CAMBRIDGE
INVESTMENTS LIMITED

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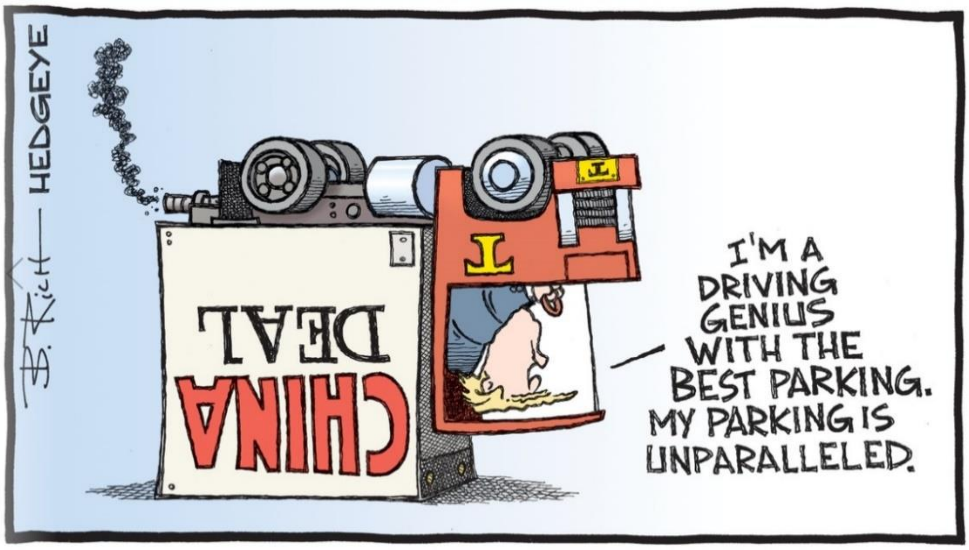

HEDGEYE
B. Rich
CHINA
DEAL
I'M A DRIVING GENIUS WITH THE BEST PARKING. MY PARKING IS UNPARALLELED.

: Donald the genius driver of the China Trade Deal 8 Oct 2019 Source: Hedgeye.com

Atmospheric improvements

It is quite incredible how much market sentiment can swing at the moment on the back of 'atmospheric' changes in the political debate. Only last week, we wrote how the political news-flow did not contribute positively to the short term outlook on either side of the Atlantic. Paired with continued indications of slowing global economic growth, stall speed concerns were making the round. This week, a far more optimistic narrative surfaced, leading to rebounding stock markets and a rapid rise in bond yields from their depressed, recession-foreboding lows.

UK readers will assume that this improvement has everything to do with the positive turn in the Brexit negotiations, after Johnson and Ireland's Varadkar signalled they had found a "pathway to a possible deal". Following confirmation from the negotiators in Brussels on Friday that there may indeed be a possible compromise over the Northern Irish backstop, both £-Sterling and UK and Continental stock markets staged a relief rally.

Despite the cartoon at the top, the US-Sino trade talks also took a turn for the better, after the US appeared to accept that the envisaged 'deal' might actually turn into a string of smaller trade agreements that address the various contentious points over time. Donald Trump's announcement that he would personally get involved further supported the impression that progress may indeed be imminent.

On the economic data front there were feeble signs that demand for manufactured goods may finally be turning upwards again – particularly in South East Asia – where the downturn had originally started. Slightly better than expected reports on the state of the UK's economy over the late summer also helped. The fact that consumer demand held up enough over the summer to prevent GDP growth over the third quarter of the year from turning negative was taken particularly well. This would prevent the UK from having to record the beginning of a technical recession which is widely defined as two successive quarters of negative growth.

One market action which went much less noticed was that the US central bank's intervention to alleviate the recent signs of stress in the US interbank liquidity exchange market (the Repo market, on which we reported over the past couple of weeks) coincided with a marked decline in the US$, following recent unwelcome strengthening. We read this as validation of our view that the liquidity shortage had little to do with a US domestic liquidity crunch, but originated overseas, where the reduction in global trade has led to a shortage of US$ receipts. This in turn has left those needing to service US$ denominated loans scrapping for cash. As we have written before, a lower US$ exchange rate is positive for global trade and particularly for Emerging Market economies.

