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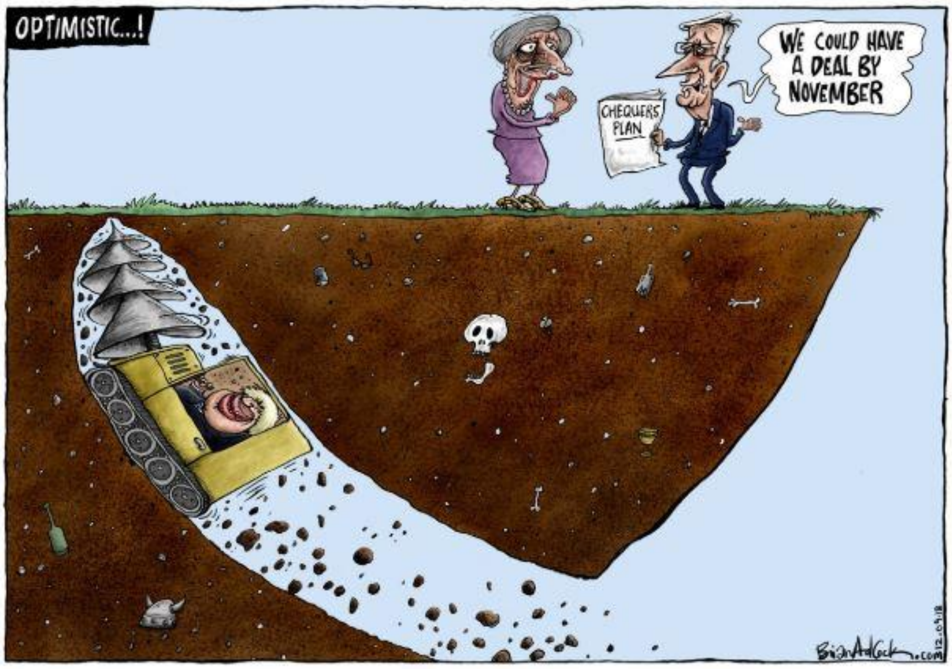


Brian Adcock's take on Boris undermining Theresa's Brexit plan saying it is 'worse than status quo'
No s*** Sherlock! Source: Political Cartoon Gallery; 12 Sep 2018

Financial crisis – 10 years on

It was 10 years ago this week that US investment bank Lehman Brothers was allowed to default. This event marked the beginning of the ultimate escalation from a severe credit crunch to a full blown global financial sector meltdown. The shock this caused to businesses led to the worst global recession since the 1930s, the aftermath of which we still experience today, with interest rates and growth rates still not having returned to pre-crisis levels.

To mark this 10th anniversary milestone, reflections pondering 'could it happen again?' were aplenty this week. We do not intend to add yet another such article to the pile but would like to provide a perhaps slightly more balanced assessment of where the world of finance differs compared to 10 years ago, where it doesn't, and what risks and challenges present themselves today.

The most important change we would note is that the years before 2008 were remarkable in their absence of credit fear and domination of financial greed and entitlement. 10 years on and, judging by media coverage, fear or credit driven asset bubbles and repeat collapse of the global financial system remain a dominant theme, while the bull market of the past 9 years is often described as the most unloved in history. Or, for those who have experienced both time periods, it feels like we have gone from exuberant overconfidence that clever financial engineering will forever make everybody a winner in finance to continuous Armageddon paranoia.

The articles this week identified various culprits and causes for the financial crisis without agreement on what single element caused it. It's not easy to dissect, but just as with other financial crises in history, the common element has always been that capital market participants at some point became convinced that they can only gain and are highly unlikely to ever lose. This leads to excessive risk taking until eventually the proverbial music stops and asset values collapse as there are no longer the prospect of yields or returns that previously perpetuated the upward trend. In the run up to the Financial Crisis, the asset in focus was structured credit securities which had created the perverse incentive to lend ever more to the worst credit risks around without having to apply the scrutiny of traditional credit checks.

Let's fast forward to 2018. The pessimists will point out that total global credit volumes today are even higher than they were in 2008 and therefore the next collapse is inevitable – as they have prophesied this to happen for the past 9 years. The optimists state that the financial sector has learned its lessons, buffers against losses are back up to what proved historically sufficient, structured credit instruments are now as regulated as banks themselves and credit due diligence and monitoring is once again what it should be.

