Investments

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Quarter Three Commentary

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INTRODUCTION

We left you at the end of June just a few brief weeks after the UK General Election which had – let's make an early bid for 'Understatement of the Year' – been a disappointment for the Conservatives. True, they were still in power, but only with the support of the Democratic Unionist Party. Theresa May was being roundly blamed for the defeat and critics doubted whether she could survive until the Conservative conference in the autumn.

Well, Theresa May is still leader and has survived to deliver her Prime Ministerial speech at the conference, (despite a prankster, her coughing fit and collapsing slogan). But she is holed beneath the waterline and the sharks continue to circle – although admittedly Boris Johnson is an unlikely looking shark...

What of the rest of the world? Federal elections have just been held in Germany and, as we report in one of the special features, the 'long twilight of Angela Merkel' may have begun. Much of the Caribbean and the Southern states of the US were battered by hurricanes Harvey, Irma and Jose, but the real concerns continue to focus on North Korea, with Kim Jong-un and Donald Trump now trading almost daily insults via social media and North Korean rockets making regular forays over Japan.

UNITED KINGDOM

Let us turn away from politics and consider economic events in the UK through the summer. As always, it was a mixture of good and bad news and whether your glass is half full or half empty may well depend on your political standpoint and views on Brexit.

The quarter didn't get off to the best of starts as the IMF downgraded its forecast growth for the year, cutting it from 2.0% to 1.7%. There was also bad news on UK productivity – the constant theme running through George Osborne's Budget speeches – which the Office for National Statistics reported had dropped back to pre-financial crisis levels.

The figures for June showed that the UK trade gap had widened. The difference between the goods and services we import and those we export widened by £2bn to £4.6bn according to figures from the Office for National Statistics, the biggest gap since September last year.

There was also gloomy news on the interest rate front, although that again will depend on your position. Throughout the summer the murmurings from the Bank of England were that there would be no rises for 'at least a year'. However, by the end of September, Governor Mark Carney was expecting a rate rise "in the near term" – which could apparently be as early as November.

There was further bad news to end the quarter as credit ratings agency, Moody's, downgraded the UK's credit rating from Aa1 to Aa2, following earlier downgrades by the other major agencies. UK growth for the second quarter of the year was also revised down to 1.5% from an earlier 1.7%.

Was there any good news in the quarter? Plenty – even for the beleaguered UK high street as UK retail growth continued, helped by stronger spending on food. The figures for July showed a 0.3% increase on June's figures. Clearly, plenty of the food was being bought at Lidl, which overtook Waitrose to become the UK's 7th largest supermarket group.

In July, the government had its first budget surplus for 15 years as more money came in from self-employed tax receipts. Maybe Chancellor Philip Hammond ordered a fleet of Aston Martins for his cabinet colleagues – the company increased its profit forecasts for the second time this year after a record six months. And UK car production was up as a whole: despite falling sales numbers, 136,000 vehicles were made in British factories in July – up 8% on July 2016.

Figures for August showed that UK manufacturing had hit a four month high, and later in the month it was reported that UK manufacturing had moved up one place in the 'world manufacturing league table' to become the 8th largest in the world. Unfortunately, the service sector couldn't match this progress as the August figures recorded the slowest growth for 11 months.

Nevertheless, UK unemployment continues to fall – it is now down to 4.3%, down from 4.4% in the previous quarter and the lowest level since 1975. However, wages continue to stagnate and with inflation hitting 2.9%, many people are still seeing a fall in real wages.

UNITED KINGDOM

Continued

We cannot finish this section without returning to politics. Having spent virtually all the election campaign deriding Labour's 'magic money tree', Theresa May seems to have, well, magically found one at the bottom of the Downing Street garden. Student loans, Help to Buy, lifting the public sector pay cap and £1bn to keep the Democratic Unionists onside... Philip Hammond's Autumn Budget – now scheduled for 22nd November – is definitely going to be interesting.

The FTSE-100 index of leading shares certainly seemed to be in a cautious, Philip Hammond-type mood throughout the summer. It rose just 1% over the three months to 7,373 and is now up 3% for the year as a whole.

BREXIT

Looking back over the last three months with regard to Brexit in particular, it is very difficult to escape the famous quote from Macbeth: 'It is a tale, told by an idiot, full of sound and fury, signifying nothing.'

