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# Investment Commentary

## Quarter Three 2016

# INTRODUCTION

Three months ago we'd just had the result of the UK's referendum on continued membership of the European Union. It would be easy to think that Brexit is now the only show in town, especially with new Prime Minister Theresa May confirming on Sunday 2nd October that Article 50 – beginning the formal process of leaving the EU – will be triggered by March 2017.

The effects of this announcement are clearly being felt in the financial markets. On the morning of Tuesday 4th October, the pound had sunk to a 31 year low against the dollar, while the FTSE 100 was above 7,000 and apparently heading for a record high.

In fact, the rest of the world has been quite busy while Mrs May was re-shuffling her cabinet. Hillary Clinton and Donald Trump were confirmed as their respective parties' Presidential nominees – and have been roundly abusing each other ever since. When they lifted their eyes from the hustings they'll have seen that the US economy continued to turn in its normal mixture of good and bad news throughout the summer.

In the Far East, there continued to be serious worries about China – both the slowdown in the economy and a potential banking crisis – whilst the Bank of Japan came up with yet another stimulus package for the economy. Even more worryingly – for the region and the wider world – North Korea claimed a fifth successful nuclear test, to inevitable and widespread condemnation.

The quarter saw a rally in the price of oil. Having been as low as $30 a barrel in February, the price briefly touched $51 a barrel in August. By the end of September, OPEC had agreed a preliminary deal to cut production for the first time in eight years and the price was hovering around $49 a barrel. We've probably said goodbye to very low oil prices for the foreseeable future.

## UK

In the event it was a coronation, not a contest. One by one the challengers fell away and Theresa May became the UK's second woman Prime Minister on 11th July. She immediately set about re-shuffling her Cabinet, with George Osborne shuffled decisively to the backbenches and Philip Hammond becoming the new Chancellor.

One of Theresa May's first pronouncements was that 'Brexit means Brexit' and only the most widely-optimistic Remainer must now think there is a chance of a second referendum. With the declared intention to trigger Article 50 by March of next year, the question has now become 'hard Brexit or soft Brexit?' We've looked at what the terms imply in a specific section below.

In the immediate aftermath of the decision to leave the EU, many commentators (and the previous Chancellor) forecast doom and gloom for the UK economy. In the event, most of the news through the summer has been positive.

Retail sales were up in July and UK tourism was also up, helped by the fall in the value of the pound. UK unemployment fell in the April to June period, with 1.64m now out of work and the jobless rate steady at 4.9%.

Figures reported at the beginning of September showed that the UK's manufacturing sector had rebounded sharply in August, with the Purchasing Managers' Index rising to 53.3 from July's figure of 48.3 – any figure above 50 indicates expansion.

There was also good news for the services sector, with the PMI jumping from a seven year low of 47.4 to post its biggest monthly rise in 20 years, up to 52.9.

Figures released for July showed that the UK trade deficit had shrunk from £5.6bn in June to £4.5bn and UK car production hit a 14 year high in August as 109,004 vehicles rolled off the production line, up 9.1% on August 2015.

At the time of our last Quarterly Report, there were real fears that the UK would be heading for a post-Brexit recession. With the good news through the summer – especially for manufacturing and services – most commentators accept that any recession is now unlikely.

However, it wasn't unremitting good news, and there was a worrying straw in the wind for UK savers, when RBS and NatWest wrote to business customers to say that they may introduce a negative interest rate – in effect, charge businesses to deposit money. For now personal customers are not affected, but who knows what may happen if global interest rates stay as low as they are?

In August, the Bank of England cut interest rates for the first time in more than seven years, with the base rate reduced from 0.5% to 0.25%. Bank of England Governor Mark Carney made it very clear that he wanted households and business to feel the benefits of the reduced rates. The Bank also committed an extra £100bn in an attempt to encourage the clearing banks to lend, and avoid a post-Brexit recession.

This has undoubtedly helped the FTSE 100 index to have an excellent quarter: having closed June at 6,504 the index rose 6% to end September at 6,899. The FTSE is up by 11% since the start of the year.

*Will it be a hard or soft Brexit?*

"People didn't vote for a hard Brexit," claimed former Chancellor George Osborne last week. No, 52% of the electorate simply voted to leave the EU. But with Theresa May having committed herself to triggering Article 50, the debate seems to have moved from, 'will we actually have Brexit?' to, 'what sort of Brexit will we have?'

You're going to hear the terms 'hard' and 'soft' Brexit an awful lot over the next few months. Not many people (including our politicians!) seem sure what they mean: so let's do our best to explain them.

**A Hard Brexit** is the option favoured by those who were passionate about leaving the EU. It would mean the UK giving up access to the European single market and concentrating on making new trade deals, controlling our own borders and applying our own laws on trade – almost certainly meaning much EU legislation would be scrapped. As far as trading with our former European partners goes, we'd be governed by World Trade Organisation rules, not EU rules.