Our view is that substantial financial crises only repeat once a few generations have passed and the horrors of the last financial melt-down fade from collective memory. Having experienced and worked in the financial sector for the past 30 years, we agree that credit risks are taken serious again. Vast volumes of credit-based finance are not in itself an issue as long as it is backed by activity or individuals that make uninterrupted debt servicing highly likely. Even that is overwhelmingly the case now, but the word 'now' is where matters get slightly uncomfortable.

Most loans these days are requiring only minimal interest payments, because rates have been so low for so long. As every householder with a variable rate mortgage knows, should rates double, there will be considerably less money left to spend on other things. Herein lies the risk of today. Not reckless lending as in the early noughties, but an uncomfortable dependence on interest rates not rising quickly. If they did, many households and businesses would have to cut back on their outgoings significantly, which is a sure recipe for an economic downturn.

This provides perspective for Bank of England governor Mark Carney's remarks this week that a cliff edge no deal Brexit could cause a UK house price crash. Should the central bank have to raise rates drastically to defend £-Sterling (in the event that large amounts of UK capital and savings leave the country for better opportunities abroad and thus drive down the currency's value), then affordability of mortgages at current house prices would equally drastically deteriorate. This would necessarily require house prices to adjust downwards to levels at which at the higher mortgage payments are once again affordable.

While this particular scenario is very specific to the UK and would not have a similar global effect as the financial crisis did, the general issue is the same. The continuation of the gradual process of economic normalisation that we have enjoyed over the past years hinges disproportionally on a just as gradual an upward normalisation of yield levels. If the increase exceeds the growth in earnings of households and businesses, then the upward trend will be in jeopardy.

Central bankers have done a formidable job in not upsetting this fragile equilibrium through very gentle policy setting. However, this is where politicians need to play their part and refrain from actions which may force central bankers' hands. A cliff edge Brexit is one example for such a scenario. Turkey and Argentina have already recently provided vivid examples of how badly things can go wrong when politicians disregard monetary and economic necessities.

Herein lies in our view the true issue of our times in 2018. In order to prevent the global economy from descending into a depression as it did in the aftermath of the 1928 financial crisis, the central banks had to support asset values in order to prevent such ultimate collapse. This approach worked – at least when compared to what happened over the course of the 10 years following 1928. Unfortunately, as asset owners have benefitted from the central banks' remedy, wage growth of the asset-poor working masses and the young generation has suffered.

This in turn has created the deep divisions in western societies that have led to the rise of populism and politicians increasingly acting against the best interests of gradual economic progress, out of fear of being replaced by outright populists.

Where populists have taken political control, central banks may be forced to increase the pace of their rate rises and thereby risk the fragile balance we have progressed under so nicely for the past years. Donald Trump's pro-cyclical fiscal stimulus through his corporate tax cuts is a case in point. The rush back to the US of US$ capital has already led to a slowdown in emerging markets and disrupted the goldilocks scenario of synchronised growth the world enjoyed in 2017. The supercharging of already healthy growth in the US is beginning to create inflation pressures, which have the potential to lead to rate rises which will be negative for growth, particularly if the US economy has to stomach a double hit from tariff induced trade restrictions.

To end this reflection on not too gloomy a note, as regular readers know, we see a far higher probability for a typical and prolonged EU 'muddle-through' approach to the Brexit challenge than a cliff edge scenario in March 2019. Regarding Trump's lack of macro-economic policy understanding and the interest rate risk this creates, well, let's say he is inadvertently creating a few counterbalancing headwind forces as well, which may allow the US central bank to refrain from stepping up their current pace of rate rises.

So, in conclusion, 10 years on from the financial crisis, history is unlikely to repeat itself and anybody suggesting as much applies gross simplification to grab headlines. On the other hand, the remedy that prevented the worst back then has created new challenges for today, of which the rising discontent and division of societies on the back of increasingly unequal wealth and income distribution is one that we should take very seriously. As we have stated here before, we'd much rather look back in a few years and reflect that 2018 was a bit like 1948 than 1938. In 1948, excess savings began to be released and deployed for one of the largest ever economic advancements over the following two decades. 1938 on the other hand marked the political taking over of the populists in many countries that led to events we really do not want to see repeated.

Trade war or trade truce?

According to reports this week, Treasury Secretary Steve Mnuchin has extended an invitation to the Chinese government for the resumption of trade negotiations. Officials in Beijing are now working on the details of a meeting with their US counterparts – likely to take place in Washington.