Should this trend continue and the political progress of the week proves to be more than a flash-in-the-pan, then the prospects for global growth may indeed brighten enough to turn around the dour economic outlook we stated last week. If this does happen, the current slowdown should not deteriorate towards stall speed levels which could trigger an eventual descent into global economic contraction.

Much will hinge on the central banks striking the right tone over the coming months. Should they use the feeble return-of-growth prospects as a justification not to continue to ease the recently too-tight monetary conditions, then market action could take a turn for the worse very quickly. On this basis, we are satisfied with our investment committee's verdict this week to keep our full equity allocations across portfolios and their respective risk profiles. If anything, this week has shown how sentiment-driven capital markets are, and how relatively little it takes to flip them back from a negative to a positive outlook. And under the current conditions of this late cycle environment, sentiment is a crucial but hard-to-forecast factor in determining where markets will go from here.

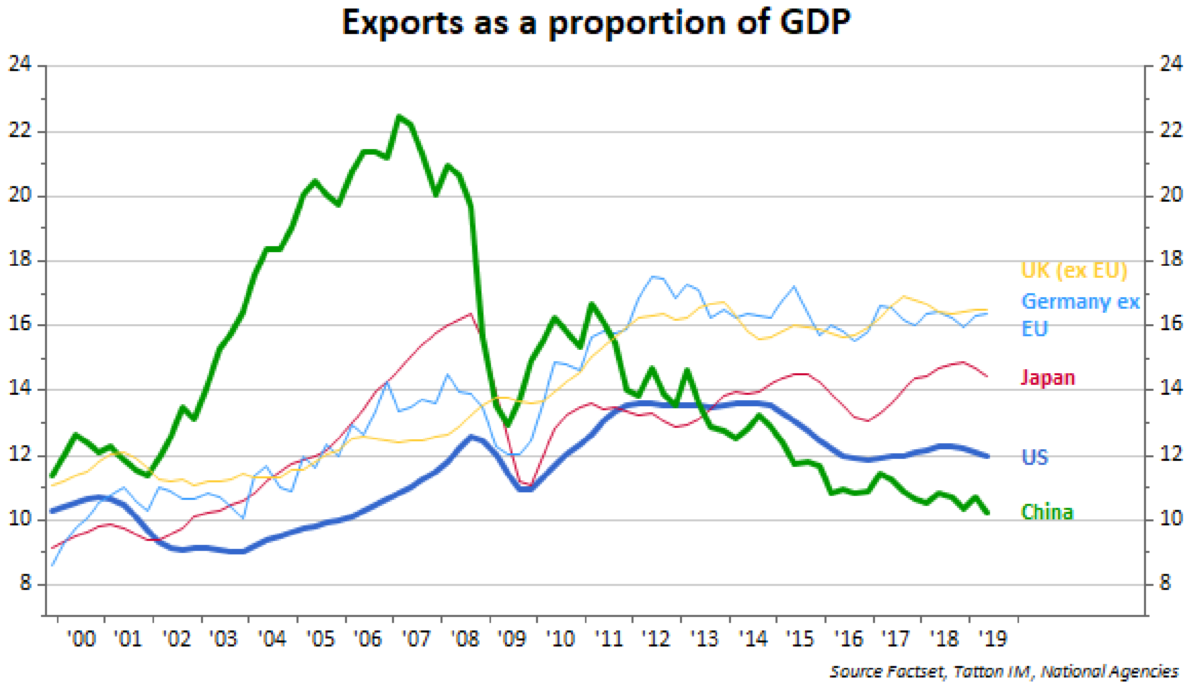
China turning domestic

We have maintained for a while now that one of the most important investment stories to watch in the coming months will be the US-China trade war. Trade tensions between the world's two largest economies have topped the list of concerns for global investors for nearly three years now, and have done further damage to the already slowing global economy. If we see a positive development on this front, it could boost investor and business sentiment enough to send both markets and the underlying economy upwards. If not, it is hard to see where the next growth spurt will come from.

