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Investment Management

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Source: KAL, Political Cartoon Gallery, 14 June 2018

No surprises

From last week's perspective – and in terms of what we wrote then - this week bore little in terms of surprises. The US' central bank, the Federal Reserve, raised rates by 0.25% for the 2nd time this year to 2%, which felt entirely justified considering the currently more than robust health of the US economy.

The Eurozone's central bank, the ECB, held on to its 0% interest rate and said it was likely to keep it at that level *"at least through the summer of 2019 and in any case for as long as necessary…."*. This was probably because they also decided to discontinue further monthly bond purchases under their QE programme by the end of the year *"subject to incoming data confirming the Governing Council's medium-term inflation outlook"*. This confirmed the view of all those who regard the current slowing of economic growth in Europe as temporary and merely a counter reaction to last year's growth overshoot.

Anybody who might have expected a replay of the 2013 Taper Tantrum with severe corrections in bond and equity markets will have been relieved. Instead, bond and currency markets did not budge particularly and hovered at the levels they had traded around for the past months. Equity markets experienced slightly more volatility, but that had less to do with central bank actions and more with the political dimension we also discussed last week.

Here, US president Trump displayed – as expected - his emotionally unstable side, although more after than during the G7 summit. Belittling of, and hurling personal insults at democratically elected leaders of the US' hitherto closest NATO allies may prove far more damaging to the USA than withdrawing support to the previously agreed G7 communique on the withdrawal of trade barriers or the imposition of the first wave of trade tariffs. At the very least it has made it much more difficult for these politicians to justify any compromises with Trump towards their electorates without indeed appearing weak.

However, what stock markets actually appeared to take umbrage at, was the administration's announcement of applying tariffs of 25% on Chinese imports worth $50 billion from 6 July, which was immediately matched by Chinese tariffs of the same amount and volume on US imports. Given

the Trump administration had already threatened to retaliate against retaliation with further tariffs on $100 billion worth of trade, it may be dawning on capital markets that Trump's approach to trade negotiations might not be leading to similar success as his defusing of the North Korea situation, but more likely a tit for tat trade war.

Despite this unsavoury global trade perspective equity markets remained fairly sanguine, with robust current global trade and strong U.S. economic activity helping investors stay calm or at least wait until trade sanctions really bite.

For the time being it appears that the buoyant economic present is distracting enough to outweigh the perspective of a future of global trade decline. And maybe markets are right, given the North Korea tensions had also previously deteriorated to the point where the actual exchange of hostilities seemed quite possible. What speaks against this appraisal is that neither the western leaders nor China's leader Xi Jinping are quite as driven by gaining Donald Trump's respect and attention as Kim Jong-un.

All this tells us that the summer of 2018 may prove less quiet than average, but there is also hope that politicians everywhere will not want to risk losing the general economic tailwinds they are enjoying at the moment. The only positive that can be drawn from the dark horizon of trade politics – and this includes the UK's Brexit stalemate – is that investors are unlikely to abandon fixed interest bonds any time soon. This may therefore go some way to explaining why markets took central bankers' insistence to continue on their path of monetary tightening quite as relaxed as they did.

G7 becomes G6 + 1

Source: German Government; 11 June 2018

Drama at the G7 summit in Canada earlier this week. After US officials initially supported a communique which committed the participants to "fighting trade barriers", Donald Trump pulled his endorsement after a spat with Canadian Prime Minister Justin Trudeau.

Following the summit, Trudeau announced he would slap tariffs on the US in response to their "insulting" tariffs under the guise of national security. In typical Trumpian fashion, the US President took to Twitter to bemoan "Justin's false statements" and announce his plans to "look at tariffs on

automobiles flooding the U.S. market!" His criticism then took a personal turn, calling the Canadian PM "dishonest & weak" for his press conference comments.

The summit looked like it would be more of a G6+1 long before the heads of state actually arrived. We wrote before that Trump's wrecking-ball diplomacy would be in full swing at the Canadian-hosted event, and so it was, beautifully encapsulated by the now-infamous 'Merkel v. Trump' photo taken by the press.

As ever, Trump's main gripe with his global counterparts was the size of the US' trade deficit (the country's exports minus its imports, or the gap between what the US consumes and what it produces), an issue which has become the core tenet of his administration's economic policy. Trump blames the deficit – which he claims currently stands at $817bn – for leaving US citizens with "a big and unfair price to pay". But herein lies the difficulty. While the G6 keep pushing for a "rules-based international trading system", where disputes are settled according to agreed principles, the Trump administration wants to focus on the numbers and regards Europe's VAT a tariff. For the US, the fact that this trade imbalance exists is itself a violation of the rules.

However, even by his own standards, the US' trade deficit with the rest of the world isn't as large as he makes out. The $817bn figure Trump points out refers only to the deficit of *goods*. The US actually has a surplus in trade in services, which offsets the overall trade deficit substantially, and brings the overall figure down to $568bn. In fact, some have even argued that the apparent US trade deficit is illusory, and merely a result of out-of-date accounting methods, which, for example, do not take into account earnings by US companies that are repatriated.

