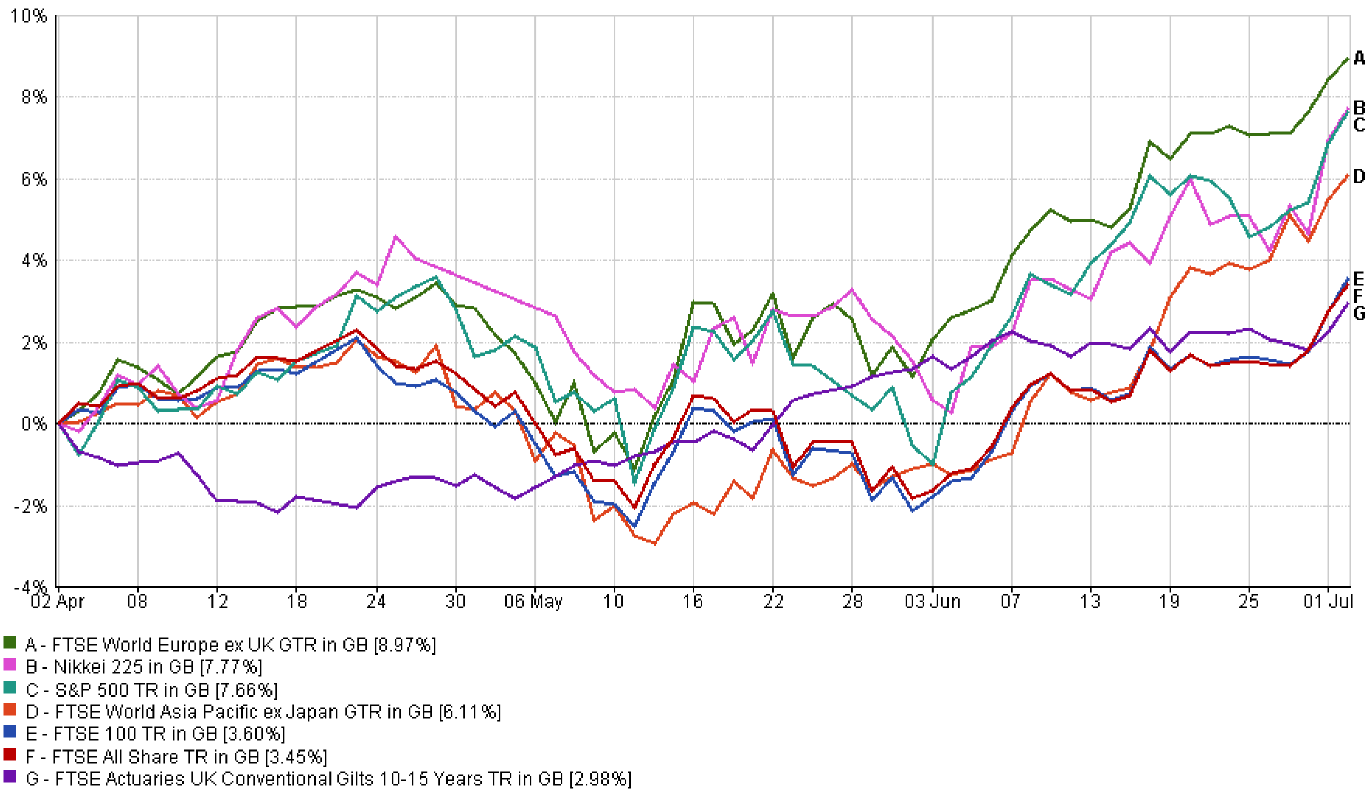
INVESTMENT
COMMENTARY

July 2019

CARTLIDGE MORLAND

The last month has seen equity markets perform well driven by a number of factors which have led to increased investor optimism. Presidents Trump and Xi met at the Osaka G20 Summit with expectations that steps would be taken to try to resolve the impasse in trade talks. They did agree to resume trade talks and stop the imposition of further tariffs. In addition, the proposed US tariffs on Mexico were suspended indefinitely earlier in June. With economic data pointing to slowing economic growth and inflation subdued, the European Central Bank (ECB) indicated that it may reintroduce stimuli to support the eurozone economy. The US Federal Reserve (Fed) left interest rates on hold with the prospect of no further rate rises this year whilst the Bank of England (BoE) kept rates on hold as uncertainty persists around Brexit and future strategies of the new Prime Minister. Oil prices have risen as Russia and Saudi Arabia have agreed to extend production cuts until March 2020.

