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Hot air for a hot summer?

Lothar is on holiday – Jim Kean, Head of Investment, writes from New York:

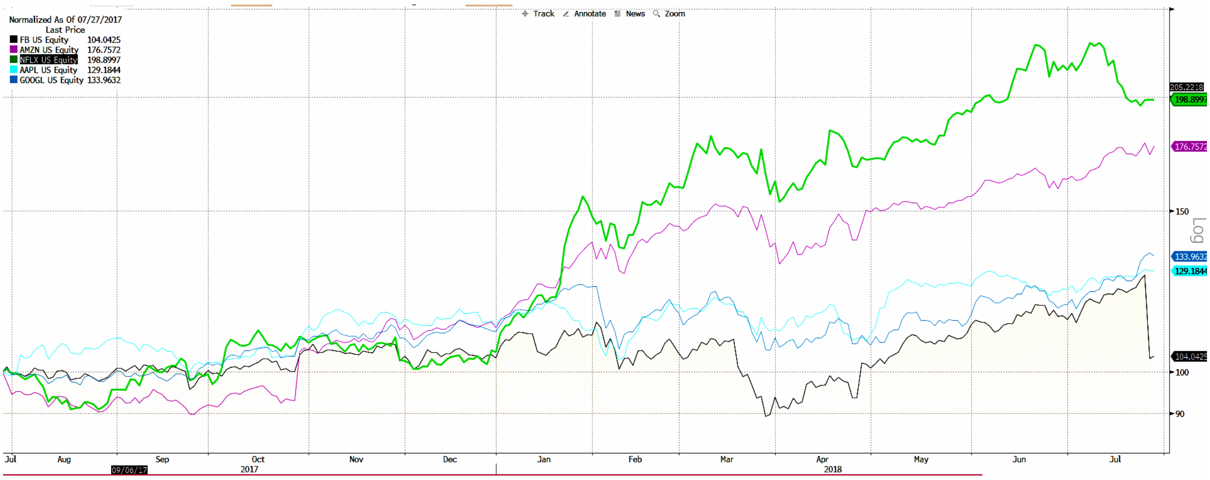
The summer holidays are underway and the silly season (that period where newspaper editors are away and the interns and apprentices are in charge but only allowed to write about pets and the weather) begins next week.

This summer they may not be allowed to talk about the weather, since this time it is a serious story. The horror in Greece, and the floods and heatwave in Japan underline the effects that climate change is having. Rising global temperatures were over shadowed by trade discussions, but let's not forget the *other* Trump policy: the withdrawal from the Paris Climate Accord announced in November last year. Trump said then that the US would return on a basis that was “fair”. I’m writing this in New York City and can say, after watching an empty docked New Jersey Ferry spend 15 minutes with its engines on half-power forward trying to push Manhattan Island into the Atlantic, the US has some way to go in reducing its addiction to heavy machines.

At some point, this aspect of world policy will become very important to the trade issue. I was struck by the outcome of the Juncker-Trump meeting in which it appeared that suddenly there might be the equivalent of a US-Europe free trade area after the weeks of escalating friction. To bolster soy bean farmers affected by Trump’s China trade war, Trump ‘trumped’ that the EU will buy US soy beans. This is extremely unlikely since the EU doesn’t buy GM food. Indeed, British hopes that Europe would accept the relatively minor modification, one of gene “exclusion” has been dashed. Hot air it appears from the President.

