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Chris Adams – Chinese pigs that fly – 5 Feb 2019 – Political Cartoon Gallery London

Is 2019's market recovery beginning to stutter?

After one of the worst Decembers for global investors since the Great Depression, followed by the best January since 1987, February has started not too badly for investors. While up overall, the 7th week of the 2019 stock market recovery ended with a little bit of stuttering. This was quickly blamed on Trump and Brexit, which admittedly are easy targets – but so they have been all along.

So, have stock markets finally woken up to the fact that the global economy is really slowing, as can be argued, they had correctly anticipated with their Q4/18 sell-off? Well, not quite. It is far more likely that the recovery has simply run out of steam and enters a consolidation phase. This could last until it becomes more evident that the easing effects of lower yields, less monetary tightening pressures, Chinese stimulus and lower energy prices – that had appeased stock markets over January - are actually taking effect and are manifesting in improving economic data reports.

As we wrote here only last week, a good January doesn't yet make a good year. Nevertheless, our conviction has increased that the direction of stock markets over the coming months is far more likely to remain positive rather than return to 2018's negativity. This is mainly for two reasons. Firstly, the less hawkish and in some cases even mildly dovish stance that central banks in the US, the UK and Europe have adopted since the beginning of the year, has reversed the lack of monetary liquidity that characterised the sell-off in the last quarter of 2018. And secondly, business outlook and consumer sentiment levels are far more robust than backward-looking macro-economic news flow would suggest.

However, in terms of our general upward trend expectation we need to caveat this with a warning that this will be interspersed with the odd but disconcerting episode of downward draft in stock markets.

From a UK perspective this must sound overly optimistic, given the currently never-ending litany of highly depressing political squabbling. Hence my choice of cartoon this week to offer a humorous note to the Irish backstop negotiations impasse with the arrival of the Chinese year of the pig, given it is all but funny. The UK's central bank, the Bank of England acknowledged this week the effect the Brexit drag has increasingly on 2019 business activity. The resultant decision against another rate rise may be good news for anybody with a flexible rate mortgage, but the reason behind it – stagnating real wage growth – is the opposite.

For UK investors it is important to recognise that while the potential future path of this country may make us fearful or at least undermine our confidence to put our savings to work until all this is resolved, typical investment portfolios' investments reach far beyond our immediate regional horizon. Furthermore, the vibe we are picking up from our many contacts across business, finance, media and politics is that the most likely outcome is currently seen as some sort of a 'fudge' between the government's proposed deal, an extension of the exit date and a customs union. The scaremongering from all sides must be understood as necessary but unpleasant part of the political process of coercing reluctant parties to agree to some form of compromise.

The relatively stable external value of £-Sterling over recent weeks tells us that the probability of the Armageddon scenarios of inadvertently sliding into a no-deal exit has a much less significant probability than some suggest.

Sad to say we predicted that Brexit negotiations would go to the wire – however, just how close it would get to the set date in the end, even we did not believe possible. In the meantime, it is worth looking beyond our immediate boundaries and realise that the rest of the world is looking far less pessimistically into the near-term future. The strong capital market recovery of the past seven weeks – while Brexit proceedings deteriorated from bad to worse – should be considered as evidence for this view.

Fiscal boost for Europe?

After covering the near-term economic prospects of China and the US over the past two weeks it is time to turn to Europe. Disappointingly, following the 2017/early 2018 upward surge, Europe's economy is struggling. Earlier this month, economists' Eurozone (EZ) growth forecasts were cut to just 1.6% for this year, while sentiment surveys painted a similarly dour picture. The latest data released this week only adds to the mood. Spanish industrial production ended last year -6.2% down year-on-year, versus expectations of -2.3%. Meanwhile, the Italian economy has already entered recession, and is now expected to stagnate with just 0.2% growth this year.

The latest growth forecasts (issued Thursday 7th February) from the European Commission are even more lacklustre than economists' predictions a few weeks ago. Here's their overview of the new forecasts:

"Overall, the GDP growth forecast for the euro area in 2019 has been revised down by 0.6 percentage points (pps), since the autumn forecast, to 1.3%. This revision mirrors a weaker carry-over from the last quarters of 2018 and a slightly weaker momentum in 2019. Next year, economic growth is expected to settle at 1.6%, i.e. 0.1 pps. lower compared to the autumn forecast. Euro area headline inflation declined at the end of 2018 on the back of a sharp drop in energy prices. The resulting base effects for this year and lower assumptions about oil prices entail a downward revision of euro area headline inflation to 1.4% in 2019. A very gradual pick-up in inflation is expected in 2020 (1.5%)."