After weeks of escalation in rhetoric and actual policy measures between the two economic giants, risk assets, especially Emerging Markets (EM), turned positive on the news.

The Chinese themselves might well be a bit more sceptical, however. Vice Premier Liu He – who is expected to attend the new round of talks if they do go ahead – met with Mr Mnuchin back in May and appeared to make significant progress. The outline of an agreement was reached between the world's two largest economies, and Mnuchin himself claimed the trade war to be "on hold".

But the truce was short lived. No sooner did the good will appear than it was extinguished by Donald Trump. In typical Trumpian fashion, the President tweeted that the set-up of negotiations was "too hard", and that the countries would "probably have to use a different structure", effectively vetoing the agreement. Soon afterwards, Trump imposed tariffs on $50bn worth of Chinese goods and threatened them on $200bn more.

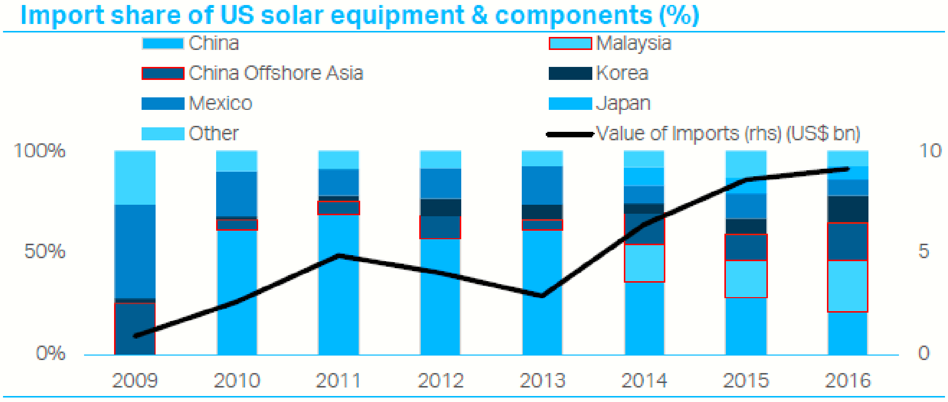
While China has always supported the idea of resumed talks, it's likely that this episode led them to believe that a Trump-led US has little intention of constructive trade negotiations. That episode also supports what we have argued before – that the Trump administration is motivated by more than just addressing China's perceived injustices in global trade. Instead, there is a significant section of Trump's team (namely economic adviser Peter Navarro, national security adviser John Bolton, and Trade Representative Robert Lighthizer) that want to use trade measures as a means to slow down China's economic, technological and political development altogether.

As a result of this perceived inevitability, the Chinese have already embarked on a long-term strategy to reduce the economic damage that specific US tariffs will have.

Firstly, the potential crimping of access to technology has caused Chinese firms to rush to hire new Japanese IT graduates the minute they pass their exams, with the Chinese firms establishing Japanese ventures and then populating them with the newly hired grads.

Secondly, manufacturing firms are shifting capacity (mostly) to other Asian nations such as Malaysia, Vietnam, Indonesia and even Taiwan. In fact, the move is just an acceleration of a process that was already underway. Chinese labour costs had already moved up and had become less globally competitive. The imposition of tariffs just makes this situation worse.

TS Lombard, one of our providers of in-depth research, points to the 2012 solar panel tariff episode as a precursor for the current situation. In 2012 the US and EU hit China with tariffs on solar panels after accusations of "dumping". US imports fell from approximately $5bn in 2011 to $3bn in 2013. In 2014, quite suddenly, Malaysia, Thailand, Vietnam and the Philippines entered the market to the tune of $2bn in capacity. The overall value of imports climbed to $6bn, well beyond the 2011 peak. Two years was all the time that China needed to "offshore" its production. Meanwhile US manufacturers had not established capacity to compete. Tariffs had merely served to increase costs in the interim and compress demand. Now imports are at $9bn with China's direct share having gone from 70% to 10%. However, China's offshore share is near 70%. Effectively China has actually increased its share. (see the chart below).



Source: OEC, TS Lombard, *China offshore Asia combines Thailand, Vietnam and the Philippines.

TS Lombard thinks an offshoring of general capacity will take somewhat longer than two years but that it's already well underway and that this suits the government's ambitions anyway. They also believe that the trade wars will lead to a more explicit China-centric trade bloc. They foresee a new phase of the world centred around three specific trading areas. Unsurprisingly, these are: The Americas, Europe and China-Asia.