A positive note on this is that, despite the increasingly erratic Donald Trump administration, Chinese officials still seem committed to achieving a deal – going as far as to hold their currency value still and suspend planned tariffs as a show of good faith. They showed that commitment again this week, with Beijing declaring it was still open to trade talks even after the US government moved to blacklist eight Chinese tech firms over the Chinese government's human rights abuses. It is still hugely unlikely that the Chinese government would be willing to make human rights concessions part of any trade deal. But the fact they are willing to negotiate in other areas nonetheless means a partial trade deal could happen – if it can get past the China-hawks in the White House that is.

We have written before that China's incentive to get a deal is strong. Trump's tariffs hit the Chinese economy just as it was going through a patch of domestic weakness. Over the past few months, the data coming out of the middle kingdom (particularly levels of company defaults) suggested that weakness could get considerably worse. But there were signs this week that the nation's economy could be in for a turnaround. The latest PMI data – which measures business sentiment – shows a rebound from soft levels. There also appears to be a rebound in infrastructure investment and even shadow financing (which the government was keen to crack down on previously).

Unfortunately, this rebound may not be as much of a positive for the global economy as China's previous growth spurts. The Communist Party has long sought more economic independence for China, and the trade war has only accelerated their plans. The move from an export led manufacturing driven economy to a domestic demand-led service and manufacturing one has stepped up in recent months – as can be seen in the drop-off in exports relative to GDP.



Source Factset, Tatton IM, National Agencies

This also means that a potential trade deal may not be as beneficial as first thought. Certainly, the rebound in business confidence it would bring would go a long way. But China's quest for trade independence means we should expect them to have less influence on the global economy going forward.

Could Republicans oust their "great and unmatched" President?

Trump-watch has become a favoured pastime of economists and market commentators since his election to the White House nearly three years ago. That makes sense of course, given that his economic, foreign and trade policies – as well as his all-round behaviour – have been a key determinant of market sentiment and the underlying economy ever since.

It is fair to say that, throughout most of 2016, the financial 'commentariat' thought the prospect of his winning the presidency was a negative one. It is also fair to say that, after his victory was confirmed, the opposite turned out to be true. US markets rallied strongly after Trump's election, on expectations of looser business regulation and expansionary fiscal policy. Then, his tax cuts in late 2017 had the economy running on a "sugar-high" for most of last year.

But it has been far from plain sailing of course. From the start of his term in office, his trade wars against America's biggest trading partners have worried global investors more than virtually all other political factors. It now clearly looks like the disputes – mostly with China – have dealt concrete damage to the global economy too. His other foreign policy forays (on Iran, North Korea, etc.) have caused similar market fears, as has his increasingly erratic behaviour. The looming impeachment inquiry is just the latest White House drama to generate political risk. If Trump was an asset to markets and the economy before, he looks more and more like a liability now.

Most importantly from our point of view, he may well have become a liability to the Republican party as well. The latest poll from the Wall Street Journal shows that 55% of Americans now support an impeachment inquiry, after the revelations of the unfolding Ukraine scandal. And while a plurality of the electorate still think actual impeachment is not yet warranted (49% said 'no' to removal from office based on what we know now versus 43% saying 'yes'), there are rumblings that senior Republican politicians are considering moving against their president.

Last month, the Senate voted unanimously for the whistle-blower complaint to be released to congressional intelligence committees – in a rare moment of bipartisanship between America's bitterly divided parties. Trump famously followed this up by releasing the full transcript of his conversation with Ukrainian President Volodymyr Zelensky, where he is alleged to have acted inappropriately in urging Zelensky to investigate former Vice President and Presidential hopeful Joe Biden.

The White House team considers the inquiry to be unfounded, as shown by this week's refusal to cooperate with Congress' proceedings. But many in Washington DC disagree. "The White House should be warned that continued efforts to hide the truth of the President's abuse of power from the American people will be regarded as further evidence of obstruction," warned House majority leader and Democrat Nancy Pelosi.

Pelosi has a reputation as a shrewd operator and vote-counter inside Congress. And while it is possible that her initiation of impeachment proceedings is a show of support for the Democrat faithful, it could also be a sign of a changing tide in Capitol Hill. The US constitution requires that at least 67 of the Senate's 100 members vote for impeachment in order to remove the President from office. Given that the Republican party has 53 of those seats, that would be a tall order. But national security is a key issue for Republicans and they may want to set a precedent on what future (potentially Democrat) presidents are allowed to do.

