CHINA DOLL

ECONOMIC OUTLOOK Q2 2019

MAZARS

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01
Foreword

Global stock markets regained their poise in the first three months of the year returning just under 10% in Sterling terms, and nearly recouping the losses from the final quarter of 2018. These gains were delivered despite continued concerns about economic growth which brought about a fall in sovereign bond yields and caused Gilts to rise by over 3% during the period. The market's change of mood was largely attributable to the US Federal Reserve's shift away from raising interest rates, and its indication that it would be "patient" in its approach to monetary policy. Thus it appears we are returning to a situation where interest rates may remain very low by historical standards for the foreseeable future, and with lots of money chasing few attractive investment opportunities (yields on safer assets remain very low) stock markets remain buoyant despite predictions of a forthcoming recession.

Leading indicators of economic growth continue to cast a gloomy shadow over the prospects for equities. Manufacturing Purchasing Managers Indices, which usually serve as a reliable indicator for future growth, fell significantly compared to the same measures from six months previous, and into contraction territory. This was particularly true in those countries such as Germany, Japan and South Korea whose economies are export led, implying a slowdown in global trade. Europe in particular is struggling to generate meaningful growth, with credit growth contracting despite record low interest rates. We do however note that valuations on equity markets are no longer at the elevated levels seen over the last few years, and hence it may be argued that much of the bad news is already priced into markets.

At the time of writing (and most likely at the time of reading too!) the Brexit debacle trundles on towards no apparent resolution. Politics aside, markets do not seem to be in the mood to predict an outcome, with speculation on Sterling subdued, and foreign investors simply choosing to ignore the UK listed market until matters become clearer. The eventual outcome is highly significant in the short term for Sterling based investors, not least because the market is likely to deliver its verdict through its valuation of the Pound. This will have an immediate impact on overseas holdings and those UK companies which earn their revenues from abroad.

Our Investment Committee agreed to maintain our cautious stance reflected by our neutral position in equities and overweight position in gold. As Brexit and the value of Sterling continues to be a risk for UK investors, we implemented changes to protect our portfolios against a possible rise in the value of the Pound, and reinstated our exposure to domestically focused UK companies.

DAVID BAKER

Chief Investment Officer
Mazars Wealth Management

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CHINESE REVERBERATIONS

It used to be that “America sneezed” and the “world caught a cold”. Yet the world seems to have changed quite a bit in the past decade. The world’s largest economy is not the only leading indicator for global economic health.

At the end of 2017 the world was growing above trend. One year later and we are faced with a broad-based economic slump. As different economies across the world slowed down in unison in the past six months, most reported one unifying characteristic: decent internal conditions, but rapidly waning external demand. Global trade indices turned sharply down. References to “trade wars” made a sensible narrative, but global supply chains are not instantly adaptable to mere political threats. It takes time to build factories, plan routes and change production lines, especially where tangible products are concerned. And when one cannot export to one country, one may increase exports to another, which means that historically trade balances have not been affected by tariffs, according to the latest research by the IMF.

Thus, much as pundits have blamed Mr. Trump’s trade stance, it has become increasingly apparent to careful observers that the world’s marginal buyer, China, has silently but sharply slowed down. There are two explanations for this, not wholly unrelated.

The first lies in Mr. Trump’s pro-cyclical fiscal policy (subsidising exporters and stimulating the economy where demand is already strong), which can unbalance trade. When the epicentre of that policy is the world’s largest and most open economy, the ripple effects can be gigantic. It is possible that China, which is in the midst of a major economic transition from the secondary to the tertiary sector and was facing an economic slowdown already, got hit by Mr. Trump’s stimulus much more so than his - better publicised - trade war efforts. “Making America Great Again” often means America claiming back some of the growth it’s been sharing with the world and the most exposed economies could get hurt.

Global trade slows down

US ahead of the pack

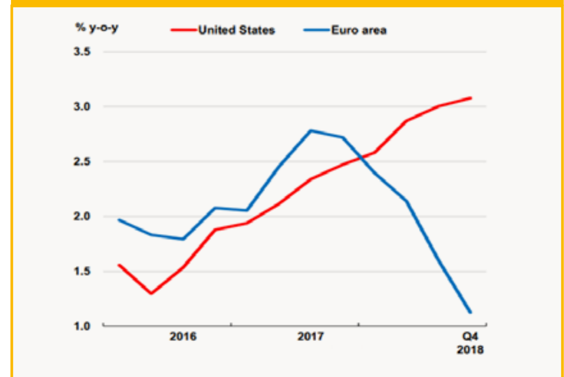

Chart source: IMF, OECD

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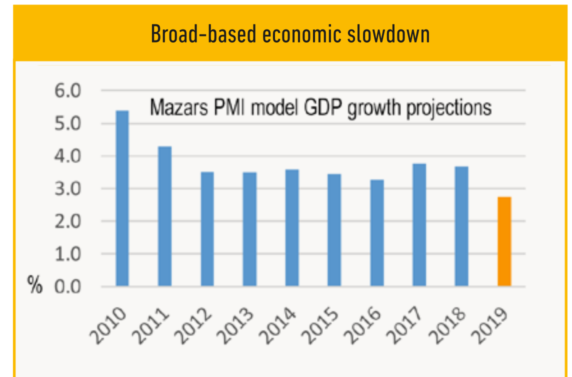
CHINESE REVERBERATIONS (continued)

The second explanation is the transformation China is already undergoing. The country has aggressively tried to cut down on shadow banking while making the transition towards a more consumer-centric model. At the same time China has tried to balance its relationship with the US, opening its markets and letting its currency float. In all this it is possible that it has overreached. Mr. Trump's policies, which claimed back some growth for the US, may have acted as a catalyst to further unbalance an economy already in the search of a new direction.

It is very difficult to imagine the global economy regaining its impetus in the current cycle with America looking inward and China slowing down. The first condition will probably not change, at least until the 2020 Presidential election. The second one could. For reasons explained further down, we believe that a Chinese cyclical rebound could happen. Additionally a successful trade deal renegotiation with the US might give a temporary boost to markets, even helping the S&P 500 to break new highs. But we are long term investors, and research suggests that trade threats and tariffs are not responsible for the current slowdown, therefore their resolution might not correct the long-run course of the global economy. The question we must really answer is: can China avoid a crash landing and continue to be a significant contributor to global growth over the longer term?

To do this, first we need to understand China's current place in the world.

Broad-based economic slowdown



Chinese conditions slowing

Chart Source: Mazars Calculations

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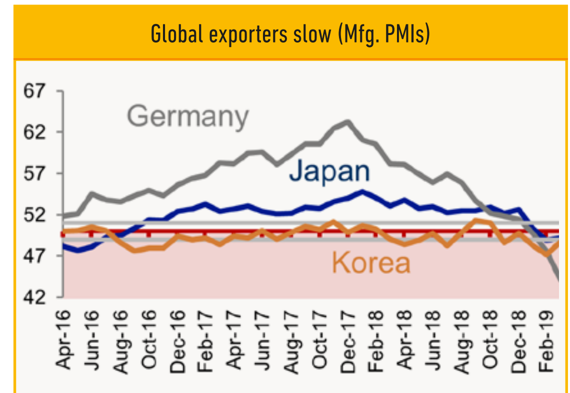
THE WORLD BEFORE CHINA

The post WWII global economic system had a built-in simplicity. The new Pax Americana meant that the non-Soviet world would construct products for American consumers. Germany and Japan in particular dropped their war mantle in part to rebuild their destroyed economic and social infrastructure, and partly compelled by a desire to improve their reputation by being on the right side of the next war, the Cold War. Redemption came from their transformation into the world's top manufacturers.

