Investments

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Quarter Four Commentary

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INTRODUCTION

By any standards, the last quarter of 2018 was a turbulent one for world stock markets. We report on 11 major markets in this Report: nine of them were down in the final three months of the year, in some cases significantly, as 2018 turned into the worst year for global markets since 2008.

As we have stressed many times, saving and investing is a long-term commitment: there will be occasional bad years and the year just ended reinforced that point – but rest assured that whatever happens, we are always here to answer your questions and make sure your long-term financial planning remains on track.

So what did happen?

Well, very emphatically, Donald Trump happened. Regular readers will know that the 'Trump Tariffs' now have their own Wikipedia entry and that the trade dispute with China rumbled on for most of last year. At the beginning of December, both Donald Trump and Xi Jinping were in Argentina for the G20 Summit, where a temporary truce in the trade war was agreed. By the end of the month, the two leaders had held a 'long and cordial' phone conversation and perhaps the end of the dispute is in sight.

It is certainly to be hoped so: in December, the US Federal Reserve raised interest rates to their highest level for ten years and the President duly fell out with Fed chairman Jerome Powell – someone he only appointed in November 2017. The US Government also faced a 'very long' shutdown as the President and the Senate failed to agree about funding for the border wall with Mexico.

All of this sent shockwaves through world stock markets with, for example, the Japanese market falling 5% on Christmas Day and the US market facing its worst December since 1931. As usual, we deal with all the country-by-country figures in the relevant sections below.

Back in Europe, the last quarter saw the French gilets jaunes (yellow jackets) take to the streets in protest against the policies of President Macron. In Germany, Annegret Kramp-Karrenbauer became the new leader of the Christian Democrats and will presumably replace Angela Merkel as Chancellor in due course. Meanwhile, Theresa May survived a vote of no confidence as another three months passed without any discernible progress in the Brexit negotiations.

Let us look at the quarter's events in more detail...

UNITED KINGDOM

Chancellor of the Exchequer, Philip Hammond, duly delivered his Budget speech on Monday 29th October and it was hard not to feel some sympathy for him. So many of his announcements – the 'end of austerity' and the extra cash for the NHS, to name but two, had already been announced by Theresa May in previous speeches.

The Budget generally received a positive reaction from the press. The Chancellor increased the personal allowance to £12,500 and lifted the level at which people pay higher rate tax to £50,000: "Conservative manifesto commitments delivered a year early." 'Phil-Good Factor,' said the Daily Mail – but the Guardian may have been closer to the mark with, 'A Budget of tax cuts and spending to shore up May.'

The Budget also saw the proposed introduction of a Digital Services Tax – not, stressed the Chancellor – an online sales tax, but an attempt to get digital giants such as Amazon and Google 'to pay their fair share'. The move has been widely condemned in the US and will not, in truth, raise that much money. As we report below, France has now introduced a similar tax as Europe-wide initiatives look set to flounder.

In wider economic news, inflation was down to 2.4% in September and unemployment fell by 47,000 in the three months to August. Unemployment was down to 4% and youth unemployment at its lowest level in history, with wage growth in the UK at its fastest for a decade. These were points the Chancellor hammered home in his speech, confidently predicting "real wage growth" for each of the next five years.

Sadly, it did not appear that these increased wages were being spent on the UK high street. A report commissioned by the government has stated that UK high streets have "twice as many shops as they need" and HMV's decision to call in the receivers, plus reports of distinctly lower footfall for the Boxing Day sales, cannot be good omens for the rest of 2019.

By December, any good news was hard to find: The Office for National Statistics did confirm that growth in the economy for the three months to October - the period immediately after the World Cup boost – was 0.4% and the figures did show wages rising at 3.3%, comfortably above the rate of inflation.

In addition, for the second year in succession, the UK came top of Forbes' 'Best Country to do Business' poll, which ranks countries on 15 different factors. Second and third were Sweden and Hong Kong.

But December ended with more gloomy news as growth in the service sector slid to its lowest level since July 2016, house price growth was at its lowest for six years and Gatwick Airport was brought to a standstill by a drone – although this did not stop French airport group, Vinci, from buying the airport for £5.8bn.

Inevitably, the FT-SE 100 index of leading shares was down in the quarter, falling by 10% to 6,728 meaning that it was down by 12% for the year as a whole. Having started the year trading at $1.3504, the pound ended it at $1.2746 – down 2% in the final quarter and 6% for the whole of 2018.

UNITED KINGDOM

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BREXIT

Three months ago, the Prime Minister had just presented her ‘Chequers Plan’ to the Cabinet. Her proposals were roundly dismissed by most of her own party and by EU Chief Negotiator, Michel Barnier. For now, though, they remain the only plans on the table, with the Commons due to vote on them on the 15th January – Theresa May having postponed the December vote as she faced almost certain defeat.