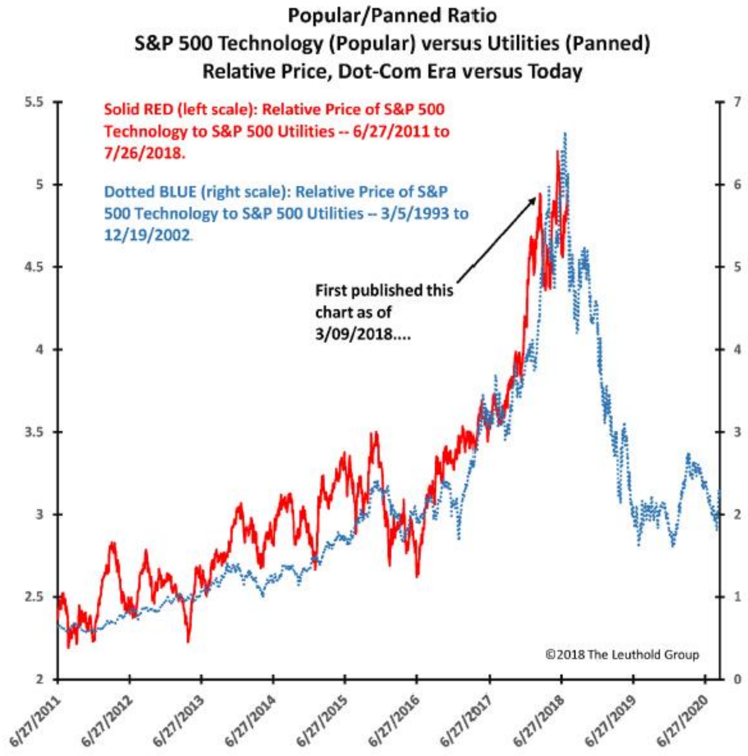
Trump may be a more complicated animal than he appears, but he has shown his colours already in respect of climate change; he thinks that the world is using it as a means of gaining economic advantage over the US. He may win deals which make simple tariffs more equitable. But with the effects of climate change becoming ever more frequent, Trump may find that trade will still not as “fair” as he thinks it should be.

Back to markets and the potential hot air of corporate earnings. The earnings season shifted into another gear this week, again with the focus solidly on the US and on the FAANGs. The western world has become besotted with these global companies, not surprisingly since they comprise so much of the delivery framework for the services and goods which we consume. Netflix disappointed the previous week so we waited for news of Facebook, Amazon and Google (Alphabet as it now styles itself, rather mystifyingly). Without going into detail, Amazon and Google had really good figures, Facebook not so much. It wasn’t horrible but the company indicated that growth was high but decelerating, and spending would reduce profits next year. It may have mishandled the results conference call with analysts but, even then, the subsequent 20% fall in its share price was the thing of investor nightmares. By value, it was the largest single drop in a day ever - $119.1bn. The chart below, sourced from Bloomberg, shows the FAANGs indexed to a year ago, on a log basis.



It's noticeable that they are individually becoming more dispersed and more volatile. At one level, the increase in dispersion is a good thing – diversification offsets the volatility. At another level, it suggests that the earnings "growth" driver is less apparent. The stocks have driven the phenomenal outperformance of the NASDAQ 100 but individually are losing leadership.

Now it may be that Facebook hit a liquidity air-pocket after its results, a little like the February fall in the NASDAQ, and the stock could be pretty resilient in the near future, now that it has got more bad news out of the way. However, some of the shine may have come off the group for speculators. John Authers wrote in the FT on Thursday, quoting another old favourite of ours, Jim Paulsen of the Leuthold Group. Jim points out similarities between the price chart for tech stocks into the millennium, and the FAANGs.



He is at pains to point out that valuations were massively more ridiculous in 2000 than they are for these current winners, and we would agree. The price action suggests that these stocks may be in a mini-bubble. Investors are always rational, as a group, about the consequences of “knowledge”, but rising prices tend to make investors ‘forecasts look more like fact than conjecture. It’s easy to think that price gains “confirm” one’s beliefs.

In terms of our investment position, we moved some weighting out of Asia into US stocks a few months ago, but earlier this month made the decision to begin reducing techs and smaller-cap US in favour of a more neutral weighting to the UK. In general, we’re a bit cautious on equities, with most of that centred on the US and Asia, especially in the emerging markets.

Below, we have a follow-up on the China article last week. Chinese authorities have stepped up action to counter the slowdown, but we think it will still get worse before it gets better. At the heart of the problems is a bad credit story; some companies are not saveable, and that includes some rather important ones linked to state-owned enterprises. The actions are designed to keep liquidity available in the system and to ensure spending continues while problem companies go to the wall. However, they’re not even part way through the process, and the most obvious policy of currency devaluation is not available. Chinese stocks rose slightly on the week but ended on a weak note, while other Asian markets were stronger.

We also look at Japan. The parallels with Europe abound, especially in relation to the extended monetary policy tools. And, like Europe, the central bank is having to consider whether its effects on the yield curve may be actually a detriment to growth rather than a support. We think they tested the water this week, may do so again quite soon, and that the consequence could hit US bonds.

We also take a brief look at the impacts of Trump’s policies on US auto-makers, employers of a lot of his supporters. Maybe the companies’ results had something to do with the outcome of the Juncker meeting. It might rain this weekend, but that’s not going to turn off the hot air just yet.