The European Central Bank (ECB) also issued their quarterly economic bulletin this week. Like the European Commission, they noted that despite slower than expected growth, consumption is expected to remain stable and gain some momentum.

Here's the ECB's words:

"Euro area annual HICP inflation declined to 1.6% in December 2018, from 1.9% in November, reflecting mainly lower energy price inflation. On the basis of current futures prices for oil, headline inflation is likely to decline further over the coming months. Measures of underlying inflation remain generally muted, but labour cost pressures are continuing to strengthen and broaden amid high levels of capacity utilisation and tightening labour markets."

As we wrote a few weeks ago, the banking system is also supportive of growth. Banks remain willing to lend and consumers willing to borrow, shown by the ECB's survey of bank senior loan officers last week.

However, the ECB did add: *"Looking ahead, underlying inflation is expected to increase over the medium term, supported by the ECB's monetary policy measures, the ongoing economic expansion and rising wage growth."*

Perhaps that's not as obviously forthright as the Fed's statement last week that they will pause their rate rises, but we'd still read it as supportive. We expect the ECB to embark on a third round of targeted long-term refinancing operations (TLTROs) to stimulate bank lending, not just renewing the expiring second round, but increasing the amounts. This should help banks recycle savings into loans more effectively (something that's long been a problem on the continent).

Still, the ECB's monetary policy levers are limited, given they have already cut short-term interest rates to negative. If support can come from anywhere in the medium-term, it will have to be governments' spending - fiscal policy. So, on that front, it's interesting that the European commission's report makes the right noises.

They first have a bit of a dig at Trump's procyclical US fiscal stance: *"In the US, the risk of an abrupt fiscal tightening appears to have increased, especially for 2020"* but then say "*On the positive side, a more extensive use of EU funds in recipient countries could trigger additional investments…"*

The union's endemic government spending (fiscal) tightness has long been a barrier to stimulating consumer demand. The common budgetary rules (member states can't have total public debt exceeding 60% of GDP or annual budget deficits higher than 3%) as well as the influence of budget hawks in Germany and the Benelux nations have prevented governments from spending big to stoke their consumers. But recent developments suggest this could change.

As we wrote in our outlook piece at the end of last year, political pressures from the populists in the EZ's two largest economies could force at least a moderate fiscal expansion on the continent. The *gilets jaunes* protestors in France seriously hurt President Macron's standing and already caused a U-turn from the government on its proposed tax hike. The young President has become the figurehead of the drive for a fiscal union (long-touted as a salve for the bloc's ailments) and it's likely that public anger at stagnating living conditions will add some weight to calls for increased spending.

Germany – the perennial sticklers for fiscal prudence – could also join in. Chancellor Merkel's heir-apparent Annegret Kramp-Karrenbauer is considered to the left of 'Mutti' Merkel economically and more supportive of mild redistribution measures. And she'll be under pressure to ease fiscal policy as the German economy slows and her party faces populist pressure at home and in Europe. The EZ's largest economy is unlikely to go on a big spending spree, but it should at least ease policy somewhat and, crucially, allow other member states more room to do the same.

That's good news for Italy. Since the coalition of populists came to power in June, it's been a constant showdown between Rome and Brussels. Italy's insurgent politicians rode to office on a platform of increased social spending but getting their budget past the eurocrats has proved difficult to say the least – with the European Commission even initiating disciplinary measures against the country. But an EU-wide move towards fiscal expansion would help their case greatly.

So too will the upcoming European Parliament elections. Any sense that the European establishment is conspiring against the will of the Italian people is likely to gain sympathy across the continent and will bolster the populist cause. Five Star head (and Italy's Deputy Prime Minister) Luigi di Maio even caused a diplomatic éclat after he met leaders of the French yellow vest protests in order to foster a sense of common cause.

This makes ongoing confrontation or punishment from Brussels less likely. And markets seem to agree, if Italian bond yields are anything to go by. On Wednesday, Italy saw record demand from investors for its government debt, attracting around €41bn of demand for €8bn of new issuance. Yields shot back up the following day when growth forecasts took a beating, but that struggling growth will itself support Italy's case that fiscal expansion is necessary.

