JANUARY 2020 MACRO BRIEF

In association with Cormorant Capital.

TOWN CLOSE
Financial Planning

LAST WEEK IN MACRO

Geopolitics (USA/Iran)

Known unknowns

A few days after Christmas, a rocket attack on an Iraqi military base near Kirkuk killed an American civilian contractor and wounded several US service personnel. Apparent in targeting US troops, it was the 11th such attack in just the last eight weeks. Two days later, three US air strikes targeted positions housed by the Iranian-backed Kataib Hezbollah militia. Another two days after that, pro Iranian protestors attempted to storm the US embassy in Baghdad, scaling walls, forcing the gates and setting fires inside the bounds of the outer perimeter. That is the sequence of events that led to another US air strike on Friday, this time targeting Qassim Suleimani and Abu Mahdi al Muhandis. Both were travelling together, and both were killed. Suleimani was commander of Iran's Quds Force – the foreign-facing arm of the Islamic Revolutionary Guards Corp – and by reputation the second most powerful man in Tehran. His obituary in the New York Times blames him for 'hundreds of American deaths in Iraq and waves of militia attacks against Israel'. Al-Muhandis was the commander of the Kataib Hezballah.

In responding to the American response, Iran has vowed 'severe revenge'. Of course, that begs the question doesn't it.

I don't know what Iran is going to do next but I'm a long way from forecasting a third Gulf war. Iran has neither the military nor the economic resources to engage with the US and her allies in any conventional sense. And, so far as I can tell, there is little appetite for that kind of war in the US.

Instead, I expect Tehran to expand on an established pattern of asymmetric attacks – more militia assaults close to US forces, more harrying in the Persian Gulf, some efforts in cyberspace too – with a broader set of targets to include US facilities elsewhere. British, Israeli and Saudi interests are also likely targets. That too would follow an already established path. Indeed, the British embassy in Tehran was overrun back in 2011 with protestors chanting 'Death to America', 'Death to England', 'Death to Israel' and the Saudi embassy in Tehran was similarly overrun in 2016 and in September this last year Iranian-backed Houthi rebels targeted two Aramco installations inside Saudi Arabia.

I don't want to appear complacent. I do concede that it's easy to see how the situation could hurtle us toward deeper conflict.

But, for now at least, I'm not taking any particular action in terms of asset allocation or fund selection.

There are two reasons for that. The first is that such short-term speculations are anathema to a long-term, full-cycle approach to investing and, in my experience, rarely prove profitable in the fullness of time.

The second is that I am constantly at pains to encourage investors to broaden their exposure to include assets likely to provide protection in the event of contingencies like this. I've been reasonably successful in that endeavour and that eliminates the tendency for post-hoc panic.

Accordingly, during Friday, alongside major stock market declines we saw gilts increase 1.5 percent, gold bullion up 1.4 percent, index-linked gilts up 1.0 percent and a basket of overseas government bonds (featuring mostly US treasuries but also some JGBs and bunds) increase 0.3 percent.

Employment Situation (USA)

I like to count things

The Bureau of Economic Analysis estimates a net increase of 140,000 new posts among those reported in December's nonfarm payroll; a little lower than the consensus expectation for 160,000. Notwithstanding the usual updates and revisions to the data, I count something like 2.10 million newly created jobs during 2019. That's down on 2018's 2.68 million but it does mark a record 10th consecutive year of gains. On this measure, you have to conclude that the US economy is in good shape. Meanwhile, I see nothing in this report – nor any of the other employment surveys – to convince me that the Federal Reserve will do anything other than remain on hold. That ought to prove reasonably supportive of asset prices in both the bond and equity markets.

Employment Situation (Eurozone)

Young and skint

Eurostat has some good news to share with us. The November estimate for unemployment across the Eurozone comes in at 7.5 percent. That's the same rate as that for October but it is 0.4 percent lower than it was a year earlier. As it happens, 7.5 percent is the lowest rate since July 2008 and not that far off a record low of 7.3 percent.

The bad news is that 7.5 percent equates to 12.3 million people. But that's only half the story. Youth unemployment is stuck at 15.6 percent where it has been for much of the last year. In Greece, Spain and Italy, something like a third of those under 25 are unable to find work. The European Union is failing its young.

Inflation (Eurozone)

Low and staying low

If the initial estimate is accurate, November saw inflation accelerate from 1.0 percent to 1.3 percent across the Eurozone. That will please the European Central Bank's (ECB) new chief, Christine Lagarde. Of course, we are some way off the close-to-but-lower-than-2-percent target but it's a step in the right direction after months of steady decline.

Mind you, that's about all we can say. The ECB is not going to change its policy approach any time soon. As it stands, I expect the Governing Council to maintain its current stance for at least the first half of this year. The implications are that monetary policy will remain supportive of bond prices and, to some extent, equity prices too.

Geopolitics (Iran)

Known knowns

Last week, as I was dismissing the potential for a third Gulf war, Brent Crude was priced at $69. Then, following a retaliatory missile attack on Iraqi air basses, it headed to $72. Today a barrel of the black stuff costs $65. That tells you most of what you need to know about the matter. President Trump's response to the missile attack – as it happens, a relatively tame affair – was to announce an expansion to already-expansive US sanctions and to promise that Iran would not be allowed to build a nuclear weapon while he was president.

So, with monetary policy at each of the major central banks likely on hold, geopolitics may well have an oversized effect on asset prices in the first half of this year.

Monetary Policy (United Kingdom)

There has been a dramatic shift in the outlook for interest rates over the last few days. A week ago, prices in the futures market reflected a 10 percent chance of a 25 basis point cut when the Monetary Policy Committee (MPC) meets at the end of the month. A few days later that probability had rocketed toward 70 percent. Two trends facilitated that increase.