Reeling from the destruction in Hiroshima and Nagasaki, Japan, eager to restore its honour and emboldened by the early successes and respect of the Douglas McArthur administration, embraced the ideas of an American engineer and statistician G. Edwards Demming. Demming's teachings propelled Japanese industrial production to the forefront of global manufacturing, pioneering quick production methods and eventually total quality management, just-in-time inventories, six sigma production, quality circles, continuous improvement (Kaizen) and other novelties still used and followed in factories and businesses across the world. Vanquished Japan almost turned a crushing defeat into victory through economics, and in 1985 it took a concert of developed nations to stop it from growing too strong, compelling the Japanese to sign the Plaza Accord, a deal that would substantially increase the value of the Yen.

Germany followed the exact same tactic, but observing the lessons from Japan, avoided trying to take on corporate US. Instead it settled for European leadership. Taking advantage of Marshall Plan funds and under no obligation to maintain an army, it built up its infrastructure to become Europe's most potent producer. America and France would take care of Germany's defence, but in the age of NATO and nuclear weapons what mattered was the ability to build cars, not bombs. The common market sealed the country's return to normality and it became the European growth engine.

"Made in Germany" meant quality, and "Made in Japan" meant speed, all for the enjoyment primarily of the American consumer. That was the zeitgeist. Then, in ten short days late in the summer of 1991, that world changed. Mikhail Gorbatchev's "Perestroika" and "Glasnost" policies had failed to save the ailing Soviet economy, the Union of Soviet Socialist Republics collapsed and the Cold War was over. The West was probably surprised that from the other side of the Iron Curtain the power that emerged was not Russia, but China.



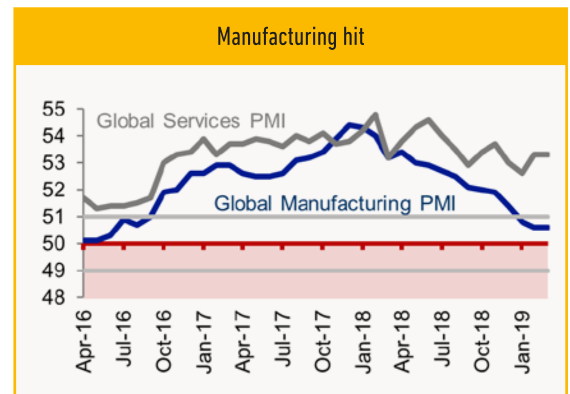


Chart Source: Mazars Calculations

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CHINA EMERGING

Under the leadership of Deng Xiao Ping and with the “communist containment” policy of the West scrapped, China took over from Germany and Japan to eventually become the world’s top manufacturer and take their place in the global supply chain. There were significant differences between the world’s new rising manufacturer and these two economies, however.

For one, the sheer size of the country and the population allowed for much lower costs, which could not be achieved by either the efficient quality-driven Germans, or the notoriously quick Japanese. Often the Plaza Accord and failed monetary policy experiments are blamed for Japan’s near 30-year stagnation, but China taking its place at the top of the global manufacturing chain likely dealt the final blow to Japanese might.

The other major difference is that China is not strategically or militarily dependent on the US, nor does it feel the need to cleanse itself from its past. Becoming a strong manufacturer was a way to assert itself on the international stage, without compromising its political structure. The concessions it has made were in exchange for access to influential international organisations, such as the WTO and the IMF. By the same token, however, America’s approach was much more cautious than with Germany and Japan. It has been more reluctant to share technology and increasingly less likely to share growth in exchange for influence.

Despite wariness from both sides, in the early 2000s the bond between the US and China was confirmed. China would now construct the cheaper end of manufacturing goods for the American consumer and the rest of the globe. It would create a symbiotic and co-dependent relationship with the US, in which it would gain growth and influence, and in exchange America would enjoy low inflation. To maintain a stable currency relationship, China bought US Dollar assets with the FX reserves it accumulated from its trade surplus. Thus Chinese savers would finance US spending and China would become a perma-buyer for US debt.

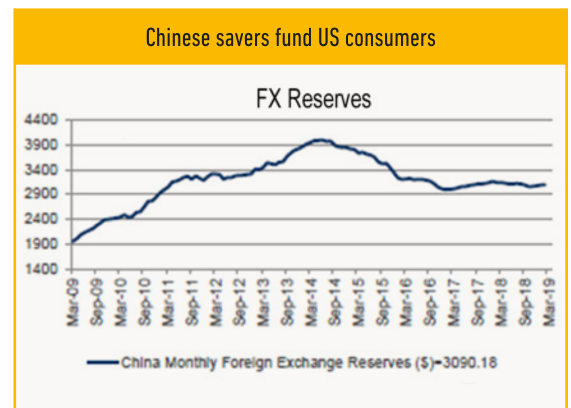

Chart source: Mazars Calculations

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AFTER THE GLOBAL FINANCIAL CRISIS

The 2008 crisis removed one of the co-dependent aspects of the relationship between the US and China. With the Fed increasing its balance sheet immensely, America could now finance its deficits without turning to Chinese savers.

Then in 2014, China decided that its economy would have to evolve from being manufacturing-centric to consumer-centric. The US initially tried to reign in Chinese ambitions by trading the Renminbi's inclusion to the IMF's currency basket (the SDR) for more market access to foreigners and by putting forth the Trans-Pacific-Partnership, a comprehensive trade deal with many nations involved, designed to ensure no one would get too much of an upper hand in trade. However, when Mr. Trump was elected, he wanted to have his cake and eat it. He dismantled the TPP and planned to reassert America's trade eminence in the world via subsidising his economy, while aggressively attacking Chinese trade practices.

Chart source: Mazars Calculations

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THE CURRENT STATE OF AFFAIRS

Currently the world's second largest economy is going through a painful transition, weaning itself off dependence on manufacturing and exports and focusing on improving the standard of living for its citizens, who have already experienced a significant bump in their per capita disposable income from 6.3K Yuan in 2000 to 36.4K Yuan in 2017 (roughly $5,000). This represents an almost 500% rise at a time when western incomes have stagnated. However citizens of the world's second largest economy are still taking home nearly a sixth of the amount compared to their US counterparts and significantly less than many other, smaller nations. Naturally Chinese consumers, imbued with national pride at their country's big player status, want more.

