creative wealth management

Investment Commentary

Quarter Two 2016

INTRODUCTION

On Friday the 24th June, the UK woke up to find that it had voted to leave the European Union. The result – and the subsequent political fallout – continues to dominate the news agenda. So it would be easy to conclude the ‘Brexit’ was the only worthwhile story in the second quarter of 2016. Far from it: in the UK the politicians took the occasional few moments off from the Remain/Leave spat to try and save the country’s steel industry; in Europe the problems of Greek debt continued and in the US there was a sudden – and potentially worrying – fall in the job creation numbers. The battle lines were also finally drawn for the US Presidential race, which at this early stage looks like it will make the Referendum campaign in the UK look restrained, polite and well-informed.

On the world’s stock markets, Q2 was a mixed bag: India – now the world’s fastest growing economy – was the standout performer, closely followed by the UK. The wooden spoon went to Japan, where Prime Minister Shinzo Abe continues his efforts to reverse ten years of deflation.

UK

Let's briefly deal with the Referendum. On June 23rd the UK voted to leave the European Union, by 51.9% to 48.1%. Within an hour of the official declaration of the result, David Cameron announced he would be standing down as Prime Minister, whilst dismay at Jeremy Corbyn's lacklustre campaigning turned into open revolt in the Labour Party. At the time of writing (the morning of Monday July 4th) it looks as though the Conservative MPs will offer the party a choice between Home Secretary Theresa May – who campaigned for Remain in the Referendum, but very, very quietly – and Brexit supporter Andrea Leadsom, the Energy Minister.

It will be the job of the new Prime Minister to invoke Article 50 of the Lisbon Treaty – which begins the two year process of leaving the EU. This is where the waters become even muddier, with the UK apparently not wanting to invoke Article 50 until substantive, informal discussions have taken place. Several European leaders, however, are sticking to the 'out is out' mantra and indicating that there will be no discussions until Article 50 has been invoked.

Hopefully, events will move quickly – at least as far as choosing a new Prime Minister is concerned. David Cameron is now the lamest of lame ducks and it seems difficult to see how he can remain in post until the autumn, as he originally suggested.

Moving away from politics, the news agenda in the early part of the month was dominated by Tata's decision to sell its steelworks – reputedly losing £1m a day – in Port Talbot. The Government has vowed to do all it can to find a buyer, with Tata understandably anxious for a quick sale – but with the continuing global oversupply of steel that isn't going to be easy. And it got even more difficult when the Chinese imposed a 46% import tariff on steel from the EU. At the time of writing, there appear to have been several expressions of interest in the Port Talbot plant, but no firm bids have yet emerged. Fortunately 4,000 jobs were saved as Tata sold its steelworks at Scunthorpe to Greybull Capital, with the workers agreeing to accept pay cuts and reductions to their pensions.

Another sector worrying about job losses was the UK's oil industry. A report by Experian predicted that job losses for this year could reach 40,000 – on top of the 84,000 jobs the sector lost in 2015. The report said that the UK's offshore industry supported 453,000 jobs – either directly or indirectly – at its peak in 2014.

There was also bad news on the High Street in the second quarter, with BHS calling in the administrators and putting 11,000 jobs at risk. BHS was swiftly followed by Austin Reed, and My Local also went into administration at the end of the quarter. With Amazon starting to roll out grocery deliveries, you wonder what the nation's high streets will look like in ten years' time.

Let's look at a few numbers. Figures released for May showed that UK inflation was unchanged at 0.3%, whilst the ONS revealed that the average house price had risen 8.2% in the last 12 months. Despite the bad news from BHS et al, unemployment still came down, falling by 20,000 between January and March to 1.67m. The unemployment rate is now 5%, the lowest since October 2005. The number in work rose 55,000 to 31.59m, taking the employment rate to a record high of 74.2%.