We suggested on several occasions that, 'progress would be made after the German elections.' In July, Theresa May went on holiday and the Cabinet immediately started squabbling like schoolchildren whose teacher had just left the classroom. August saw UK exit supremo David Davis saying that "good progress has been made." His European counterpart, Michel Barnier, responded by saying that, "Britain is demanding the impossible." Jean-Claude Juncker, the President of the European Commission, said that none of the UK's position papers were "satisfactory" and warned that there would be no discussions of a free trade deal until progress was made on the so-called Brexit bill, the border with Ireland and the rights of EU citizens.

No matter, 'there would be progress after the German elections', we thought.

But as you will see in the section on the German elections, the net result was a serious weakening of Angela Merkel's position. The possibility of 'no deal', with the deadline of March 2019 now only 18 months away, is looking increasingly likely.

In the same way that the Labour Party is now apparently 'war-gaming' a run on the pound should they come to power, so the Government are supposedly doing the same with the prospect of 'no deal' by March 2019. It is looking increasingly likely: credit ratings agency Moody's goes even further, describing 'no deal' as a 'substantial probability'.

EUROPE

We have dealt with the German elections separately, so let us leave those to one side for now. Likewise, the troubles in Spain with Catalan independence, which really erupted on 1st October – but it would be uncharitable to leave the Iberian Peninsula without reporting that the second quarter of the year saw the economy grow by 0.9%, finally taking it back to the level it was before the credit crunch of 2008.

There was less good news in Italy, with CNBC describing the country's economy as a 'basket case.' The country has€2tn of public debt, which is around 133% of the country's GDP and – as we have reported in previous commentaries – several of the country's banks have needed rescuing, burdened by loans that will simply never be repaid. Greece may steal the headlines, but if the EU is ever brought down by a financial collapse it may well be the Italian banks that are to blame.

What did the summer bring for the rest of Europe?

Well, long hours waiting for news of your cancelled flight if you were a Ryanair customer in what must be one of the biggest own goals in corporate history. Neither was there good news for Volkswagen as the bill for their emissions scandal reached $30bn. However, emissions will presumably become a thing of the past as French Ecology Minister, Nicolas Hulot, announced a ban on the sale of any car that uses petrol or diesel fuel by 2040. There is some way to go, however: at the moment hybrid vehicles make up 3.5% of the French market, with pure electric vehicles accounting for just 1.2%. The announcement was part of a renewed commitment to the Paris climate deal, with Hulot saying that France planned to become carbon neutral by 2050.

By and large, the economic news was good for Europe through the summer. The unemployment rate in the EU has fallen to 9.1% - the lowest level since February 2009 – and the European Central Bank is now predicting the fastest Eurozone growth since 2007, forecasting economic growth of 2.2% for this year.

This was reflected on the major stock markets, with both the French and German indices up by 4% in the quarter to 5,330 and 12,829 respectively. The French index is now up by 10% for the year as a whole while the German DAX index is up by 12%.

EUROPE

Continued

THE TWILIGHT OF ANGELA MERKEL

The German elections, which we mentioned in previous reports, were finally held on the last Sunday in September. With no obvious pantomime villain, like Geert Wilders in Holland or Marine le Pen in France, the elections received a lot less coverage in this country. They were largely seen as rubber-stamping another four years as Chancellor for Angela Merkel: four more years with 'Mutti' leading Germany and – by extension – Europe.

Merkel became German Chancellor in November 2005 and was commonly acknowledged as the most powerful woman politician in the world. In the 2013 election, her Christian Democrat/Christian Social Union group recorded its best result since 1990, winning 42% of the votes and nearly 50% of the seats in the Bundestag. With their previous coalition partner, the Free Democrats, failing to get over the 5% threshold for parliamentary representation, the 'grand coalition' was formed with the main opposition party, the Social Democrats.

On the last Sunday in September, all that changed…

The Christian Democrat vote was down nearly 10% to 32.9%: the Social Democrats recorded their worst result since the war, with just 20.5% of the vote and in third – with 12.9% of the vote – was the right-wing anti-immigration party, Alternative fur Deutschland (AfD).

Where did that leave Merkel? Substantially weaker: the Social Democrats have gone into opposition to lick their wounds and Merkel is likely to be left with what is scathingly referred to as 'the Jamaica Coalition.' Based on the colours of the respective parties, this is a coalition between the Christian Democrats, the Free Democrats (roughly equivalent to the Liberals in the UK) and the Green Party.

Where does the result leave the EU, the UK and Brexit?

Commentators have been quick to analyse the results and ask what it means for Europe and – by extension – the Brexit negotiations and the UK.

First things first: as one commentator put it, "Angela Merkel's twilight has begun." She is already facing a barrage of 'I-told-you-so' comments from her own party, having ignored the constant warnings on unrestricted immigration.