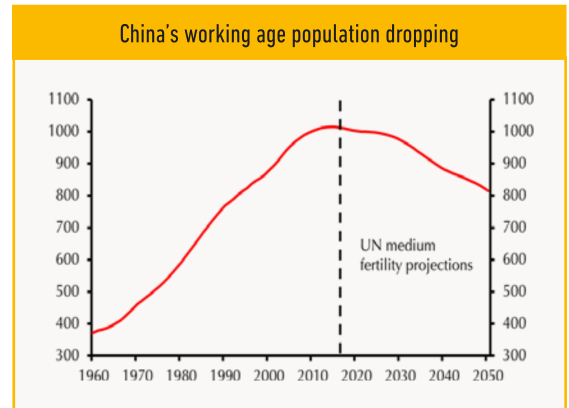
Achieving it is a difficult proposition. Apart from the economic transition, which has already come at a significant cost to manufacturing jobs, China has to contend with a litany of other challenges:

Debt: An increasing total debt/GDP burden, eerily similar to that of Japan before the country went into a 30-year stagnation cycle. While government debt adds up only to around 30%-40% of GDP, total debt, including municipal, is well over 260%.

Unfavourable demographics: The one-child policy has already warped the demographic bell curve. Interestingly, even with the policy lifted, fertility rates have collapsed.

Inefficiencies: An equity market dominated by grossly inefficient State Owned Enterprises. Despite the removal of significant barriers for foreign investors, corporate governance remains poor. Chinese companies fail to attract the "slow" institutional money necessary for the sector to develop over the longer term.

Thus, Emerging Market tumult, similar to what we experienced last year, may still lead to large outflows from China. Additionally its shadow banking system has been aggressively rolled back and new loan creation from shadow banks has been consistently falling. The Belt and Road initiative is facing hurdles, as some countries are resisting taking Chinese money considering the stipulations involved.



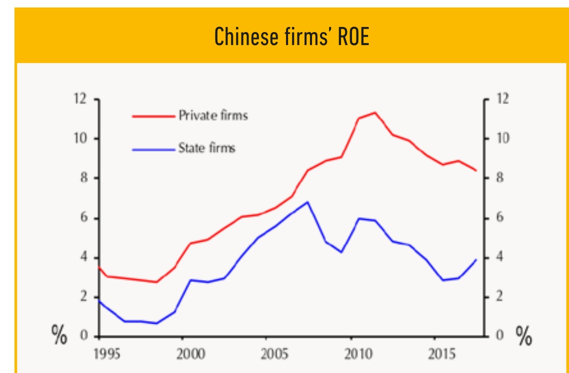


Chart source: Capital Economics

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SHORT TERM: CYCLICAL REBOUND POSSIBLE AND MARKET FRIENDLY

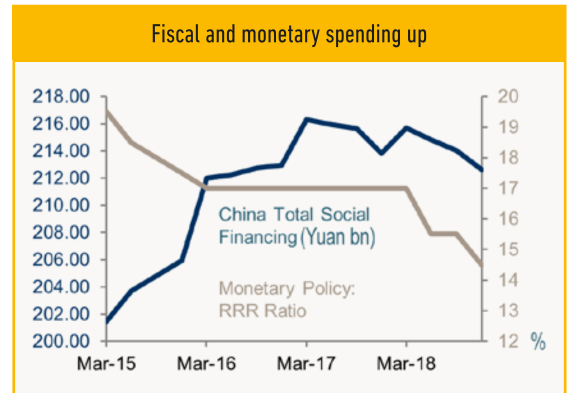
The economy may still outperform over the shorter term. At the beginning of the year we observed data suggesting resurgent commodity demand, a leading indicator for the Chinese economy. Exports also improved in the last two readings. Monetary policy and banking reforms are picking up the slack from the clampdown on shadow banking, with Chinese lenders handing out more cash and total social financing remaining stable, despite the collapse in shadow banking activities, suggesting that the official banks are picking up the slack successfully. Still, transition to a new, more regulated banking regime will be challenging. The credit conditions required to obtain a loan from a shadow bank are not the same as those required by a state-owned bank, especially in a non-open market regime where Party access usually ensures more favourable terms.

This is why monetary policy has come to the aid of fiscal policy. The People's Bank of China has already reduced the Required Reserve Ratio, the amount of money banks should hold with the central bank instead of lending it out, by 2.5% last year and is expected to deliver a further 1.5% cut this year.

On top of these policies, the Chinese consumer remains undeterred (and on occasion blissfully uninformed).

As the effects of the US stimulus wear off, a potential trade deal with the US could provide just enough fuel for the economy to stage a cyclical comeback. A number of global trade and manufacturing indicators now appear overly negative, and it is quite possible that markets might have priced in too much economic pessimism, as revealed by falling bond yields across the globe, and that a Chinese cyclical rebound could become a catalyst for further global equity market upside.

Fiscal and monetary spending up



Some trade data encouraging

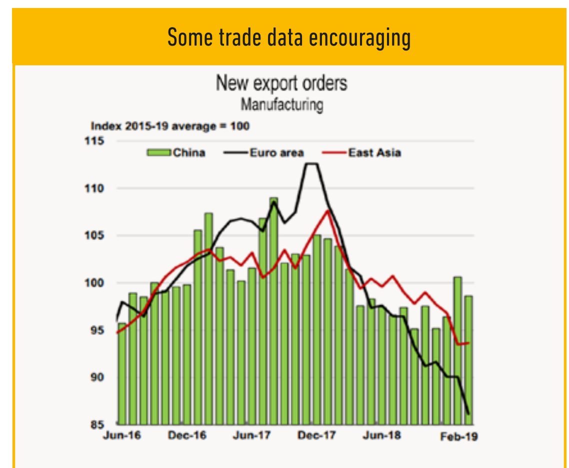


Chart source: Mazars Calculations, OECD

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LONG TERM CHALLENGES

A cyclical rebound is by nature short-term, and does not solve the problem for truly long term investors. Will a Chinese growth slowdown continue to hurt global growth prospects over the longer term?

Opportunities

Just ten years ago China was 18% of the MSCI Emerging Markets index. Now it is 32%. The country's GDP is an estimate one fifth of global GDP. The Chinese market has gradually opened up to investors and has allowed its currency to fluctuate. Still, according to the Economist, global investors own just 2%-3% of Chinese stocks and bonds. The more the market opens up and more institutional money willingly flows into it, the better for its financial system and ultimately the economy. The Chinese government is geared towards investing in the future. Its infrastructure spending continues unabated, and may even accelerate as part of its effort to re-stimulate its economy. It is already investing heavily in quantum computing, the natural home for real Artificial Intelligence, spending as much as $10bn for a Quantum Research Laboratory. In contrast the US is planning to spend anywhere between $200m and $1.2bn on a similar project. China's navy has developed a pulse gun, which can deliver a hit at great distances, at only 1/25th the cost of a Tomahawk missile.

Additionally, loyalty and trust to the Party and the leader go a long way towards maintaining positive consumer sentiment, which is key not only to maintaining consumption rates but to achieving the economic transition goal.

However, there's a series of longer term challenges

The first issue is the quality of the data itself. In 2016, the Liaoning province, a major industrial province and current Prime Minister Li Kequiang's former post, revised GDP down by 20% for the previous decade. Despite this move by a key economic contributor, aggregate national accounts did not change. The country's lack of volatility in terms of GDP compared to every other GDP reading around the world suggests that broad national accounts are not trustworthy. We simply do not know how fast the Chinese economy is growing. If PMI numbers are any indication, China is currently growing at a speed no greater than 3%.

