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Christian Adams on Brexit cliff edge threat; Political Cartoon Gallery in London 22 Feb 2019

Progress?

We prognosticated in January that we thought it likely that the impossible US President Trump would reach a trade deal with China before the hapless UK prime minister would achieve a constructive divorce settlement with the EU. This week both issues appeared to progress as predicted. Judging by the US president's relentless tweets about imminent negotiation success with the Chinese, not only will the threatened trade tariffs not come into force on 1 March, but there may quite likely be some form of trade deal in the not so distant future.

Unfortunately, it also seemed that our expectation that 29 March would not after all mark the UK's formal exit from the EU is becoming probable reality. While there were persistent rumours from government ministers that a break-through on the Irish back-stop was imminent, there were equally persistent rumours from the EU side that the negotiations will go into 'overtime'. With the UK government's inability to gain parliamentary support it was seen as being forced to ask for an Article 50 extension of at least three months. Much reported change dynamics in Parliament also suggested that the May government would have no choice but to abandon any idea of using the threat of a no-deal Brexit to blackmail MPs or the EU into concessions.

Capital markets greeted the improving US-China trade settlement prospect with further stock market advancement, while the likely UK Brexit stalemate extension was either shrugged off or even judged positively, insofar as a light rise in £-Sterling versus the €-Euro can be interpreted as such.

What insight into the likely future short-term path of investment return, if any, can we draw from the latest political developments and market action? The global recovery in stock markets has progressed to the extent where most of our investment portfolio strategies have very nearly recovered their losses of 2018, with some slightly in positive return territory and others slightly in negative. This means that markets no longer discount a significant fall in 2019 economic activity, despite all ongoing economic indicators confirming that the global economy is indeed slowing down, even if not outright contracting. As has been the case before in this prolonged cycle, risk asset investors appear to be willing to look further ahead –having mistaken a liquidity driven market correction as a harbinger of recession.

As far as the political side is concerned, a US-Sino trade settlement would introduce considerable upside into 2019 growth prospects, while the Brexit deadline extension is pointing towards the possibility of a softer divorce settlement than originally envisaged by the government. As we have stated before, this is likely to be positive for the UK economy, but whether British society will be able to return to political stability under such a scenario is currently questionable. From this end the formation of a new political movement in Parliament opens an interesting perspective in an environment where, according to surveys, an increasing proportion of the electorate is deeply dissatisfied with the political party options currently available to them.

In conclusion, we see an ever-increasing probability of 29 March 2019 not marking the end of Brexit uncertainty. Instead we see - as a result - pressure on the whole political establishment rising to levels which could quite possibly become the catalyst for seminal change to the UK's political landscape. In the meantime, the economy will plod on, even if held back by uncertainty and the extra cost burden of much redundant preparation for events which may never happen.

US monetary tightening on hold while credit market soars back

According to their latest published meeting minutes, US central bank officials are now considering ending their balance sheet reduction before the end of 2019. In a somewhat surprising turn, the rate setters of the Federal Open Markets Committee (FOMC) recorded that "it would be desirable to announce before too long a plan to stop reducing the Federal Reserve's asset holdings later this year."

As we reported this marks a significant change for the Fed. Since QE (quantitative easing) turned into QT (quantitative tightening) over a year ago, the central bank had been firm in its commitment to roll off its bond holdings and 'retire' the cash received in the same way that it was 'printed' for the QE bond purchases – by computer key stroke.

While the bank's interest rate decisions are dependent on incoming data, the unwinding of QE's extraordinary liquidity expansion measures had appeared to be set in stone. And it is fair to say that this caused markets a few teething issues. As we have discussed here many times before, a liquidity shortage towards the end of last year (partly due to Fed tightening, partly due to a host of other issues) was probably the main factor behind the sharp falls we saw in equity markets. With hindsight its capital markets impact also looks very similar to previous episodes of central bank attempts to reverse the extraordinary monetary easing measures of the post financial crisis years (see chart below).

2013 -Taper Tantrum; 2016 – commencement of US rate rises; 2018 - US: QT start, ECB: QE end

Now, it looks like that market pressure has swayed the Fed's decision. January's minutes put emphasis on the effect Fed policy was having on risk assets like stocks and corporate bonds.

