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Hedgeye, 26 Nov 2019, 'Better than expected' – all markets currently appear to need

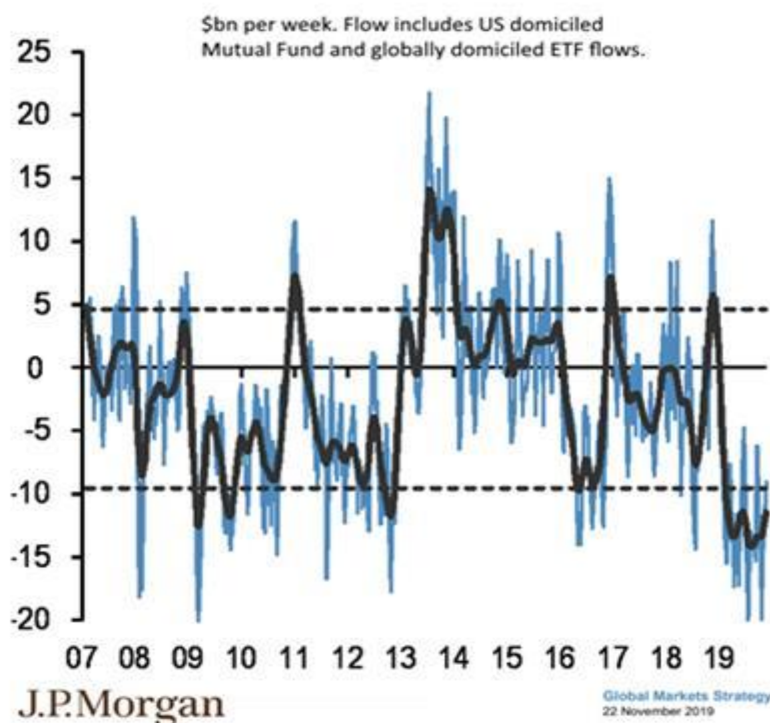
Markets are driving the markets – will the economy keep up?

It has been another quiet week in capital markets, which may be a surprise given the political shouting about the General Election. As we have written before, the recent rally in risk assets is at odds with the still slowing global economy, leaving many uneasy about potentially overvalued asset prices. For the moment, investors seem to be pondering where to go next. Bond markets have calmed down after a couple of weeks of volatility. Equities continue to edge higher and, in the US, have moved up to valuations not seen since the end of 2017 – when talk of 'irrational exuberance' was rife. This time around, markets are definitely getting ahead of the economy – investors are placing a lot of faith in global production and profits turning.

Some context. There is an adage that markets have just two emotions: fear and greed. These bouts of pessimism and optimism tend to come in waves that characterise broad market moves. The biggest swings in price happen when the overall mood is changing – as has been the case over the past eight weeks.

To be pessimistic is to "be prepared", to "batten down the hatches" and not be swayed by "false dawns". These phrases convey a good sense of how pessimism is not easily displaced. For these reasons, the initial stage of a market rally tends to be accompanied by words of warning and a sense of disbelief. This is understandable; after all, if the reasons for optimism were clear and obvious for all to see, the rally would be in full swing rather than just starting. But. Importantly, it can lead to missing out on key turning points.

The recent rally since mid-September is a good example. By a number of measures, pessimism about the economy was enormous at the end of last quarter. This was reflected in investment flows: retail equity ETFs (Exchange Traded Funds) saw huge outflows which extended all the way through October. This can be seen in the chart below, which shows how, this year, flows into bonds have vastly outstripped flows into equities (the bold black line is just a smoothed four week moving average of the blue line).



The data in this chart probably looks worse than it actually is, because it is not scaled by the enormous growth in ETFs. Still, it does show an indication of relative pessimism: investors were certainly feeling fearful.

And yet, all along, markets have only gone up despite there being no tangible improvement in the underlying economy. This should give heart to the bulls (those optimistic about risk assets), showing that equity markets can rally – significantly – without any change in economic fundamentals. Much of this is to do with the current set-up of the market. Investors are heavily weighted towards assets with very low returns. This is particularly true in Europe, where historically low bond yields have moved even lower. Even Italian bonds have now moved into negative yield, while Greek bonds have seen huge demand, compressing their yields to record lows. As we have written before, central banks are playing a huge role in this – successfully pushing up the money supply and leaving the financial system awash with cash.

