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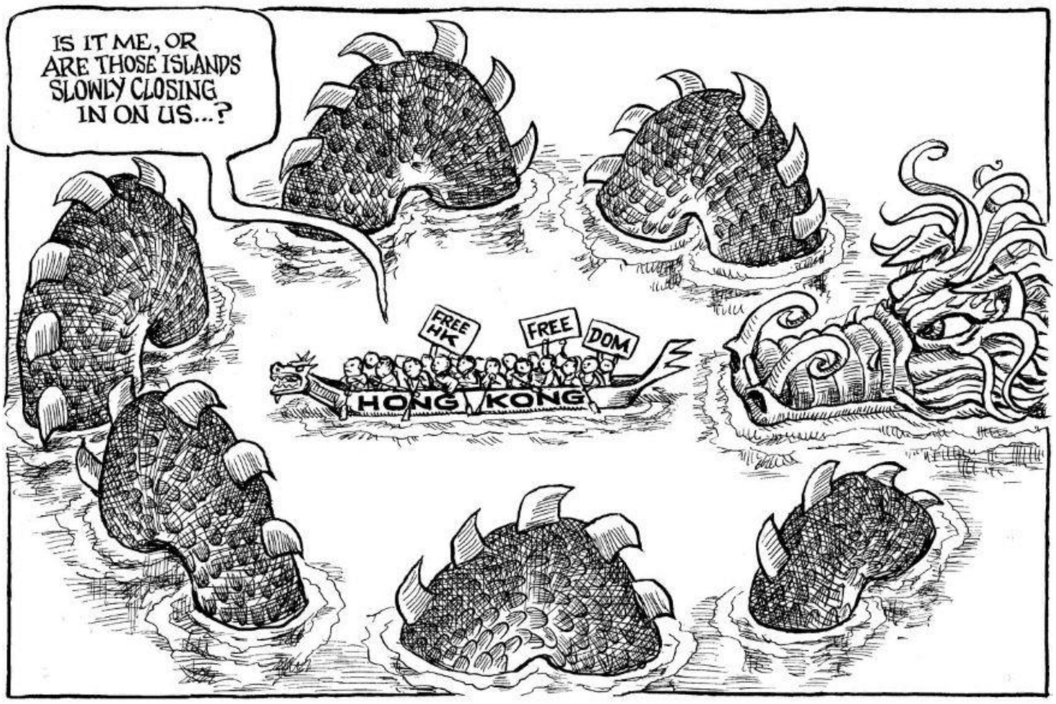


KAL - China closing in on Hong Kong's freedom movement; 14 Nov 2019

Swilling cash eases the market mood music

As the electoral machine whirrs on here, global capital markets have had a comparatively quiet week. The resurgent optimism of the last few weeks has waned somewhat, without turning around. But the US's S&P 500 is still sitting at an all-time high, which may well be due to private equity funds: they are awash with cash and have had difficulty finding unlisted targets that are profitable enough.

The move by KKR (formerly Kohlberg Kravis Roberts & Co, one of the private equity giants) for Walgreens Boots suggests that they are having to turn to the less preferred route of taking large listed companies private. That's risky in execution terms, but at least utilises larger blocks of that cash (even though a large proportion of the buyout funds will be borrowed). They also tend not to be so dependent on the near-term underlying economic background (because they take so long to organise and execute), perhaps underpinning markets against soggy economic data.

The drip of private equity leveraged buyouts of listed firms has yet to become a flood, but mergers and acquisitions like these tend to set a trend, helping the equity market in general, and the recently so unloved "value" stocks in particular.

Despite this positive, stock market indices around the world traded mostly sideways throughout the week. As for why this is, we turn to the usual suspects.

The latest indicators show that the global economy is still sluggish, with growth slowing yet again. As we wrote before, improving market sentiment in previous weeks implies that investors are betting that the current global economic slowdown will turn around soon – but they have yet to be vindicated by hard evidence through the incoming data. The longer it takes for improving data to appear on the horizon, the more nervous markets will get.