Whether the change of tone is a capitulation to stock markets or to faster-than-anticipated credit conditions (which can be a secondary market effect) is debatable, but it is undoubtedly what equity investors will have wanted. The expectation of a more dovish Fed has probably been the decisive driver of the factors underlying the recovery rally in equities this year, and the S&P 500 continued its upward grind after the news. It's also been one of the main factors keeping a lid on US bond yields, which, after spiking higher than 3.2% in November, are now at below 2.7%.

That in itself has helped support the equity rally, as stocks keep looking more attractive by comparison. It has also helped companies themselves, as a lower 'risk-free' bond rate lowers their own cost of credit. What is even better for US companies is that the fall-back in Treasury bond yields has coincided with a tightening of credit spreads (the difference between government bond yields and corporate bond yields). All of this has pushed their financing costs back down and alleviated the pressure on companies that may otherwise have struggled to meet their ongoing debt servicing obligations.

This is a big change from the end of last year. As stock markets went into their autumn meltdown, credit spreads widened substantially, and Treasury yields spiked. This sparked fears that not just asset prices but the US economy itself could be under serious threat, as falling liquidity and a burgeoning leveraged loans market made many businesses look ripe for default. We wrote at the time that actual corporate default

risk was not nearly as high as markets had seemed to price in – meaning buyers of corporate bonds would effectively receive an outsized premium for relatively little risk. But higher financing costs themselves make things trickier for businesses, so things did indeed look difficult and deteriorating.

Now however the sky looks a lot clearer. Investors seem to have realised that the end isn't nigh, and credit spreads have come in enough to give businesses some relief. They have been making the most of it too. In recent weeks, there has been a surge of corporate bond issuance in the US to record levels. It's hard to say exactly why this is, but debt rollover is probably playing a big role. $26bn worth of bonds in the investment grade market matured last year. In 2019 that figure will be around $600bn. And in the following two years it will be over $700bn.

Even so, there is undoubtedly a credit splurge going on at the moment. The key question for us is whether this is a sign of strength – as businesses feel confident enough to borrow more – or of weakness – with businesses wanting to borrow as much as they can while lower rates are still around. The former would mean that the current economic cycle has a while longer to run. The latter would mean it could come to an end sooner than we'd like. Right now, it is impossible to say which of these it is.

But whatever the case, it is a positive sign for the short term at least, both for capital markets and the underlying economy. More capital available to businesses should stimulate an economy that has been lacking in positive momentum since the effects of Trump's corporate tax cuts waned. The fact that the Fed seems to have taken a breather on its monetary tightening should help them even more.

On that note, perhaps the Fed's 'capitulation' to markets makes more sense. They are in a delicate situation, with tantrum-prone markets on one side and fragile economic growth on the other. So, it is not too surprising that their policy decisions are so dependent on the incoming data – be that growth, inflation or credit market conditions. As we move deeper into one of the longest economic cycles in history, we should not expect anything else. Against that backdrop it also makes sense that despite their hint that QT bond sales may be suspended later in the year, they also appeared to hint at the possibility that the rate rise cycle may nevertheless resume at such a future point which did seem contradictory at first sight.

Three retail news stories that - combined - tell a bigger story

In the last week, three separate pieces of retail sector news in the US and UK have provided some insights into consumer behaviour, the shape of the high street going forward and whether big is still always beautiful.

The news started at the end of last week with US retail sales data that frankly shocked markets. December sales, excluding autos were reported to have fallen by 1.8%, undershooting consensus forecast by a massive 1.9%. Economists rarely get forecasts exactly right; but they usually don't miss by this much! Not surprisingly, we have seen compelling arguments that the retail sales figures may not be keeping pace with seasonal adjustments particularly as Thanksgiving was early this year (on the 22nd November) and we should expect revisions higher. It is also true that other retail indicators such as the Redbook chain stores sales data have not shown such a significant fall. Seasonal adjustments and other indicators aside, the retail sales numbers did trigger a wave of economists lowering their expectations for US Q4 economic growth as spending is expected to be weaker.

This sentiment adjustment was challenged mid-week by the news from Walmart, the US largest retailer, disclosing that it had seen the biggest rise in domestic sales for the holiday period in 15 years. The results reported annual revenues rising nearly 3% to $514bn with grocery sales helping like-for-like revenues rise 4% in the 3 months to end of January, its strongest performance since 2004. Several one-off factors distorted some of this good news. The US government brought forward benefits on food welfare due to the New Year US Government shutdown. Tax changes earlier in the year has also helped lift consumer net income.