Japan’s yield curve dilemma

Bank of Japan (BoJ) governors meet next week, amid reports that they are considering changing certain key aspects of their monetary policy. Since 2013, the bank has used a host of unconventional measures to spur inflation to the 2% target – to little avail. Inflation in Japan hasn’t met the 2% level since 2015, and has largely been at or around the zero mark for the past few years. Recent data have also been disappointing, with June’s core price inflation coming in at 0.7%, below expectations for the third successive month. Excluding food and energy, prices in Japan rose just 0.2%.

There have been various ideas floated that the BoJ is reportedly considering. The least controversial and most likely of these is an adjustment of the bank’s ETF purchases. The BoJ’s QE program is unique in the developed world in that it’s purchases extend beyond bonds to equities through ETFs. But this policy is coming under increasing pressure for its impact on the stock market. The central bank is now reportedly a top-10 shareholder in around 40% of Japan’s listed companies. According to the Nikkei Asia review, the BoJ plans to address this problem by switching its investment from ETFs that follow the Nikkei Stock Average to broader indices such as the Topix.

More boldly, some have suggested rethinking or abandoning the 2% inflation target. MUFG CEO Nobuyuki Hirano argued this week that the BoJ should consider revising its target, given that the economy is improving even without inflation moving higher. The chief of Japan's largest bank said that an aging population means the country has a "lower potential inflation rate and lower potential growth rate,"

It's a fair point. The likelihood of the BoJ consistently reaching its 2% inflation target is so low that most consider the bank's professed aim little more than lip service – especially as their policy leeway is virtually non-existent, after years of incredibly loose monetary measures. Back at their April meeting, even the BoJ dropped any reference of their commitment to meet the target in 2019, an admission that that was extremely unlikely. However, we doubt that the bank would change it anytime soon since it clearly has the intention to increase inflation from its current level.

That brings us to the suggestion that we find the most interesting: allowing long-term bond yields to rise. Back in 2016, the BoJ added yield curve control to their extensive monetary arsenal. This has meant the bank is effectively committed to holding 10-year government bond yields down at or around zero, even if inflation starts to pick up. But now the central bank is reportedly considering easing up on this policy, and allowing long-term bond yields to rise. This raises the question: why would the BoJ want to increase long-term interest rates at a time when inflation keeps undershooting their target?

BoJ members are clearly concerned about the effect their policies are having on the financial sector. In the absence of strong private sector demand for loans, banks make money out of the spread between short-term interest rates, and long-term bond yields, taking deposits at the short end and lending at the long. A flatter yield curve (the difference between long-term and short-term bonds) therefore hurts their profitability. Indeed, that lack of profitability constrains their ability to lend, which then tightens credit availability in the economy.

If the BoJ were to lift their pin on 10-year bonds while also reducing the requirement on banks to put aside capital against private-sector loans, the rising yields would hopefully allow banks to offer more credit. The central bank could actually stoke inflationary pressures – most likely through increased business capital expenditure although hopefully there might be some credit-fuelled consumer spending – by doing what looks like monetary tightening. Standard monetary loosening in the form of low interest rates focuses on wage inflation and the Philips curve (the inverse relationship between unemployment and interest rates). But given that Japanese wages have proven incredibly unresponsive to the BoJ's measures so far, allowing the yield curve to steepen could be the thing to pull the country away from deflation.

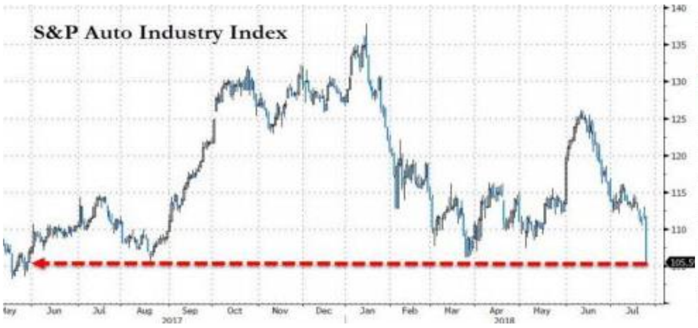
On their part, the BoJ has cast doubt on the rumours that they plan to lift their yield curve control in next week's meeting. Governor Haruhiko Kuroda said that he knew of no basis for these reports (not exactly a denial). BoJ watchers also don't think the bank is likely to announce any large policy changes on Monday – bar the details of its equity buying mentioned. But we don't doubt that this issue is on the minds of the central bank's policymakers. As Yuji Shimanaka of Mitsubishi UFJ Morgan Stanley Securities says, removal of yield curve control "at the October meeting is a possibility,"

