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Bob Moran, 6 June 2018

Delicate equilibrium

One week after Italy's disruptive reminder that capital markets are still quite sensitive to the wrong sort of news, equity and bond markets returned to much quieter waters. Italian bond yields remain more elevated compared to other Eurozone countries than they have for a long time and this might not change for a while.

All the more important for the Eurozone and the EU as a whole then that German chancellor Angela Merkel finally put her EU reform proposals forward in the form of a newspaper interview. Strangely, they received little international attention, even though they had been eagerly awaited ever since France's Emmanuel Macron shared his grand vision 8 months ago.

While she somewhat bluntly rejected a debt union – which would be the natural and most stability instilling next step for the lose currency union – she did make quite detailed alternative proposals, which may be more achievable than a grand vision anyway.

Namely, the conversion of the existing European stability mechanism and fund into a European IMF in all but name. This could prove to be what it takes to make the sensitive Eurozone construct more resilient against future crises. It would provide a proper framework for the extraordinary emergency measures the ECB was forced to apply under Mario Draghi's 'whatever-it-takes' leadership to avert the last Eurozone crisis, and thus prevent it from reoccurring in the first place.

Perhaps even more important in fighting the cancer of populism across Europe could be her initiative to work towards a common immigration and asylum policy, to be enforced through a joint European border force. If such a policy shift succeeded, then it would even have the potential to remove a number of highly controversial Brexit red lines.

Speaking of the dreaded Brexit, it appeared to us as though the UK moved yet further away from an actual March 2019 exit from the EU. First, Labour's swing towards demanding the government assured 'full access' of the UK to the EU market, and then the government's agreement of a back-

stop plan of remaining in the customs union should it be impossible to reach a new free trade accord in time.

A BINO ('Brexit in name only') environment would move the potential economic cliff edge further into the future, and would therefore be preferential for the UK economy compared to a 2019 exit without a well-defined trade framework. Nevertheless, the uncertainty is increasingly a drag on the UK's economy and the fragile balance this creates between the currency markets, UK interest rates and the property market (!) is something we are discussing this week in a separate article.

From the global political perspective, trade also remains centre stage, as the G7 heads of state gather in Canada. It will be interesting how Trump will fare in what is expected to be a hostile environment towards him, given it is the US consumers who will be hit by the imposed tariffs. Given the relative strength of the US economy at the moment, Trump's measures may also lead to an even larger current account deficit, which we discuss in our third article this week.

If it was not for political risks, we would be looking increasingly optimistic towards the summer months. Economic data flow continues to confirm that the global economy continues to prosper, even if it is no longer doing so in quite as synchronised a manner. Europe has cooled from unsustainable boom back to a far more sustainable speed of expansion, while China remains stable and the US is now running at Europe's speed of last year. This will result in another 0.25% rate rise by the US Fed central bank next week. The general tightening of financial conditions that this causes, together with the uncertainty and trade headwinds Trump feels obliged to introduce, could soon slow the rate of expansion there in the same way Europe slowed when the Euro strengthened.

Oil has become slightly less of a concern over the past week, because the predictable supply increase on the back of the higher prices has become evident. As a result, further oil price upside now appears capped, despite the likely fall in future supply from Iran and Venezuela.

This leaves the further global economic expansion in a delicate equilibrium between further improving business sentiment, the return of more normal (albeit tighter) monetary conditions and the risk of collateral damage from Trumplomacy.

The much predicted 'Sell-in-May-and-go-away' market sell off pattern has passed us by and, on the basis of the stable and measured global economic expansion, we expect a similar medium-term path for equity markets. Sadly, this may well be interspersed with bouts of volatility, as politicians grapple to establish a new world order in which the USA and China play very different roles compared to the past we have known.

Precarious balancing act: Brexit, the BoE and Housing

Bob Moran, 7 June 2018

Tension on the Brexit front this week. On Thursday, Theresa May faced off with Brexit secretary David Davis over her EU "backstop" proposal, which was published after their talks. If no trade deal is agreed, then in order to avoid a hard border between the two Irelands the UK will have to match the union's trade tariffs.

Davis was reportedly furious that May's original plan had no definite end date to the 'temporary' arrangement; he feared it would essentially amount to the dreaded BINO (Brexit in name only), with the UK tied to EU regulation indefinitely. But after their showdown, the document now includes the "expected" end date of 2021.

What does this amount to? To avoid both a hard Irish border (a violation of the historic good Friday agreement) and regulatory split between Northern Ireland and the rest of the UK (which May's DUP supporters have ruled out), the UK would effectively remain within the customs union but without any political influence and most likely with considerable contributions to pay.