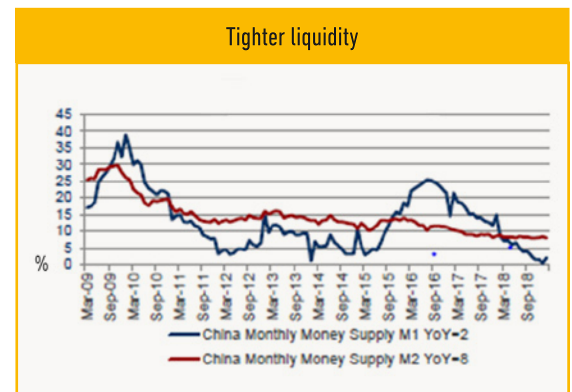

Chart source: Mazars Calculations

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LONG TERM CHALLENGES (continued)

The second major issue is the transition itself. The Chinese economy is going through a major transition from the secondary to the tertiary sector, the results of which are still up for debate. The underlying assumption, that in a planned economy such a transition will be easier - people will just be told what to do - is naïve at best. When the same country attempted a transition from the primary to the secondary economy, the “Great Leap Forward” in the 1960s, an estimated 45m people died of starvation. This time around starvation is not an issue, but relying on the Chinese consumer to lift the economy is precarious at best. China’s savings rate is excessive, mostly because state pensions do not cover older citizens. The time bomb of the one-child policy and the fact that fertility rates have crashed only exacerbate the issue. A geriatric cohort of citizens who use savings to support themselves, not to invest or spend, could significantly hurt the economy over the next few years.

The transition coincides with attempts to reign in the country’s excessive municipal debts, effectively tightening credit at a time when it should be loosening. Attempting a quick structural shift from shadow banking into more legitimate ways of borrowing might sound like a good idea to western investors, but it is a very difficult situation for people accustomed to another way of doing business and a banking system which is largely unprepared.

Financial stability challenging

China’s debt-to-GDP increasing

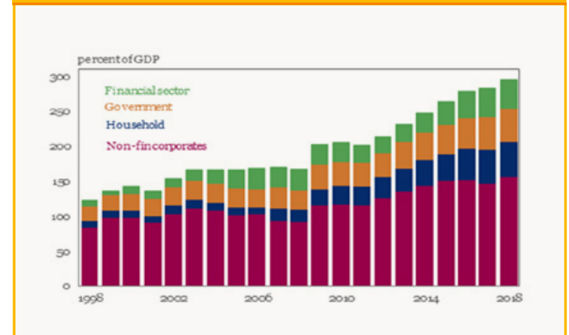

Chart source: Mazars Calculations

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CONCLUSION

Whereas we do believe in the possibility of a cyclical rebound, investing in China means overlooking a number of dangers that would threaten to derail even the most structured western economy. The eventual endgame of stimulating the economy to cushion the blow from the transition and change of debt structure could be a Renminbi devaluation.

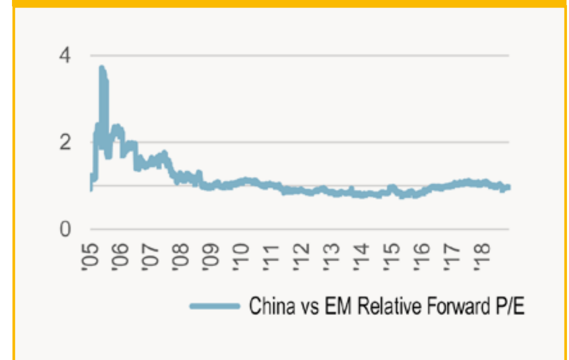
But the real issue that investors often forget is the political backdrop.

In western countries, politics serves to set the competitive backdrop for businesses. In China, politics is the driver and business a means to an end. National Champions may sacrifice profitability where China needs to increase influence. In terms of reforms, we need to take a sanguine view. The proposed reforms, even when they open up markets for investors, are geared towards further increasing influence. Reforms on corruption were targeted rather than deep and broad-based.

Looking at the broad picture, the Chinese economy is on the verge of its own USSR moment. Should the economy manage to acquire the necessary velocity to escape the gravitational pull of excessive debt, bad demographics, regime-associated corruption, poor corporate governance and the potential devaluation of its currency, it will probably become the economic epicentre for the 21st century. However, historically this has been a task never before attempted in a country of such size. Further such reforms under communist regimes have largely been economic failures.

The crux of the issue then is that the step China has to make has a lot of potential to go wrong. The publically available data is scant and not very trustworthy. Reform is aimed at increasing influence, not at attracting and retaining foreign capital. The potential for the currency to weaken is enough to deter foreign investors. It is difficult - historically it would be a first - to see how technological innovation and leadership can be used in business quickly, rather than in the military. China may well overcome these obstacles and set a new model of successful authoritarian capitalism for the 21st century. But at this point, the odds are stacked against it.

Valuations at par with EM ex China



Slower fixed investment

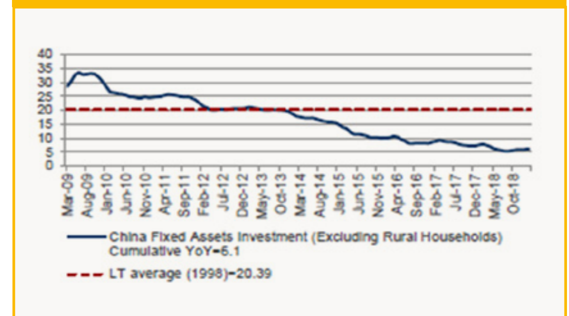


Chart source: Mazars Calculations

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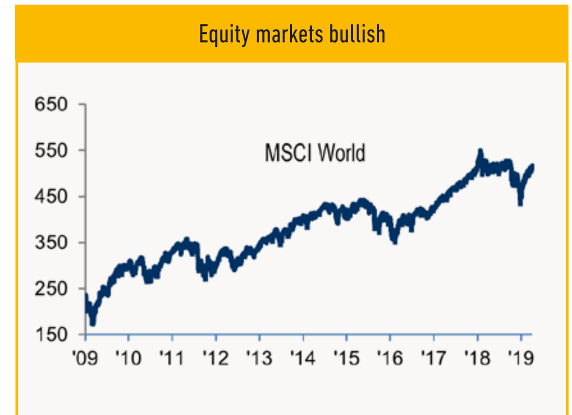
CONCLUSION (continued)

We would thus not be surprised by a resurgent China in 2019, boosting markets and helping global economies rebound. However, as America's moves continue to unbalance the global economy, we are wary of China's impact on the global economy over the longer term and feel that it is difficult for China to reassert itself economically, at least in the current cycle. With this regard, we believe that global growth might have peaked in early 2018.

Currently, equity and the bond markets are at odds. Equities at near all-time highs suggest relief from constricting monetary policies. The bond rally, however, and especially the US yield curve inversion, suggest fears about growth. While both scenarios may simultaneously be true for some time (a dovish Fed can uplift investor sentiment and global growth might still slow), over the longer term economic fundamentals may prevail over sentiment. Our analysis of China, the world's marginal buyer, suggests that economic risks are higher on the downside rather than the upside.