Investment Markets Sterling Returns over Three Months



02/04/2019 - 02/07/2019 Data from FE 2019

US

The US Federal Reserve voted by 9-1 to keep interest rates on hold at a range of 2.25%-2.50% at its meeting in late June. The Fed now seems more dovish as members had become concerned about slowing economic growth against a background of rising trade tensions. The US manufacturing sector continues to grow but at the slowest rate in over two years whilst the services sector is also growing at a far slower rate. The Fed stated that it would “act as appropriate to sustain expansion.” This was a change from its “patient” stance at its previous meeting. Whilst the employment rate is very strong, with the unemployment rate at 3.6%, inflation remains below the Fed’s 2% target. Wage growth has also slowed to around 3.1% pa although retail sales have remained strong. Against this background, there appears to be little chance of a change in interest rates this year and perhaps even a cut/s in 2019. President Trump remains critical of the Fed; he believes that rates should not have been raised so quickly as this has led to a strong US dollar so impacting on the US’ competitive position in the world. The US equity market has been supported by the lack of action by the Fed in recent meetings and the hope that issues surrounding the US/China trade war will be resolved in the light of discussions being reopened. The suspension of proposed tariffs on Mexico also helped sentiment. However, it should be borne in mind that US company earnings have fallen 3% over the year with earnings estimates being revised downwards across most sectors - in particular the crucial technology sector.

UK

The Bank of England maintained Bank Rate at 0.75% at its meeting in late June. It expects there to be minimal economic growth in the second half of 2019 whilst Brexit uncertainty persists. Companies are holding back on investment as a result which has had a negative impact on economic growth. Against the backdrop of a slowing global economy, factory orders are at their lowest level in nearly three years. Economic indicators across the services, construction and manufacturing sectors all point to weaker economic growth. The economy contracted in April by 0.4% - its worst fall in around three years. This was due mainly to the dramatic reduction in car production as annual shutdowns were brought forward. Stockpiling ahead of the original Brexit date had also boosted March figures. However, employment is at a record high with the unemployment rate at its lowest level since 1974. Weekly earnings are rising in real terms at around 1.5%. To date increasing earnings have not impacted the inflation rate as inflation fell to 2% pa in May from 2.1% pa in April.

EUROPE

The European Central Bank has kept its main interest rates on hold in common with the other main central banks. It has indicated that rates will remain on hold until mid-2020. Given slowing economic growth and sub-target inflation in the eurozone, the ECB has committed to a new stimulus package which may involve renewing its bond buying programme and perhaps even interest rate cuts. However, it may be these stimuli prove to be insufficient and countries may have to act independently using other fiscal measures. Germany, the powerhouse of the eurozone economy, has continued to experience weak export growth so the Bundesbank has cut back its growth forecast to 0.6% for 2019 from 1.6% forecast in December 2018. The German government is also expecting slower growth too. Italy's economy is forecast not to grow at all this year with domestic demand very weak. Whilst wage growth elsewhere is rising, in Italy it is not. The Italian government's budget is unacceptable to the EU although the EU is trying to reach a deal so that sanctions are avoided.

EMERGING MARKETS

The performance of emerging markets equities had been negatively impacted by the ongoing trade war concerns. The recent agreement to reopen talks has been positive for these developing economies. Economic data in Brazil appears to be slowly improving as the key pension reform legislation is making its way through parliament. Bank lending has increased and inflation appears to be falling. The gradual economic recovery is helping the fiscal balance with the primary deficit declining. However, unemployment is still at an elevated level indicating spare capacity in the economy. In India, Narendra Modi led his party to a landslide victory in May. However, the Indian economy has slowed to a growth rate of 5.8% pa in the first quarter of 2019 – its lowest increase in five years and sharply down from 6.6% in the last quarter of 2018. The new administration faces economic and social challenges.

ASIA PACIFIC

The Bank of Japan continued with its monetary policy, leaving interest rates on hold as weakness in global growth and trade tensions persist. The slowing global economy has led to downgrading of earnings expectations with market valuations now at historic lows. Japan is continuing to improve its corporate governance and is making progress on free trade deals against the backdrop of its stable government. Sentiment in the Asia Pacific region has improved recently as the US and China have agreed to reopen trade talks and suspend planned increases in tariffs. In addition, the ban has been lifted on US companies supplying the Chinese technology giant, Huawei. Economic statistics point to a contraction in manufacturing across the Asia Pacific region, including China. New business and international sales have fallen in China. The Chinese government continues to boost its economy with significant infrastructure spending with new initiatives announced for railway and road construction as well as projects to improve electricity and gas supplies. Investment growth is likely to quadruple in the rest of 2019 relative to 2018. The Chinese government continues to try to rebalance the economy away from reliance on traditional exporting heavy industry to one based on stronger domestic demand.

FIXED INTEREST

Government bonds have rallied around the world since the start of 2019 due to weakness in economic data and the increased likelihood of the major central banks easing monetary policy. The ECB and the US Federal Reserve have both indicated that interest rates will not be rising in the short term and indeed could be cut. Inflation in developed economies does not currently appear to be a problem. The US bond market is indicating two interest rate cuts by the end of the year. Investors are still seeking yield and corporate bond markets continue to perform well against the more dovish tones of the central banks. It is likely that the ECB will restart purchases in the corporate bond sector and this will only add to the strong demand for corporate bonds. With government bond yields likely to remain low, investors have sought and continue to seek higher yields within the bond market.