The Prime Minister did at least win her vote of confidence. Chairman of the backbench 1922 Committee, Sir Graham Brady, finally received his 48 letters expressing no confidence (although there were rumours that some had been submitted by pro-May loyalists to hasten the vote) and the Prime Minister won by 200-117. She cannot now face a challenge until December 2019.

But has anything changed since December last year? Not really. The DUP has stressed that the plans for the Irish backstop still do not give the assurances they wanted. There have been suggestions that the EU will offer a promise that it “does not want to keep the UK in the backstop permanently” in a bid to help Theresa May get her proposals through parliament. This has already been dismissed as an ‘operation fig leaf’ and you suspect that there will be plenty more plots and plans in the run-up to the vote.

Meanwhile, 29th March, the date on which the UK is due to leave the EU, draws ever closer. Italy has just agreed its controversial budget with the EU with an 11th hour compromise that allowed both sides to claim victory. You would not bet against the same thing happening on 28th March...

EUROPE

The last quarter of the year in Europe was a tale of three countries: Germany, France and Italy.

Angela Merkel has been Chancellor of Germany and de facto leader of Europe since 2005: but that may be about to change.

In October, the Christian Socialists – Merkel's allies in the 'grand coalition' – lost their long-held majority in Bavaria as voters swung sharply to the Greens and the far-right AfD.

That was clearly a warning shot and when the coalition suffered losses in Hesse at the end of the month – again to the Greens and AfD – Merkel announced her decision to stand down as Chair of the Christian Democrats, a position she has held since 2000. She has subsequently been replaced by Annegret Kramp-Karrenbauer (generally known as AKK) who will presumably take over as Chancellor at some point.

The big story of the quarter was in France, where November saw the worst civil unrest since 1968.

The Gilets Jaunes (yellow jackets) movement began as a protest against Emmanuel Macron's climate change inspired fuel tax rises. But in reality, it goes deeper than that as protesters claim that Macron is a 'president of the rich' who does not care about the concerns of ordinary French people and the higher living costs they are facing.

A recent poll showed that Macron had broken new ground by becoming the most unpopular French President ever at this early stage of a Presidency – he is roughly 1½ years into a five-year term – with populist leader Marine le Pen (whom he beat in the Presidential election) now more popular.

Eventually, Macron caved in, buying off the protesters with measures which could well send France's budget deficit to 3.5% of GDP (and possibly to 4% in the event of a recession).

This is well ahead of the EU's limit of 3% and put the squabble with the Italian government over a deficit of 2.4% into perspective. That 'squabble' has now been settled with a compromise and, as mentioned above, the Italian parliament has passed a revised budget – but the coalition government still wants to kick-start its stagnant economy, and cannot have failed to notice the latitude given to France.

France also announced the introduction of a 'tech tax' on companies like Amazon and Apple, as Europe-wide plans for such a tax faltered, with Ireland and the Nordic countries (notable beneficiaries of the tech giants) objecting.

All of this was set against a backdrop of slowing economic growth in the Eurozone, with the Purchasing Managers' Index showing growth at a four year low and the economy in France starting to contract. The European Central Bank also finally brought its €2.5tn (£2.25tn) financial stimulus package to an end as interest rates in the Eurozone remained at 0%.

Like all the leading world markets, the German and French stock markets were down in the quarter, with both falling by 14%. For the full year, the German DAX index was down 18% at 10,559 while the French market fell 11% to 4,731.

UNITED STATES

We have reported on the President's various fall-outs above. What of the other news in the US?

The quarter got off to a positive start. President Trump concluded new trade deals with Mexico and Canada, hailing them as "the most important ever done" by the US.

Figures for September confirmed that the jobless rate had fallen to 3.7% - the lowest for 49 years. October also brought news that the US economy had grown faster than expected in the third quarter of the year at an annualised rate of 3.5%: this was down from the 4.2% recorded in the second quarter but still better than the expected 3.3%.

Sadly, October also saw Florida hit by Hurricane Michael, causing what was described as 'unimaginable destruction.'

In company news, the beginning of the quarter was once again the old economy vs. the new. Netflix soared on record subscriber numbers and Amazon racked up profits of $2.9bn (£2.3bn) for the third quarter of the year, well ahead of expectations of $1.9bn (£1.5bn). The old economy? Sears, the department store that once dominated American shopping malls, filed for bankruptcy.

The good news for the wider US economy continued in November: figures for October confirmed that 250,000 new jobs had been added, wages were up by 3.1% and unemployment was still at 3.7%. "Wow! Incredible numbers. Keep it going," tweeted the President.