The German parliament – with maybe seven or eight parties in it, including the fiercely-combative AfD – is likely to be a fractious place. It will take enough effort to produce a working government at home, without worrying about Europe. Germany is also likely to be tougher with countries like Hungary and Poland who have so far refused to take their share of Middle Eastern refugees. German patience is likely to wear thin, with many in Merkel's party blaming this refusal for their poor showing at the polls.

Whichever way you look at it, Germany is going to be 'muddling through' for the foreseeable future. The AfD will be the official opposition and they are "committed to fighting the foreign invasion." There will be problems with the Free Democrats in a coalition as they want to throw Greece out of the Eurozone. And Emmanuel Macron will undoubtedly try to fill the new vacancy for de facto leader of Europe.

EUROPE

Continued

The potential for chaos – and deals between the smaller parties – is considerable. In their manifesto, the Greens talked of Scotland and Northern Ireland being given a route back into the EU if they decide to split from the UK. The Free Democrats also support Scotland re-joining the EU. In the same way that the UK has been accused of wanting to 'cherry pick' those parts of EU legislation it will comply with after Brexit, could we now start to see the ruling German coalition try to 'cherry pick' parts of the UK?

Could the main beneficiary of Sunday's German elections and Angela Merkel's 'twilight' end up being Nicola Sturgeon?

UNITED STATES

We report below on Donald Trump's first eight months as President, trying to look behind the headlines. Certainly, the US economy appears to like what it has seen of the new President, creating 220,000 new jobs in June, 209,000 in July and 173,000 in August, with unemployment remaining low at 4.4%. Figures for the second quarter showed that the US economy had bounced back from weak growth in the first quarter, growing at an annualised rate of 2.6% between April and June.

There was good news for the 'old economy' – specifically the US motor industry - as Toyota and Mazda announced plans to team up and invest £1.6bn in a new car plant which will produce 300,000 vehicles a year and create 4,000 jobs. Electric car maker Tesla also said it was aiming to raise $1.5bn to fund its Model 3 car.

...And in the 'new economy' (perhaps not so new now), Apple's profits for its third quarter were up 12% to $8.7bn, with the company boosted by Apple Pay, the App Store and Apple Music. Across the road at Facebook, profits continue to grow strongly: the company's revenues and profits soared in the second quarter with more than 2bn people now logging into the site each month. The firm's revenues hit $9.3bn for the April to June period, up 45% year-on-year as profits for the quarter rose to $3.9bn.

However, it is not all good news, especially for the American retail sector. Amazon bought Whole Foods and immediately embarked on an aggressive raft of price cuts – some prices were cut by as much as 43% - which sent shockwaves through grocery shares around the world. In September, Toys-R-Us filed for bankruptcy protection: with an increasing number of malls threatened with closure over the next five years. You have to ask if this is a straw in the wind and whether Amazon and other online retailers will now do to out of town shopping what they have done to so many high streets in the US and the UK.

As we noted in the introduction, the Southern states in the US were hit badly by Hurricane Harvey, with one estimate now putting the repair bill in Texas at $180bn and further devastation caused in Puerto Rico by Hurricanes Irma and Jose.

The US economy appears to like the new President and so does Wall Street. The Dow Jones index rose 5% in the quarter to end September at 22,405. It is now up by 13% for the year as a whole.

UNITED STATES

Continued

EIGHT MONTHS OF THE DONALD

Donald J Trump was inaugurated as the 45th President of the United States on 20th January of this year. It is easy to look at Trump and only see the hair, the tan, the frequent use of Twitter and the seemingly revolving door as he continues to fall out with – and fire – members of his administration. And with North Korean rockets launched on an all-too-regular basis, it is also easy to view him simply as the man who has to deal with Kim Jong-un, through increasingly vitriolic posts on social media.

But let's take a look behind the headlines: Trump has now been in power for eight months – one-sixth of a four year term in office. What has he achieved? Or not, as the case may be...

On foreign affairs, he has been blunt and not afraid to preach his 'West is best' approach. These sentiments have played well with his core support in the States, who regard the simple statement of American values as something George Bush was reluctant to say and Barack Obama didn't say at all.

His supporters would also give him credit for the competence of the national security team he has assembled, and for the explicit willingness to side with Israel as one of America's key allies. They might be less impressed with the increase in defence spending, which does not include a plan to reach a 350-ship US Navy, one of his less-reported campaign promises.

