mended.

For me, the one key indicator I would like to see improved is the Real Wage Index. Wages, after inflation, were down 2.8 percent in 2014, down 0.9 percent in 2015, up 0.7 percent in 2016 and down 0.2 percent in 2017. The 2018 figure is not yet in but I'd hazard a guess at a low positive increase over the year. Still, we are yet to see a sustained increase.

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Data source: US Treasury, OECD.

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Japan – Getting There

And, on that front, trouble is brewing. As part of the government's efforts to address its huge fiscal deficit it has scheduled an increase in consumption tax (the equivalent of our VAT) from 8.0 percent to 10.0 percent for October 2019. Policymakers have delayed that increase twice before because of the havoc it brought in the form of plunging retail sales with a knock-on effect on economic output and falling inflation.

As an aside, and to give you some idea of the scale of Japanese government debt note that Japan's debt-to-GDP ratio stands at 253 percent. That compares with Greece at 179 percent and Italy at 132 percent. (In case you're wondering the comparable figure for the US is 105 percent, the UK is 85 percent and Germany is down at 64 percent).

In the round, I think it not unreasonable to conclude that there are grounds for optimism for the outlook for Japan – certainly compared with the outlook at the same point in recent years.

Whether that optimism extends to the Japanese stock market is another question. For now, I'm maintaining something approximating a neutral position in Japan with a tendency to underweight.

There are some terrific Japanese companies out there and they really ought to form a part of any sensible diversified portfolio of investments. But my gaze, from a value perspective, is very firmly fixed on the UK and in Germany.

Data source: US Treasury, OECD.

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Asia Pacific – An Apple A Day

Apple's CEO, Tim Cook, recently admitted that while the giant US tech firm 'anticipated some challenges in key emerging markets, [they] did not foresee the magnitude of the economic deceleration, particularly in Greater China'.

Get used to it, Tim.

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 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, has fallen 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 is 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. If I'm right, 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.

A week or so ago, for example, China's Premier of the State Council of The People's Republic of China, Li Keqiang, ordered three of the largest state-owned banks to allocate as much as 30 percent of new lending to smaller Chinese businesses. And that lending was to be granted at specially low rates of interest.

That's fine, I suppose, assuming that the beneficiaries of those loans are businesses with good ideas likely to be fruitful enough to repay the debt. But something tells me that won't be universally true. And of course, the lending banks have little choice but to make the loans as ordered by the administration.

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Data source: US Treasury, OECD.

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Asia Pacific – An Apple A Day

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

Beyond the build up of bad debt and the inevitable misallocation of large pools of capital, China has another problem looming on the horizon. Here's how Stratfor, a geopolitical intelligence firm I hold in good standing, summarise the problem I allude to…

'Chinese society is on the verge of a structural transformation even more profound than the long and painful project of economic rebalancing, which the Communist Party is anxiously beginning to undertake. China's population is aging more rapidly than it is getting rich, giving rise to a great demographic imbalance with important implications for the Party's efforts to transform the Chinese economy and preserve its own power in the coming decade'.

Their analysis is, I think, spot on…

The crux of China's demographic challenge lies in the fact that, unlike Japan, South Korea, the United States and Western European countries, China's population will grow old before the majority of it is anywhere near middle-income status, let alone rich. This is historically unprecedented, and its implications are made all the more unpredictable by its coinciding with the Chinese economy's forced shift away from an economic model grounded in the exploitation of inexhaustibly cheap labour toward one in which young Chinese will be expected to sustain the country's economic life as workers and as consumers. A temporary reprieve from the demographic crisis will be difficult but possible with reform, but a long-term solution is far out of reach.'

China's development path is not a foregone conclusion. The dragon nation faces significant challenges; challenges which are economic, demographic, political and geopolitical.

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Data source: US Treasury, OECD.

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Asia Pacific – An Apple A Day

On other emerging market economies

The International Monetary fund sees 'mixed prospects' for medium term growth across the emerging markets….

Projections remain favourable for emerging Asia and emerging Europe, excluding Turkey, but are tepid for Latin America, the Middle East, and sub-Saharan Africa, where—despite the ongoing recovery—the medium-term outlook for commodity exporters remains generally subdued, with a need for further economic diversification and fiscal adjustment.

I can't see anything to disagree with in there, though I have to admit to being a little keener on the prospects for Latin America, at least from the narrow stand point of equity investment. That might be because I'm keen to diversify away from China a little.

Data source: US Treasury, OECD.

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