Trump's penchant for alienating previous allies is well known (as shown in his recent firing of National Security Adviser John Bolton). But his decision this week to remove US military forces from Northern Syria led to the most strident condemnation that he has ever received from his own party. Senate Majority leader Mitch McConnell – usually one of Trump's most ardent defenders – criticised the move as benefiting "Russia, Iran and the Assad regime," Meanwhile, Lindsey Graham, chairman of the Senate Judiciary Committee and outspoken Trump supporter, called the move "a disaster in the making" and "a stain on America's honour".

The events that followed will have only hardened their resolve. Turkish forces began bombarding Kurdish forces just hours after the withdrawal, and have since launched a ground offensive. It is being described as a humanitarian crisis for the persecuted Kurds – who were key US allies in the fight against ISIS. And while the White House denies giving President Erdogan of Turkey the green light for the incursion, the removal of US forces will be seen by some as a tacit approval – regardless of Trump's promise to "totally destroy and obliterate the economy of Turkey" if they do anything that he, in his "great and unmatched wisdom", considers off-limits.

Still, it would take a lot to convince Senate Republicans to abandon their president. His sizable voter base is big enough and most likely dedicated enough to do serious harm to Republicans' chances in 2020 if they believe their movement has been betrayed. The key question for many on the red (Republican) side of congress will be whether securing the Trump base is worth the votes they are likely to lose from more moderate Republicans.

If that calculation did finally switch, it would more likely be sudden than gradual. And it would probably be met with only more erratic policy decisions from the White House. The end result could well be welcomed by markets. But the likely chaos before it probably would not.

Tax revolution to cope with the tech revolution?

One of the more interesting large-scale macro trends we had expected and have written about over the past 18 months is the political move against the large multinational technology companies. Up until a few years ago, it seemed that the likes of Facebook, Amazon and Google were allowed free rein in the uncharted territory of the technology frontier, as long as it led to price reduction for consumers and increased service levels. But the pressure on large technology stocks has been building for some time. In the wake of Facebook's Cambridge Analytica affair and the competition stifling effects of Amazon and Google's ever-expanding empires, there has been talk of new regulations to combat the dominance of the tech giants.

Taxation of mega-cap multinational companies has been the one area that has received less attention, until now. While the UK and France have introduced 'digital taxes', the OECD has released proposals this week for an attempt to shake up the different tax systems of multiple countries. Current tax systems are nearly a century old and appear unable to cope with modern digital businesses, who shift profits from country to country to minimise tax liabilities.

The OECD has proposed creating a "stable" and "unified" international system that would allow national governments to obtain a higher tax take on profits generated in each respective country, thereby negating a firm's ability to shift profits across multiple jurisdictions.

The current rules in international taxation stipulate that countries are only able to tax the activities of firms who have a physical presence within their borders. The OECD initiative is that countries should have the right to a percentage of a firm's global profits regardless of which jurisdiction they have been shifted to.

In theory, this would allow the UK to tax a percentage of the sales of Google or Facebook to British advertisers, or the US government to extract taxes on profits of a European luxury goods firm with sales in America. Such a system might face some push-back from President Trump and his penchant for tackling perceived trade imbalances, in that it would predominantly target US technology firms, who are highly profitable (like Apple) or have a perceived monopoly (Google/Amazon). While Trump has his issues with certain tech firms, he has shown a clear willingness to defend US interests and companies. But even so, a scheme that is seen as universally 'fair' could win US support.

Technology firms would not be the only ones impacted by a global tax system. Oil companies (BP, Shell, Total, etc), luxury goods makers and global car companies (Volkswagen, Toyota, etc.) would also be on the hook.

The main beneficiaries would very likely be large developed countries in Europe and North America, but China and other emerging markets might also gain increased tax revenues. The losers would be countries with lower tax rates like Luxembourg, Holland and Ireland (the countries where multinationals elect to place international operations) and tax havens in the Channel Islands and the Caribbean.