As usual, that situation could be helped or hindered by politics. Here in the UK, the General Election and what it means for Brexit are all-consuming issues. But for global investors, a bigger worry remains the US-China trade war. Trade relations between the world's two largest economies actually gave markets some hope last week, as both sides agreed in principle to a removal of tariffs in phases. But those hopes took yet another beating this week, with Donald Trump showing his erratic side again and threatening further tariffs. What's more, the worsening situation in Hong Kong – where political protests have paralysed the city – dim the chances of a deal happening. We cover this issue more in a separate article.

Our other article this week focuses on the UK economy and what effect the next government could have on it. According to betting markets, that government will probably be a Conservative majority – currently with implied odds of around 66%. The Tory party has been helped by a number of developments this week, including the UK avoiding a technical recession (only just, see article below), a withdrawal of Nigel Farage's Brexit party from 317 constituencies and well-publicised criticism of the opposition Labour party. In the shorter term, currency markets have reacted positively to this development, with £-Sterling receiving another upwards boost. It would seem that capital markets have flipped their preferences from Brexit avoidance to an end of uncertainty, even if this comes at the price of an end of frictionless trade.

In other market news, the bond market has had a volatile week on the back of some interesting moves by central bankers. The Bank of Japan opted not to cut interest rates at the end of October, and this week refrained by boosting bond purchases, thus steepening the yield curve (the difference in bond yields across different maturities) by allowing longer term rates to rise. Meanwhile, Federal Reserve Chair Jerome Powell signalled to a congressional finance committee that US interest rates will not come down if growth remains stable. The most interesting aspect of his speech was a hint that, if growth instead rose, rates would *not* rise to meet it.

We still have yet to hear from Christine Lagarde in her new capacity as European Central Bank President, but she has already been vocal (as many other central bankers have recently) about the need for looser fiscal policy. We suspect that the policy of steepening yield curves to help banks and increase the credit flow to the economy has won the debate among developed market central bankers. A proactive fiscal policy from governments would go hand in hand with this.

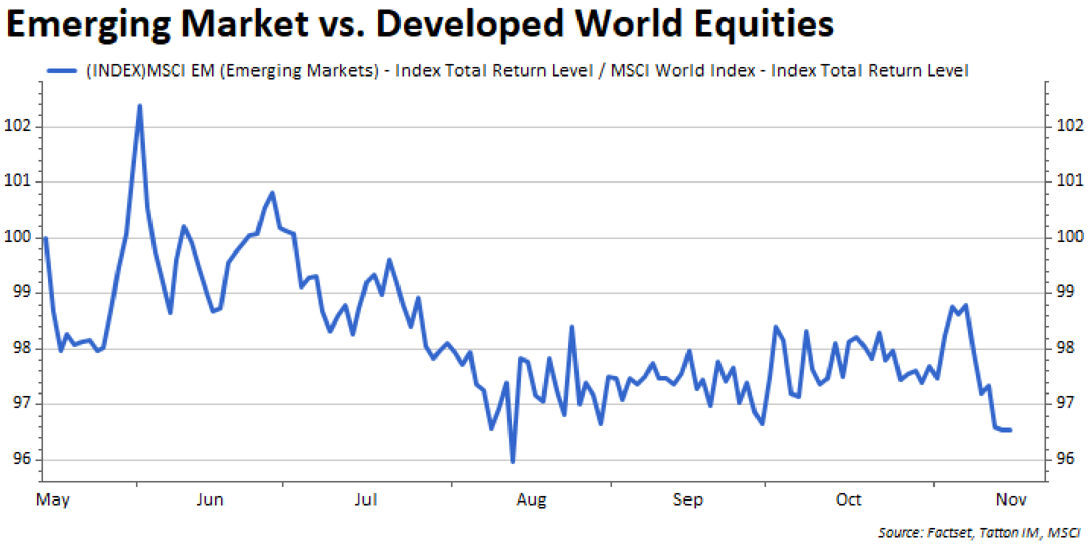
If that does happen, prices of longer maturity bonds will come under pressure (as rising yields means falling prices). But central banks may be unable to enact this policy if the global economy slides further downwards. And that uncertainty is inducing bond market volatility, particularly with economic data coming in so varied.

