Investments

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Quarter Two Commentary

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INTRODUCTION

Last November Donald Trump, 49th President of the United States, visited China. The trip could not have gone more smoothly, either from a political or a business point of view.

Hosting a dinner at the Great Hall of the People, Chinese premier Xi Jinping said that the potential for cooperation between the US and China was limitless. “The two countries will be able to open a new page of bilateral ties and make a new contribution to the future of all humankind,” said Xi.

Trump warmly returned the compliments, saying he believed that cooperation between the countries would bring peace, prosperity and security to the world.

It all started to unravel remarkably quickly, with rumours of the US imposing tariffs on a raft of Chinese goods and Beijing threatening immediate retaliation. Seven months on from the Great Hall of the People we appear to be on the verge of a global trade war which – unsurprisingly – had a negative impact on world stock markets in June, although looking at the quarter as a whole several of the leading markets did make progress.

Away from trade wars the big story of the quarter was the two visits made by North Korean leader Kim Jong-un, firstly to meet his South Korean counterpart and to make a commitment to rid the Korean peninsula of nuclear weapons. This was followed by a meeting with Donald Trump in Singapore, something which would have seemed barely credible this time last year.

UNITED KINGDOM

A perennial theme running through these Quarterly Reports has been the seemingly inexorable decline of the retail sector in the UK. The quarter started with a wet Easter ruining holiday trade, and there was a steady stream of bad news, ultimately leading to suggestions that 50,000 retail jobs have been lost in the first six months of the year.

On the morning of Monday July 2nd both the Mirror and the Daily Mail were leading with ‘the battle to save Britain’s high streets.’

Can anything be done? June brought us almost uninterrupted sunshine, and it may well be that the retail figures – like those for May – will show a rebound from the depressing figures disclosed in the Spring. The Mail – highlighting the job losses – was calling for an urgent review of ‘crippling business rates.’

Even that may not be enough: the simple fact is that it is easier, quicker, more convenient and cheaper to shop online. Even Costa is starting to struggle, reporting a 2% fall in like-for-like sales in the first three months of the year, which it blamed squarely on a lack of shoppers. You suspect that Costa’s like-for-like figures may well become a barometer of the high street.

The long term trend was neatly captured by the problems of House of Fraser. On June 4th it “rejected talk of a collapse:” three days later it was announcing that 31 of its stores would close. With M&S also planning a programme of store closures, Debenhams issuing constant profit warnings and 60 bank branches closing every month, the UK high street increasingly looks like an idea whose time has passed.

What of wages and jobs? Unemployment has continued to fall, and there are now a record number of people – 32.4m – in work in the UK: that is up 440,000 on 12 months ago.

…And in the main, those people in work started to see their wages inch ahead of inflation through the quarter. Inflation dipped to 2.4% in April, although the Bank of England suggests it may be the end of the year before we see significant wage growth.

It does, though, look like the Bank will be active before then, with the signs pointing to a rise in interest rates to 0.75%, perhaps as early as August.

The quarter ended with MPs voting overwhelmingly for the expansion of Heathrow airport – but the decision will be widely challenged in the courts by local and environmental campaigners. It will be some time before the building work starts.

The FTSE 100 index of leading shares had an excellent quarter, rising 8% to close June at 7,637. But having started the year at 7,688 it was really only making up ground lost in the first quarter. Overall it is down by just 51 points for the year to date.

The pound went in exactly the opposite direction, falling by 6% in the quarter to $1.3211 – where it is down by 2% for the year as a whole.

UNITED KINGDOM

Continued

BREXIT

June brought us the second anniversary of the Referendum: at the end of March there appeared to be good progress as the key points for the transition arrangement were agreed. Three months on there seems to be some uncertainty on how to move forwards any further.

Much of the debate over the past three months has centred on what sort of customs arrangement/agreement/partnership the UK will have with the EU after March next year.

In April the debate seemed to be between two models. The first – favoured by the Brexit supporters and known in Whitehall as ‘Max Fac’ (short for Maximum Facilitation) would see the UK and EU agree to minimise all checks, using smart technology and building on best practice from around the world. This means that there would be a border between the UK and the EU, but it would be as light touch as possible.

