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ECONOTE No. 78: Global economies and markets: What, Why, How and Where is going on? 29/11/2018

Summary

The recent repeated collapses of the global stock markets have spooked investors, as it is very likely that, on a USD YTD basis, most stock investments will end up in 2018 in the red, edged on by losses in bonds. Bar the US, the rest of the major and minor Asian economies are flat or slowing down, with China still keeping the 6.0% growth path but with the decimals declining. There are plenty of explanations of why and how all this is happening. Fortunately all the explanations are sensible and likely to be true, but here certainty is not comforting. The best explanation of the current uncertainty is a mixture of cyclical and policy induced changes plus the vague and gnawing sensation that the attack on some aspects of globalization will lead to further instability and a real recession. The US-China trade spat, the mess of Brexit and the hikes by the Fed have not helped either.

Investment Conclusions

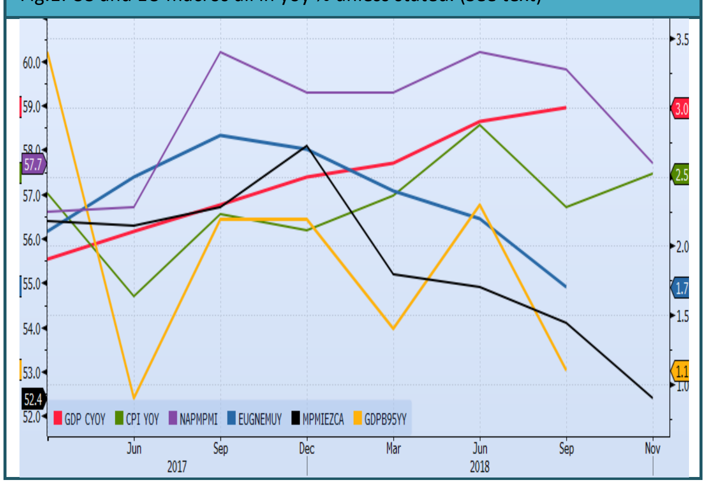
The growing uncertainty over further hikes in Fed rates may not necessary help but could still keep the US stock markets under pressure and, thus, also lead the rest of the stock markets to negative or flat territory. Smaller Asians have "done better" in terms of not losing much money. Bonds are not safe either with rising USD rates and a widening fiscal deficit, which leaves investment recommendations looking for "special" cases or assets Ecognosis has been a keen opponent of Brexit, arguing that it will not happen. The UK not leaving the EU will be bullish for the GBP and EUR, and for EU shares, by proving that the EU as an institution is resilient, can take knocks and still keep together as members appreciate more the benefits rather than the costs.

US and EU: Different stories

The **US economy** is growing now fast, registering at 3.0% GDP growth tthroug the third quarter of this year.Factors which have helped were the loose fiscal policy of the Trump adminsitration which resulted to the fiscal deficit for 2018 FY rising by 17.0% over 2017 FY to USD 779 bl, the largest deficit since 2012 when the economy was just recovering from the 2008-9 crisis.The widening deficit was caused primariy by the USD 1.5 tr tax cut spread over ten years and a steep rise in selected expenditures especially on defence.The current military expenditures at USD 874.4 bl account for about 20.0 % of all spending, and are larger than the next 10 largest government expenditures combined.Claims that tax cuts ultimately raise federal revenue through higher GDP growth are not supported by evidence and the US budget is en route to hit a USD 1.0 tr deficit by 2020.The problem, however, with a widening deficit is that it pushes UST yields up at the time that the Fed is hiking, a combination that does worry the markets.In Fig.1 US GDP growth (red) is on a uptrend while inflation (green) is now over the Fed's target of 2.5% which encourages further hikes.The ISM comp index (violet) is still over 50.0 but of uncertain trend ,one more cause for concern.The fate of FAANGs is here significant.Since the October sellouts they have lost a combined USD 575 bl with Facebook losing over 21.0% of its market capitalisation and Apple losing its USD 1.0 tr valuation.It is indicative that the markets made no distinction between companies which make things (Apple) or just sell services only (Alphabet) as concerns over future profitabiity and managemen efficiency tooks their toll.Turning now to the **EU economy,** Fig.1 shows the the slowdown of EU's GDP growth (blue) reflected even more strongly in the growth of the mainstay of EU (yellow), Germany.Expectations **(black,** PMI) have been declining which is hardly surprising given the following issues:

Italy's controversial budget, well over the EU fiscal deficit limits, has led to a political conflict not made easier by the impending exit of the UK. Both issues have affected EU bond yields.The changeover in Germany's political leadership was an added uncertainty.The threat of import duties on cars by the US has been averted for now, but issues remain.Last but not least the ECB has persisted with its plan to end QE in 2019.The ECB has reduced the amount of liquidity injected but has kept the official rates close to zero for now.