Turning elsewhere, we have recently heard from many fund managers that they are bullish about emerging markets. Part of the general thesis is that the US dollar has reached the end of a strengthening trend, and emerging market currency stability is allowing their central banks to cut domestic interest rates, which will support local economies.

Maybe. Indeed, there have been a large number of rate cuts in the past three months, and Mexico's central bank lowered borrowing costs (for the third time this year) on Thursday.

Unfortunately, the timing may not be auspicious. Treating emerging markets as a bloc tends to gloss over the specifics, and each area appears to be under pressure from its own internal fragilities, especially around domestic finance systems. As has happened before, these problems have been exposed by the general fall-back in global growth.

EM risk assets have had a bad week following the previous week's bout of optimism over the US-China trade deal. Latin American currencies fell again on Friday, the ninth consecutive decline, as broader risk sentiment took a hit from weak economic data.



In China and India, the domestic banking inadequacies are creating credit crunches for small enterprises. Reforming their banks will be a long slow process.

Some of the worst problems are in the "LatAm 6". Moody's now estimates that the area comprising Brazil, Mexico, Argentina, Chile, Colombia and Peru will register growth of just 0.7% in 2019 and 1.7% in 2020, well below the global growth trend. While some cyclical pick-up in private investment is expected across South America, a limited supply of domestic savings raises the cost of internal capital, meaning sources of investment will be hard to come by. Meanwhile, worker productivity is falling, continuing the trend of the last five years. Each country also has its own social and political issues to contend with, such as damaging drug cartels in Mexico, widespread protests in Chile and ongoing political scandals in Brazil.

One can indeed make the positive macro economic case for emerging markets. But this is only a convincing investment argument if it comes with a reason why the multifarious issues facing individual markets will not get in the way. One such reason would be the combination of a weakening US$ and resurgent global trade conditions. And on that point, we are not yet convinced.

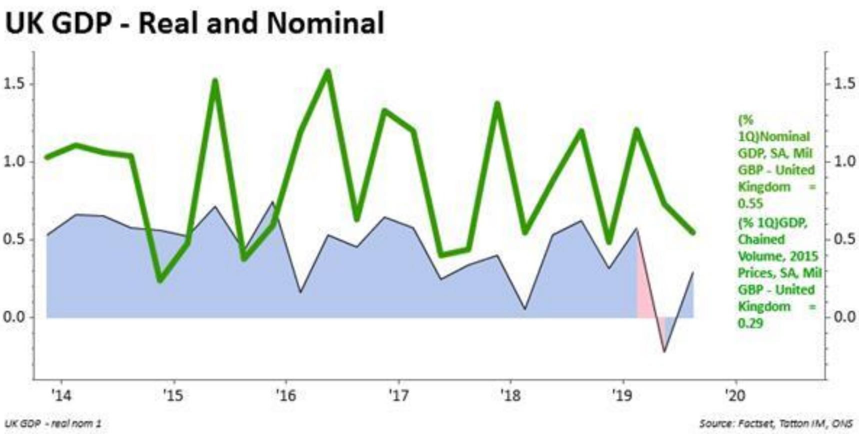
UK elections: Fiscal easing more certain than end to Brexit impasse

With election hostilities and flooding gloom filling our newsfeeds, there was at least one (apparent) ray of good news this week: The UK is not currently in a recession. That the bar for "good news" is set so low speaks volumes perhaps, but it is a positive nonetheless. In the second quarter of this year, GDP growth turned negative, with Britain's economy contracting -0.2%. There was a real possibility that we would befall the same fate in Q3 – which would mark the onset of a technical recession, defined as two consecutive quarters of GDP contraction – but as it turned out, the UK economy grew 0.3% last quarter. What was all that Brexit worry again?