And, as their report indicates, the EU Commission is fully onboard, and doing their bit for fiscal expansion. This week, Pierre Moscovici, EU Commissioner for economic and financial affairs, proposed that European legislation on national tax policy should be decided by qualified majority voting (QMV), rather than by unanimity. QMV is fairly standard within the EU set-up, but on certain key issues member states reserve the right to veto. Tax is one of those key issues. Under Mr Moscovici's proposal, EU-wide tax policy would pass if 55% of member states representing 65% of the continent's population agreed to it.

While the move towards QMV on tax policy (if it ever happens) isn't itself a reason to think that tax policy could turn expansionary, the make-up – or rather future make-up – of the EZ is. After Britain leaves the EU, the northern European nations, who are more fiscally conservative, will become a minority of the union's population, meaning that the southern and eastern countries will be able to out-vote them.

Altogether, this makes fiscal expansions on the continent look likely. Combined with a stable labour market and a more accommodative monetary policy than expected at the end of last year, consumer

demand should be strong. Weak internal demand has long been the thorn in the EZ's side, forcing the economy to rely on external demand for its exports. If fiscal loosening or integration can alleviate that problem, it'll help more than just short-term prospects. Europe is struggling now, but the struggle may prove to be worth it.

UK's Interserve: shareholders take it in the neck

After a few days of teetering on the brink of administration, Interserve, one of the UK's largest public service providers, has managed to get very close to a restructuring deal this week that it hopes will keep the company alive. The rescue package essentially involves giving its creditors £480mn worth of newly issued stock in exchange for some of its existing debt, and shifting much of the remaining amount onto its profitable businesses. £275mn of debt (although some sources state it as high as £350mn) will be put onto the balance sheet of RMD Kwikform, an equipment services unit of Interserve and one of the few bright spots in the entire set up.

In making this deal, Interserve avoids a near-term collapse, its creditors retain value, albeit with a substantially increased risk, and – crucially for the government– taxpayers don't have to foot the bill – as was the case when services firm Carillion collapsed last year. The catch? The new equity issued will account for 97.5% of the enlarged share capital; current shares are effectively worthless.

Needless to say, the deal isn't proving too popular with some of Interserve's shareholders. US hedge fund Coltrane, who owns 17% of Interserve's stock, has demanded a meeting where it plans to fire those on the board that have been too ready to cave in to the debtholders and government pressure. They think that news of the company's demise has been greatly exaggerated, and so equity-holders shouldn't be squeezed out. It remains to be seen whether the restructuring plan will make it past shareholders, but even if it doesn't the board has alternative plans to force it on them anyway.