So, there is currently a disconnect between official figures and those we are seeing through Walmart. But putting it down to "one-off factors" misses another change. Walmart sales figures were boosted by the relaunched Walmart.com, its online shopping platform, which saw an increase of 43% in sales during the 4th quarter. Moreover, footfall at Walmart stores rose only 0.9% but the results showed that customers who did enter the shops spent more, driving transaction value up 3.3%. This move in online and footfall resonates with the changes we are beginning to see in the UK high street.

In the UK, during 2018, over 28 retailers and over 2,000 shops closed including famous names such as Toys R Us, Maplin, Poundworld, Mothercare to name but a few. As we ended 2018, more than a tenth of retail properties were vacant. Several factors have been touted as the reason behind this move including poor real wage growth, rising business rates and poor company management particularly overborrowing to fund expansions. But arguably the most damaging has been the change in how the consumer shops. According to the Office for National Statistics, more than £1 of every £5 in retail sales (20%) is now spent online, whilst 10 years ago this figure was 5%. This increase seen in UK online sales is mirrored in the US where the figure has increased from 4% to 10% over the last 10 years.

There is no doubt that investors have fallen in love with online retailers such as Amazon and this has been reflected in their share price. But this masks some of the problems in the existing online model particularly around the cost of delivering the goods to your doorstep and the number of returns online retailers must deal with. Last September Amazon surprised the market by announcing it was planning to open physical stores by 2021 to focus primarily on groceries but it is also expected that these stores are intended to deal with returns more cost effectively. The cost of delivery of goods, currently mostly free to the consumer, does put online retailers at a disadvantage to bricks- and- mortar stores, where consumers come to them – also for returns. As a result, if online sales volumes continue to expand, it is somewhat unlikely that free deliveries can be sustained indefinitely. We are likely to see more examples of bricks-and- mortar chains performing a click and collect function such as Sainsbury now does for Argos which it bought in 2017. This also mirrors the behaviours seen at Walmart where online and footfall supported results whilst providing an outcome that appealed to consumers.

Which leads us to the third news story and the UK's Competition and Market Authority (CMA) provisional report that could end the merger plan between Asda (owned by Walmart) and Sainsbury. The CMA noted "*we have provisionally found that should the two merge, shoppers could face higher prices, reduced quality and choice and a poorer overall shopping experience*". Whilst, according to Sainsbury and Asda the merger would help reduce prices through the benefits of scale; and both companies have already moved towards the change in consumer shopping experiences such as click and collect. The provisional report, from the CMA, has in effect killed the merger and this was reflected in Sainsbury share prices falling over 15% on the news. What it has also indicated is that the CMA, as we've seen in

the banking sector, want at least four substantial companies competing in key areas of the economy, suggesting that big is fine but only to a point.

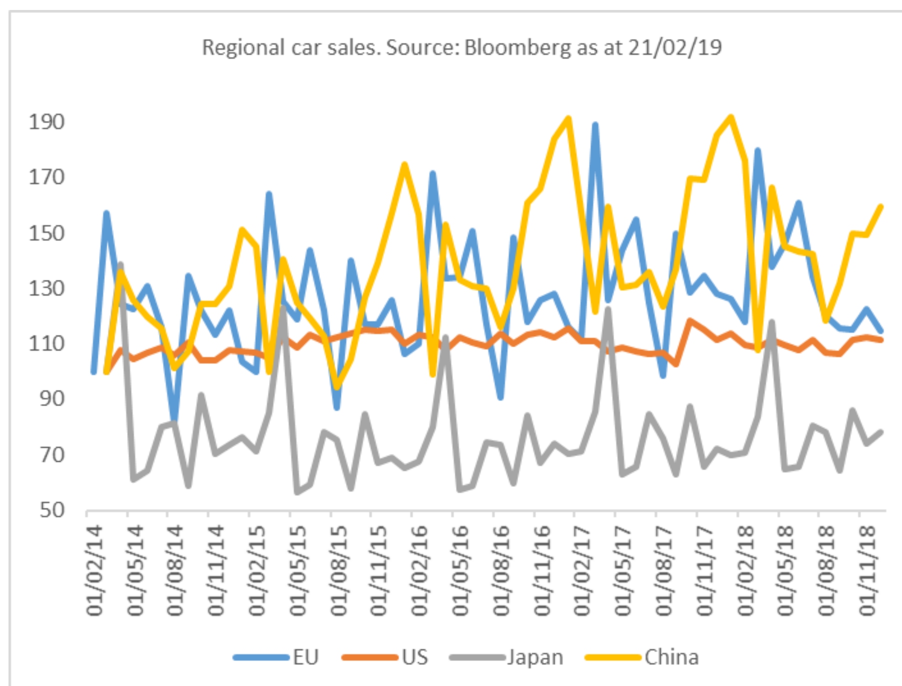
Another potential lesson from the three stories provides some hope for UK growth forecasts. As we saw in the US the tax breaks helped boost consumer spending. It is worth remembering that since April the UK consumer has also seen a tax cut boost to real wage growth. Growth in household take-home pay has been supported by the increase in the personal allowance to £12,500, its biggest jump since 2013, which is estimated to see year-on-year growth in household disposable income pick up to 2% in 2019 from 1.3% in 2018. As household spending accounts for 63% of UK growth this will provide some support to the economy, if confidence can be maintained, especially amongst middle income earners.