Looking a little deeper into the figures reveals a less inspiring picture, however. Consensus expectations of 0.4% were disappointed, while year-on-year growth came in at a sluggish 1%, the slowest year-on-year expansion in almost a decade. What's more, all of that growth came during July, with monthly growth figures for both August and September coming in negative.

As we have written before, Brexit Britain has been characterised by weak business sentiment and investment, only offset by government spending and a surprisingly chirpy consumer. As a result of a lack of planning certainty, growth in business investment has been sorely lacking since the referendum result, and has been negative since early last year.

The Q3 data continues that pattern somewhat, but with a slight change. Economic strength in July was again propelled by consumer spending, but that tailed off into the late summer. Given that the British consumer has been one of the few things keeping the economy afloat, that is a worrying sign. What's more, as the chart below illustrates, nominal growth was actually weaker than in Q2, which means that real (inflation-adjusted) growth for Q3 only looked good because inflation fell back. Overall spending, in current pound terms, was slow.



There is little sign that this will imminently improve either. The employment data – a key support for consumer spending – looks a little concerning. Despite the fact that the official measure of unemployment fell to its lowest level in decades, the claimant count rate (measuring gains in unemployment claims) rose sharply over the summer. Due to government changes to the process of claiming unemployment, that figure might currently not be the most reliable indicator but, if we take it at face value, it is not a good sign. A strong labour market has been crucial in preventing Britain from falling into recession over the last few years because it supported wage growth and thereby consumer spending across the UK's all-important services sector.

If unemployment is rising, it could put the stability of the housing market at risk. House prices showed surprising strength at the beginning of the year – after significant struggles in previous years – but the latest Halifax house price data suggests stagnating prices again. We could see renewed falls if unemployment doubles up in the face of existing Brexit uncertainty headwinds.

Fortunately, one factor that could stem the troubles already looks a certainty: increased government spending. Ahead of the upcoming election, both major political parties have unveiled large spending plans in an attempt to woo austerity-disgruntled voters. At the last election (and in previous ones) critics of the Labour party derided their supposed reliance on the "magic money tree" of public funds. But now Boris Johnson and co. have joined Labour leader Jeremy Corbyn in promising a large programme of public spending.

Much has been said about what this could mean for the government's balance sheet, so a few things are worth pointing out. In the midst of Brexit uncertainty and an economy already teetering on the edge of a recession, an increase in government spending almost certainly will not be matched with an increase in tax receipts (in the short term at least). That means that an expansion of the public deficit is almost a certainty. But this is not, in itself, a bad thing.

Most (though certainly not all) macroeconomists would agree that when growth and investment are low and unemployment is rising, targeted government spending has the potential to increase growth substantially. When government bond yields are low (as they still are now) this presents a particularly good opportunity for deficit spending. As we have written recently, even the world's central bankers have now joined the chorus of voices calling for increased government spending.

Of course, how effective this is at boosting growth depends on where that government spending is going. Investment in infrastructure, education and the like is generally thought of as being better for growth over the medium-to-long-term, as it boosts overall productivity. Ongoing spending on public services – while no doubt a public good – is thought of as being less so.

We will avoid any comment on the particular merits of any party's fiscal plans. But suffice it to say that we do not think that a 'Greek-style crisis' will result from most or all of the proposed policies. The Conservative party's spending plans in particular are a reversal of the government cuts made over the past decade, with pledges, while Labour's plans go well beyond them. What is certainly true is that, with Brexit providing a now undeniable drag on the economy, without an increase in public spending the economy will most likely struggle.