But how sustainable is a rally with little or no economic basis? Well, the question might be a little ill-formed. For now, markets are jumping ahead of the economy. But moves in risk asset prices can *cause* changes in the economy – as a cursory glance at the global financial crisis could tell you. This link has always been well-known, but with the 'financialisation' of the last few decades, there is a growing belief that asset prices may well be the biggest factor for economic growth - a substantial part of this being

down to the wealth effect from savers. So, the narrative goes, equity price rises lead to economic growth, which leads to earnings growth, which leads back into equity price rises.

That circularity, combined with the recent change in sentiment, has led to a sharp short-term shift in price-to-equity valuation ratios, particularly in the US. It could well be that the turn in global growth - that markets appear to be expecting - is in its very early stages, and that the rapid market moves are forcing the pessimists to capitulate. And it could easily run further because the narrative has to change, with the pessimists becoming optimists.

But we should not get ahead of ourselves. The market is still definitely in a fragile state. As we wrote last week, from talking to others you get the sense that no one is truly convinced by the current rally – despite the fact that most are buying into it. Because of that underlying fear, the longer we have to wait for confirmation – from positive economic data – that the upswing is truly in train, the more fearful markets will get. Helping to bolster optimism have been various political hopes: that "phase 1" of a trade deal between the US and China is close, that China is about to do another significant round of stimulus, that the UK will get more clarity on Brexit, etc.

One certainly does not have to be a complete pessimist to think that not all of those things are a given.

Election manifestos: taking stock for investors

Britain heads to the polls in two weeks. Boris Johnson's Conservative party entered the election campaign with an average 11-point lead over Labour in opinion polls. Despite all the well-publicised drama since then (leaders' debates, endless Brexit, unaffordable spending plans, no shows and no apologies), that lead has remained pretty consistent, with some pollsters reporting a widening and others a narrowing. According to the betting markets, the odds of a Tory majority after the 12th of December are around 70%, a slight increase on a week ago.

That is a pretty solid chance and even if Johnson's party do not come out with a majority, the bookies odds of it emerging as the largest party in parliament assume it's almost a certainty. However, that the Conservatives will definitely form the next government is far from a sure thing. Remember the odds were similarly favourable for Theresa May with two weeks to go and we all know that just one week is a long time in politics.

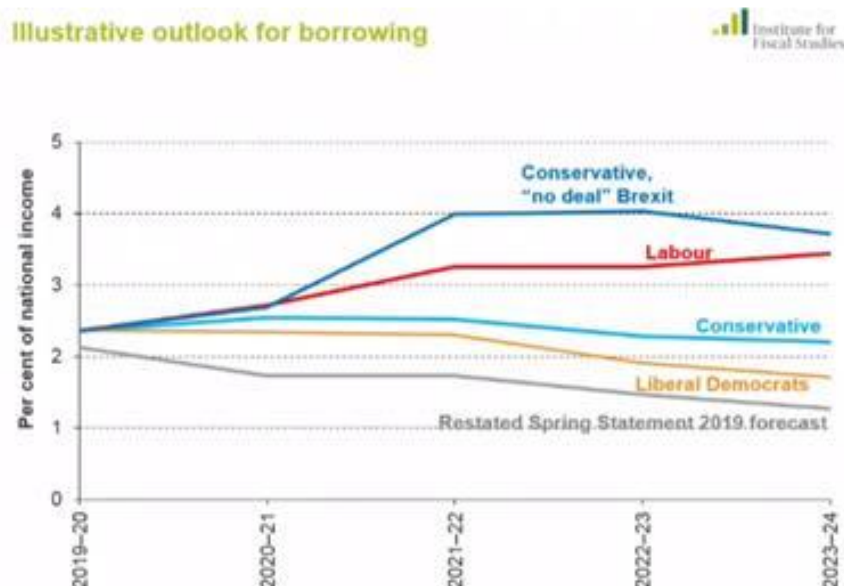
There are a number of permutations to consider and it's interesting to note the odds of a Tory minority government compared with a Labour minority government – or some kind of coalition involving Labour – favour the Labour Party. This is due to the fact that, while opposition parties are split across ideological and national lines, there is essentially now only one party on the right in town. Barring hugely unlikely number of Brexit party victories in Labour or Liberal Democrat seats, the Tories will struggle to find allies in parliament. With that in mind we take a look at Labour and the potential impact of a Labour led Government.

The assumption that a Labour Government would damage investment has worried many investors. . These worries would not have been helped by the recent report from the Institute for Fiscal Studies (IFS), and the interview from its director Paul Johnson where he gave his headline-grabbing verdict on

Labour's plans: not credible – with the IFS subsequently stating that neither of the major parties offered a "credible prospectus" for their spending plans.