He has not built his famous wall along the border with Mexico: he has been given plenty of money by Congress for border barriers, and is moving towards a system of migration based on skills preferences.

Trump has also rolled back much of the Obama legislation, although Senator John McCain continues to stand firm against the repeal of 'Obamacare.'

He has pulled the USA out of both the Trans-Pacific Trade Partnership and the Paris Climate Deal – both very much reflecting his 'America first' view of the world. Again, this has played well domestically and his approval ratings are good in those counties and states that voted for him last November. As Trump says, "I was elected by the people of Pittsburgh, not Paris."

Oh, and he's tweeted 991 times...

Not everything Trump has done has been good: clearly, he has made plenty of diplomatic mistakes. However, behind the bombast and the bouffant there has been progress made – good progress if you are someone who voted for him. Many in the UK will disapprove: many will worry about the future of the world. But Donald Trump won't change course: if the people of Paris didn't vote for him, neither did the people of Preston or Pyongyang.

FAR EAST

As we have already noted, the last three months have seen no let-up in North Korea's missile-testing programme, with rockets now flying over the north of Japan on two separate occasions. This has been a contributory factor in Japanese Prime Minister Shinzo Abe's decision to call a snap general election, as he looks to take advantage of opposition disarray and seeks support for his hard line against North Korea. Abe said the election would be a judgement on his spending plans and his handling of the Korean crisis. The election is due to be held on 22nd October and at the moment Abe and his Liberal Democratic Party have a comfortable lead in the polls.

China has now cut back sharply on imports from North Korea: in theory, this should rein back the North Korean economy and hence the money the country has to spend on missile tests. We shall see: clearly, North Korea is buying the rocket parts from somewhere...

Another theme running through the summer has been concern about mounting levels of debt in China. Growth for the second quarter of the year was 6.9% - ahead of the Government's target of 6.5%, but there are real worries that the growth is being fuelled by debt. Figures from the Bank for International Settlements showed a surge in lending to China and Chinese companies: international banks lent $92bn to China in the first quarter of the year, well up on the same period in the previous year.

The International Monetary Fund also warned (again) about the country's credit boom, saying that China's credit growth was on "a dangerous trajectory." The problem is that China is now the driver of much of the world's economy. It is a difficult balancing act for the Chinese central bank: if growth ever slows down there will surely be pressure to allow further credit in order to maintain demand.

These worries were confirmed in September when credit ratings agency Standard & Poor's cut China's rating by one point from AA- to A+. From a credit ratings point of view, this puts China on the same level as Ireland and Chile.

The downgrade comes just a month before the Communist Party Congress, which is held only twice every decade and sets economic policy for the next five years.

Hong Kong led the way on Far Eastern stock markets in the third quarter, rising 7% to 27,554 where the market is up by an impressive 25% for the whole of 2017. China's Shanghai Composite Index rose 5% to 3,349 (up 8% for the year) and despite the rockets whizzing overhead, Japan's Nikkei Dow index was up 2% (and 6% for the full year) at 20,356. In South Korea, the market was virtually unchanged in the quarter, but is up 18% for the year as a whole at 2,394.

EMERGING MARKETS

By and large, it was a quiet summer for the three major emerging markets on which we report. By 'quiet' we mean that it was a quarter in which no senior Brazilian politicians were impeached or imprisoned and – as you will see below – the country's stock market duly responded.

September saw the BRICS summit – a meeting of the leaders of Brazil, Russia, India, China and South Africa and their associated economic entourages. Chinese leader Xi Jinping told the delegates that an 'open world economy' was needed, with ever-increasing trade liberalisation: "The development of emerging markets and developing countries won't touch anyone's cheese," he said, "but instead will diligently grow the world economic pie." Hopefully, the various translators managed to make sense of that, but with China committed to massive investment in Pakistan you suspect that China and India may be squabbling over rather more important matters than pie and cheese in the long term…

On the stock markets, Brazil was the star performer, rising 18% in the quarter to close September at 74,294: the market there is now up 23% for the year as a whole. Russia had a good quarter, with the stock market rising 11% to 2,077 – however, all the damage was done in the early part of the year and the market remains down 7% for the first nine months of the year. The Indian stock market had a quiet quarter, rising just 1% to 31,284, but having enjoyed a good start to the year it is still up by 17% for the year as a whole.

CONCLUSION

And so the third quarter of the year draws to a close. Maybe it's a sign of age but it does seem as though time is speeding up. We hope you've enjoyed reading the report and, as always, if you have any questions on any of the comments above then don't hesitate to get in touch with us. We are never more than a phone call or an email away.

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