Essentially, the new plan from May and co means a further postponement of the divorce day. Her government already kicked the Brexit can a couple of years down the road when they agreed a transition period until the end of 2020, through which trading conditions with the EU will remain the same. Now it's been kicked a little further.

Aside from the government's own internal drama, what's the wider relevance of this news? In our own discussions, an interesting thread is emerging between Brexit politics, the Bank of England (BoE) and the UK property market. Bear with me.

The government is currently walking on a precarious tightrope, with untenable scenarios on either side below. To its right, there's a hard Brexit that would see the UK divorced from its main trading partner, mired in the economic pain that would bring and with one hell of a tricky situation in Northern Ireland. To its left, there's a customs union arrangement that would see the UK playing under EU rules – and even potentially paying into the budget – but with no power to change them. Falling either way could be disastrous for May politically, economically or both. But the further she

walks, the closer the cliff-edge deadline gets. The solution? Push the deadline further out, indefinitely if need be, and just carry on as before.

But the long-term uncertainty that brings puts a dampener on business investment, and on external demand for UK goods which need longer contracts. A weak sterling is needed to counteract these impacts, to give UK exporters a price advantage over their competitors – particularly within the EU. That stops the central bank from tightening monetary policy too much or too soon.

This sterling weakness has two big impacts. Firstly, it helps support the labour market, as external demand buoys businesses and businesses prefer employing more staff to investing for improved productivity of their existing staff. This can be seen in the employment figure, which rose to 75.6% in the last quarter, the highest since records began in 1971. Secondly, it helps support British assets, as they become cheaper to overseas buyers.

Both of these factors may be providing some support for the housing market. House prices rose 1.5% in May, recovering somewhat from a 3.1% dip the month before. We've written before how UK property prices are under serious pressure at the moment, as Brexit uncertainty and (more importantly) falling real incomes are taking their toll. They are still under pressure, but the effects of (full) employment and external demand are keeping the correction a managed one.

It's hard to overstate the importance of the housing market for the UK economy. It serves as a source of wealth and allows households to run down their savings, boosting consumer demand for mostly domestic housing related goods – a vital pillar of Britain's economy. At a time when consumer confidence is already being knocked by Brexit effects, further house price falls could be a serious blow.

At the moment, however, we're in a precarious equilibrium. All these factors reinforce one another, as the political leaders on either side of Parliament don't want to be the ones to send the economy into a downspin. Each party has its own balancing act: the rebel Tories don't want to force an election they might not win, and Labour seem content to watch May drink from the poison Brexit chalice until the fight for post-Brexit Britain can begin.

But this precarious equilibrium could be disrupted in a few ways. For starters, it renders the UK reliant on external demand, particularly from the EU. If the EU economy starts to struggle, the pull-through demand for UK exports will drop off, with most likely devastating effects for Britain's growth. And the bloc has its fair share of problems to deal with – its own reliance on global export demand and the Italian situation being the first to spring to mind.

Even if European demand stays strong, domestic issues could just as easily cause trouble. If the Brexiteer wing of the Tory party tries to revolt against the Government's plans, it would make a crash exit from the EU more likely. That would likely send sterling plummeting, forcing the BoE to intervene and stop a dangerous devaluation. But that would mean sudden monetary tightening through rapid rate rises, which would choke off both the housing market and kill off domestic demand.

For the moment, walking carefully between the two extremes looks like the best option. Suddenly, making the tight-rope a little longer doesn't seem such a bad idea, and thus puts some sense behind what otherwise seems like madness or incompetence.

The Great Attractor: How capital flows are boosting the US economy

As we have written in these pages over the past few weeks and months, the US economy has been in rude health lately. Whereas 2017 saw Europe and Japan picking up momentum, this year the US has firmly taken the reins and is now powering global growth.