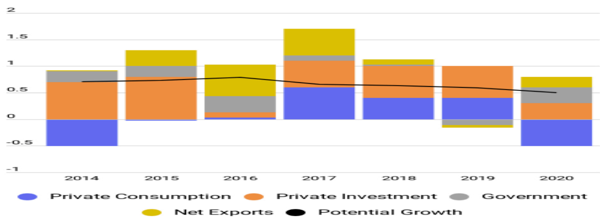
Fig.1: US and EU macros all in yoy % unless stated. (See text)



Source: Bloomberg

Japan and China: Different stories different preoccupations

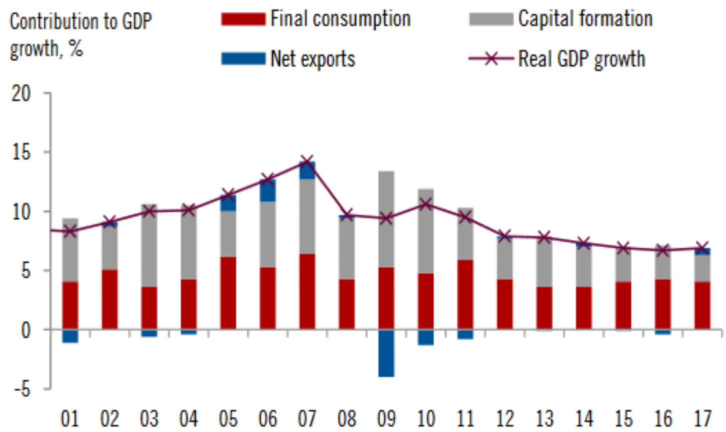
As the chart (IMF) shows **Japan's** GDP growth has been dependent on investment and consumption with net exports making avariable contribution.The BoJ's zero interest rate policy and injections of liquidity has helped spending but failed to push inflation to a 2.0% level. Keeping the JPY weak had a modest effect on growth via exports or on inflation by more expensive imports.A loose fiscal policy with a national debt at 220% of GDP will, inevitably, lead to fiscal tigthtening, possibly in 2019 with a consumption tax.The structural problems of the Japanese economy remain unsolved with an ageing population and shrinking labour force.



Fact Box: G3 Stock indices metrics 2017-2018

China's GDP growth rate has decelerated to 6.35 % in 3Q.18 with investment making progressively a smaller contribution while consumption's contribution rose. (Fig. 2) As for China's "export driven economy" since 2013 the contribution of net exports has been negligible to negative. This a falsehood of China's growth dependence on exports is very difficult to eradicate and stops from putting in perspective that any reduction in exports to the US because of Trump's tariffs will have a modest impact on China's growth, as indeed it would make on Japan's growth, when Japan's turn comes to face US tariffs. China's slowdown reflects the impact of the official push to debt deleveraging and the after effects of the tighter monetary policy started in 2015 but progressively loosened in 2018. Poor handling of stock market reforms as well as the mentioned factors led to China's stock market's performance being one of the worse in the world. The US-China tariff war does, and will continue to have an impact on Chinese sectors affected most, such as electronics, and this will impact sentiment across the economy thus impacting housing and, possibly, consumer spending at some point.

Fig.2: Contributions to China's GDP growth, 2001-2017



Source: Pictet, China's National Bureau of Statistics

The stock markets: A long good bye but Hello to EU

The Fact Box shows the basis metrics of S&P 500 (red) .Nikei(yellow) and and Eurostoxx 50 (blue).All indices are on decling trends and all are below their 50D moving average (greens).That on its own would not signal a time to buy, as the RSI for all three indices is not anywhere near oversold.For the US there is still the lingering issue of higher Fed rates, and for the EU there is the signalling of the ECB starting the process to hike rates.For Japan there cannot be a message of hiking as the BoJ is still on a QE mode with zero official rates, albeit its QE is at lower pace.There is not a lot ot be said about bonds in this interest rates enviroment. Smaller Asian markets, such as Thailand,Malaysia and Indonesia, have performed better to the extent of registering smaller YTD USD terms index losses and ,hence, may do better in the recovery phase.China's stock market may need the resolution one way or another ,of the tariff war to start on a recovery, but not in the next few months.

As for alternative assets, the Ecognosis, a long-standing detractor of what we had called "financial aberations", is delighted to witness the death throes of cryptos.It might not be appropriate to gloat over other people's losses, but buying cryptos was such an irrational act driven by pure blind greed, that investors who indulged have only themselves to blame.We look forward to the Bitcoin price going to zero USD, the only rational price for an assest created by a software and backed by absolutely nothing bar the expectations that other people would buy it.

We stay,however, with our bullish call on the GBP, EUR and EU stocks based on our expecation that the UK will not leave the EU.There are 101 ways that this could happen. All we claim is that there will be no "No deal" Brexit, the present planned Brexit will not be approved and the British people will return back to political and economic sanity and will stay in the EU.We are aware of the risk of making this kind of hard call but we feel that only this will be right thing to do in the case of UK, but also this is what is going to happen.

Andrew Freris (writing compleed 29/11/2018)