German Chancellor Angela Merkel hit back at Trump's trade complaints by arguing that the world's largest economy actually runs a trade *surplus* with the EU when all the relevant transfers are taken into the equation. According to statistics from the US Department of Commerce, when including goods, services and 'primary income' (which includes financial transactions such as interest payments), the US actually had a slight current account surplus of $14bn with the EU in 2017.

Ms Merkel is right up to a point. Trump's mix of half-truths and outright lies (he claimed the US had a trade deficit with Canada when they in fact have a $2.7bn surplus) does distort the wider economic picture somewhat. But it's the wrong point.

After all, there's a reason that Trump repeatedly focuses on the figures for goods rather than those for overall trade. Those working in the production of traditional goods form Trump's core votership. For them, the most visible and relevant effect of globalisation is the loss of jobs and wealth that came from global competition in the manufacture of goods. It makes no difference to them that interest payments or overseas earnings for US corporations offset their losses in the national accounting figures.

This point is especially relevant with the US midterm elections coming up. Despite much discussion of the 'Trump effect' dissuading voters from the Republican party, those elections aren't a forgone conclusion. And the recent economic strength in the US and popularity of Trump's hard-line trade measures could well lead to another Republican victory in November. In fact, a tough stance on trade disputes has become a rare point of bipartisan support in Washington. Even if the Democrats are successful in the midterms, there's no guarantee that they will pressure the President into a softer line on trade disputes.

As all this goes on, we move ever closer to the reality of a trade war between the US and its closest partners. Until now, Trump's threats to the rest of the G7 have been just that. But as tensions escalate, concrete tariffs and other trade barriers become more likely. We've already seen Canada move to impose tariffs on the US and vice versa. Further measures will undoubtedly put a dampener on global trade, particularly at a time when the US is acting as the growth powerhouse for the global economy. In fact, as the US is currently accelerating faster than much of the developed world, we should expect the US' trade deficit to grow only larger in the short term. This could well create a vicious cycle, as Trump moves to impose more and more tariffs to address the imbalance – in vain.

We have written before about the pros and cons of 'Trumplomacy', and about how his focus on deal-making differs hugely from the international relations of the past. Interestingly however, his current extreme public antagonism towards allied leaders may make future deals harder to reach than the President expects. Trump is hugely unpopular with electorates outside the US, and his personal attacks will likely only worsen that fact. That would most likely make any compromise deal with the US a tough sell for politicians.

In short, the 'trade war' frenzy looks like it's only going to get worse, for the time being at least. Expect a bumpy ride ahead.

Fed neither hawkish nor dovish

As widely expected, the US Federal Reserve raised interest rates again by 0.25% on Wednesday. The Fed's benchmark rate is now in the 1.75-2% range, a level not seen since the latter half of 2008. The central bank also signalled that two further rate rises were on the way for this year, and that they no longer believe that accommodative monetary policy is necessary to sustain US growth.

The Fed's belief in the strength of the US economy doesn't seem to be shared by markets however. While the Fed's own median forecast for interest rates sees them peaking at 3.4% by the end of 2020, the two year contract in the Fed futures market implies that investors don't expect rates to rise above 2.7%.

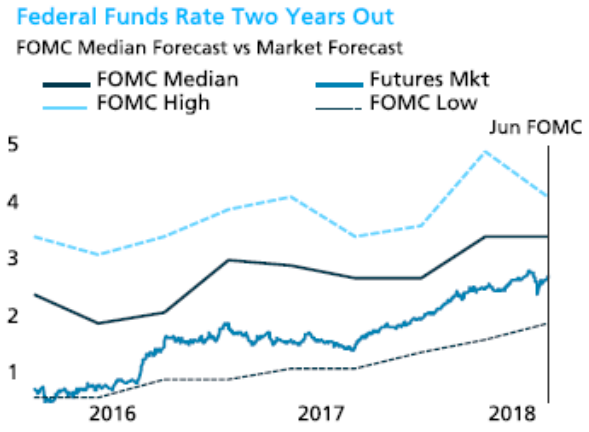
Looking at the US economy it doesn't seem unreasonable to conclude that this expectation may be misguided. In May, retail sales saw their biggest gain in six months. Unemployment is currently at just 3.8%, and the Fed expects it to fall even further to a low of 3.6% before rising higher. And, historically speaking, the US has a tendency to accelerate more quickly in the later stages of a cycle than other economies – due to its reliance on consumption. All the signs currently seem to be pointing towards further expansion. Consumer confidence has been very strong for a while now, and seems to be getting stronger – according to the Conference Board's survey data. And while President Trump's tax cuts have already filtered through somewhat into profits and wages, there could well be a second-round boost effect from the likely increase in capital expenditure (capex).

This doesn't quite mean we're expecting the Fed to be outright hawkish, however. While markets may be underestimating the extent of the Fed's hiking path, we should also bear in mind the central bank's desire to see inflation running "near the symmetric 2 percent objective". That is, given that inflation undershot the Fed's 2% target for so long, they are comfortable to see it overshoot the target by the same amount in the short term. In addition to this, the recent dollar strength (a result

of US economic strength) should quell some of the inflationary pressures through lower prices of imported goods.