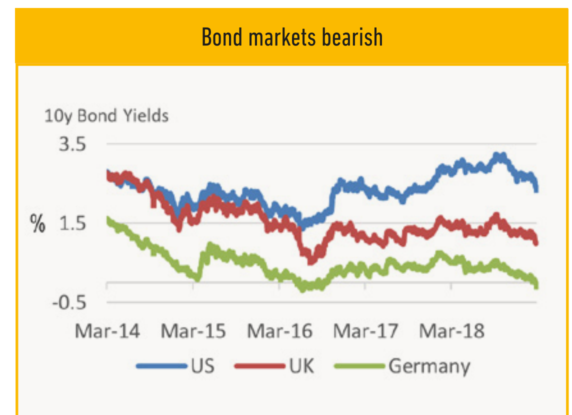


Chart source: Mazars Calculations

03
Asset Allocation

The global economic slowdown has persisted, with conditions in the manufacturing sector further deteriorating, especially for exporters. However some improvement in the service sector and evidence of inventory depletion give hope for a cyclical economic rebound.

Risk asset divergence seems to have abated, even as economic divergence persists. US risk asset underperformance closed part of the gap with Europe and Emerging Markets following strong outperformance last year. Oil prices have rebounded somewhat since the beginning of the year, but overall investors worry more about deflation rather than inflation. New orders have been consistently slower, especially when it comes to manufacturing exports, suggesting the slowdown is broad-based.

Meanwhile trade wars, an uncertain Fed, Brexit uncertainty and growing suspicions of a sharper than anticipated Chinese slowdown, along with the fact that the cycle is entering its tenth year, continue to unnerve investors, causing more profound bouts of equity volatility such as the one in December. Global equity valuations have returned to above historical averages, especially in the US.

At this point, we see a reasonably high probability that the market will trade sideways. More dovish central banks and moderate valuations provide a cushion for investors. On the other hand a dearth of potential upside catalysts, save the possibility of a trade deal between China and the US and significant earnings surprises, leave us sceptical about what it will take for indices to break into new all-time high territory.

Given the extent of uncertainty surrounding Brexit we remain cautious about the UK as lower valuations are still justified by overall slowing growth. Overall, we are "neutral" equities. We feel, however, that a significant portion of bad news is already priced in, and that Sterling has significant upside in anything but a "No Deal" scenario.

Thus we have decided to reduce our 3 year underweight in UK risk assets and move closer to the benchmark before any final decisions on Brexit are made. We focused on eliminating our underweight in UK mid-caps and hedged a portion of our overseas equity exposure to mitigate possible downside from a significant Pound rebound.

We have no strong geographic preferences, favouring large-caps overall and slightly pro-growth rather than value. We believe that the cycle, for the time being, remains intact but it is showing signs of maturity.

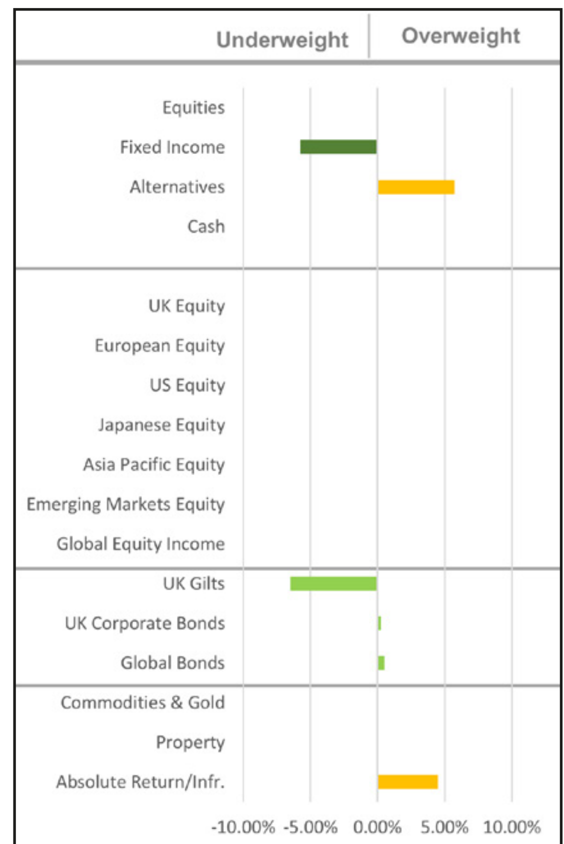


Chart source: Mazars Calculations

03

Asset Allocation – Risks

Risk Monitor

In this issue we focused on China, as one of the key risks to the global economy. There are however a number of other risks we are currently monitoring:

- Global debt levels continue to be a concern, especially at the lower quality end of the corporate sector. Excess demand, which drove output in early 2018, has subsided.
- Central banks may have loosened monetary conditions, but especially in the US official rate intentions are still significantly higher than market expectations. Meanwhile risks from the ECB mount, as November approaches and Mario Draghi's heir will soon be decided.
- In the US the main risk is the Fed failing to keep up with increasingly dovish investor expectations. After Q2 2019 when the effect of the tax-cut stimulus is expected to expire, growth concerns could be renewed. Additionally, investors have yet to discover the true depth of recent tax reforms, which could put additional strains on the budget. A Democratic win in November brought back the possibility of gridlock in Congress.
- In the UK we have seen the impact of Brexit in the form of slower growth, dented consumption, a slowdown in house prices and companies considering new host countries.
- In Europe there are renewed fears over the political fate of the EMU, after the new government in Italy seems set to challenge the dictums of EU institutions.

We feel that short-term systemic risks are mostly manageable and liquidity is still ample. However we are closely monitoring the increasing number of headwinds, the confluence of which could upend the economic and financial cycle.

04

Economies and Markets

	Q1 2019	Q4 2018	Q3 2018	Q2 2018
Equities				
UK	9.42%	-10.22%	-0.85%	9.15%
US	11.49%	-11.52%	8.96%	9.89%
Europe	7.94%	-10.59%	1.05%	4.42%
Japan	4.84%	-13.04%	4.53%	2.99%
Emerging Markets	7.81%	-5.23%	0.19%	-2.00%
Fixed Income				
UK Gilts	3.38%	1.92%	-1.73%	0.16%
UK Corporates	4.06%	0.14%	-0.36%	-0.15%
Global Bonds	0.39%	3.71%	0.33%	3.75%
Other Assets				
Gold	-1.15%	10.04%	-3.73%	0.60%
Hedge Funds	2.01%	-2.07%	1.76%	6.47%