Brexit driving Honda and Nissan out of UK?

It's the economics stupid! It is a play on the words of Bill Clinton's successful 1992 Presidential campaign slogan, but the point is far more applicable to the Japanese car manufacturers' decision to reduce their UK based production capacity than "it's Brexit". While Brexit has to take the blame for much of the UK's economic slowdown at the moment, Honda's decision this week to follow Nissan back to Japan has indeed less to do with Brexit and everything to do with monumental shifts in consumer demand, as regular readers of The Cambridge Weekly will know.

Big global car brands appear to have been caught flat footed. The recent introduction of stricter emission tests (WLTP – Worldwide Harmonised Light-Vehicle Test), talks of new US tariffs, governmental plans to phase out diesel engine sales (UK target is 2040), and the expansion of Low Emission Zones in large cities like London and Beijing/Shanghai have left consumers bewildered and sales of conventional combustion-engine driven cars faltering.

The solution to the above mix of challenges is thought to be pure electric (Plug in EV's) or hybrid cars as an interim step. However, over the past decade, the big car brands altered their product mixes and promoted diesel cars, as this strategy was seen as the only one that had a chance of aligning average fleet consumption with western society's ambitious global warming CO_2 reduction targets. Development cycles in the car industry take many years, so the sudden switch from the diesel preference to EV is not achievable overnight.



It's against this backdrop that we have to view the news that Honda was set to close its Swindon plant, even if much of the media – given the time proximity - pinned it on Brexit uncertainties. The reality is that the Japanese car company is ceasing all European car production (its Turkish factory will also close).

Honda's market share across Europe's total car market was just 1% or around 6% of Honda's global sales, and to make matters worse European operating profitability fell 48% year-on-year as Honda – despite its low diesel dependency – struggled to meet European consumer preferences with its model and design mix. Swindon operated at just 65% capacity in 2018, with production destined primarily for the US market – which is why production was shifted to North America.

Europe was just simply too small for Honda. Contrast this to its healthier Asian business, where sales rose 10% even as other peers faced challenges, resulting in Honda now producing over 25% of its units there. Profit margins in Asia are 9% (five times their European margins). Additionally, Honda's motorbike sales in India are decent and the company is one of the strongest brands amongst vehicle manufacturers in China.

While this is a clear blow to UK Plc in terms of manufacturing, the simple truth is that Swindon at 150,000 units per year (Turkey 50,000/year) was not globally competitive for Honda, particularly when logistics, labour, procurement and other costs are factored in. The profitability of Honda's Turkish plant probably also struggled.

Honda's Swindon closure will impact 3,500 jobs directly and a further 3,500 indirectly through supplier relationships. Nissan's recent decision to build the new X-Trail SUV in Japan rather than Sunderland builds on the same business rationale. Given EV- powering Lithium Ion batteries are largely produced in Asia it means the company can streamline production and lower its costs.

Brexit probably brought the decision forward – given the current lack of clarity of the UK's future terms of trade – while Japan's new EU trade deal removes European tariffs of 10% on Japanese cars by 2027. The relative attraction of producing in the UK for the European market would fall away if the UK ended up without a comprehensive free trade agreement with the EU.