Clearly the IFS have an important voice, but they're one of many. The IFS was criticised by some economists for focusing too heavily on microeconomic analysis of taxation, while ignoring important macroeconomic factors. Oxford economist Simon Wren-Lewis (left-wing but not a Corbynite), is one of 163 economists who wrote to the Financial Times backing the Labour party's spending plans.

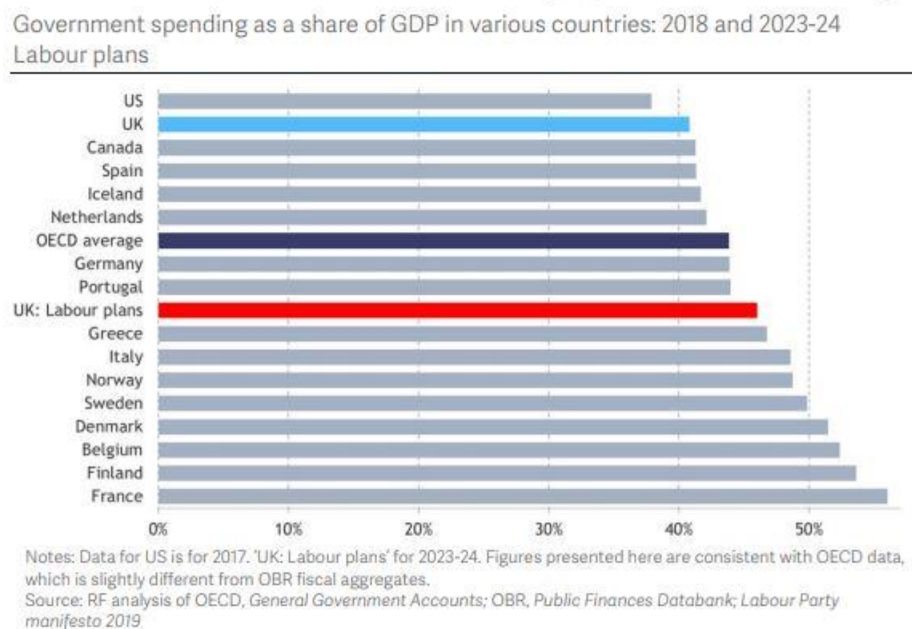
The key takeaway is that none of the parties' predicted outcomes from their spending plans are based on firm evidence. That is not so surprising, given that the country may or may not be about to see its biggest economic change in decades: leaving the EU. Brexit uncertainties make any government policy difficult to assess. As you can see from the IFS chart below, what happens on government borrowing depends massively on the outcome of Brexit.



In the medium term, a no-deal Brexit would increase borrowing more than any of Labour's spending proposals. This may not be so over the longer term (given Labour's pledge to maintain retirement age at 66) but this is difficult to say with confidence, given the potential effects of their investment pledges (for which estimates vary).

Looking coldly at the UK's pubic spending and not the politics it's clear that whatever the colours of the next government, public spending and the debt-to-GDP ratio are set to go up. Yes, there is a wide range of estimation by how much these will go up depending on the next government, but all those manifesto pledges cost money.

With a Labour Government the state's share of spending is going to be very high by historical standards, but, as Wren-Lewis and the other signatories pointed out in the FT, historical comparisons are misleading for one very important reason: the NHS. Health spending as a percentage of GDP has been increasing since the Second World War. While at various times this has been offset by other factors (falling military spending following the end of the Cold War) this means that we should expect – for better or worse – overall government spending to increase over time.



But are Labour's spending plans as terrible as many assume? As the chart above shows, even under Labour's plans, government spending would not be high by European standards. In fact, it would only be slightly above the OECD average. For a country with a healthcare service free at the point of use, that is not so alarming.

Of course, this may not assuage concerns about other Labour policies: financial transaction tax, worker ownership of company shares, etc. We believe these types of policies are the least likely to come into reality. Realistically, the Labour party's chances of getting a parliamentary majority now or anytime soon are extremely small. But it does mean that any Labour government would almost certainly have to rely on the support of smaller parties. And those parties are highly likely to water down some of Labour's more radical ideas.

The Liberal Democrats, for example, would probably be on board with some of Labour's spending plans if push came to shove, especially in relation to the investment spending, but would probably baulk at the kinds of market intervention policies being proposed, and would be unlikely to back nationalisations without proper planning. Those tend to be the things that worry investors the most, but it is because they are so unlikely that we would advise against making investment decisions on the basis of any change in opinion polls.

From our perspective, the biggest issue for the UK remains what happens on the Brexit front. Given a Tory majority looks the most likely result, this will probably mean a passing of Boris Johnson's deal. That is, if he can get the Brexiteer backbenchers on board. Then, as the IFS ably showed in the first chart, the negotiations over "Deal or No Deal" will determine the most important path for the UK economy.