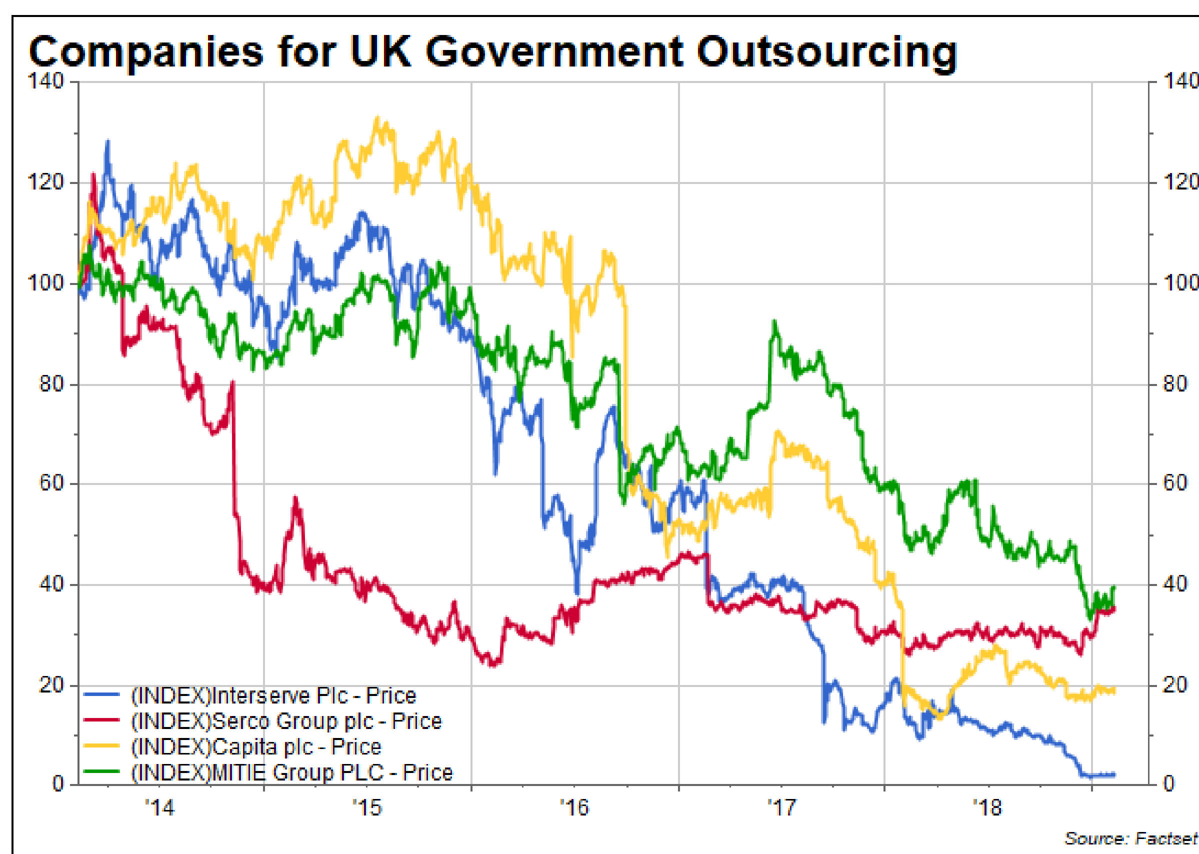
Coltrane's assertion that Interserve can dig itself out of the pit may have some merit. Its management of the government contracts may not have been brilliant but that side of the business was not the worst in the sector. Where it went wrong was in introducing a capital-intensive, highly volatile, untested business – energy from waste (or EfW as its abbreviated), which went badly wrong; and then accounting for it in an appalling manner (treating its run-off costs as exceptionals) which "allowed" the payment of a £37mn dividend in 2017. By 2018, interest costs had soaked up all of the available liquidity and short-term debt was rising sharply.

How did we get here? As we wrote way back when Carillion first collapsed, the issues facing the public services sector stem almost entirely from the nature of public-private-partnerships and how they've been handled.

Though Thatcherite privatisation was the genesis of the public services sector, it was under Tony Blair's New Labour that the industry really exploded. Labour's private finance initiatives (PFIs) saw private capital being raised to fund the construction of public infrastructure, with the government paying 'rent' and giving out contracts to private firms for ongoing management. It was supposed to be a win-win situation: the government gets public services with private sector efficiency, without having to fund the initial capital outlay, and private contractors get a steady stream of juicy government contracts.

Of course, the reality has been anything but. The government ended up paying over the odds for its services and the public was left on the hook for private ventures. To make matters worse, austerity and PFIs made for an unhappy marriage. Government cuts meant providers' revenues declined while costs continued to rise, squeezing their margins to breaking point. Debt built up from the PFI heydays left firms like Carillion, Capita, Serco and Interserve over-leveraged.

It's always risky having only one customer. When that customer is an elected government, it makes things even more difficult. But Carillion's collapse last year added another element to the mix. The fall of the services giant covered front pages, led to high profile job losses and made an easy target for the opposition Labour party. Since then, the government are determined not to allow a repeat. Avoiding a



Carillion-style collapse at Interserve and protecting tax money has been a top priority.

That's why the current restructuring deal reportedly involved a fair amount of government strong-arming. Interserve's board originally wanted to sell its profitable RMD Kwikform unit and use the funds to pay off some of its debts. According to reports, that idea was quashed after the government, shall we say, *suggested* against it.

Therein lies the issue for public service behemoths: In the current circumstances, they have risky, potentially unstable business models. As one of the competitors is forced to exit, it may be that the pricing power of the remaining few improves.

May be. Their major (almost sole) customer has a lot more power than the usual customer. The services provided are too important to the public to be allowed to fail. When things take a turn for the worst, it

won't be financial creditors and (now) it won't be taxpayers that take it in the neck. The suppliers first, and latterly the shareholders bear it.

