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Market View

As we write the defining event of 2019 seems to be getting closer, not the UK General Election, but a trade deal between the two economic superpowers China and the USA. The trade war has pushed the US close to recession with factory orders falling, the news flow does now suggest a "phase 1" deal is imminent. The global economy needs it. Growth is way behind where it should be at this point in the cycle and Central Banks are struggling to respond to the slowdown. The global economy needs the stimulus that a resumption in trade would bring. The unrest in Hong Kong is creating last minute tension and with someone as unpredictable as Donald Trump markets are excited that a deal is close but nervous that it all could go horribly wrong at the last minute. A trade deal would help, but governments do need to spend more, but will struggle to do so.

The Global Economy and the Bond markets

The path to the current global economic situation began with the financial crisis of 2008/09. The Credit Crunch saw the collapse of many businesses, those that did survive cut costs savagely. Not only were employees made redundant but also the nature of employment changed. We saw the widespread introduction of zero hours contracts, agency work etc., low cost and flexible for the employers, not so good for the employees. Governments bailed out banks and went beyond their borrowing limits, consequently the bond markets demanded the promise of a balanced budget in the future and thus cuts in spending. In the UK these austerity measures led to Local Authorities cutting many services; reduced defence spending hit many manufacturing industries and the banking industry was decimated, losing hundreds of thousands of employees. Globally, Central Banks responded to the crisis with cheap money and QE, this saved the banks and inflated asset prices. Bond yields consequently fell which forced equity prices up and crucially for the UK economy also property prices. The net result was those with assets, got richer and the poor got poorer. A pattern not just in the UK but in the USA and Europe as well. The UK economy is unique amongst the major economies, it is perhaps the first post manufacturing one? The wealth of the UK as a whole is dependent on the servicing, recycling and growing of existing wealth i.e. money makes money and the housing market is central to this. Our economy needs low interest rates and restriction-free bank lending. Low mortgage rates are a major determinant of the future direction for the UK economy. Mortgage interest rates are set according to bond yields and these are set according to how much money a government borrows and whether they have confidence in a government.

Funding Governments

Governments cannot create money (only Central Banks can), they are a conduit for tax revenue and borrow what else they need from the markets. There is a psychological threshold up to where people are "happy" to pay tax. The tax raising model started in Hong Kong when the Colonial masters realised that canny Hong Kong residents found myriad ways of avoiding tax, introduced a simple flat rate of income tax and soon the territory's coffers were overflowing with cash. Corporations are also very flexible and can easily change tax domicile, just as Apple did, from Ireland to Jersey when the EU decided it needed to pay more tax. For the very rich paying tax is a voluntary activity. Government funding is a fine balance, remember Cameron and Clegg didn't desire austerity, it was forced upon them by the Gilt market. If the bond and currency markets have no confidence in the economic management of a country then the exchange rate will collapse and interest rates have to rise to compensate. At the same time, if you borrow excessively and lose your credit status you end up having to pay punitive interest rates, governments are no different to any other borrower. Bond yields globally, because of QE, have fallen to extreme lows, even in the UK, but the underlying economies still need stimulus, but where will it come from? It can only come from fiscal measures, but governments are in a bind, they can't tax more as it won't raise any more hard cash. They can't borrow any more, as they are up to their "overdraft limits" and the bond markets will punish profligacy and any sign of economic mismanagement?

Green "New Deals"

As ever politics can come up with an answer, the changing climate is now being used to justify fiscal stimulus and circumvent existing borrowing protocols. Notably in Germany, the country in Europe with both the deepest pockets and greatest financial headroom has strict borrowing limits. But their economy is heavily reliant on manufacturing the internal combustion engine and also coal power. Using the climate as an excuse, there are now plans for heavy investment in new "green" technologies and power generation infrastructure etc. For the global economy it doesn't matter whether it is green or not, it is fiscal spending and it is needed to take the onus away from Central Banks to get and keep the global economy moving. The task will be that any green-justified investment is not wasted and does actually stimulate productivity and growth.