Still, given the recent strength and further expansionary signs, the Fed may well have to signal a faster pace of rate rises or a higher end target in the latter half of the year. Even with the dollar strength – which we expect to continue – markets may be in for a surprise, if the Fed futures market is any indication at least.

This surprise would be even greater if the dollar were to unexpectedly weaken. The recent trade disputes between Trump and just about everybody else would be the most likely cause of that. As we cover in the previous article, trade frictions between the US and its major trading partners are now approaching the point where genuine tariffs on a more substantial volume of trade are looking ever more likely – just the kind of external shock which could result in more inflationary pressures and a weakened dollar. In that case, the Fed would have little choice but to raise rates even faster.



Source: Thomson Reuters Datastream, TS Lombard

As shown in the chart above, markets have consistently underestimated the Fed's hiking path for rates. And as mentioned, the recent economic data – as well as the capex effect of tax cuts – suggests that they are still doing so.

Conversely, markets have consistently overestimated the chance of rate rises from the ECB. This week marked yet more diversion between two of the world's most important central banks. While the Fed has embarked on its tightening cycle in earnest – and now sees its own role in supporting the economy as diminished – the ECB is still relying on its accommodative monetary policy to boost growth. On Thursday, the ECB said they expected rates to remain at their current levels "at least through the summer of 2019" and "for as long as necessary", while net bond purchases would end by the end of the year.

It's widely recognised that the ECB's extensive QE program was one of the main factors keeping a lid on US 10-year bond yields. With Europe's central bank pinning European government bonds around or below the 1% yield mark, this has meant that higher-yielding US treasuries become more attractive. The fact that they are comparatively attractive has nothing to do with the fundamentals of the bond itself (i.e. the expected health of the US economy), but only its risk premium (how much investors are willing to pay for the given level of risk). Interestingly, now that the ECB has announced an end date to its program, we can expect to see a rise in the long end of US treasuries, despite no change in the underlying perception of the economy.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7,648.7	-0.4	-32.4	↘
FTSE 250	21,023.4	-0.6	-137.1	↘
FTSE AS	4,217.4	-0.4	-18.0	↘
FTSE Small	6,014.8	0.5	29.7	↗
CAC	5,513.6	1.2	63.4	↗
DAX	13,029.6	2.1	263.0	↗
Dow	24,928.3	-1.5	-388.2	↘
S&P 500	2,768.8	-0.4	-10.2	↘
Nasdaq	7,241.3	1.2	88.6	↗
Nikkei	22,851.8	0.7	157.3	↗
MSCI World	2,142.0	0.2	4.3	↗
MSCI EM	1,125.7	-0.9	-9.7	↘

Currencies

PRICE	LAST	%1W
USD/GBP	1.33	-0.84
USD/EUR	1.16	-1.24
JPY/USD	110.52	-0.88
GBP/EUR	0.87	0.37
CNY/USD	6.44	-0.50

Commodities

CMDTY	LAST	%1W
OIL	73.3	-4.1
GOLD	1278.9	-1.5
SILVER	16.6	-1.0
COPPER	314.1	-4.8
ALUMIN	2256.0	-2.4

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.328	-4.3	-0.06
US 10-Yr	2.913	-1.1	-0.03
French 10-Yr	0.733	-10.4	-0.09
German 10-Yr	0.403	-10.2	-0.05
Japanese 10-Yr	0.038	-19.1	-0.01

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.8	13.4x	13.5x	17.1x
FTSE 250	2.6	16.0x	14.8x	17.1x
FTSE AS	3.6	13.7x	13.7x	16.6x
FTSE Small	3.1	12.4x	-	-
CAC	2.8	16.3x	14.1x	15.4x
DAX	2.5	13.0x	12.7x	16.9x
Dow	2.1	20.1x	15.9x	15.3x
S&P 500	1.8	20.5x	16.7x	17.6x
Nasdaq	1.0	26.2x	20.7x	20.2x

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.3
2-yr Fixed Rate	1.6
3-yr Fixed Rate	1.7
5-yr Fixed Rate	1.8
Standard Variable	2.1
Weighted Average Interest Rate (BoE)	4.18
Nationwide Base Rate	2.50
Halifax Standard Variable	3.99

Top 5 Gainers

COMPANY	%
ROLLS-ROYCE	13.7
CARNIVAL	6.0
RECKITT BENCKISER	4.9
MARKS & SPENCER	4.7
CENTRICA	4.6

Top 5 Losers

COMPANY	%
JUST EAT	-8.1
ANGLO AMERICAN	-7.1
ANTOFAGASTA	-7.1
PERSIMMON	-6.7
BHP BILLITON	-5.3

* LTM = last 12 months' (trailing) earnings; **NTM = Next 12 months' estimated (forward) earnings

For any questions, as always, please ask!

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Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document.

The value of your investments can go down as well as up and you may get back less than you originally invested.

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