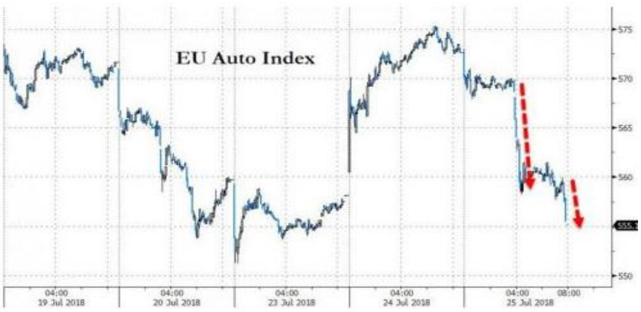
The story is wider than just Japan. Media alarm bells have been ringing for some time now over the flattening and possible inversion of the US yield curve – historically a precursor of recession. Some have argued that the historically unique set up of the bond market at the moment means that these signals are less important because Yen and Euro excess liquidity has had a large impact on US yields. It may have been even greater than the effect on their own bond markets.

Meanwhile, the effect of ultra-low yields on bank profitability is clear to see. We wrote a couple of weeks ago about the torrid share price performance of the global systemically important financial institutions (SIFIs), and how it was more to do with profitability than credit demand. The combination of strict post-crisis regulation and ultra-low interest rates has sapped bank profits globally.

It's clear that the Japanese authorities are unhappy that the current policy set may be ineffective and that its side-effects may be actually currently more a problem. Still, it might have actually been effective and removing some policies could cause the economy and markets to react badly. Bloomberg suggested that the reports themselves could be the bank's way of testing that reaction. Kuroda and co. will have noted that the ripples were rather small, that the currency did not rise sharply, yen bonds moved less than US treasuries, and equities did ok - bank share prices did better than ok. If it was a test, we should expect a larger one soon.

What (or who) is driving cars?





The US S&P Auto Sector fell to 13-month lows (equalling May 2017) on Wednesday, after General Motors' results highlighted the cost to US manufacturing of the current state of Trump's tariffs. This despite Trump's comments (before his Juncker meeting) that he would impose a further 25% tariff on $200 billion of car imports in order to encourage people to buy US-made cars.

More generally, auto manufacturers everywhere are under the cosh. Margins are not great, so hefty input cost rises really hurt. It is the threat of trade tariffs that has really hung over the sector like the Sword of Damocles. At the start of 2018, President Trump imposed a 25% tariff on steel and aluminium imports, forcing up the cost of production.

The reality hit home this week in the form of either missed earnings or lowered outlooks from the auto and aerospace sectors. Aside from GM, there were disappointing Q2 earnings reports from Fiat Chrysler and the world's largest aeroplane maker, Boeing. Their earnings revealed the negative impacts of steel and, aluminium tariffs and swings in commodity currencies.

Bloomberg reported that GM might face a $1 billion profit headwind from higher input costs, while rival Fiat Chrysler posted disappointing sales in China on retaliatory tariffs. GM's shares were down 5% on Wednesday and Fiat Chrysler was lower by an eye-opening 11%. Boeing reported a $418 million charge from additional costs and investors are concerned about threats to its order book.

European firms are also feeling the pain. Germany's Daimler lowered its earnings outlook on trade tensions (Daimler has large factories in the US that export to China), leading to falls across the European automotive sector.

Demand is not the issue facing the sector.

LMC Automotive predicts another record year for global car and truck sales during 2018, driven by large gains in Eastern Europe and South America. LMC estimate a record 97.3 million units sold, up 2.1% in 2018. LMC sees demand growth in every region bar North America, where sales are forecast to fall 1% amid a tightening of financial conditions, which is pushing up the cost of car loans.