Market optimism lacks validation from US and Chinese profits

Hopes of a resolution to the US-China trade war took a blow this week. As we have written before, the ongoing troubles in Hong Kong presented a difficult issue for negotiators – with US politicians picking at Beijing's sore spot by backing Hong Kong protestors. The US President signed the bill on Wednesday which threatens sanctions on Chinese and Hong Kong officials deemed responsible for human rights violations.

To give a sense of how widespread the support is for Hong Kong in Washington, just one lawmaker in the House of Representatives voted against the bill, and it passed through the Senate with unanimous support. President Trump – who had previously made a vow of silence on the matter – finally, signed the law with neither words of protest nor approval.

Chinese officials characteristically described the bill as "full of prejudice and arrogance". It will certainly add another element to discussions on tariffs. However, as we have written before, there is still a great economic incentive for both sides to come to the negotiating table. Amid a global economic slowdown, the negative effects of the trade war are now plain to see.

The latest economy-wide data on company profits are weakening for the both the US and China, but China looks weaker of the two. In the US estimates from the National Income and Product accounts were stronger than expected. Pre-tax corporate profits managed a small increase of 0.2% quarter on quarter (though fell 0.8% year on year). After-tax profits were slightly better, climbing 1.3% last quarter (but only up 0.4% year on year).

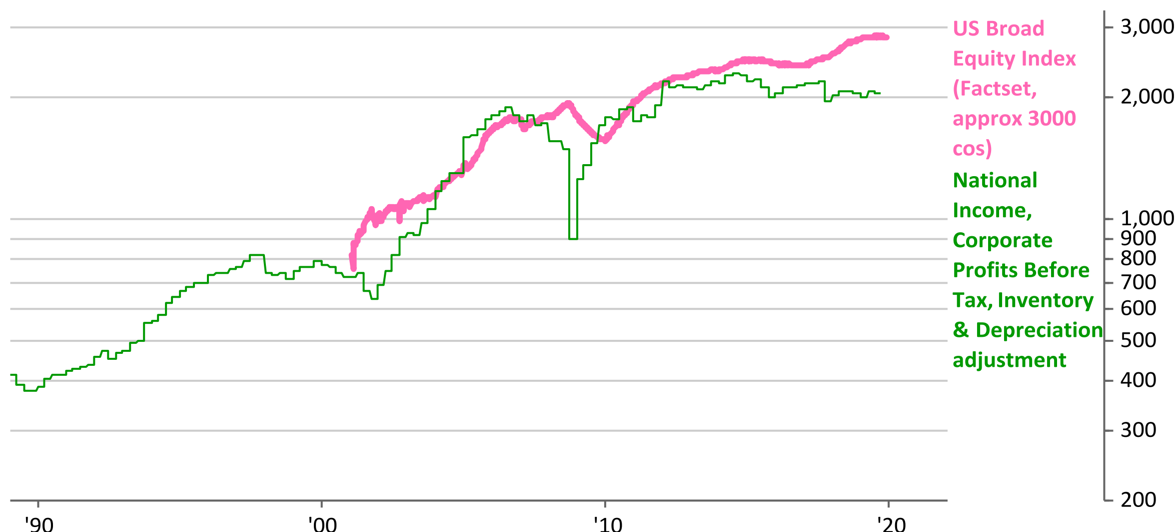
The profit numbers generally quoted by commentators aggregate analyst estimates of all profits from companies in indexes such as the S&P 500. The national accounts are profits from just US activity.

These national profit measures beat expectations, but still look weak compared to figures from the second quarter of this year, when both measures rose 4%. The outlook for next year looks better (and the stock market is pricing in much better) but it will not be plain sailing. We still expect that rising unit labour costs will impact corporate profit margins next year.

It is noteworthy that stock market index profit growth has been stronger than for the domestic US economy. The chart below shows how anaemic these profit measures have been across the whole US economy for some time – barely moving since 2012 – and this time around pre-tax profits contracted.

US Corporate Profit Measures

Factset US Index & Domestic US Profits (before interest and tax, $bn)



Source: Factset, TattonIM, US BEA

Still, the fact that things were not quite as bad as expected is a positive for the US. It is more difficult to put a positive spin on China's profit data. This week's release of the monthly industrial profits data showed an even sharper contraction than was expected – making for a 9.9% decline year-on-year, with the year-to-date growth rate running at -2.9%. According to JP Morgan, weak pricing power and softer global demand – as well as the ongoing trade uncertainties – are all weighing on Chinese profit growth.