**Soft Brexit** would leave our relationship with the EU as close as possible to existing arrangements and – not surprisingly – is the option favoured by many who voted Remain. The UK would no longer be a member of the EU – but it would keep unrestricted access to the European single market. Britain would remain within the EU customs union ('Hard' Brexit would see us leave the customs union) and our exports would not be subject to border checks, or to possible tariffs. This is a similar model to countries like Norway and Iceland, who are part of the European Economic Area. In return for this, these countries make payments into EU budgets and accept the "four freedoms" of movement of goods, services, capital and people.

There are obviously advantages and disadvantages on both sides – with, very often, the 'advantage' or otherwise being determined by your initial view on Europe. One near certainty seems to be that by March of next year you'll be heartily sick of the terms 'hard' and 'soft' Brexit: but for now at least, the above is a very simple explanation of what they mean.

## EUROPE

We have written consistently over the past year about the slow rate of growth in the Eurozone and in the wake of the Brexit decision the International Monetary Fund downgraded its forecast for the region even further.

They are now predicting growth of 1.6% this year and 1.4% next, down from 1.7% in both cases. The forecast for 2018 was also revised downwards, with prospects for the bloc described as “mediocre’ due to high levels of debt and unemployment.

One country where the outlook is decidedly worse than ‘mediocre’ is Italy. The IMF has implied that Italy has “two lost decades” and that the economy will not return to levels seen before the 2008 crash until the mid-2020s, by which time other European economies will be 20-25% bigger than their 2008 levels.

One of the key problems in Italy is the parlous nature of the banks, with German Chancellor Angela Merkel ruling out help for them on more than one occasion. Quite what this means for Germany’s Deutsche Bank – described by the IMF as, “the most dangerous bank in the world” – is anyone’s guess. We’ve looked at the reasons for the problems at Deutsche Bank and the possible implications below.

The other story which rumbled on through the summer (apart from the continuing problems at Volkswagen which look set to rumble on through several summers) was the question of Apple’s tax bill. The European Commission said that Ireland had enabled Apple to benefit from a corporate tax rate of a maximum of 1%, with the company paying an effective rate of 0.005% in 2014. “Member states cannot give tax benefits to selected companies,” said Competition Commissioner Margrethe Vestager. Unsurprisingly, Apple said they would be appealing against the ruling: rather more surprisingly, the Irish Government also said they disagreed with the record penalty and would also be appealing, to, ‘protect the integrity of our tax system.’

Unsurprisingly, the move attracted widespread criticism in the US. Austrian Chancellor Christian Kern took exactly the opposite view and weighed in heavily against all multinationals. “Every Viennese café, every sausage stand pays more tax in Austria than a multinational corporation,” he fumed.

Away from the sausage stands, the German economy continued to be the engine of European growth, consistently generating a trade surplus of around €20bn each month. This was reflected on the stock market with the German DAX index up 9% in the quarter to 10,511. The French index was up by 5% to 4,448, although all the growth came in July: the market managed a gain of just eight points through August and September.

*What’s happening to Deutsche Bank?*

As we commented above, Angela Merkel seems intent on denying the Italian banks any possibility of a bail-out, should they need one. What then will be her government’s attitude to Deutsche Bank if – as many experts predict – Germany’s iconic bank ultimately ends up needing precisely that?

## EUROPE

Tidjane Thiam, the chief executive of Credit Suisse, recently said that Europe's banks were "not really investable" in a remark underlining the problems they may face if they require extra funding. Most prominent among those banks is Deutsche Bank, currently battling (and apparently asking for Government help in doing so) to reduce a $14bn penalty from the US authorities for mis-selling mortgage bonds.

However, the problems of Deutsche Bank don't end there…

German banks are traditionally cautious, with the sector dominated by savings and co-operative banks and not-for-profit institutions. Deutsche Bank, however, has followed a different path, aggressively pursuing expansion overseas in much the same way that Royal Bank of Scotland did. This started in 1998 with the purchase of the UK merchant bank, Morgan Grenfell, and continued with global expansion.

For a decade, the plan worked: profits soared and the share price rocketed. Deutsche Bank even managed to weather the financial crisis of 2008 without seeking help: but in doing so, critics argue, it became arrogant, less risk-averse and started to cut corners.

The bank is now paying a heavy price for those risks: the $14bn fine for mis-selling mortgage bonds comes on top of penalties for manipulating LIBOR rates and fixing gold prices. Unsurprisingly, the bank has few assets left – apart from a famously impressive art collection – and is struggling to retain its key staff.

The IMF has called Deutsche Bank "the world's most dangerous bank" – not surprisingly because after 25 years of expansion, it is linked to a myriad of financial institutions around the world. As one insider at the IMF remarked, "If Deutsche Bank goes down, everyone else has a problem too."

Right now, the person with the biggest problem is Angela Merkel. Deutsche shares have recently been at a 30 year low and the German government has been forced to deny reports of a bailout in which it would take 25% of the bank. With the hard line taken over the Italian banks it is difficult to see where Mrs Merkel goes from here: whatever the German equivalent of 'between a rock and a hard place' is, she's in it. But don't think for a minute that Deutsche Bank is purely a German or a European problem: it has the power to affect us all.