The second option is a hybrid model – the Customs Partnership – which rests on the EU recognising UK customs checks as equivalent to their own (and vice-versa), so that goods entering the EU at say, Rotterdam, could in theory travel on to the UK without further checks.

This appeared to be Theresa May’s favoured option, but has been described by the darling of the Tory right, Jacob Rees-Mogg, as “cretinous.”

Towards the end of June we saw Environment Minister Michael Gove publicly rip up plans for a customs partnership, as we headed for a third model – described by Theresa May as “the best of both worlds” but apparently acceptable to virtually no-one else in the run up to a crisis meeting at Chequers.

The cabinet emerged from the meeting in ‘agreement’ but, as has been the way with Brexit, quickly swung back into something other than agreement. David Davis and Boris Johnson resigned from their posts and a swathe of not-so-vague threats indicated that more ministers could go if the Prime Minister didn’t reconsider ‘the Chequers plan’.

We’re now well into the next quarter of the year and things look no clearer. To muddy the waters further still, Donald Trump has arrived in the UK for several events, including dinner with the Prime Minister. Just prior to that dinner the president declared in an interview with The Sun that Theresa May’s plan would “kill” a proposed trade deal between the UK and US whilst simultaneously declaring that Mr Johnson “would make a great Prime Minister”. The Brexit part of this report seems to grow with ‘bigger’ headlines every quarter and only a brave person would bet against there being more of the same when we sit down to right next quarter’s summary.

EUROPE

The second quarter of the year was a busy one for Europe's politicians as Italy finally formed a government, courtesy of an uneasy coalition and a threatened return to the polls. In Spain Prime Minister Mariano Rajoy lost a vote of no confidence following allegations of corruption and was forced to resign, while in Turkey Recep Erdogan won a new five year term as president, with some commentators arguing that it effectively spelled the end of the country as a democracy.

Perhaps more significantly we seem to be nearing the end of Angela Merkel's time as German Chancellor and de facto leader of Europe. For now she has survived a threat by coalition partner and Interior Minister Horst Seehofer, who came close to resigning over her immigration policy.

'In office but not in power' is the phrase which comes to mind, and Emmanuel Macron's high profile visit to Washington in April and his speech on the future of Europe were widely seen as a bid to take over from Mrs Merkel. Sadly his vision of an ever closer Europe seems to be at odds with what most countries – especially the former Soviet bloc members – currently want.

Away from the corridors of power and in the banking halls, the European Central Bank announced in April that it would leave interest rates unchanged, despite the pace of growth in the Eurozone starting to slow. In June the ECB made the decision to end its huge programme of bond-buying which was introduced in a bid to stimulate the economy of the Eurozone. In a statement the ECB said that it would halve the current scheme – worth €30bn (£26.6bn) a month – after September "as long as the data remained favourable" and end it completely in December. ECB President Mario Draghi acknowledged that Eurozone growth had stuttered recently, but was adamant that the underlying growth "remained strong."

The big company news was in the steel industry, as German industrial group Thyssenkrupp signed a deal with Tata Steel to combine the two companies' European businesses. The new company will be headquartered in Amsterdam and will have a total workforce of 48,000 – but there are fears of up to 4,000 redundancies.

Despite the political uncertainty it was a good quarter for Europe's two main stock markets, with the German DAX index up by 2% to close June at 12,306 whilst the French market rose 3% to 5,324. On a year-to-date basis the German market is down by 5% for the first six months of 2018, while the French index is virtually unchanged.

UNITED STATES

So what of the land of the free and the home of the brave? The first thing to say is that whatever the rest of the world thinks, the US rather likes its President. Donald Trump's approval ratings have surged in the first half of 2018 and he is currently a very clear favourite to win a second term in 2020.

Popularity does not, however, translate into a trade deficit that is under control. While the US economy might be consistently adding jobs those newly employed workers are spending their wages on imports and the quarter opened with the US trade deficit surging to $57.6bn (£43.6bn). There are suggestions that the US could have a trade deficit of a trillion dollars a year by 2020: that is equivalent to an annual deficit of £750bn – or more than £60bn a month – and simply cannot be a good thing in the long run.