Region	Mar 2018	% Change	2018 (Q1)	% Change
Europe (EU+EFTA)	1,837,000	-5.2	4,282,100	0.6
Russia*	157,300	13.9	392,900	21.7
USA*	1,647,300	6.4	4,093,100	2.1
Japan	562,500	-3.6	1,303,900	-2.7
Brazil*	200,400	8.8	528,200	14.7
India	300,700	6.4	861,500	7.2
China	2,124,100	5.1	5,994,100	3.7

*Light vehicles Source: VDA

During Q1, car sales reached record highs in the US, Europe and China but the fastest growth was in Russia, Brazil and India. Japan was the only country to report a fall in sales in the first 3 months of the year. In March, new light vehicle sales surprised with the best levels since 2001. Sales in Europe were weaker year-on-year in March following a record 2017.

China is still the world's largest single country market, in both March 2018 and Q1 overall. In March, the sales grew 5.1% to 2,124,100 units. So far in 2018, the Chinese car market expanded 3.7% to a new high of 5,994,100 cars.

But this positive demand data has clearly been overshadowed by a number of factors.

It's not just current input costs. The changes forced by environmental issues, by technology advance, and the cost of past business, are forcing large capital demands on both old and new manufacturers. This week concerns around Telsa's working capital requirements flared up again, while European manufacturers faced new claims about altered emission tests on their vehicles.

Trump is using broad tariffs to counter what he believes to be unfairness such as the US charging just 2.5% on EU car imports, while the EU charges 10% on US cars.

It appears the realities are getting leaders to the negotiating table, bringing us to this week's meeting between the US and the EU.

It may be that Trump and the 'art of the deal' has won. The US and the EU have agreed to negotiate on trade and drop potential tariffs on car imports. His meeting with Juncker on Wednesday was a "big day, very big", marking a "new phase of trade relations". Both would seek to "resolve" the steel and aluminium tariffs…".

In a joint statement, Trump and Jean-Claude Juncker (EU Commission President) announced they had "agreed to work together towards zero tariffs, zero non-tariff barriers and zero subsidies on non-auto industrial goods".

In relation to Europe, reducing tariffs appear to have been Trump's main goal since the NATO summit. There were some specifics mentioned, like the EU increasing imports of US LNG (liquefied natural gas) and soybeans and talk of creating a "working group" to reform the WTO (World Trade Organisation). This group would address unfair trading practices, including "intellectual property theft, forced technology transfer, industrial subsidies, distortions created by state-owned enterprises, and overcapacity", which might be intended to increase joint pressure on China.

We think this week's events are a broadly positive development and financial markets appear to agree for now. However, with Trump, the press conference doesn't always lead to substance.

A few months ago the brewing trade war between the US and China was also declared "on hold". However, that truce didn't hold for long and tariffs were eventually introduced. The US-EU announcement has a few more specifics, meaning there is a higher chance of a formal agreement. But there is still a clear risk from a lack of follow-through.

Trump may view the fact that the EU has offered to negotiate to avoid tariffs as a 'win', leading him to pile more pressure on China, under the assumption they might offer concessions as well.

For now, the automotive sector can breathe a temporary sigh of relief, but Trump's unpredictability could bring us back to square one, should he believe other nations are "ripping off" the US.

Charts: sourced from Bloomberg

China rolls out stimulus

China unveiled both fiscal and financial measures this week in order to ease the current deleveraging pain. The government politburo proposed a tax cut aimed at fostering research, special bonds for infrastructure investment and a "more proactive fiscal policy", all announced after a meeting of the state council on Monday. The central bank continued to pump liquidity and ease bank capital requirements.

As is widely publicised, the world's second largest economy is currently unwinding a credit bubble that an IMF paper has described as "one of the largest and longest in history." The government has been trying to deleverage the economy and crack down on shadow banking practices in as orderly a way as possible, but the economic slowdown that has come these efforts is threatening to turn into a crisis. The fact that this is happening at the same time as trade tensions with the US – their largest trading partner – could be a very dangerous mix for Chinese policymakers.

It's clear that this has worried officials. The People's Bank of China (PBoC) have already effectively eased monetary policy through a cut to banks' reserve requirement ratios (they are the only major emerging market currently easing policy), and followed that up this week by telling certain banks that a particular capital requirement rule will be eased to support more lending. This also came after a record injection of liquidity via the medium-term lending facility earlier in the week. Now, by declaring a fiscal policy that's looser and more coordinated with monetary policy, it seems as though the finance ministry is stepping up its part to support demand.