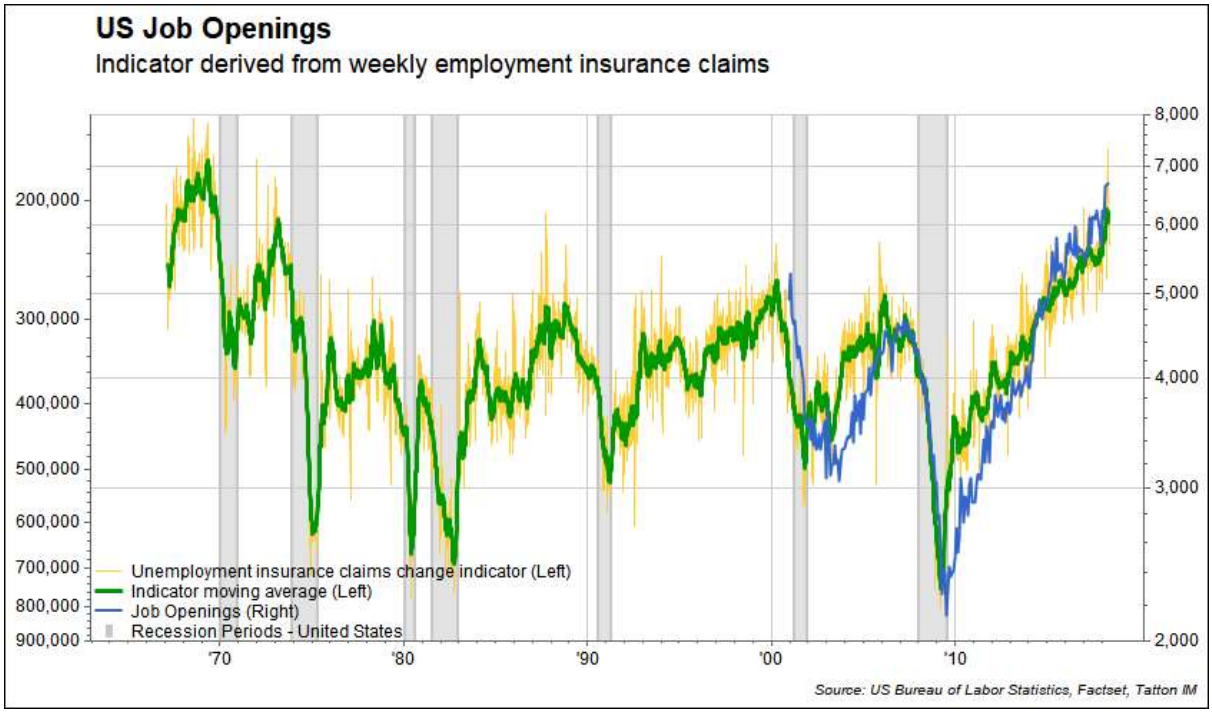
In large part, those other two economies (particularly Europe) fell victim to their own successes. Economic growth resulted in a stronger euro, which dampened external demand and led to a fall in business confidence. Now, it's the US which is seeing its currency rise – again propelled by its own success.

So, should we expect the US to suffer Europe's fate? Not really. The EU has a large current account surplus (it exports more than it imports), which makes it particularly reliant on external demand. The US, on the other hand, relies mainly on its own domestic demand, meaning that dollar strength is unlikely to affect the economy anywhere nearly as much as Europe. And on that note, it's internal demand is looking very strong indeed. Consumer confidence is high, and the economy is benefitting from fiscal expansion and increased business spending.

All this economic activity needs funding however, which has driven up the demand for capital in the world's largest economy. In effect, money is rebalancing away from financial markets and into the real economy. This has been a big component in the rise in bond yields – both government and corporate. 10-year US treasuries, for example, now yield 3%, which is around double what they did two years ago.

But rising bond yields have done little yet to hurt the US economy. In the first quarter of the year, US GDP grew 2.8% over the same period last year. Importantly, this growth came while yields were high and the dollar was rising, suggesting that further acceleration is ahead.

Labour market statistics also point towards strong growth. The much-watched non-farm payrolls figure came in at 223,000 last month, beating expectations of 189,000 and, in April, nominal wages



were 4.6% higher than the year before. The chart below plots job openings data (averaged over four weeks) and the way it tracks federal insurance claims for unemployment (the fewer the claims, the better the jobs market). Essentially, it shows that there are more job openings and fewer registered unemployed. The US job market may be the tightest since the early 1970s.

All this puts the interest rate setting central bankers at the US Fed in a difficult position. The fact that the economy looks as though its running hot despite the fact they have tightened monetary policy already suggests that interest rates may have to go up by more than what markets currently expect – perhaps by a lot.

For the rest of the world, this could make things tough. The US capital demand is so strong that it's started to drag money away from other markets. In particular, the relative attractiveness of US debt (combined with the strength of the dollar) is pulling large amounts of capital away from emerging markets (EM). And if rates go substantially higher, the US will attract even more capital from overseas. Some may be able to cope with this, but plenty will struggle.

