

SEPTEMBER 2019 MACRO BRIEF

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TOWN CLOSE
Financial Planning

LAST WEEK IN MACRO

ECONOMIC OUTPUT (USA)

Still plodding on

Last week, the Bureau of Economic Analysis (BEA) released its revised estimate for growth during the second quarter, indicating that US gross domestic product increased at a rate of 2.0 percent rather than 2.1 percent. A downgrade isn't quite as happy an occasion as an upgrade but 0.1 percent is neither here nor there, though it does confirm a sharp deceleration from the 3.1 percent increase in output growth during the first quarter.

The bright spot in the US economy remains the consumer, just as it is in the UK. Indeed, the BEA's Personal Incomes and Outlays report, also released last week, evidences strong household spending in July in particular. That being the case, the current record-long expansion might well persist a while longer. Indeed, third quarter growth on a par with that in Q2 feels about right to me and is further supported by the most recent GDP 'nowcast' from the Atlanta Federal Reserve (see page 3).

In fact, my expectations are pretty much in line with the consensus. The Wall St Journal's monthly survey of economists outlines similar predictions between a low of 1.9 percent and a high of 2.3 percent. Mind you, the economist herd is a little spooked by the recent yield curve inversions; the average response on the likelihood of a recession in the next twelve months or so has charged toward 34 percent, up from 18 percent at the same time last year. Joel Naroff, of Naroff Economic Consulting, is in the lead with a comparatively pessimistic 65 percent chance. I think, though I am not certain, that he is driven by a belief that the Sino-US trade war will 'continue for an extended period and is likely to ramp up'. That is an entirely reasonable belief of course, even if you might

disagree with the extent to which the US economy will suffer. The stragglers include, Brian Wesbury, Chief Economist at First Trust Portfolios. He sees the chance of a recession as low as 10 percent. Presumably zero percent felt just too darn bullish. He argues that the cost of the tariffs imposed on China by the US (and vice versa) will be mitigated as production moves away from China.

His argument is sound – it is Chinese-produced goods that are being targeted, not the goods per se. The same goods sourced from other countries will escape the hiked tariffs.

INFLATION (USA)

Still off a little

The Federal Reserve's preferred measure for inflation is the Personal Consumption Expenditure price index. The BEA calculates a 1.4 percent increase in the year to the end of July, up from 1.3 percent in June. Save for some time last year, PCE has undershot the 2.0 percent target for much of the last seven years (see page 4). That, allied with moderate economic growth at home and near static growth abroad, is why market participants are predicting with near certainty that the Federal Reserve will reduce the target for the Fed Funds rate at the next opportunity on 18th September. And while I remain thoroughly unconvinced of the need for lower rates, I'm not betting against the consensus on this one.

GENERAL ELECTION (UK)

To me, to you

Did the markets ‘breathe a sigh a relief’ when parliament took the no-deal option off the table last week? That’s certainly how some commentators see it. After all, between Monday and Friday, the pound gained 1.7 percent on the dollar and stocks in the CBOE UK 250 index jumped 2.0 percent. Yet the pound remains 8.0 percent lower than it was in mid-March when MPs blocked no-deal ahead of the original deadline. That, in my view, is the more informative observation. Nothing is resolved. And the longer a resolution alludes us, the worse it will get for the pound and the British economy more broadly.

With luck, a general election will come sooner rather than later. With luck, a general election will give rise to a government with a workable majority.

As it stands, the polls put the Conservatives on 33 percent, Labour on 24 percent, the Liberal Democrats on 19 percent, the Brexit Party on 13 percent and the Greens on 6 percent. William Hill estimates the chance of a Tory majority at somewhere near 38 percent with the same for a Labour win at just 9 percent. A hung parliament is, though, the single most likely outcome as far as the bookies are concerned. If they are right, it seems to me that a coalition of the right, rather than of the left, is the more probable. But just such a coalition – involving the Conservatives, Brexit Party and DUP – would likely display a cast iron will with regards to leaving the EU but it may prove too brittle to persist beyond that. And so, Labour – or a coalition of the left – might get more than one bite of the election cherry in the near-ish future.