The first two months of the quarter saw slightly disappointing jobs growth, but figures for May were excellent. Forecasters had been expecting 190,000 jobs to be added in May, but that figure was comprehensively beaten as the US economy added 223,000 jobs, with unemployment dipping below 4% for the first time since 2000.

As had been expected the US Federal Reserve responded by announcing a rise in interest rates, moving the target rate up from 1.75% to 2%, and going so far as to forecast a further two rate rises this year, reflecting the strength of the US economy. It is the seventh time that rates have been increased since 2015 and takes them to their highest level since 2008.

In company news it wasn't a good quarter for Facebook as Mark Zuckerberg returned from the Congressional hearings to announce that Facebook would be launching a dating service – and then found the company wrestling with another 'privacy bug,' this time affecting the details of 14m people.

It was much more 'business as normal' for Apple as the company showered its investors with cash and announced plans for a $100bn (£75bn) share buyback. Legendary investor Warren Buffet liked what he heard and bought 75m shares, sending the stock price to a record high.

On Wall Street it was relatively quiet quarter for the Dow Jones index which closed March at 24,103 and climbed just 1% to end June at 24,271. For the year as a whole, however, the Dow is down by 2%.

UNITED STATES

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THE TRUMP TARIFFS

Donald Trump campaigned on a platform of protecting American jobs and – having started with products as unlikely as washing machines and solar panels – imposed a 25% tariff on steel imports and 10% on aluminium from Canada, the EU and Mexico on June 1st.

$50bn worth of tariffs on Chinese goods are due to be imposed on July 6th and inevitably all the countries involved are planning retaliatory tariffs. India has also been hit with penalties on imports of $1.2bn worth of steel and aluminium.

So far, Morgan Stanley estimate that the Trump Tariffs cover just over 4% of US imports. Traditionally, protectionist measures such as tariffs do not work in the long term as all they are doing is protecting inefficient industries – and 80% of 104 economists surveyed by Reuters believed that the tariffs will harm the US economy.

Whatever the economists think, this is exactly the basis on which Trump ran for office. He has called the North American Free Trade Association, "the worst deal the US ever signed" and called the planned Trans Pacific Partnership a deal which would "signal the death blow of American manufacturing."

So the current tariffs are not a whim – and clearly a long, drawn out trade war with China would have global implications. Like many Americans, Trump believes that China has stolen US intellectual property, and says the tariffs will make the US a "stronger, richer nation."

In response the Chinese introduced tariffs on 128 different US goods, with 120 (including fruit and wine) taxed at 15% and a further eight (including pork) taxed at 25%.

The US list of Chinese products now extends to more than 1,300 products, with the Chinese ambassador to the US saying that his country "has no alternative other than to fight back."

The problem, of course, is that neither side will back down – and risk showing weakness – and that the trade war will go on for some time, with increasing numbers of tit-for-tat tariffs. Trump fairly and squarely blames his predecessors for allowing the situation to develop and for allowing the theft of US intellectual property. Ultimately, China needs the US as a market – but Xi Jinping will play a long game: Donald Trump cannot be President after January 2025, by which time he will be 78. Xi Jinping will be a relative youth of 71 – he can afford to wait...

FAR EAST

The quarter certainly got off to a good start for the Chinese economy, with news that first quarter growth was 6.8% - comfortably ahead of the government's growth target for the year of "around 6.5%."

It was the exact opposite in Japan, with figures for the first quarter of 2018 showing that the economy had contracted by an annualised rate of 0.6%, worse than the expected contraction of 0.2%. This was the first time the Japanese economy had shrunk in two years, ending the longest stretch of economic growth since the 1980s.

In company news, Chinese smartphone maker Xiaomi (it's pronounced 'show-me') announced plans for a $10bn listing on the Hong Kong stock market, while TenCent – China's biggest social media company and now worth more than Facebook – posted a 61% year-on-year jump in profits to $3.7bn (£2.7bn).