Initially, after the January 2018 Carillion demise, other companies in the sector seemed to benefit. However, the government didn't face public pressure to ensure the stability of these companies. Rather, the sector was painted as the baddies. Neither Capita, Serco or even Interserve are (were) in as bad a situation as the fallen giant was. But none of the business pressures were alleviated. Indeed, the Brexit drama continued to ensure it worsened. Inevitably suppliers became increasingly wary.

It may be that we are witnessing a slow-motion domino chain, with Carillion's demise the first domino. This restructuring (if it happens) may be the lifeline both Interserve and the sector desperately need. But the fact is that their business models, their proximity to the government, and the Brexit effects make them still a somewhat unattractive investment proposition. Coltrane can complain all they like – perhaps even justifiably – but in the end the political element means shareholders will always come last.

While that may feel like a win for government and 'the people' over greedy capitalists, ultimately it is bad news for the future of the PFI model. Private funding may in future well require a higher risk premium for such projects than the government otherwise has to pay when raising public financing through the issuance of gilts. It may turn out that monopolistic public goods and services provision through a well organised public sector is more cost effective and efficient after all. If you find that too hard to swallow, we would suggest a holiday in Scandinavia or Switzerland[1].

[1] although the latter may have an unfair advantage through influx of 'free capital' from certain regions of the planet to their secretive banks

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Global Equity Markets

MARKET	FRI, 16:30	% 1 WEEK*	1 W	TECHNICAL
FTSE 100	7071.2	0.7	51.0	↘
FTSE 250	18652.9	-0.8	-158.5	↘
FTSE AS	3869.4	0.5	17.5	↘
FTSE Small	5391.8	0.1	3.7	↘
CAC	4961.6	-1.1	-57.6	↘
DAX	10906.8	-2.4	-273.9	↘
Dow	24962.6	-0.4	-101.3	↘
S&P 500	2684.0	-0.8	-22.5	↘
Nasdaq	6870.0	-0.1	-5.6	↘
Nikkei	20333.2	-2.2	-455.2	↘
MSCI World	2026.9	-0.1	-2.6	↘
MSCI EM	1042.0	-0.8	-8.2	↘

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM** PE	NTM*** PE	10Y AVG
FTSE 100	4.8	15.5x	12.4x	13.2x
FTSE 250	3.6	20.8x	13.0x	14.1x
FTSE AS	4.6	16.4x	12.4x	13.3x
FTSE Small	4	-	10.8x	14.0x
CAC	3.5	15.1x	12.6x	13.4x
DAX	3.3	12.2x	11.7x	12.6x
Dow	2.3	16.0x	15.1x	15.0x
S&P 500	2	17.9x	16.0x	15.8x
Nasdaq	1.1	21.8x	18.9x	17.8x
Nikkei	2.2	14.8x	14.7x	19.8x
MSCI World	2.6	16.6x	14.9x	15.2x
MSCI EM	2.8	12.5x	12.0x	12.1x

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
Compass Group	7.2	TUI AG	-21.4
Smith & Nephew	5.8	Melrose Industries	-10.4
GlaxoSmithKline	5.5	Ocado Group	-8.8
Hiscox Ltd	5.1	John Wood Group	-8.5
BP	4.3	WPP	-8.5

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.29	-1.12	OIL	61.6	-1.9
USD/EUR	1.13	-1.13	GOLD	1314.0	-0.3
JPY/USD	109.77	-0.25	SILVER	15.8	-0.8
GBP/EUR	0.88	-0.03	COPPER	281.2	1.4
CNY/USD	6.75	0.04	ALUMIN	1894.0	-0.8

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.151	-7.8	-0.10
US 10-Yr	2.634	-1.9	-0.05
French 10-Yr	0.541	-5.6	-0.03
German 10-Yr	0.087	-47.6	-0.08
Japanese 10-Yr	-0.029	-141.7	-0.02

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.34
2-yr Fixed Rate	1.73
3-yr Fixed Rate	1.81
5-yr Fixed Rate	2.01
Standard Variable	4.40
10-yr Fixed Rate	2.64

* The *% 1 week* relates to the weekly index closing, rather than our Friday p.m. snapshot values
** LTM = last 12 months' (trailing) earnings;
***NTM = Next 12 months estimated (forward) earnings

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