Putting aside my own political affiliations, the potential for a Labour-led government is

cause for concern for some investors. Indeed, Labour’s manifesto pledges include a new higher top rate of personal tax, increased corporation tax and below-market-price nationalisation for the utilities. Not yet policy, but mooted at least, is an enforced right-to-buy option for tenants in privately owned housing and a mandated stock transfer of 10 percent for listed companies with more than 250 employees. None of those policies are what you might call market-friendly. But what has spooked investors most – if the kinds of questions I am fielding is representative – is the chanced imposition of capital controls.

Ordinarily, capital controls come in the form of limited bank withdrawals and banned transfers of money to abroad. John McDonnell has been quizzed on this issue a number of times since it became public knowledge that he had commissioned contingency plans dealing with a postelection run on the pound. He told the Financial Times earlier this year that he wants to ‘make it explicit that we will not introduce capital controls’.

Still, if you have particularly nervous investors with large liabilities overseas (including those with intentions to live overseas) it might be worth maintaining sufficient capital out with UK borders to fund those liabilities. Of course, investors transferring sterling assets into any of the other major currencies at this time are doing so when the pound is comparatively weak. They also risk missing out on gains if their fears don’t manifest.

It is an immutable fact I’m afraid; investors cannot avoid risks altogether, they can only choose those they wish to take.

MONETARY POLICY (EUROZONE)

A bit like Predator II

Imagine my excitement; the European Central Bank was about to deliver what the Finnish central bank chief suggested might amount to a ‘significant and impactful policy package’.

And then, at the post-meeting press conference Mario Draghi announced to us all that ‘in pursuit of its price stability mandate’ the Governing Council would reduce the main policy rate of interest by 10 basis points (to -0.5 percent) and would keep it at that level (or lower) until inflation edges closer to, but below, 2.0 percent. Additionally, it will, effective from 01 November, revive its asset purchase (or ‘QE’) programme at a pace of €20 billion per month for an open-ended period of time. Oh, and let’s not forget that ‘the modalities of the new series of quarterly targeted longer-term refinancing operations will be changed to preserve favourable bank lending conditions’.

Hmm. Well, its not a bad policy package I suppose, but I can’t say it was worth the wait. And the markets were barely more impressed than I was. Indeed, yields across the eurozone finished the week higher rather than lower and the euro gained 0.7 percent in trade-weighted terms during Friday. I’m afraid Super Mario’s last act won’t be a blockbuster. Mind you, his supporting cast have let him down. Here’s what he had to say, during the Q&A session of the press conference, about the performance of policymakers at the governmental level... “Almost all the things that you see... the creation of more than 11 million jobs... the recovery, the sustained growth... were by and large produced by our monetary policy... there was very little else.” That is a barbed observation and it throws the spotlight on Germany in particular where a reluctance to provide any sort of fiscal stimulus is a contributing factor to a likely recession in the eurozone’s largest economy.

MONETARY POLICY (USA)

Still going down

Prices in the bond market are consistent with a 25 basis point cut in the Fed Funds rate when the Federal Open Market Committee meets later this week. It is very likely, in my estimations, that the Fed will deliver what the market expects and the upper limit of the target range will be reduced from 2.25 percent to 2.0 percent.

Having said that, we did see a fair degree of change in expectations over the course of last week. On Monday, the CME Group’s Fed Watch Tool suggested that the futures market assigned a 91 percent chance of a cut. By Friday the same likelihood had dropped to 80 percent.

ECONOMIC OUTPUT (UK)

Fragile

The Office for National Statistics estimates that the British economy grew by 0.3 percent in the opening month of the third quarter. That’s good news of course, even if there is some evidence to suggest that more stockpiling – this time ahead of the second Brexit deadline - is at least partially responsible for that increase.

In any case July’s strong-ish showing reduces the risk of recession by increasing the likelihood that the third quarter will deliver positive (or flat) growth following a contraction of 0.2 percent in the second quarter.