Inevitably, tariffs, retaliatory trade measures and the threat of a trade war took their toll on the region's stock markets. China's Shanghai Composite index closed March at 3,169 and fell 10% over the quarter to end June at 2,847 – where it is down by 14% for the year as a whole.

Hong Kong was also down in the quarter, although only by 4% to 28,955 while the South Korean market fell 5% to 2,326. Japan went in exactly the opposite direction (despite the gloomy news on growth) and rose 4% to 22,304. However, all three markets are now in negative territory for the first six months of the year, with Hong Kong down by 3%, South Korea by 6% and Japan down just 2%.

FAR EAST

Continued

WILL CHINA RULE THE WORLD?

Some of you will have heard of China's massive infrastructure project, the Belt and Road Initiative. It refers to the Silk Road Economic Belt and the 21st Century Maritime Silk Road – and focuses on connecting Eurasian and African countries to China.

The Chinese government calls it "a bid to enhance regional connectivity and embrace a brighter future." Critics term it a naked power grab.

The UN estimates that the population of the world will increase to 11bn by the end of this century, with most of that growth coming in areas China intends to reach and trade with through the Belt and Road.

The initiative was first mooted by Xi Jinping around 2013, and sees China's push into global economic affairs extending through massive investment in infrastructure, construction, railways and highways, automobiles, power and iron and steel.

Speaking at the recent Communist Party Congress Xi told his audience that China will "take centre stage in the world." The Belt and Road is designed to do exactly that. The land based Belt runs across Asia and through Europe. The Maritime Road reaches South East Asia, Oceania and North Africa. More than 65 countries, 4.4bn people (63% of the world's population) and 29% of the world's GDP are in its path.

Importantly the countries it reaches are those countries poised for rapid growth – and they have been eager to accept China's offer of help with infrastructure projects. Kazakhstan (population 18m) is a good example. Chinese investment in the country has stimulated trade and investment: in return China gains access to the country's vast mineral resources, which may be vital to China's future energy needs.

With the Party Congress effectively confirming Xi as ruler for life, there is little doubt that China will pursue the Belt and Road initiative vigorously – and it will extend into Africa as well as Eurasia, as Xi looks for "a paradigm of globalisation that favours China." Africa will be a key source of raw materials, especially crude oil. China is now the world's second largest consumer of crude, with 25% of its imports already coming from Sudan and the Gulf of Guinea.

Add the Belt and Road initiative to a huge domestic market, the world's largest standing army and what appears to be an ongoing commitment to industrial espionage and you undoubtedly have the global superpower of the coming decades.

EMERGING MARKETS

The second quarter of 2018 was a relatively quiet one for the three major emerging markets which we cover in this Report.

At the beginning of April there was a BBC headline reporting that 'US sanctions hit Russian shares' as sanctions supposedly struck at the dubious wealth of some of the Russian oligarchs. By the end of the quarter the US – as we have seen – had rather bigger fish to fry. As for the shares, on a year-to-date basis the Russian stock market is currently the best performing of all the markets we cover in this report.

It was up 1% in the second quarter of the year to finish June at 2,296 – but is up by 9% for the year to date, having started 2018 at 2,109. The star performer of the second quarter in this section was India: having ended March at 32,969 the market there rose 7% in the second quarter to close at 35,423. For the year as a whole, though, it is only up by 4%.

Sadly there was a complete contrast in Brazil as all the old worries about debt, corruption and long-term unemployment re-surfaced. The stock market ended March at 85,366 and then tumbled 15% in the quarter to close June at 72,763. On a year-to-date basis that is a fall of just 5% but the Brazilian market is nothing if not volatile. It will be interesting to see what happens over the next three months.

...By which time the summer will have ended and we will be just three weeks away from the clocks going back. There's a depressing thought, so make the very most of the sunshine and – if you are going on holiday – have a wonderful time. Should you have any questions about your financial planning in between the beach and the barbecue, then remember that we are never more than a phone call or an e-mail away.

Craig Harrison FPFS IMC
Chair of the Investment Committee