Asset Class Performance in Q1 2019

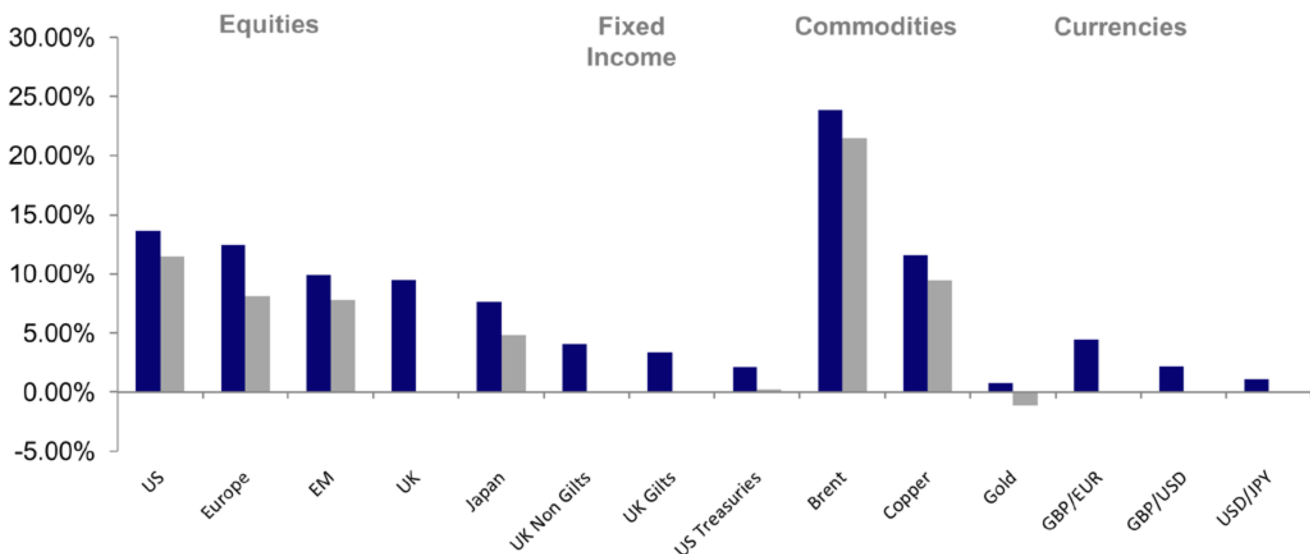


Chart source: Mazars Calculations

04

Economies and Markets

GLOBAL

Risk Assets

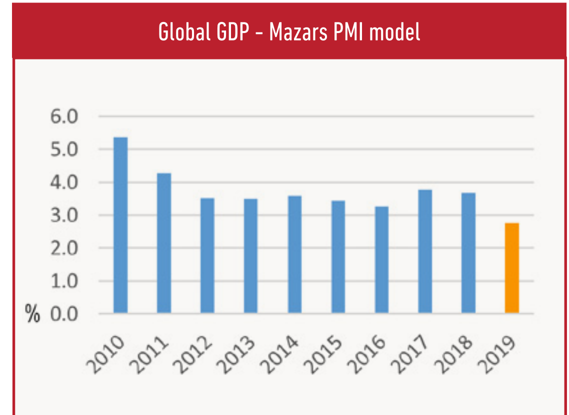
Global equities were up 9.75% in Sterling terms in Q1 2019, with most of the returns coming in January. They are trading at 15.8x forward PE, slightly higher than average. Performance was led by technology and industrials, whereas financials and healthcare lagged. Sovereign yields retreated significantly, as fears over growth rose and inflation expectations fell, affecting the longer end of sovereign yield curves.

The Economy in Q1

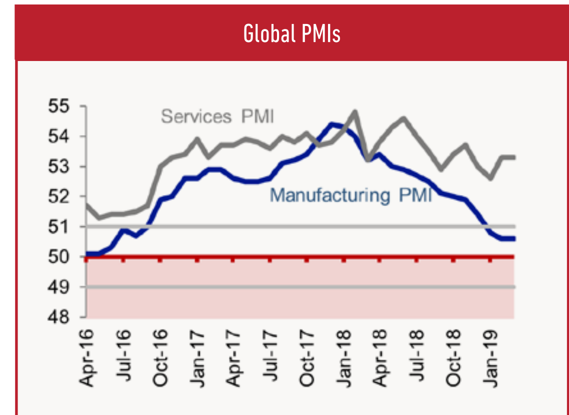
The global growth slowdown continued in Q1 across the board. Economic divergence persisted, with the US in a better position than most of its competitors, while Europe manifestly decelerated. Global trade conditions continued to deteriorate, although some pockets of strength could be seen, especially in the service sector.

Liquidity conditions have become more accommodative after key central banks such as the Fed and the ECB revised their recently more hawkish stance, citing weaker external conditions. Meanwhile China continues to pump liquidity into the financial system to mitigate the credit pressures from reducing its dependence on the shadow banking system. Overall employment conditions remain tight across key developed markets, such as the US, the UK and Germany, with wages continuing to increase. However, weakness in manufacturing and the decrease of backlogs suggest that these conditions might not persist in the next few months, especially if inventories are rebuilt before demand conditions improve. Despite tight labour conditions inflation pressures remain muted, as overall demand is weak and extra income in key countries remains strong, partly because of cautious consumers and partly because of the exacerbation of income inequality, which means a larger accumulation of wealth to top income earners, who have a smaller marginal propensity to consume compared to lower income tiers.

Global GDP - Mazars PMI model



Global PMIs



Stocks correlated this year

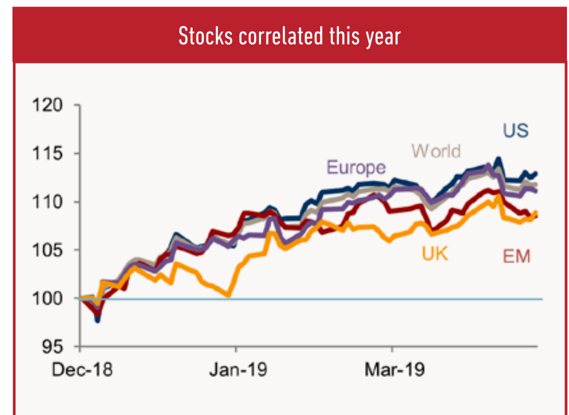


Chart source: Mazars Calculations

04

Economies and Markets

GLOBAL (continued)

Global manufacturing conditions remain broadly weak as new order inflows have stagnated and international trade flows declined. Weakness is focused around key investment goods industries, a key component for any recovery to last. Conversely some positive news came out of consumption industries, which tend to be more cyclical in nature. The services sector has seen a rebound in February and March, especially in the US and Germany. However key service consumption economies, such as the UK and France, remain weak. According to Markit surveys "New business rose at the fastest pace in five months to March, aided by stronger domestic market conditions in several nations and a modest gain in new export work".

Outlook

Valuations for global stocks are still slightly above long term averages, especially in the US. However persistently dovish central banks pumping liquidity into the system, more than a decade after the global financial crisis, continue to create an environment where unprecedented amounts of liquidity chase few opportunities. This has reduced the usefulness of historic data for comparison purposes. We believe that earnings growth could slow further in 2019, as last year's US tax cut effects wane. Having said that, we also believe that the global economy is due a cyclical rebound, although only scant leading indicators at this point suggest that this could become a reality in the next 3-6 months. In this environment we wouldn't be too surprised if stock market volatility, which has abated in the early months of the year, re-emerges, as global markets try to find direction and while equities and bonds point to different conditions. Inflation concerns could also re-emerge, especially if China sees a cyclical recovery, as oil and copper prices have rebounded in the past few months. China's central bank support for risk assets means that global liquidity conditions are still supportive of risk taking and economic fundamentals. A key risk to our thesis is that the global economic slowdown could accelerate should trade tariffs between the US and China fully come into effect, becoming a threat to overall global growth. Despite some risks we are still long-term positive on risk assets, especially equities, but believe conditions are more challenging for bonds which are still comparatively expensive.