The ECB has signalled that it will soon begin its own monetary tightening, which will likely limit the capital outflows from Europe. But emerging markets are in a worse position. EM credit spreads (I.e. what their businesses have to pay in yield above those elsewhere) have widened a great deal lately, and many are trying to combat this effect by raising their own interest rates. Recently, India's central bank governor even tried pleading with the Fed to stop the "double whammy" of shrinking their balance sheet through QT at a time when the US government is borrowing ever more. Unfortunately for him, Fed chair Powell will likely take no notice against the backdrop of inflationary signals from the fast expanding US economy. If the Fed does get more hawkish, there will be little EMs can do.

However, there is one thing that could stem the capital tide for EMs. President Trump's trade spat with just about everyone has seen his administration repeatedly impose or threaten tariffs on the US' trading partners in order to address the country's habit of consuming more than it produces itself (I.e. a large current account deficit). But all of this is going on while the rest of the world is effectively acting as the US' financer – due to the latter's huge demand for capital. Those countries could try to stop the flow of capital into the US as a way of hitting back against Trump's tariffs.

In particular, Japan and China could have a huge impact here, due to their large stockpiles of US treasuries. If they decided to stop buying or even sell those bonds – at the same time as the US government is expanding its balance sheet – US yields could go significantly higher. Such yield rise would no longer be a reflection of strong economic growth, and as a consequence turn into a significant economic dampener for the US economy that also reverses the direction of travel for the US$ from up to down.

Ironically, that would likely go some way to addressing the trade imbalance that Trump so despises, if only because US citizens' cost of capital would be too high to afford imported goods. With this in mind, the upcoming G7 meeting will be one to watch. Naturally, we'd expect Trump to go into the summit all guns blazing. But this time, he might just find more pushback than he bargained for.

China's structural modernisation via removal of credit 'subsidies'

Last week, we discussed how China's deliberate and aggressive deleveraging of its $10 trillion shadow banking sector has reduced monetary liquidity in China's capital market and led to a rise in corporate defaults. This is because reduced shadow funding has taken away a crucial source of refinancing for impaired borrowers – who, in the current market climate are often referred to as (credit) zombie companies. Financially stable companies have remained largely unaffected.

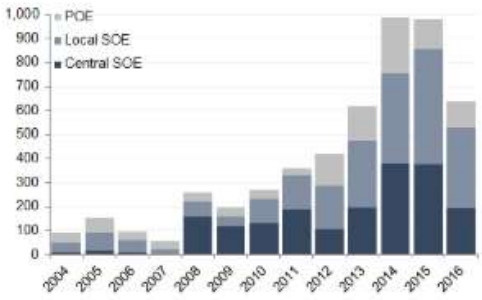
At the same time, Local Government Finance Vehicles (LGFVs) and State-Owned Enterprises (SOEs) are beginning to default on credit-related asset management products. So it is understandable that investor concerns have become more widespread. The rapid growth of debt-based finance in recent years has been described as a debt bubble that could destabilise the Chinese economy, and in its wake cause a global downturn as big as the one following the subprime mortgage crisis.

However, we believe these fears are unfounded, for a number of reasons. Investors should take a slight rise in corporate defaults, during otherwise economically stable and expanding circumstances, as a positive. In the short-term, there may be some local market pain. But over the longer-term, China's real economy should see a more efficient economy and more resilient capital markets.

We believe that China's willingness to allow defaults stems from a position of relative economic stability; it's only because these defaults won't cause a 'credit crunch' that they are being allowed to happen. It reflects the country's intentional shift towards a more orderly market framework by reigning in excess credit creation – especially where this money helped to prop up older and inefficient SOEs which investors assumed would enjoy implicit government backing.

It is hardly surprising that this shadow funding crackdown has mostly impacted weaker companies known as zombies – firms that are persistently loss-making but remain a going concern merely through (perhaps unwarranted) access to cheap credit.

Exhibit 3 : Total amount of "zombie" debt outstanding by company type
(RMB bn)



Source: Wind, Goldman Sachs Global Investment Research

A Goldman Sachs analysis found that zombie debt as a percentage of total corporate debt peaked at around 10% in 2014 and has since been on a steady downtrend, on the back of improved earnings and rebounded commodity prices. The "zombie" debt ratio fell to 8.0% in 2015, followed by a more significant fall to 4.6% in 2016.

Central and Local SOEs make up the bulk of zombie debt, with Private Owned Enterprises (POEs) accounting for just 3% of total debt outstanding.