COMMERCIAL PROPERTY

Transaction volumes in the commercial property market continue to remain low as Brexit uncertainty weighs on the market. A variety of domestic and international investors still wish to invest in the market but stock availability is very low. Capital returns have been negative very recently with the values of retail assets most at risk due to concerns about rental levels and occupier stability. Retail warehouses, in particular, have been adversely affected as vacancy rates increase and rental levels reduce. The demand for office space has been broadly stable with a rise in demand in the industrial sector. Rental growth expectations remain positive for the industrial sector in the short term and also for prime offices.

OUR VIEW

Slowing global economic growth is our principal concern. Policymakers wish to manage stable growth year after year – applying the brakes when growth rates seem high, with asset bubbles building and providing stimuli when growth slows and recession appears to be a risk. Getting this balance right is difficult.

Although much is written about China, it is the US which remains pivotal to global financial markets and is the key centre for global demand. A Democrat House of Representatives has poured cold water over President Trump's plans for a tax-lite, (potentially) Federal debt-fuelled boom. Much to the President's frustration, the Federal Reserve acted decisively to deter break-neck expansion followed by bust. Added to this, the global trade tensions caused by the President's muscular approach to trade relations have acted as an effective suppressant globally.

As we have observed previously, there has been no serious challenge to an increasingly integrated global economic order for decades. China emerged only to become increasingly integrated within a global economic order designed by the West (and dominated by the US) since WWII. President Trump believes other countries, especially Germany and China, have progressed largely at the expense of the US and its citizens. He wishes to impose a new global order which is 'fairer' to the US but less advantageous to other states. At this same time, the ramifications of the UK's withdrawal from the European Union are virtually unknown for either party despite the assertions of commentators on both sides of the argument. The question for the US, China, the EU and the UK is really whether the global economy is now so fully integrated that tariff barriers and predatory trade practices simply harm the perpetrator's customers and result in less business for all. China's attempts to build its own 'co-prosperity sphere' with countries signing up to quasi-colonisation in return for 'investment' is likely to be a financial drain on China and a source of political tension with its major Western customers, potentially damaging much more important trade with them.

The danger is that a harmonious global economic order is fractured by tensions amongst the major participants resulting in lower volumes of global trade – potentially to the immense disadvantage to all but especially to countries such as Germany and Japan which export a high proportion of GDP. This in turn would affect the global revenues of the World's largest corporations suggesting lower earnings and less value for shareholders. This scenario would result in a pause in share prices at best and at worst a fundamental reappraisal of the value of the World's major corporations. Those that are heavily indebted with highly leveraged balance sheets might not survive a severe reduction in earnings.

OUR VIEW continued

It is far more likely that the global economic order and the international institutions that support it will be reformed successfully and, if this turns out to be the case, businesses will be confident in investing. Ultimately, China will have to accept the rules of the game if it wishes to continue playing, which means cutting production of counterfeit goods and patent theft, for example. That along with a fairer tariff regime will mollify Mr Trump and if he can 'make a deal' with the Communists, the EU will surely be easier? As for the EU/UK, the EU will surely realise that introducing tariff barriers to its largest external customer is unlikely to be beneficial and the UK will have to accept that if it concludes a 'free-trade' agreement with the EU, it will have to accept their requirements for exports into their markets. (The tension in this is that the EU demands the same rules should apply to trade within the UK itself and to the UK's trade with third party countries).

Financial markets have performed strongly since the beginning of the year, largely recovering their early Winter losses*. The summer holiday period is often one of increased volatility and it seems unlikely markets will gain clear direction until early Autumn. Portfolios are positioned to gain from opportunities wherever they may arise but to protect the downside risks too. We have become more concerned about UK commercial property now that economic growth has faltered throughout Europe and the political impasse surrounding 'Brexit' is hitting business investment. Our weightings in commercial property have been reduced over time (since before the Great Financial Crisis), not least because commercial property funds have limited liquidity and will need to be gated if a 'no-deal' Brexit causes an exodus of investors. The latter said property will re-establish proper value level once the situation is calmer. It should be remembered that commercial property should be retained for the longer term and its income generation proves a useful diversifier in a portfolio.

*Markets/portfolios have reflected this recovery in their strong returns over the past six months. However annual returns take into account the weaker performance from July to December 2018 so UK equity performance has been almost flat over a year, for example. It would be wrong to gain the impression that all equity markets have performed as well as the US. The US market has been supported by strong forward earnings expectations and share buy-backs. As earnings prospects weaken and leverage appears less attractive, such buy-backs are likely to be reined in. Revenues will be weaker in response to a slowing US/global economy.

INVESTMENT COMMENTARY BY EMAIL

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