Last week, we wrote that the government in Beijing wouldn't embark on an easing of policy as extensive as in previous years, despite the pressures on the economy. So, what should we make of this move? It represents a shift in tone (policymakers didn't use the word "neutral" as usual or mention deleveraging), but we still don't think that China is embarking on a stimulus program in earnest. The State Council was clear that it wouldn't resort to a "deluge" of extensive stimulus policies, and said that prudent monetary policy would be neither too loose nor too tight.

Markets took the news well, with both Chinese bonds and equities rising this week. Some even suggested that the shifting policy tone could end the months of bearish sentiment that's been hanging over China. But we think they are overestimating how far the government will or can go.

On top of the State Council's more cautious comments, the underlying situation remains the same. Unlike in 2015/16, loosening financial conditions now and embarking on a full-blown easing process will undo the necessary deleveraging and near-removal of shadow-banking. As Martin Wolf wrote in the FT this week, almost all analogous cases to China's current credit bubble in history have ended in some form of crisis. That the government has a tight control on capital flows is one reason for thinking that China may be different, but that worry will no doubt be in the minds of Chinese officials – and will likely stop them from resorting to the "deluge".

We think it's telling, for example, that the State Council talked about the importance of well-timed regulation in the face of "external uncertainties". This thinly veiled reference to Donald Trump's trade measures against China shows that officials are worried about what a trade war could do to an economy that's going through a functional but fragile rebalancing. That they stressed policy coordination over stimulus is another sign that the government is 'fine-tuning' rather than following an over-arching plan. We shouldn't doubt Beijing's commitment to the deleveraging process, but they reserve the right to make tweaks as and when circumstance (particularly Trump) requires.

Some months ago, we wrote about this fine-tuning approach – the whack-a-mole policy – being dangerous because it doesn't stem the increasing pressures resulting from the underlying issues. Since then, the pressures have clearly increased, and the authorities are still taking it out on the moles.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7709.2	0.4	30.4	↗
FTSE 250	20840.7	-0.4	-84.9	↗
FTSE AS	4235.2	0.3	10.7	↗
FTSE Small	5904.4	0.0	1.3	↗
CAC	5502.3	1.9	104.0	↗
DAX	12860.3	2.4	298.9	↗
Dow	25523.3	1.9	465.2	↗
S&P 500	2834.3	1.2	32.4	↗
Nasdaq	7363.0	0.2	12.8	↗
Nikkei	22712.8	0.1	14.9	↗
MSCI World	2161.9	1.1	22.8	↗
MSCI EM	1089.2	1.8	19.1	↗

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.1	13.4x	12.9x	19.4x
FTSE 250	3.1	17.4x	13.7x	23.4x
FTSE AS	3.9	14.1x	13.0x	19.7x
FTSE Small	3.7	72.5x	11.1x	-
CAC	3.1	17.0x	13.5x	22.5x
DAX	3	14.3x	12.1x	21.1x
Dow	2.1	18.5x	15.1x	25.4x
S&P 500	1.8	21.0x	16.0x	29.8x
Nasdaq	1	26.2x	19.0x	48.5x
Nikkei	1.8	17.0x	14.4x	32.0x
MSCI World	2.3	18.7x	15.0x	25.9x
MSCI EM	2.6	13.6x	11.0x	19.1x

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
BT GROUP	8.5	SSE	-6.8
ANGLO AMERICAN	6.7	INFORMA	-5.7
BHP BILLITON	6.6	RIGHTMOVE	-5.4
PEARSON	6.1	INTERCONTINENTAL	-4.6
EVRAZ	5.4	SCHRODERS	-4.4

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.31	-0.07	OIL	74.6	2.1
USD/EUR	1.17	-0.60	GOLD	1225.0	-0.4
JPY/USD	110.96	0.41	SILVER	15.5	0.0
GBP/EUR	0.89	0.54	COPPER	282.5	2.5
CNY/USD	6.81	-0.66	ALUMIN	2067.0	3.3

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.3	4.4	0.05
US 10-Yr	3.0	2.4	0.07
French 10-Yr	0.7	3.2	0.02
German 10-Yr	0.4	10.3	0.04
Japanese 10-Yr	0.1	197.1	0.07

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.34
2-yr Fixed Rate	1.74
3-yr Fixed Rate	1.81
5-yr Fixed Rate	2.04
Standard Variable	4.16
10-yr Fixed Rate	2.76

* 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