UK

Despite the uncertainty surrounding the EU Referendum, the FT-SE 100 index of leading shares had a good quarter. Having ended March at 6,175 – and dipping below 6,000 after the Referendum result as Standard & Poor's removed the UK's AAA credit rating - it recovered sharply and closed June at 6,504. It was helped in no small measure by a speech from Bank of England Governor Mark Carney, in which he suggested that the next move in UK interest rates might well be down – which would reduce corporate borrowing costs. The FTSE eventually finished up 5%, in what by any standards was a turbulent quarter.

What is a country's credit rating? And why does it matter?

In the immediate aftermath of the UK's vote to leave the EU, much was made of credit ratings agency Standard & Poor's decision to remove the UK's 'Triple A credit rating.' According to S&P, Brexit could lead to 'a deterioration of the UK's economic performance' and they subsequently downgraded the UK from AAA to AA. Another agency, Fitch, also lowered the UK's rating from AA+ to AA, forecasting an 'abrupt slowdown' in growth in the short term.

But what is a country's credit rating? And why does it matter?

Virtually every adult has a 'credit score.' In simple terms it's a measure of how creditworthy you are. Are you likely to repay your loans? Are you a good risk if someone gives you credit?

In essence a country – and its credit rating – is just the same.

Many countries rely on foreign investors to purchase their debt: in turn, the investors rely on the credit ratings. A good credit rating means that a country can access funds from outside the country – and access those funds at a competitive rate. A good rating also helps with direct foreign investment, as it's an indication of stability and economic outlook to a potential investor.

So which countries come top of the ratings and which are at the bottom? The website 'Trading Economics' awards a 'TE rating' to countries, aggregating the ratings of the three main agencies – Standard & Poor's, Fitch and Moody's.

As of July 2nd, only five countries had a (riskless) score of 100: Denmark, Germany, Liechtenstein, the Netherlands and Switzerland. Norway scored 99, the USA 97 and the UK scored 95. At the other end of the scale, Puerto Rico (having just defaulted on $779m of loans) was given a zero. Venezuela scored 5 and Greece just 10. Italy and Spain were given 60 and 62 respectively. And the world's biggest economy? China scored 80, with two of the three agencies rating the outlook for the Chinese economy as 'negative.'

EUROPE

Nothing much seems to change in Greece. May saw a three day general strike, called to protest against further austerity measures. Shipping, public transport and civil service departments were among the sectors hit in a bid to stop the introduction of tax and pensions changes. But you know what happened: the government (still a left-leaning coalition led by Syriza) went ahead and passed the cuts as it sought to unlock the next tranche of the €86bn bailout agreed last year.

Two days later, an 11 hour meeting with the IMF and Greece's creditors saw European officials agree to unlock €10.3bn in bailout money. That's all very well: the problem is that total Greek debt amounts to €321bn – equivalent to 180% of the country's economic output.

Let's contrast that with Germany. The second quarter started with figures for March confirming a record trade surplus of €26bn. April's surplus was €25.6bn (up from €21.8bn a year earlier) as exports rose by 3.8%. The Federal Labour Office reported unemployment down to 4.2% in May, a record low since re-unification in 1990. In comparison, the jobless rate across the Eurozone fell to 10.2% in April.

You have to wonder how much longer the German people will be prepared to bail out Greece. As was famously said when the Greek crisis first erupted, "You cannot export olives and import BMWs." If Italy were to have the same problems as Greece – which is by no means impossible – you suspect that patience might wear very thin in Germany.

Meanwhile, the other major European economy, France, saw its balance of payments going off in the opposite direction, with a trade deficit of €5.21bn in April. Inflation in June was up to 0.2%, but unemployment remains worryingly high at 10.2%.

We've mentioned the problems of the UK steel industry above: there was also concern about the steel industry in Europe, with campaigners warning that it 'will not survive' if the EU grants China a special international trading status. The European Steel Association urged the EU to reject the idea, saying that China would flood the market.

Both the leading European indices slipped back in the quarter. The German DAX index was down by 3% to 9,680 whilst the French index was down by a similar amount, ending June at 4,237. Despite the bail-out, Greece had a poor quarter, with the stock market down by 6% to 542.