But there was less good news for Donald Trump as the US mid-term elections saw the Democrats gain 40 seats in Congress and regain a measure of control. Previously, the President had benefited from Republican control of both the Senate and Congress, and the new arithmetic was immediately apparent as Trump struggled to get the $5.7bn (£4.5bn) funding he wanted for the border wall.

By that time, he was – as reported above – falling out with everyone. While the Dow Jones index did stage a brief post-Christmas rally as Mastercard data showed holiday retail sales up by 5.1%, the best level for six years, the market eventually closed the year at 23,327. The Dow fell by 9% in December and 12% in the final quarter of the year, but was only down by 6% for the year as a whole.

What is 'Shorting?'

Back in November, there was a news story about American hedge fund manager Steve Eisman 'shorting' British banks. Eisman is someone who made millions – if not billions – betting against the US housing market in 2008; he was famously portrayed in the movie 'The Big Short.'

He has shorted the banks in expectations of a 'no-deal' Brexit – and the ensuing chaos – and has said that he could short as many as 50 UK stocks if a Labour government under Jeremy Corbyn were to come to power.

Similarly, you may have read stories about investors 'shorting' shares in high street retailers (especially Debenhams) in anticipation of poor Christmas trading.

UNITED STATES

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So, while ‘shorting’ is complicated and something very definitely left to the professionals, we thought you might like an explanation.

Simply put, shorting is selling shares (or commodities) you do not own in the hope of buying them back later at a lower price. And it is by no means new: American businessman, railroad developer and financier Daniel Drew (1797-1879), is credited with perhaps the most famous of all sayings about shorting:

“He who sells what isn’t his, must buy it back or go to prison.”

And therein lies the difficulty with shorting. Steve Eisman is making a bet that the share price of British banks will fall, and that he will be able to buy them later at a lower price to cover his position. As an example, if the price of Lloyds TSB shares was 52p and a no deal Brexit saw the price tumble to 42p, Eisman would make 10p a share. Having agreed in theory to sell several million shares at 52p, that would represent a substantial profit. However, if the share price went up then he would need to buy the shares at a higher price – and the higher the price went, the bigger his loss, hence the saying credited to Daniel Drew.

Clearly ‘shorting’ can be very profitable. As the gloom on the UK high street has deepened, shares in Debenhams (again in very round terms) have fallen over the last year from 30p to 5p. But markets can rebound very quickly in these volatile times, meaning that ‘shorting’ is very definitely only something for hardened professionals with very deep pockets.

FAR EAST

As we shall see below, it was a very difficult quarter for stock markets in the Far East with all the major markets we cover suffering significant falls. The quarter started with the worries about the trade war between China and the US and ended with the impact of the US interest rate rises – and with the trade war still not settled.

To add to the worries in the region, Chinese growth also missed its target for the third quarter of the year, coming in at 6.5%, below analysts' expectations of 6.6% and down on the 6.7% recorded in the previous quarter. The central bank duly took steps to boost liquidity in the economy as the trade war continued, but this came too late to avert an 11.6% drop in sales of new cars in September, the third straight month of decline.

These worries were, however, pushed to one side in November as China turned its attention to its annual shopping bonanza, Singles Day (on 11th November), which far outstrips the West's Black Friday and Cyber Monday. Once again, all online records were broken as Alibaba – roughly China's equivalent of Amazon – took $1bn (£780m) in just 85 seconds of trading.

Over in Japan, it was a very different picture as the economy contracted by an annualised rate of 1.2% in the third quarter, with the blame placed on natural disasters. Japan has been hit by both a typhoon and an earthquake this year, which have significantly impacted the economy.

We have written separately about Chinese telecoms maker Huawei, which has now overtaken Apple to become the world's 2nd biggest maker of smartphones. More pressingly, though, there are real concerns about its ties to the Chinese state and possible involvement in espionage, especially as it is manufacturing equipment for so many 5G networks around the world.

December started with the company's finance chief Meng Wanzhou being arrested in Canada and facing possible extradition to the US over fraud charges – which, of course, brought the inevitable threat of reprisals against Apple and other US companies.

Meanwhile, Huawei shrugged its corporate shoulders as chairman Guo Ping said that revenues would hit $108.5bn (£85.7bn) for the year, up 21% on the previous year.

If Huawei was on the expansion trail, so was China as a whole. Ever-hungry for natural resources, the country is apparently now describing itself as a 'near-Arctic' power and taking a keen interest in investing in Greenland – home to a strategically important US base at Thule, in the far north of the country. The potential for dispute is obvious.