There is still plenty of room between the pledges of the different parties, but it is significant that – after a decade of austerity policies – all the major parties are in agreement that a loosening of the public purse strings is in order. Given the pressures Britain faces, that is likely to be a good thing – in the short-term at least – and as long as bond investors do not worry about the UK's longer-term ability to service the additional debt. With the annual interest burden currently being around 0.75% for the next 10 years (I.e. the yield on UK 10 year gilts), the threshold for such concerns should be higher than it has been for a very long time.

Hong Kong uprising getting in the way of US-China trade deal?

Back in August, one Chinese official declared that the Hong Kong protests represented the city's worst crisis since the handover from British rule in 1997. In the months since – despite the official retraction of the extradition bill that incited the demonstrations – things have only got worse. Reports this week are that the city's universities have become battlegrounds, with international students being urged to return home. Police have accused the Chinese University of Hong Kong of being a "manufacturing base for petrol bombs and a refuge for rioters and criminals". On Tuesday, they raided the university – only to be met with barricades, road blocks and even makeshift brick walls from students. With public transport suspended and all universities closed, the city has become paralysed.

Meanwhile, on the mainland, the Chinese government are intensifying their approach. Beijing has been running a media campaign against protesters for around five months now. But this week, the head of China's Hong Kong liaison office called for stronger security laws in the territory. Leaders, administrators and the judiciary should be "patriots", and the government should work to bolster residents' "national consciousness". According to the officer, unrest in the city is due to the failure to implement the controversial Article 23 of Hong Kong's basic law – which would bar secession and subversion against Beijing.

It is hard to overstate Hong Kong's importance to China. The return to (limited) Chinese rule was a source of immense national pride in the late 1990s – coming just after the political upheaval of the 1980s and signifying to citizens that China could once again become a major global power. Since then, it has been an economic and financial gateway to the mainland, bringing in huge amounts of outside investment and fuelling rampant economic growth. The neighbouring city of Shenzhen was little more than a fishing village 40 years ago. It is now the country's technology hub and home to some of the largest companies in the world. This is partly why the Communist Party sees Hong Kong issues as a matter of sovereignty – entirely separate from the domain of international relations.

Unfortunately for the Chinese, the US is unlikely to agree. In a recent speech, Vice President Mike Pence expressed solidarity with Hong Kong protestors, delivering to them the message that "we stand with you," He even went as far as to criticise American companies that are seen as bowing to the demands of the Chinese government. "Nike promotes itself as a so-called social justice champion, but when it comes to Hong Kong, it prefers to check its social conscience at the door,"

In a rare show of restraint, President Trump has remained mostly silent on the topic. He has been extremely vocal on many Chinese practices he considers unfair. But according to a CNN report, the President promised his Chinese counterpart Xi Jinping in a private phone call that America would refrain from comment on Hong Kong, as a show of good faith during trade negotiations.

The vice president, meanwhile, seems to have free rein. He has become the administration's leading China hawk – quite a title considering that economic adviser Peter Navarro wrote a book titled "Death by China". As well as lambasting Beijing for its supposedly unfair trading practices and expansionary military policy, Pence has criticised the government for its treatment of Uyghur Muslims in Xinjiang.

From an investment perspective, the main question from all this is what it means for the US-China trade war. As we wrote last week, negotiations between the world's two largest economies have come along well recently. But these developments could well throw a spanner in the works.

On the one hand, both sides have strong incentives to go for a deal: China's domestic economy is slowing precariously, with growth so far this year at its lowest in decades. And with a US presidential election coming up next year, Trump could do with a win – given tariffs are now having a recognisable effect on the US economy, particularly in those industrial and agricultural States which Trump won from the Democrats on the promise of economic revival.

On the other hand, the political situation makes things difficult. The Republican party now has a definitive anti-China stance, on both economic and national security grounds. If Beijing initiates more repressive measures against Hong Kong, there will be a great deal of pressure on Trump to take a hard line – at a time when he needs every Republican senator behind him to avoid a successful impeachment process. Trump has been extremely erratic in his China policy (publicly threatening increased tariffs this week just after a supposed agreement was reached). It probably will not be hard to sway him back to an anti-China stance – especially with Hong Kong protests receiving such publicity.