While last year's declines in global vehicle sales have already dealt a blow to all manufacturers worldwide, there are even darker clouds on the horizon in the form of even stricter CO_2 targets across the EU from 2021. By then, manufacturers' fleet average of CO_2 per kilometre has to fall by another 20% to just 95g or car companies will face very substantial fines of €95 per gram and for every car sold over the limit. With a majority of diesel-powered vehicles the target was thought achievable, but with petrol cars and the recently rising popularity of SUVs the target is very unlikely to be met. This leads to suggestions that firms like VW may face fines as high as £1.4bn per annum, which would be yet another significant blow to manufacturers' profitability.

Against this broader backdrop it is perhaps understandable why car companies have embarked on a vehement campaign against the diesel vilification. It is telling that in a car country like Germany – which probably also has the most eco receptive public in the EU – recent months have seen a continuous stream of widely published challenges by professional bodies to the current political consensus that diesel powered vehicles constitute a higher hazard to public health than petrol cars. They argue (a) that diesels now emit lower levels of NOx (Nitrogen Oxides) than petrol engines and (b) that the danger of NOx to human health has been vastly exaggerated – or at least that the scientific foundations of what has become accepted wisdom is based on what they regard as dubious empirical evidence.

It will be interesting to see where this debate ends up but given how much more than the UK countries like Germany depend on the health of their car industry, we would not be surprised if we saw a political U-turn on the subject of NOx emissions. It would not be the first time this had happened around diesel engines as many readers will remember from the diesel particulate pollution debate in the late 1990s.

As the French yellow vest movement has only recently proven, CO_2 and NOx emissions are more of a focus of liberal thinking urban elites, while car-based transportation and jobs in vehicle production are far more important to those parts of western society who also support the populist political movement. Politicians may therefore be very tempted to rethink and to weigh up their position with regard to reaching environmental targets versus the changing odds of their getting re-elected.

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Global Equity Markets

MARKET	FRI, 16:30	% 1 WEEK*	1 W	TECHNICAL
FTSE 100	7178.6	-0.8	-58.1	↗
FTSE 250	19269.6	1.5	282.4	↗
FTSE AS	3938.1	-0.4	-16.5	↗
FTSE Small	5442.2	0.1	5.2	↗
CAC	5215.9	1.2	62.7	↗
DAX	11457.7	1.4	157.9	↗
Dow	26043.1	2.4	603.7	↗
S&P 500	2791.8	1.7	46.1	↗
Nasdaq	7091.5	1.0	69.0	↗
Nikkei	21425.5	2.5	524.9	↗
MSCI World	2077.4	0.5	10.9	↗
MSCI EM	1051.0	2.0	20.4	↗

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM** PE	NTM*** PE	10Y AVG
FTSE 100	4.8	15.7x	12.6x	13.2x
FTSE 250	3.5	22.3x	13.5x	14.1x
FTSE AS	4.5	16.7x	12.6x	13.3x
FTSE Small	4	-	10.9x	13.9x
CAC	3.4	17.6x	13.3x	13.4x
DAX	3.1	12.9x	12.4x	12.6x
Dow	2.2	16.6x	15.8x	15.0x
S&P 500	2	18.5x	16.7x	15.8x
Nasdaq	1.1	21.8x	19.6x	17.8x
Nikkei	2.1	15.8x	15.5x	19.8x
MSCI World	2.5	17.1x	15.3x	15.2x
MSCI EM	2.8	12.1x	12.2x	12.1x

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
Micro Focus Intern.	11.0	J Sainsbury	-18.4
Antofagasta	8.3	Centrica	-10.9
Next	5.7	BAE Systems	-10.7
Anglo American	5.4	HSBC Holdings	-6.4
Severn Trent	4.4	DS Smith	-5.7

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.31	1.43	OIL	67.2	1.4
USD/EUR	1.14	0.50	GOLD	1333.0	0.8
JPY/USD	110.62	-0.14	SILVER	16.0	1.2
GBP/EUR	0.87	0.90	COPPER	294.5	6.1
CNY/USD	6.71	0.89	ALUMIN	1905.0	3.0

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.2	-0.2	0.00
US 10-Yr	2.6	-0.7	-0.02
French 10-Yr	0.5	-3.7	-0.02
German 10-Yr	0.1	-5.0	-0.01
Japanese 10-Yr	0.0	-76.2	-0.02

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.34
2-yr Fixed Rate	1.73
3-yr Fixed Rate	1.81
5-yr Fixed Rate	2.01
Standard Variable	4.40
10-yr Fixed Rate	2.64

* 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

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