Little inflation going forward

Chart source: Mazars Calculations

04

Economies and Markets

UK

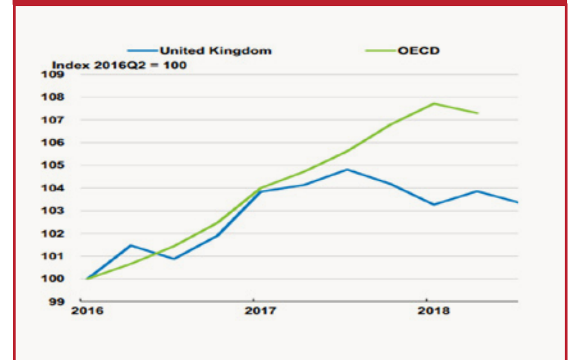
Risk Assets

UK large-caps gained last quarter, in line with global developed markets, continuing to correlate with global stocks in same currency terms. Gains were led by the resurgent retail sector, followed by materials and household goods. Conversely, financials lagged, while the telecoms sector was negative. UK stocks were trading at 12.9x earnings at the beginning of Q2, close to the 12.7x average since 2006. The yield for the 10 year Gilt moved back down to near 1%, the lowest in a year and a half. Sterling lost 2.14% versus the US Dollar.

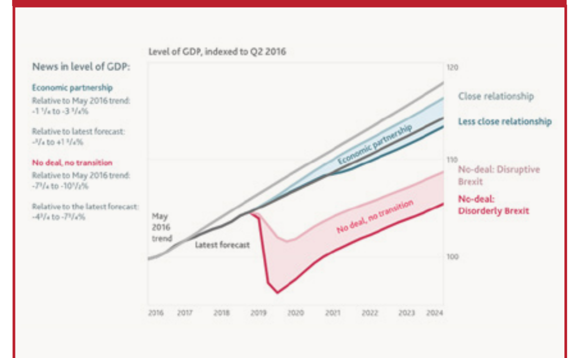
The Economy in Q1

The British economy, long sensitive to the global economic cycle, is still facing headwinds from weaker growth, especially in Europe. Meanwhile Brexit-related uncertainty continues to hamper growth, as some international companies have already triggered their contingency plans and moved operations overseas. In Q4 the economy grew by 1.2%, the third consecutive quarter of acceleration. Overall liquidity conditions are accommodative, and the BoE remains “on hold” for the time being, although this could change rapidly subject to Brexit. The economy continues to enjoy full-employment conditions, although some anecdotal evidence suggests that hiring in key industries, like finance, has become more difficult. Inflation remains benign, hovering just below the 2% threshold. UK manufacturing bucked the global trend as industries stockpile goods ahead of Brexit. New business improved for both domestic and export markets. Meanwhile, the service sector has been slightly weaker, mostly due to weakness in high street retailers, which continue to lose ground to online stores.

UK investment has declined



Bank of England suggests big Brexit risks



Forward P/E relative to world

Chart source: Mazars Calculations

04

Economies and Markets

UK (continued)

Outlook

Brexit and the uncertainty surrounding the process has already impacted the economy. Manufacturing has improved somewhat, but over the longer term it is becoming obvious that uncertainty is taking a toll on large scale foreign investments in the country. Consumers are also more reserved, as Brexit threats now dominate the news. Brexit continues to hover like a Damocles Sword over the economy as key issues regarding the economy, such as trade relations, export conditions, access of financial institutions to the common market and access to skilled personnel are yet to be determined.

The British government has gone back on many red lines, but with the UK relying on EU agreement to extensions to prevent a "No Deal" outcome and no solid plan on the table, risks are elevated. The EU Commission and the Bank of England are now discussing the potential for a No Deal Brexit, even as Parliament frantically tries to take the option off the table. This uncertainty has unnerved both investors and CEOs, with a lot of companies considering resorting to their contingency plans and moving headquarters and jobs. It will be very difficult to reverse those plans even if an 11th hour deal is struck. Consumer sentiment remains subdued. Rate hikes from the BoE could complicate things for a generation that has not really experienced any material increase in their mortgage payments, although we don't expect this immediately, even in a benign Brexit scenario, as the economy has now substantially slowed. Factors which have caused the economy to grow significantly below potential are expected to persist in 2019, as the underlying conditions are set to remain stable.

Despite our negative view on the UK economy, where a lot of damage has already been done, we take a more sanguine approach to British risk assets which tend to move faster along with political developments. An outcome which leads to a customs union or even defers Brexit further into the future is now both possible and potentially imminent. In that environment our long-standing and profitable underweight in Sterling assets would suffer. Additionally, valuations are slightly below average and an abrupt change in sentiment could provide an uplift for stocks, especially in the mid and small-cap space. Therefore we are moving these positions to neutral, as Sterling upside potential becomes more apparent.

Upside for Pound

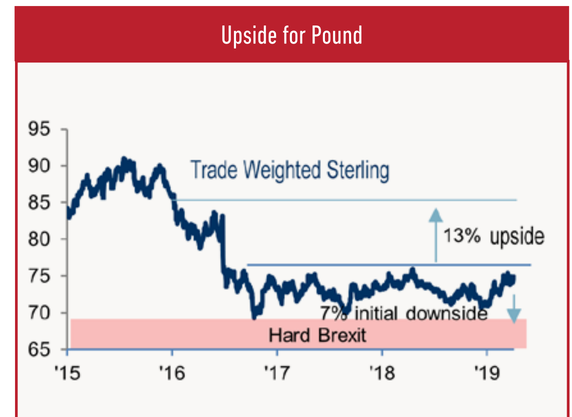


Chart source: Mazars Calculations

04

Economies and Markets

US

Risk Assets

US large-caps rose for the quarter in line with global developed markets, gaining 11.49% in Sterling terms. Gains were led by technology, which resumed its S&P 500 leadership, and home builders, despite deteriorating housing conditions. Financials and healthcare lagged. US stocks were trading at 17.3x earnings at the beginning of Q2, above the 10 year average of 16.1x. Yields on the 10 year Treasury fell from a high of 3.2% to 2.4% at the end of the quarter, while the 3 month-10 year yield curve inverted.

The Economy in Q1

Growth conditions in the US moderated in Q4 last year, with annualised growth falling from 3.6% in Q3 to 2.2% in Q4. Data for the first three months, as well as historical patterns, suggest that moderation has continued in Q1. However the world's biggest economy is still outperforming other major economies, mostly on the fumes of last year's pro-cyclical fiscal stimulus. Nevertheless, the slowing global economy and lower inflation expectations have prompted the Federal Reserve to put rate hikes on hold, declaring "patience" at the beginning of the year. This stance was affirmed with the central bank's decision to maintain interest rates in January and use dovish language in March as well. Quantitative Tightening is also set to pause in September.

Despite central bank dovishness, inflation continues to be benign and near the Fed's long run 2% target. The economy continued to face challenges, however data did not show any significant weakness related to the one-month government shutdown. Employment remains relatively strong overall, and wage growth is increasing consumer confidence, if not their actual spending. Manufacturing has not recovered substantially since the end of 2018, but overall production is still at a good level. The service sector continues to expand at a healthy pace, however actual retail sales, which slowed significantly at the end of last year, have failed to accelerate.