Despite the long-term counter measures, China does seem willing to engage in talks again, with commerce ministry spokesman Gao Feng claiming that Beijing is hoping for a breakthrough. That's understandable, given their current position. The slowing in China's rate of economic growth is now abundantly clear, and has even forced the government to ease off in their attempts to unwind China's credit problem.

As we wrote recently, what started as a government-controlled deleveraging process in China has now moved into a new phase: the economic slowdown and increased bankruptcy rate – which the government's policies started – has now caused financial institutions themselves to become wary of their own loan books and led to them tightening available credit. The drying up of liquidity that this brings is reinforcing the slowdown. This is a natural part of any credit cycle, but the double whammy of Trump's trade war risks turning the situation into a genuine economic crisis.

The government's recent loosening of fiscal and financial conditions is intended to prevent this. But the problem is that they simply can't deliver whole-hearted stimulus as they did back in 2015/16. Back then, China faced a similar problem – after the intense post-crisis credit build-up began to unwind – and their response was to inject vast amounts of liquidity into the economy. In the short term it worked, but the present problems suggest that it merely cranked up the pressure in the credit bubble. Companies, state-owned enterprises and local governments have to be weaned off debt.

That's why, even though the current expansion of local government financing is fairly full on, it will have to be limited. Meanwhile, they will welcome any opportunity to take some of the external pressure off the economy by re-engaging with Trump – even if they suspect not to succeed.

As for the US, it's interesting that Mnuchin himself (a pragmatist on China rather than an ideologue) arranged the meeting. It seemed that the problem in May was he didn't hold enough sway with the

President, and so was overruled by the China hawks. Unfortunately, it's not clear that he has any more clout now, so his negotiations might be all for nought.

We wrote last week that the upcoming midterm elections in the US would most likely lead to Trump taking a harder line on China in search of popularity, rather than making a deal. But this week's news seems to suggest the opposite. It's possible that he is keeping his options open, in case a very good deal can be reached, and he can be seen in his favourite pose: winning. We're still sceptical it will lead to anything though, considering that Trump will ditch any such deal if he feels that fighting will win more votes.

Italian job needs German demand not bailout

The ongoing spat between the EU and Italy's coalition government continues to preoccupy markets. Investors fear that another euro-crisis – with potentially far wider-reaching consequences – could develop if Italy can't agree a budget deficit position with the EU.

After a more compromising tone from the government's finance minister seemed to cool bond markets early in the week, an Italian news report on Wednesday suggested that coalition party M5S would try to remove finance minister Giovanni Tria if he didn't deliver the €10bn universal basic income policy they promised during the election. This sent investor sentiment the other way and pushed yields on 10-year Italian debt back up to 2.85% on Wednesday. M5S denied the report, but later separate sources suggested that Tria himself threatened to resign over the issue.

The key issue is whether Italy can stay within the EU's budgetary constraints, which require members to maintain an annual budget deficit of no more than 3% of GDP. The coalition – made up of populist parties Lega Nord and the Five Star Movement (M5S) – has promised a large spending plan that, even if only partially implemented, would likely see Italy break that barrier.

To recap, market panic over Italy centres around their large total public debt – which stands at 132% of GDP – and the refinancing crisis it could spawn when the European Central Bank's QE purchases dry up at the end of this year. The combination of increased borrowing and the loss of such a large buyer could send Italian bonds skywards, resulting in one of three uncomfortable scenarios: An EU bailout with harsh austerity measures, which Italy's populists would be unlikely to accept; some form of continued easing from the ECB, which Germany are adamantly against; or Italy's exit from the Euro, causing an earthquake in the European and even global economy.

As we have written before, by far the biggest risk is that each side will stand their ground long enough on the first two options to push us over the cliff-edge of the third. Fortunately, the coalition government seems keen to avoid aggravating their eurocrat negotiating partners. For all the 'helicopter money' style rhetoric that's frightened bond traders, government representatives have stressed that they plan to keep within the EU's fiscal rules.

But part of the problem comes from the political games being played within the populist coalition itself. While M5S – an anti-establishment grassroots movement – emerged from recent elections as the largest party, the far-right anti-immigration Lega has since surged ahead in opinion polls. It's charismatic leader Matteo Salvini now looks like the most powerful figure in Italy, due in large part to the popularity of his hard-line stance on immigration. That's left M5S grasping at any opportunity to regain ground – and they see generous spending plans as the way to do that.