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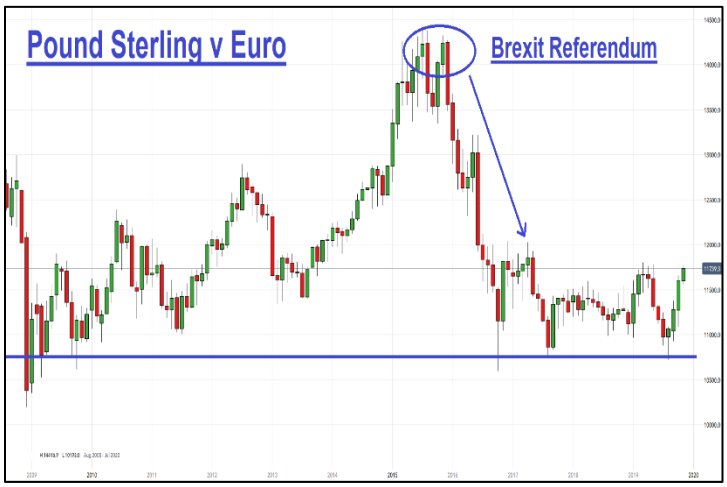
Sterling

The key financial arbiter for any economy is the currency, in the short term it can act as a "safety valve", just as it did in the UK after the EU referendum. The UK's economic performance since the vote has surprised many commentators. It shouldn't, UK economic growth always accelerates after a currency crisis and relative to the rest of Europe that is exactly what has happened.



Post the referendum the pound fell in value against the euro, it also fell against the dollar but then again so did all the major currencies. The rate found support and since then has moved up or down based on the likelihood of a Brexit deal or indeed second referendum etc. What has changed recently is that following the agreement with the EU, traders have spied an opportunity in the undervalued pound. The tone has now changed, the currency markets are seeming, at present, to be comfortable with the Brexit process and are now focusing on politics, whoever forms the next government in the UK will dictate the immediate direction of sterling. Any recovery will be good for holiday spending, but actually not that good for the UK economy.

Impact of Nationalisation on Investment funds

One of Labour's main headlines in its manifesto is to nationalise a number of Utilities including Royal Mail and part of BT. This is easy to say and but in reality could be very hard to do. Large parts of the utility infrastructure are owned by European companies e.g. EDF, EON, Iberdrola, Abiello and EU law, including the Pillar directive for railways, will make nationalisation a legal nightmare. A Customs Union with the EU might mean retaining European Laws, many of which expressly forbid nationalisation. Nevertheless, we need to assess what the impact might be on the UK investment funds that are held in client portfolios. Such companies are most concentrated within UK Equity Income funds and generally represent no more than 5% of a portfolio's assets. However, Utilities do tend to be heavy dividend payers and as such funds may have to restructure their portfolios in order to maintain expected yields.

Markets

The final trading month of the year will bring a very odd investment year to a close. This time last year equity markets "flash crashed" after a poor set of earnings numbers. When the New Year started the buyers returned and pushed prices higher. However, earnings haven't changed, they have remained flat, with many industries virtually in recession. So, as prices have risen so have valuations. The blame has been placed on the trade war. Now, markets are confident that a trade deal will be done and corporate profits will return to growth, thus they are looking through this "flat spot". This is where the risk lies, any delay or indeed cancellation of a trade agreement will leave the equity markets exposed. All eyes will also be on the US Leading Indicators as well as on the global consumer. This will of course be a record breaking Thanksgiving/Black Friday/Christmas, the headlines always say it is, but will company profits confirm it?

As regards sentiment the two major issues of 2019 might just be taken off the table before the year end? One is Brexit, depending of course which party(s) form the next UK government. The other is the much anticipated China/USA trade deal, markets are assuming this will come and will be the panacea for a sluggish global economy. December usually sees the traditional Santa Rally, this comes after Options and Futures expiry on the 19th, many hope it will come earlier. That ultimately depends on Donald Trump, will he be Santa this year or Scrooge?

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