MONETARY POLICY (USA)

Contrasting styles

Forward guidance, as a policy tool, is thriving in fertile soils in the euro zone but it was left untended to die a certain death in New York last week. Contrast this from Mario Draghi...

‘The [European Central Bank] now expects the key interest rates to remain at their present or lower levels until it has seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2 percent’.

...with this from Jerome Powell...

‘There will come a time, I suspect, when we think we’ve done enough. But there may also come a time when the economy worsens and we would then have to cut more aggressively. We don’t know’.

The latter statement, which followed the Federal Reserve’s decision to prune 25 basis points from the target for the Fed Funds rate, is the more pleasing to me. And not just because I prefer the monetary policy landscape a little wilder. I think ‘forward guidance’ has contributed to the horribly flat yield curves we see across the developed markets by thinning what ought to be healthy term premia and I am not sorry to see it go.

From here on, the Federal Reserve really is ‘data dependent’ and with just two more meetings – on 30 October and 11 December – it’s anyone’s guess where rates will be come the end of the year. As it stands, the markets are pricing the probability of a 50 basis point cut at, or before, the December meeting at just 15 percent with a 25 basis point cut at a more likely 63 percent.

INFLATION (UK)

Below target

The Office for National Statistics estimates a 1.7 percent increase in the Consumer Price Index in the year to August, down from 2.0 percent in the year to July. That’s a little below the Bank of England’s target rate but not so low as to be cause for concern. Indeed, inflation is pretty much exactly where most, including the Bank, expected it to be.

Looking at the detail of the ONS release it seems that downward pricing pressure was observed broadly but most noticeable in the ‘recreation & culture’ and ‘clothing & footwear’ categories - good news for those that like a night out in a new frock and trainers.

MONETARY POLICY (UK)

On hold

The Bank of England’s Monetary Policy Committee voted unanimously, as it had on each of the prior seven occasions, to maintain Bank Rate at 0.75 percent. The Committee also agreed to maintain the stock of bonds it has bought at £445 billion.

Rate setters face a terrific amount of uncertainty in their attempts to keep inflation at 2.0 percent. The terms of our departure from the EU are still not clear and a general election is around the corner. Sterling could rise a lot or it could fall a lot. Domestic demand could rise a lot or it could fall a lot. Mind you, the chances that Bank Rate moves a lot any time soon are much, much lower.

INFLATION (USA)

Getting louder

There are two important measures of inflation in the US. The Consumer Price Index (CPI) is the more familiar to us over on this side of the Atlantic. On this measure, the most recent reading compiled by the Bureau of Labour Statistics suggests that inflation is rising at 1.7 percent compared with the same time last year. Meanwhile, core-inflation increased 2.4 percent over the same period.

But it is inflation as measured by the Personal Consumption Expenditure (PCE) index that is the more important; that is the one the Federal Reserve reference with regard to the 2.0 percent target. The most recent PCE report, published last week by the Bureau of Economic Analysis, insists that year-on-year inflation is running at the cooler rate of just 1.4 percent. At the same time, Core-PCE increased 1.8 percent.

There is a big difference between the two. No so much in absolute terms, I'll grant you, but certainly in terms of policy. The Federal Open Market Committee has, for some time, expressed a concern that inflation has been running at a pace well below the target. Indeed, PCE has average 1.4 percent over the last seven years or so and it is one of the reasons the Fed has cited in cutting rates of late. But while PCE remains muted, inflation has trended higher on the CPI measure – so much so that the most recent increase in CPI marked the sharpest shift in more than a decade.

Ordinarily, I ignore the CPI release and focus more readily on PCE. But I don't feel comfortable doing that today. Other measures of inflation that don't share the celebrity attached to the CPI and PCE measures are singing a song not dissimilar to CPI and I am beginning to worry that PCE may be understating inflation a little or that accelerated increases in CPI inflation is a precursor for the

same in PCE. Economists polled by the Wall St Journal expect CPI to trend from 1.7 percent in the most recent reading (which accounts for the year to the end of August) to 2.0 percent come the end of December. If the PCE measure does join that particular choir soon, the Fed will have one fewer reason to dial down rates.