## UNITED STATES

As we reported above, the US now faces a straight choice between Trump and Clinton in November – and whoever takes office in January 2017 will come face to face with the ever-present US trade deficit. The country continues to have a trade deficit of $40bn or thereabouts every month – so in round terms the US is adding a trillion dollars of debt every two years.

Debt levels aside, the US reported the usual mix of good and bad news through the summer. August started badly with figures for the second quarter showing that the US economy had grown far more slowly than had been expected – at a rate 1.2% against forecasts of 2.6%. Conversely, consumer spending surged in the three months to June, rising at an annual rate of 4.2%, the fastest pace since the fourth quarter of 2014. The jobs numbers were also encouraging, with 275,000 jobs being created in July.

But then the jobs figures for August were disappointing with only 151,000 jobs created – down sharply on July. The average monthly increase over the past 12 months has been just over 204,000 so these figures were particularly poor and suggested that a rise in US interest rates might be delayed – although most commentators still anticipate a rise by the end of the year.

The latest US inflation figures showed a slight rise to 1.1%, while the jobless rate appears to be holding steady at just below 5%.

On Wall Street, the Dow Jones index started the quarter at 17,930 and finished at 18,308 for a rise of 2%. It is up by 5% for the whole of 2016.

# FAR EAST

As we reported in the introduction, there continue to be worries about the slowdown in the Chinese economy. Experts – this time it was former IMF chief economist Ken Rogoff – continued to warn that the slowdown might be much sharper than official figures would indicate.

Those official figures had confirmed that growth for the second quarter was 6.7%, exactly in line with the Government's target for the year. Most economists had more cautiously predicted a rise of 6.6%.

Whatever the debate about the second quarter, there was no doubting July's bad news. The figures confirmed a drop in Chinese exports – generally seen as a snapshot of the wider global economy. Exports fell by 4.4% compared to a year ago: this was an improvement on June's 4.8% fall but was still weaker than had been expected. Imports were also disappointing, falling by 12.5% in July. A few days later it was also confirmed that retail sales and industrial output had failed to reach July expectations, underlining the difficulty China is having as it attempts to move the economy away from a reliance on manufacturing and exports to more domestic consumption.

Figures for the third quarter will therefore be eagerly awaited. Official figures confirming a 6.7% growth rate would – you suspect – be met with widespread scepticism.

There are also worries about a potential banking crisis in China. The Bank for International Settlements was the latest institution to warn about this, as the banks continue to extend credit in a bid (presumably Government backed) to fend off the economic slowdown.

This extension of credit may help to explain the record levels of Chinese investment overseas, with data for 2015 now showing that Chinese companies have invested more overseas (£111bn) than overseas companies invested in China.

There were also problems across the China Sea, with Japan's economy growing at a weaker-than-expected rate in the second quarter of the year, despite an aggressive spending policy by the government. Japan's GDP grew at 0.25 in the three months to June, against expectations of 0.7%. The government responded with yet another stimulus package, injecting 28tn Yen into the economy – equivalent to £200bn.

…And then September came and the Bank of Japan announced a complete overhaul of the stimulus package. It set long term targets for the economy and apparently abandoned its 2% target for inflation, as well as maintaining the 0.1% negative interest rate.

Despite the bad news regarding imports, exports and sundry stimulus packages, all the major Far Eastern markets were up in the quarter. Hong Kong led the way with a 12% rise to 23,297 whilst the Nikkei Dow in Japan was up 6% to 16,450. The South Korean market was up by 4% to 2,044 with China's Shanghai Composite Index up just 3% to 3,005.

# EMERGING MARKETS

India remains the world's fastest growing economy, although inflation is a constant worry for the government. In a bid to combat that, the country appointed Urjit Patel as the new head of the Reserve Bank (India's central bank) with the specific remit of keeping inflation under control.

If only events were so orderly in Brazil. Ex-President Lula and his wife have been accused of widespread corruption, while immediate past-President Dilma Rousseff has been impeached for breaking fiscal and budget laws. Meanwhile, the new President Michel Temer has announced a privatisation plan in a bid to revive the country's struggling economy. It plans to sell off four airports and two port terminals, as well as offer contracts for a range of projects from building new roads to operating mines. "The state cannot do it all," said the new President.

It was a relatively quiet quarter for Russia, the other major emerging economy which we cover. The stock market there rose by 5% between July and September to close at 1,978 whilst Mr Patel will have been pleased to see the Indian market advance 3% to 27,866. The star of the show though – despite all the problems – was the Brazilian stock market: clearly thinking that President Temer may have got it right, the market rose 13% in the quarter to end September at 58,367 and is now up by 35% for the year as a whole.



## CONCLUSIONS

That's it for another three months. By the time we return at the end of the year, the UK will be three months closer to leaving the European Union – and the terms of the split will hopefully be a little clearer – and the US will have a new President.

Let us hope the last quarter of 2016 is as successful for world markets as the one which has just ended. All the markets on which we report were up between July and September: for once the old stock market adage of 'sell in May and go away' was completely wrong. What the next three months will bring is – as usual – anyone's guess: the world is a volatile place at the moment. Rest assured though, that whatever happens we will be here to answer your questions: we are never more than a phone call or an email away.

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