Stocks trading slightly above average

Equities nearing highs

Chart source: Mazars Calculations

04

Economies and Markets

US (continued)

Outlook

The outlook for the US economy is overall positive, albeit more cautious than in the past two quarters. The tax reforms added about 14% to EPS and about 1% to growth, but now are beginning to peter out. As a result consumer and business sentiment indices have slightly retreated from historic highs. The tech sector returned to the driving seat, with cyclical sectors responsible for the majority of positive performance. Capital expenditure and private investment are rising at an improving pace. Oil below $65 is keeping inflation in check, but is still supportive to energy companies. Stronger demand patterns coupled with low unemployment are translating into meaningfully higher wages, but going forward we could see more consumer weakness.

We are positive on US equities, but cognisant of the fact that after the passing of the tax plan there could be a dearth of significant growth catalysts going forward, at least for companies which are more domestically oriented. We expect growth to be challenging after H2 2019. In the bond space the sovereign curve continues to flatten and in parts has inverted, historically a precursor to a recession, while the deficit is climbing along with the cost of borrowing for the world's biggest economy. However, with the Federal Reserve directly influencing parts of the yield curve we feel that this particular recession signal may have lost its potency. Going forward, the economy will again rely on exporters, which is why investors (and consumers) would like to see trade uncertainty dissipate for positive momentum to be maintained.

Dovish outlook

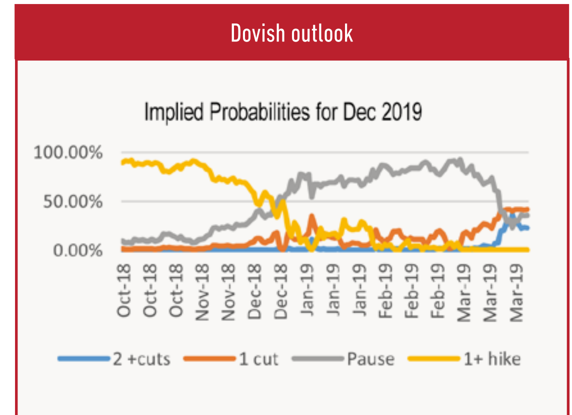


Chart source: Mazars Calculations

04

Economies and Markets

EU

Risk Assets

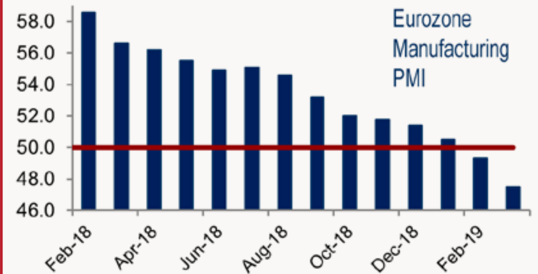
EU large-caps rose for the quarter in line with global developed markets, gaining 8.64% in Sterling terms. Gains were led by materials and retail, while financials and telecoms lagged. European stocks were trading at 13.9x earnings, close to the 10-year average. Yields on the 10 year German Bund almost fell back into negative territory at the end of the quarter.

The Economy in Q1

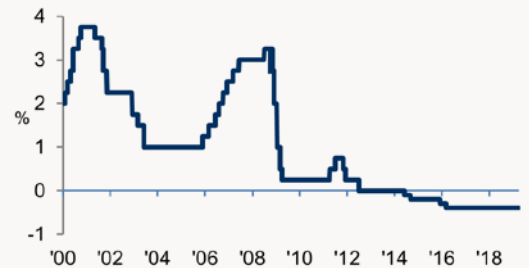
European economic growth has continued to decelerate. The main economic driver, German manufacturing, has gone through a significant decelerating patch, as prior Euro strength and slowing global trade conditions have caused a precipitous slowdown in new orders. German manufacturing PMI is now in contraction territory and manufacturing continues to slow due to weak export orders. Worries about fresh political tumult after the formation of a populist government in Italy have intensified, even if they are now out of favour with the press, especially after the new government's threats to break European spending rules. German GDP for Q4 ground to a halt, down from 2.8% at the end of 2017 to 0.6% a year later. French output has also slowed to 0.9%, exactly at pre-Macron levels.

Inflation conditions on the continent improved, with all CPI figures pointing lower. The central bank remains accommodative. However credit conditions for Spain and Italy deteriorated.

Eurozone manufacturig slowing



Interest rates remain floored



Profitability is low

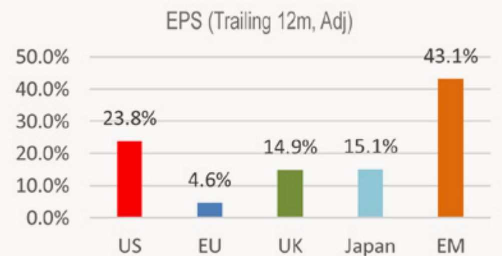


Chart source: Mazars Calculations

04

Economies and Markets

EU (continued)

Outlook

The European economy has slowed after an impressive 2017.
The confluence of a stronger Euro early in 2018, fresh political worries, trade threats from the US and a Chinese induced slowdown in global new orders has taken a toll on the export driven German economy. The German economy has also been plagued by Ms. Merkel's weakening political position. Meanwhile the French economy is sobering up after a year-long Macron-induced economic resurgence. The deterioration in margins has persisted as companies reduce profitability to gain market share. This could have an impact on earnings and stock prices.

Another headwind is a manifest slowdown in European integration efforts. France's Macron has spent the last quarter reforming the internal market, while the German ruling party has been in negotiations to produce a working government, in the process acquiescing to demands for softer integration and no debt mutualisation. Already efforts to push EDIS through (a pan-European deposit protection) have stalled. We are still positive on European risk assets on the basis of valuations and significant monetary accommodation. However we remain cognisant of the inherent weaknesses of the common currency and will monitor sovereign spreads closely for signs of a 2012-like crisis.

George Lagarias,
Senior Economist

Credit growth slowing

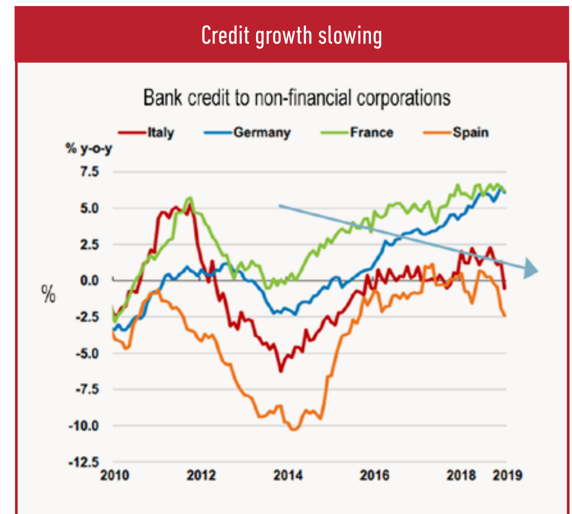


Chart source: Mazars Calculations

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