Across the Pacific, the Chinese government is unlikely to back down on Hong Kong, regardless of the trade implications. It is a point of principle for the government that issues of sovereignty (Hong Kong, Taiwan, Tibet, Xinjiang etc.) should be kept separate from trade disputes. At a meeting earlier this month, President Xi reiterated that "Stopping the storm and restoring order remains the most important task in Hong Kong." Officials are no doubt worried about the effect that tariffs, but also a paralysed Hong Kong, could have on the struggling economy. However, in light of this dilemma, tolerating dissent remains a red line they will not cross.

This makes a deal less likely than it may have recently seemed. At the moment, the incentives are still there for it to happen – and it may be that Pence's harsh words are just that. But with no end in sight for the turmoil in Hong Kong, an agreement is far from a foregone conclusion.

Global Equity Markets

Market	FRI 15:31	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7281.5	-1.1	-77.9	→	→
FTSE 250	20367	0.0	9.5	→	⬀
FTSE AS	4021.0	-0.9	-34.7	→	→
FTSE Small	5520.2	-0.4	-22.1	→	→
CAC	5927.4	0.6	37.7	➚	➚
DAX	13207.6	-0.2	-21.0	➚	➚
Dow	27904	0.8	223.0	➚	➚
S&P 500	3108.4	0.5	15.4	➚	➚
Nasdaq	8305.2	0.6	49.3	➚	➚
Nikkei	23303.3	-0.4	-88.5	➚	➚
MSCI World	2265.3	-0.2	-3.5	➚	➚
MSCI EM	1042.3	-2.1	-22.6	➚	→

Top 5 Gainers

Company	%
RBS	6.4
Lloyds Bank	5.6
Persimmon	5.3
United Utilities	5.3
Burberry	5.0

Top 5 Decliners

Company	%
DCC	-11.0
Fresnillo	-8.4
Antofagasta	-6.8
3i	-6.7
Rolls-Royce	-5.7

Currencies

Pair	last	%1W
USD/GBP	1.291	1.0
GBP/EUR	0.856	0.7
USD/EUR	1.11	0.3
JPY/USD	108.74	0.5
CNY/USD	7.008	-0.2

Commodities

Cmdty	last	%1W
Oil	62.69	0.3
Gold	1468.2	0.6
Silver	16.97	1.0
Copper	263.3	-1.8
Aluminium	1741.0	-4.0

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.7	-0.1
UK 15-Yr	1.0	-0.0
US 10-Yr	1.8	-0.1
French 10-Yr	-0.0	-0.0
German 10-Yr	-0.3	-0.1
Japanese 10-Yr	-0.1	-0.0

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.9	17.6	13.3	13.2
FTSE 250	3.7	24.1	14.7	14.2
FTSE AS	4.7	18.6	13.5	13.4
FTSE Small	3.7	170.1	-	13.9
CAC	3.1	21.2	16.2	13.4
DAX	3.0	24.5	15.8	12.5
Dow	2.2	19.2	18.9	14.9
S&P 500	1.9	20.6	18.9	16.0
Nasdaq	1.0	25.8	22.7	18.0
Nikkei	1.9	18.6	17.5	17.5
MSCI World	2.4	19.7	17.4	15.2
MSCI EM	2.9	14.6	13.5	11.9

UK Mortgage Rates

Mortgage Rates	Oct	Sep
Base Rate Tracker	2.62	2.59
2-yr Fixed Rate	1.55	1.56
3-yr Fixed Rate	1.63	1.65
5-yr Fixed Rate	1.74	1.77
10-yr Fixed Rate	2.61	2.61
Standard Variable	4.29	4.29

* 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

For any questions, as always, please ask!
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18th November 2019

Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document.

The value of your investments can go down as well as up and you may get back less than you originally invested.

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