UNITED STATES

If the UK had the Referendum, the US had the battle lines being drawn for November's Presidential Election. With both the Democrat and Republican conventions due to be held this month, it now appears inevitable that Hillary Clinton and Donald Trump will be confirmed as the respective candidates. To paraphrase the philosopher Thomas Hobbes, the campaign promises to be nasty, brutish and long. The latest exchange of pleasantries has seen the Trump campaign accuse Clinton of being 'the most corrupt candidate ever' – but by using an image that was apparently 'anti-Semitic.' Four more months of mud-slinging awaits…

One of the most eagerly awaited indicators of the US economy is the number of new jobs created each month. Over recent months it has generally hovered around the 200,000 mark, and the first quarter ended with 215,000 new jobs being created in March. However, the figures for May showed a startling slowdown, with the US Labor Department confirming that only 38,000 jobs were created in the month, the fewest since September 2010. The unemployment rate did fall from 5% to 4.7% - the lowest since November 2007 – but this was largely due to people dropping out of the labour force and no longer being counted as unemployed. These were worrying figures for the US economy, and may well hamper the Federal Reserve's ability to raise interest rates later in the year.

Federal Reserve Chairman Janet Yellen has now stated that a rate rise in the coming months is 'unlikely,' also citing the uncertainty surrounding Brexit as a reason for keeping US interest rates on hold.

In corporate news, the second quarter was good for Facebook (tripled quarterly profits as ad revenues continued to grow) but bad for Apple (revenues down and constantly thwarted by the Chinese courts ruling that 'iPhone' wasn't a well-known brand name). Meanwhile, Microsoft found $26bn in loose change to snap up LinkedIn and access to its 430m professionals around the world.

The Dow Jones index responded to all this by creeping up 1% in the second quarter. The Dow ended March at 17,685: by the end of June it had made the painstaking journey to 17,930.

FAR EAST

As we report in the below section on Chinese corporate debt, figures released for the first quarter showed that Chinese economic growth had 'slowed' to 6.7% in the first quarter of the year. This is down on the 6.8% recorded in the final quarter of 2015 and the lowest quarterly figure for seven years – however, it was in line with both expectations and the Chinese government's own forecasts.

Inflation in China is steady at 2%, whilst the unemployment rate hovers around 4.4%. The unemployment rate is higher than Japan's – but it's the Japanese economy which is still stuck in a rut as Prime Minister Shinzo Abe continues to try and stimulate it. The planned increase in the sales tax – from 8% to 10% - has been delayed until 2019, with Abe stating that he wants, 'to fulfil my responsibility by accelerating Abenomics more and more.'

There were no such problems in South Korea, which recorded a record $11.6bn trade surplus in June, with imports dropping 8% on a year-on-year basis.

Three of the four Far Eastern markets we cover had unspectacular quarters: the Hong Kong index was largely unchanged, finishing June at 20,794. Despite the surplus, the South Korean market slipped back by 1% to 1,970 and China's Shanghai Composite index was down by 2% to 2,930. The big story – perhaps unsurprisingly – was Japan, where the market was down by 7% in the quarter to 15,576. Having started 2016 at 19,034, the Nikkei Dow is now down by 18% over the first six months of the year.

What is Chinese Corporate Debt and why does it matter?

As we wrote in the introduction, not every story in the last three months was about Brexit – and as George Osborne remarked in virtually every Budget speech he gave, Britain cannot be immune to what is happening in the rest of the world.

So let us briefly consider Chinese corporate debt, and the impact it might have on the wider world economy.

At first glance, the Chinese economy isn't something you'd associate with debt.

China produces a massive trade surplus every month - $50bn (£35.3bn) for May, up from $45bn in April. That's impressive – to put it in perspective, Germany had a surplus of €25bn (just under £20bn) in April, while the UK had a deficit of £3.29bn.

The Chinese economy is also growing rapidly. True, it's not growing as fast as it once did, but the rate of growth – 6.7% in the first quarter of this year – is something western economies can only dream about.

So how can the Chinese economy possibly have debt problems? And even if it did, how can those debt problems impact the UK – and possibly the wider Eurozone economy?