One could argue that such debt levels no longer constitute a rising systemic risk for China's financial sector. Nevertheless, last year, the governor of the People's Bank of China (PBoC) highlighted high corporate leverage and a lack of progress in dealing with zombie firms as a potential systemic risk. It would seem that Chinese authorities have decided to use the route of credit market reforms as a means to not only to make the finance sector more resilient, but also modernise their economy.

By the end of May, the Economic Information Daily noted a total of 20 corporate defaults, amounting to over 17 billion yuan. This is an unusual situation for a country that until recently had not experienced a single corporate bankruptcy.

The government's strategy appears to have the desired impact on Investors. Buyers have become more selective over which corporate issues they buy, with riskier bonds increasingly requiring higher interest premia. According to Bloomberg, the yield premium of three-year AA- rated bonds over similar-maturity AAA notes has widened by 72 basis points (0.72%) since March to 225 basis points (2.25%), which is the highest level since August 2016. This is an indication of the recent pressures on weaker firms.

While authorities have adopted what we term the "whack-a-mole" approach, micro-managing its transition to more of a market economy. This appears somewhat 'hit-and-miss' at times, and it is worth noting that Chinese authorities are notoriously cautious and seek to avoid risks.

For example, this week's liquidity injection by China's central bank could be seen as a risk mitigation policy. They tried to limit potential collateral damage to the wider economy that the liquidity tightening could otherwise have done. The PBoC decided to lower credit quality restrictions for collateral and injected 463 billion yuan ($72 billion) of liquidity via its MLF (Medium Term Lending Facility). Additionally, the PBoC expanded the pool of eligible collateral for the MLF by including AA+ or AA rated bonds, with the proceeds helping to support rural development, small businesses and green projects.

Ultimately, we believe that further policy action towards SOE reform could be key in helping contain the zombie debt problem, given the rise in zombie debts since the Global Financial Crisis has largely been driven by state-related entities.

As we have said, we think the probability of systemic risk arising from the Chinese debt market is low. This is because the volume of distressed debt emanating from the actual private sector and owned by private individuals or institutional investors is low. The impact of defaults by state-related entities on the other hand is entirely under the control of the government, who can ease the resulting pressure on creditor banks through the central bank if they think it's necessary to avoid a tightening of liquidity.

We may even draw parallels to the slow demise of old industries in the western world in the late 70s and 80s, when governments gradually withdrew subsidies. If we replace 'cheap credit' for 'subsidy' in our reflections, then this provides a fairly good description of China's modernisation challenge. Painful perhaps, but unlikely to cause collapse.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7683.1	-0.2	-18.7	→
FTSE 250	21151.7	0.8	166.7	→
FTSE AS	4235.9	0.0	-1.6	→
FTSE Small	5983.2	0.7	43.0	→
CAC	5437.4	-0.5	-28.2	→
DAX	12735.8	0.1	11.5	→
Dow	25234.8	2.4	599.5	→
S&P 500	2766.4	1.2	31.8	→
Nasdaq	7123.9	0.6	39.9	→
Nikkei	22694.5	2.4	523.2	→
MSCI World	2137.6	1.3	28.4	→
MSCI EM	1149.7	1.7	19.5	→

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.8	13.4x	13.6x	17.1x
FTSE 250	2.6	15.9x	14.7x	17.1x
FTSE AS	3.6	13.7x	13.7x	16.6x
FTSE Small	3.1	12.2x	-	-
CAC	2.8	16.2x	14.1x	15.4x
DAX	2.5	12.9x	12.7x	16.9x
Dow	2.1	20.0x	15.9x	15.3x
S&P 500	1.8	20.4x	16.6x	17.6x
Nasdaq	1.0	26.0x	20.6x	20.2x

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
NEXT	4.7	MEDICLINIC INTERN	-9.5
INFORMA	4.6	FRESNILLO	-7.6
BARRATT DEVELOPM	4.4	OLD MUTUAL	-7.2
INTERTEK GROUP	3.9	CARNIVAL	-5.8
HALMA	3.7	SMURFIT KAPPA	-5.4

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.34	0.41	OIL	76.6	-0.3
USD/EUR	1.18	0.90	GOLD	1298.6	0.4
JPY/USD	109.38	0.15	SILVER	16.7	1.9
GBP/EUR	0.88	-0.46	COPPER	330.3	6.6
CNY/USD	6.41	0.22	ALUMIN	2312.0	0.9

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.387	8.5	0.11
US 10-Yr	2.926	0.8	0.02
French 10-Yr	0.810	14.2	0.10
German 10-Yr	0.443	14.8	0.06
Japanese 10-Yr	0.047	-2.1	0.00

UK Mortgage Rates

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

* 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.

Lothar Mentel