The first came in the form of a series of comments from members of the MPC suggesting that they were ready to vote for a reduction should incoming economic data deteriorate. There's nothing particularly newsworthy in that regard, that's pretty much what you'd expect – especially from those (Michael Saunders and Jonathan Haskell) that had already voted to cut rates at both the November and December meetings. But the market was alerted by similarly dovish comments from two more policymakers (Gertjan Vlieghe and Silvana Tenreyo), bringing those we know to be inching toward a cut to a total of four of the nine rate setters.

The second trend was represented by the afore mentioned deterioration in economic data. First, we learnt that gross domestic product shrunk by 0.3 percent during November. That was a surprise to those of us with consensus views expecting a more moderate decline. Then came an equally unanticipated fall in the pace of inflation during December, wrongfooting the consensus again. Indeed, news of a fall in the headline Consumer Price Index from 1.5 percent in November to 1.3 percent more recently was accompanied by a sharper slowdown in core inflation, this time from 1.7 percent to just 1.4 percent. As if that wasn't bad enough, the Office for National Statistics also estimated a fifth consecutive monthly decline in retail sales, marking the longest period of stagnation for the sector in a record that stretches back to 1957.

I have some sympathy with those likely to vote for a cut in Bank Rate. The data has been awful and, with rates already low, the Bank will be keen to leverage what little room it has by moving sooner rather than later.

But I'm yet to be convinced that a rate cut is warranted at this stage.

The data being released now pertains to a period of parliamentary paralysis, peak Brexit uncertainty and, ahead of the general election, the potential for another hung parliament and/or a Marxist Chancellor of the Exchequer. Contrast that with a strong (and united) Conservative majority with a clear timetable for Brexit and an inclination to add fiscal stimulus to pre-existing, highly-accommadative monetary policy. There is, at least in my mind, a world of difference.

Still, I think we can count on Haskell and Saunders to vote for a cut, and it seems likely that Vlieghe and Tenreyo will too. Whether we get a fifth member to bring the majority onside is dependent on the data between now and then. It's going to be a close run thing either way.

Still, we are only talking about the potential for a 25 basis point move. So far as I can tell, market participants are not expecting any parallel bond purchases or other policy measures that might signify a more aggressive shift. In that sense, we are currently in a low inflation, low interest rate environment and that isn't going to change soon.

Looking beyond the immediate future, I'm increasingly optimistic for the prospects of both the UK economy and the domestic stock market. If Blighty and her fleet of enterprises can maintain forward momentum, however slow, through the turmoil of 2019, she can certainly do so in the calmer seas of 2020.

Monetary Policy (United Kingdom)

Well, this is exciting. The Financial Times describes this week's interest rate decision as 'the most unpredictable for years'. The FT's hyperbole usually makes me wince, but I found myself nodding – imperceptibly - when I read that. A great many agree with me and the FT. Indeed, the futures market is pricing the probability of a rate cut, during Mark Carney's last meeting of the Monetary Policy Committee (MPC), at 55 percent with a hold coming in a shade less at 45 percent.

Either way, it's going to be a close-run decision, with a notunlikely 5-4 split in the voting pattern. That doesn't happen very often at all. Indeed, I suspect that the MPC will collectively regard the level of uncertainty attached to this meeting as less than ideal. Central bankers like to be the deliberate authors of surprising shifts.

The reason this meeting is so difficult to judge is that last the week-before-last's run of awful economic data - including a 0.3 percent decline in real GDP during November, a surprising drop in headline inflation from 1.5 percent to 1.3 percent and a fifth month of declining retail sales during December – was followed last week by a run of more cheerful indications.

The first release came from the boffins over at the Office for National Statistics. They revealed on Tuesday that most recent estimate – coinciding with the three months to November – suggests that employment had risen to its highest levels in a record that stretches all the way back to 1971. Additional analysis also suggests that wage growth was stable at 3.2 percent.

A day later, on Wednesday, the CBI unveiled the results from its survey of 300 manufacturing firms. Their findings report that 'business optimism improved significantly in the quarter to January'. According to the report, the apparent improvement came at a faster pace than it has at any point in more than five years.

Finally, on Friday, the IHS Markit/CIPS Flash UK Composite Purchasing Managers' Index highlighted a 'decisive change of direction for the private sector economy at the start of 2020' and increased business activity for the first time in five months 'driven by the sharpest increase in new work since September 2018'. IHS Markit's Chief Business Economist, Chris Williamson, is minded to believe, like me, that easing political uncertainty is at least partly responsible for a much-improved outlook.

I have to admit though, Williamson, is far less equivocal than I am about the impact the results of this survey will have on the MPC. He's adamant that 'the rise in the PMI kills off the prospect of an imminent rate cut'.

I have a reasonable degree of sympathy with his view. The malaise evidenced in the declines in output and inflation pertains to a period of terrific uncertainty in parliament,
afflicting broad sweeps of the British economy from business investment to housing activity. Now, the political landscape is spectacularly transformed. If I were voting on Friday, I'd vote to hold.

Of course, all of this matters. The capital markets dance to the modern monetary policy beat. But, having said that, a 25 basis point cut – or not – doesn't alter the outlook much at all. We are locked into a low interest rate environment for a while longer, whatever comes this week.

—

P.S. The Federal Open Market Committee also meets this week. The outcome of that – a hold - is as close to a dead cert as you can get in the fuzzy field of economics.

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

Suite 2, 258a High Road

Loughton

IG10 1RB

Tel: 020 7993 4898

Email: advice@townclosefp.co.uk