Well, it seems that the only way China has produced so much, so quickly, is by companies taking on potentially dangerous levels of debt. And the International Monetary Fund (IMF) – the organisation that works to secure financial stability and sustainable growth around the world – is getting worried about it.

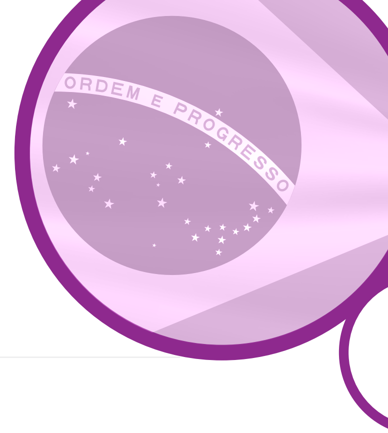
The great and the good of the IMF have just spent two weeks in China. They met with Chinese bankers and high-ranking Communist Party officials – and they came away issuing stark warnings.

Speaking before they left Beijing, David Lipton, the IMF's deputy manging director, said China's economy stood at a 'crucial juncture.' He went on to say that 'mounting corporate debt is a key fault line in the Chinese economy.'

If the Chinese government mis-manage the corporate debt problem, it could affect all of us. China is different from most other countries around the world in that many of their biggest companies are still owned by the state (State Owned Enterprises – SOE's). Corporate debt in China is around one and half times the country's GDP: these SOE's account for 55% of that debt – but produce only 22% of the country's economic output. No wonder that the IMF says, 'Many SOE's are essentially on life support.'

If nothing changes, then these companies may become unable to pay their suppliers and service their debt. That will put pressure on the banks and affect the economy as a whole – as the banks won't be able to lend to successful companies. A vicious circle will begin…

A slowdown in China will inevitably lead to a slowdown in European economies – just as the Eurozone is climbing out of a recession. As the Chancellor has said, no economy is unaffected to what is going on in the rest of the world. And as the steelworkers of the UK have found, if China finds itself with over-capacity, it very quickly starts 'dumping' – with potentially devastating effects on local economies.



EMERGING MARKETS

We're now little more than a month away from the opening of the Rio Olympics and Brazil finds itself in a state of chaos. The Senate voted to impeach President Dilma Rousseff, accusing her of borrowing from state banks to conceal a looming deficit and secure her re-election two years ago. New President Michel Temer may herald a shift to the right as he battles with an economy that could kindly be described as a mess, a complete lack of any social policy and deep-rooted corruption.

Brazil's economy is continuing to contract. It shrank by 0.3% for the first quarter of 2016, the fifth consecutive quarter in which the economy has contracted. This was highlighted by the state of Rio de Janeiro declaring a state of financial emergency. As if all these problems weren't enough, the country continues to battle with the negative impact of the Zika virus.

Despite these problems, the Brazilian stock market was up by 3% in the quarter – possibly in relief that the news wasn't worse. The index closed June at 51,527, having started the quarter at 50,055.

There was a much happier picture in India, which retained its place as the world's fastest growing major economy. Growth in 2015/16 was 7.6%, up from 7.2% in the previous year, with quarterly growth in the three months to April up to 7.9%. Finance Minister Arun Jaitley said that with China slowing, 'the world was seeking other shoulders to rest growth on.' Indian manufacturing was certainly playing its part, jumping by 9.3% in the first quarter of the year. This was reflected on the Indian stock market, which gained 7% in the second quarter, finishing June at exactly 27,000.

The other major emerging economy on which we report – Russia – had a much more sedate quarter, with the stock market rising by just 1% to 1,891. Figures for the first quarter confirmed that the Russian economy had contracted by 1.2% in the first three months of 2016: inflation remains steady at 7.3% and the interest rate has just been cut to 10.5%. Given these numbers, a rise of 1% in the stock market looks a good performance.

The UK markets and, indeed, our wider economy are likely to see increased volatility in the coming weeks, which may well also impact world markets. We appreciate that clients may have questions and queries in such conditions so please do not hesitate to get in touch with us on **info@creativewm.co.uk** at any time.

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Chair of the Investment Committee

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