Developing economies might also benefit, as they could gain additional tax revenue from multinationals even if the firm has no physical presence in a specific country. Internet-based services such as Google Search do not require a physical presence in a country for that country's residents to use them, but they might still generate revenue there through advertising.

While the OECD proposals are merely an opener for a wider discussion about global taxation policies, the unified system approach received a favourable reception among many nations, who would reportedly consider dropping their national and often incompatible solutions, such as the UK or French DST (Digital Services Tax). French finance ministry officials called it a "promising basis for further work", with a view to obtaining an "agreement on international taxation in 2020".

The OECD's proposal clearly shows that the regulatory and taxation pendulum has begun to swing towards some kind of coordinated global action. Perhaps we are seeing the early signs of a broader governmental push to strengthen competition law and perhaps even a wider move leading to a possible break up of some of these tech and multinational monopolies. This need not be something to fear: the break-up of "Ma Bell" (AT&T) into smaller "Baby Bells" in 1984 in the US led to a renaissance of new business formation, setting the stage for today's mobile telecoms evolution in America. Maybe the same thing can happen to the internet and e-commerce sectors if Google, Amazon and Facebook were 'broken up'.

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Global Equity Markets

Market	FRI 15:31	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7239.3	1.2	83.9	⬀	⬀
FTSE 250	20044	2.9	563.6	➚	➚
FTSE AS	3989.1	1.4	55.9	⬀	⬀
FTSE Small	5409.0	0.4	20.8	→	→
CAC	5663.0	3.2	174.7	➚	➚
DAX	12496.3	4.0	483.5	➚	➚
Dow	26923	1.3	349.5	➚	➚
S&P 500	2990.4	1.3	38.4	➚	➚
Nasdaq	7879.8	1.6	125.7	➚	➚
Nikkei	21798.9	1.8	388.7	➚	⬀
MSCI World	2150.2	-0.2	-3.7	⬀	➚
MSCI EM	996.5	-0.0	-0.1	⬀	⬀

Top 5 Gainers

Company	%
Lloyds Bank	14.3
RBS	12.5
Barclays	12.1
Auto Trader	11.6
BT	11.6

Top 5 Decliners

Company		%
Flutter Ents		-5.7
Pearson		-4.7
Fresnillo		-4.6
WPP		-4.5
Brit-AM Tobacco		-3.7

Currencies

Pair	last	%1W
USD/GBP	1.269	2.9
GBP/EUR	0.871	2.3
USD/EUR	1.10	0.6
JPY/USD	108.53	-1.5
CNY/USD	7.088	0.8

Commodities

Cmdty	last	%1W
Oil	60.37	3.4
Gold	1481.3	-1.6
Silver	17.49	-0.3
Copper	262.4	2.4
Aluminium	1753.0	2.0

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.7	0.3
UK 15-Yr	0.9	0.2
US 10-Yr	1.7	0.2
French 10-Yr	-0.1	0.2
German 10-Yr	-0.4	0.1
Japanese 10-Yr	-0.2	0.0

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	5.1	17.6	12.9	13.2
FTSE 250	3.8	23.1	14.0	14.2
FTSE AS	4.8	18.5	12.9	13.4
FTSE Small	3.8	135.2	-	14.0
CAC	3.3	19.4	15.1	13.4
DAX	3.2	20.3	14.6	12.5
Dow	2.3	18.0	17.8	14.9
S&P 500	1.9	19.7	18.1	15.9
Nasdaq	1.0	24.8	21.7	17.9
Nikkei	2.0	15.6	16.1	17.6
MSCI World	2.5	18.3	16.4	15.2
MSCI EM	3.0	13.3	12.9	12.0

UK Mortgage Rates

Mortgage Rates	Sep	Aug
Base Rate Tracker	2.62	2.59
2-yr Fixed Rate	1.56	1.59
3-yr Fixed Rate	1.66	1.71
5-yr Fixed Rate	1.80	1.85
10-yr Fixed Rate	2.61	2.61
Standard Variable	4.29	4.29

* The *% 1 week* relates to the weekly index closing, rather than our Friday p.m. snapshot values
** 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.

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