As we noted above, it was a very difficult quarter for the region's stock markets. Japan led the way – if that is the right phrase – with a fall of 17% in the last three months of the year: South Korea was down 13%, China 12% and Hong Kong was down by 7%. Taking the year as a whole, China's Shanghai Composite index closed down 25% at 2,494; the South Korean market fell 17% to 2,041; the Hong Kong market was down 14% at 25,846 and Japan's Nikkei Dow was down 12% at 20,015.

FAR EAST

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Huawei and Chinese Telecoms: should we worry?

In 1987, Ren Zhengfei, a former engineer in the People's Liberation Army, founded Huawei (it is pronounced Wah-way) in Shenzhen, a major city in the Chinese province of Guangdong.

The company has grown exponentially and now employs 170,000 people (around 40,000 more than work for Apple) with 76,000 of those staff engaged in research and development around the world, including the UK.

Huawei is becoming increasingly well-known in the West as its latest phone, the Mate 20 Pro, earns impressive reviews. But there are increasing security concerns about the company and, in particular, its close ties to the Chinese state.

Could Huawei be using the telecommunications networks it now builds to obtain information for the Chinese government? In the UK, O2 is set to use some Huawei equipment in its 5G testing, but Defence Secretary, Gavin Williamson, has become the latest high-profile person to voice concerns - and around the world an increasing number of countries have decided that it is a risk not worth taking.

The story first came to light last year when there were concerns raised that Amazon and Apple may have been spied on by China.

Back in October, Bloomberg published a report suggesting that Amazon and Apple were among US companies and agencies that have had data stolen by Chinese spies. Specifically, the report suggested that the data was 'siphoned off' via tiny chips inserted on server circuit boards made by a company called Super Micro Computer. The allegation was that the chips had been compromised during the manufacturing process, apparently by Chinese sub-contractors acting on the orders of the Chinese army. Once compromised, the chips had become active once they were up and running.

All three companies denied the allegations and Amazon and Apple dismissed Bloomberg's claims as "untrue".

But with 90% of the world's PCs built in China and Huawei now overtaking Apple to become the world's second largest smartphone maker, as well as having the lion's share of the world's 5G contracts, concerns about the security of Chinese equipment are understandable.

New Zealand has become the latest country to block a proposal to use telecoms equipment made by Huawei because of national security concerns. Spark NZ – New Zealand's equivalent of BT – wanted to use Huawei equipment in its 5G mobile network. NZ's government security agency vetoed the move, fearing that the deal would bring significant national security risks.

FAR EAST

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NZ is not the only country to have acted in this way. As 5G networks are being built in more and more countries, so an increasing number are saying 'no' to Chinese technology being included. The move in New Zealand follows a similar decision in Australia, where the government blocked the involvement of both Huawei and fellow Chinese firm ZTE on the same national security grounds.

In the US, President Trump signed a defence funding bill in August that blocked US federal agencies from purchasing any Huawei or ZTE equipment.

It may all sound a little like James Bond or 'Spooks', but we suspect that this is a story which will run throughout 2019 as companies and governments in the West increasingly realise how vulnerable reliance on Chinese-made equipment may make them.

EMERGING MARKETS

The big story in Emerging Markets came in October, with the victory of Jair Bolsonaro in the Brazilian presidential election. Dubbed the 'Trump of the Tropics' for his confrontational and often controversial views, Bolsonaro won with 55% of the vote.

He is a 63 year old former military officer and was formally sworn into office on 1st January 2019, serving a four year term and replacing previous president Michel Temer. Bolsonaro has promised to stamp out corruption and be tough on crime. He is unashamedly right-wing in both social and economic policies: critics worry that his close ties to the agribusiness lobby may lead to yet more deforestation in Brazil, with its consequent impact on the world's climate.

President Bolsonaro could at least look with pride on the Brazilian stock market as he took office. The three major emerging markets we cover provide the only positive returns in this Report and Brazil took pride of place, rising 11% in the final quarter and 15% for the year as a whole, to close 2018 at 87,887.

Despite falling 4% in the final quarter, the Russian stock market ended the year up 12% at 2,369 and the Indian market – virtually unchanged in the final quarter – was up 6% for the year as a whole at 36,068.

We appreciate that this may not have been the easiest Quarterly Economic Report to read. As the cautionary note always says, 'markets can fall as well as rise' and 2018 certainly emphasised that point. But, as we said in the introduction, saving and investing is a journey and there will sometimes be bumps in the road. Be assured that we will be with you every step of that journey and – as always – should you have any questions on the above, we are never more than a phone call or an email away.

Craig Harrison FPFS IMC
Chair of the Investment Committee