As it stands, I expect another 25 basis point cut in 2019, and most likely during the December rather than the October meeting. In that sense, my expectations are in harmony with the broader consensus. It seems to me that market participants are confident that the Fed will loosen policy further in a bid to support the current expansion and mitigate downside risks from the trade war.

But if the US economy grows at a moderate pace for a while longer, unemployment remains at or close to a 50-year low and inflation does creep back toward target, how easy will it be for the Fed to maintain lower and lower rates?

The answer to that is 'not easy at all'. All things being equal, and given a prolonged period of inflation-undershoot, I think the Fed could reasonably defend a relatively passive role in the light of a limited overshoot (say up to 2.2 percent) but only then for a short period of time.

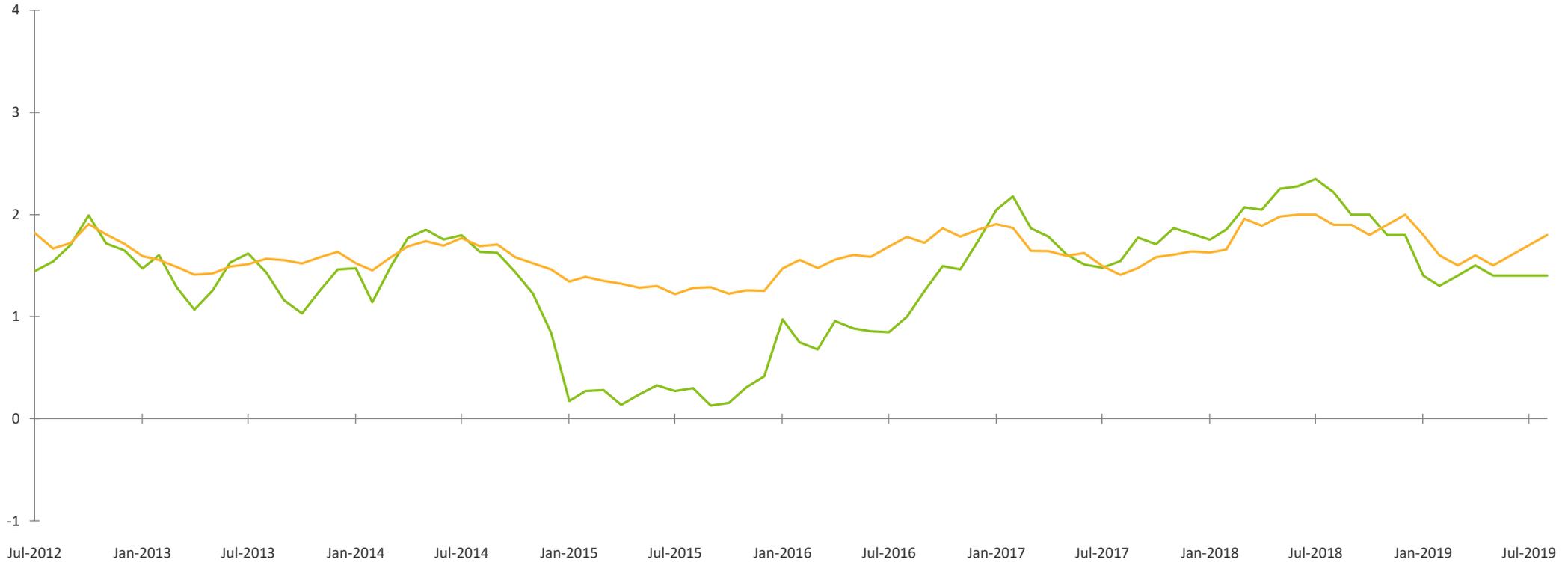
What seems increasingly apparent today though, is that for first time in a long time it is not automatically clear in which direction, and to what extent, US inflation is headed.

What is more certain however, is that both the equity and bond markets are very sensitive to that outlook.

US BASKET COSTS

Personal Consumption Expenditure Price Index

— PCE (%) = 1.4 — PCE ex food & energy (%) = 1.8



NOTES.

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