For perspective, Italy is no basket case. The country's overall debt levels are relatively low. The large government debt pile is a legacy of the economic stagnation the country has endured since the 1990s, but not the result of recent fiscal profligacy. The Italian problem is not a difficult one for the EU in economic terms. And while eurocrat budget hawks have proven destructively stubborn in recent history, Italy has more bargaining chips than they did in 2011. Beyond the sheer size of their economy and its importance to the eurozone, their position as the effective gatekeeper for migration from North Africa gives them leverage in negotiations.

In any case, Italy's grievances with the EU are nothing new. In some ways, their problems are a symptom of the bloc's structural weaknesses. It's a well-worn argument that some form of fiscal union accompanying the monetary union is needed to address the structural imbalances between nations – and that Germany and the eurocrats' insistence on stringent fiscal rules handicaps the bloc. We've been here before and will no doubt be here again.

What we find interesting this time is how these issues tie in with the other big confrontation facing the EU: Donald Trump's US. The President suggested recently that the agreement to lower automobile tariffs between the world's two largest single markets to zero wasn't good enough because Europeans just don't buy American cars. While this comment may just sound like typical Trump, it does point to a deeper issue. The EU's (and especially Germany's) focus on export-led growth has left the union with a shortfall in consumption and a current account surplus (exports minus imports) that irks trading partners who see this as 'stealing' their domestic demand.

If Trump's pressure is enough to help rebalance Europe's economy away from surplus savings and towards consumption and internal investment, Italy, France and the periphery nations would likely benefit too. And fortunately enough, things are moving in that direction. Savings rates across the union – and particularly in core nations like Germany – are coming down while credit growth is expanding.

While politically far-fetched but economically sound ideas like a fiscal union or Eurobonds are often floated (and always rejected) as a solution to the EU's structural imbalances, just encouraging Germans to buy more Italian goods could well do the trick. With any luck, this would help the associated political problems too. Paradoxically, if Trump gets his way, it might well be a good thing for the EU.

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Weekly capital market metrics

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7306.0	0.4	28.3	→
FTSE 250	20357.0	0.7	147.4	→
FTSE AS	4038.3	0.4	16.3	→
FTSE Small	5791.7	-0.6	-37.0	→
CAC	5357.9	2.0	105.7	→
DAX	12129.6	1.4	170.0	→
Dow	26192.4	1.1	275.8	→
S&P 500	2907.4	1.2	35.8	→
Nasdaq	7563.9	1.8	133.6	→
Nikkei	23094.7	3.5	787.6	→
MSCI World	2162.7	1.2	25.1	→
MSCI EM	1017.6	-0.5	-5.3	→

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.4	16.2x	13.1x	13.0x
FTSE 250	3.2	18.2x	14.7x	13.9x
FTSE AS	4.1	16.8x	13.3x	13.2x
FTSE Small	3.8	347.0x	13.2x	13.7x
CAC	3.2	17.0x	14.2x	13.2x
DAX	3.2	14.0x	12.9x	12.5x
Dow	2.1	18.6x	16.8x	14.9x
S&P 500	1.8	21.0x	18.0x	15.7x
Nasdaq	1	26.4x	21.6x	17.6x
Nikkei	1.8	16.7x	16.2x	20.0x
MSCI World	2.3	18.6x	16.3x	15.0x
MSCI EM	2.8	12.3x	11.8x	12.0x

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
ASHTEAD GROUP	5.8	SSE	-13.6
ANTOFAGASTA	5.1	PEARSON	-6.6
SHIRE	4.8	OCADO GROUP	-6.4
ANGLO AMERICAN	4.7	SMURFIT KAPPA	-4.6
DCC	4.1	WPP	-4.0

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.31	1.24	OIL	77.9	1.4
USD/EUR	1.17	0.93	GOLD	1196.8	0.0
JPY/USD	112.17	-1.05	SILVER	14.1	-0.2
GBP/EUR	0.89	0.31	COPPER	266.8	1.7
CNY/USD	6.87	-0.33	ALUMIN	2064.0	1.2

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.532	5.0	0.07
US 10-Yr	2.996	1.9	0.06
French 10-Yr	0.766	6.5	0.05
German 10-Yr	0.451	16.5	0.06
Japanese 10-Yr	0.118	4.4	0.01

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.34
2-yr Fixed Rate	1.75
3-yr Fixed Rate	1.83
5-yr Fixed Rate	2.04
Standard Variable	4.33
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.

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