This pressure on Chinese firms is reflected in the performance of the stock market. Equities are not falling, but Chinese markets are lagging behind their global counterparts – especially the US. We know there is upward pressure on stocks coming from a liquidity surge from central banks – making them more attractive than holding cash. So, the fact that Chinese equities are staying still in this environment is a sign of weakness.

Most of this weakness is concentrated in the large State-Owned Enterprises (SOEs), with private companies faring slightly better. SOEs worsened more than their private sector counterparts.

Manufacturing Fixed Asset Investment has also been sluggish this year, but on that front, there was some improvement. It had a modest boost in October (3.4% year on year compared to 1.9% in September). If Producer Price Inflation (PPI) turns positive next year, and sentiment and inventories improve, there could be further improvement. PPI is a reasonable indicator of company pricing power and is watched closely by Beijing. China commentators suggest that it has been weak enough to spur another round of stimulus. Indeed, local government bond quotas were increased this week, which supports the idea that a recovery in industrial profits in China could be in store over the next couple of quarters.

The problems in China's private sector are obvious. But when looking a little deeper into the US private sector the anaemic profitability for domestic companies may also give reason for concern. Profitability is concentrated in large-cap companies. This hoarding of profitability by big companies is not a good sign for the overall economy, as strong growth needs mid-cap profits to rise too. Until business sentiment in those mid-caps recovers, large caps are themselves on potentially shaky ground.

The US economy has fared better over the year compared to the struggles in China. But this latest round of data – while not particularly good news for China – suggests that they may be in for a recovery. Whereas in the US, the future is somewhat less clear.

As for trade, what this means is that the incentive for a deal is still there – for now. Developments around Hong Kong make negotiations difficult, but US officials can take heart from the fact that, despite all the events of the week, Beijing has still held the value of its currency stable, suggesting that they are still open to discussions. How long it will remain that way – especially if the Chinese economy starts to rebound – remains to be seen.

Global Equity Markets

Market	FRI 14:37	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7384.5	0.8	57.7	→	→
FTSE 250	20944	2.2	458.0	↗	↗
FTSE AS	4088.1	1.0	42.3	⬀	⬀
FTSE Small	5632.2	1.4	77.2	↗	→
CAC	5920.0	0.5	26.9	↗	↗
DAX	13266.7	0.8	102.8	↗	↗
Dow	28081	1.1	315.1	↗	⬀
S&P 500	3153.6	1.6	50.1	↗	↗
Nasdaq	8422.7	1.9	157.1	↗	↗
Nikkei	23293.9	0.8	181.0	↗	↗
MSCI World	2301.8	1.2	27.9	↗	↗
MSCI EM	1050.4	0.2	1.8	⬀	→

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Ocado	18.9	Compass	-6.6
Hiscox	8.2	BP	-3.2
Kingfisher	7.2	Royal Dutch Shell	-2.6
InterCont'l Hotels	6.2	Royal Dutch Shell	-2.3
Prudential	6.1	Rolls-Royce	-2.2

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.289	0.4	Oil	62.97	-0.7
GBP/EUR	0.853	0.7	Gold	1455.9	-0.4
USD/EUR	1.10	-0.2	Silver	16.90	-0.7
JPY/USD	109.60	-0.9	Copper	264.2	0.7
CNY/USD	7.030	0.1	Aluminium	1752.0	1.0

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.7	-0.0
UK 15-Yr	0.9	-0.0
US 10-Yr	1.8	0.0
French 10-Yr	-0.0	-0.0
German 10-Yr	-0.4	0.0
Japanese 10-Yr	-0.1	0.0

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.9	17.8	13.6	13.2
FTSE 250	3.8	25.6	15.2	14.2
FTSE AS	4.6	19.0	13.7	13.4
FTSE Small	3.5	223.8	-	13.9
CAC	3.1	21.2	16.1	13.4
DAX	3.0	24.6	15.7	12.5
Dow	2.2	19.3	19.0	15.0
S&P 500	1.8	21.0	19.2	16.0
Nasdaq	1.0	26.3	23.2	18.0
Nikkei	1.9	18.5	17.8	17.5
MSCI World	2.4	20.1	17.8	15.2
MSCI EM	2.8	15.2	13.9	11.9

UK Mortgage Rates

Mortgage Rates	Oct	Sep
Base Rate Tracker	2.62	2.59
2-yr Fixed Rate	1.55	1.56
3-yr Fixed Rate	1.63	1.65
5-yr Fixed Rate	1.74	1.77
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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