Art of the Deal?

Owing to my travel schedule, as I embark on a month of presentations around the country, I started writing this week's missive on Friday, which was always going to be a bit of a risk, what with both the Brexit negotiations and the US/China trade talks hurtling towards important calendar deadlines. Our government needs to present something concrete and acceptable to the EU by Friday, and the next round of tariff increases on Chinese goods arriving into the US was due to kick in tomorrow (and has been postponed). Uncertainty about the lack of any sort of final deal on both fronts weighs heavily on corporate confidence and, by extension, financial markets.

On the Brexit front, rather than re-hash all the details of the negotiations (which might yet founder by the time this reaches your inbox), it feels appropriate to post a reminder of what the implications are for UK-based investors. Whatever one's side in the debate, one has to accept, in the short-term at least, that the market is firmly entrenched in its opinion that a "No Deal" outcome is the equivalent of economic Armageddon. We are not here to debate the merits of that view. The most impactful mover would be the pound, which is expected to fall up to another 10% in value against other currencies. Somewhat counterintuitively, the stock market might rise owing to the high exposure to overseas profits which would be translated into sterling at a more favourable rate, although there would be a sharp divergence between these overseas earners and their domestically-exposed peers. Gilt yields might also fall in response to the potential for interest rate cuts from the Bank of England and a rush for safe haven assets. The playbook is very much as happened in 2016, with overall portfolio valuations probably rising. However, the purchasing power of those assets would diminish owing to higher domestic inflation (driven by higher import costs) and weaker international buying power. So something of a pyrrhic victory perhaps, although one worth taking in the eyes of many in pursuit of the objective.

What we saw last week was a sharp rise in the pound and also Gilt yields (thus leading to falling bond prices) as word leaked out of constructive talks between Boris Johnson and Leo Varadkar, the Irish PM. Against this background, UK share indices lagged behind other markets, with the currency rise creating a headwind, no need to cut interest rates and less demand for safe havens. The stand-out winners were domestically-focused banks and housebuilders, some of whose shares rose more than 10% in just one trading session. The FTSE 250 Mid-Cap index advanced 4.2% on Friday, its best day since 2010. Good news in the eyes of the market, then, but not so sweet for the relative value of sterling-based portfolios – although handy for any Christmas shopping trips to the Continent!

The latest trade negotiations between the US and China are also coming to a head, although no final settlement is likely. Furthermore, it pays to remind ourselves that a tariff war is just one symptom of a much deeper malaise that will, in all probability, keep the two countries at loggerheads with each other for years to come. The US does not like its global "top dog" status being threatened, and will do everything it can to maintain its position.

Although we continue to view the Trump presidency as destabilising, we are more encouraged by the view that he has another big date on his mind – the next presidential election on November 3rd 2020. A full-scale trade war with China would almost certainly lead to negative consequences for both the economy – especially in Trump-supporting states - and the stock market, which would, in turn, reduce the probability of his being re-elected. Thus he has a motive to reach some sort of agreement with China. For China's part, there is the risk that its negotiators could dig their heels in and scupper a deal, with some suggesting that they could effectively unseat Trump by doing so. But they might then find themselves up against Elizabeth Warren (who appears to have the strongest momentum in the Democrat race currently), who could be even worse. First she is much less pro-business, and second, the Democrats are trying to outdo Trump in their anti-China stance. In fact, standing up to China is about the only policy that both sides can agree on. Also, China itself can ill afford a domestic recession owing to a precariously balanced pile of its own domestic debt and what a collapse of that might do for the standing of the Communist Party. In the end, pragmatic self-preservation will most probably be the order of the day.

In many ways it looks as though both Trump and Johnson have utilised a classic negotiating tactic by anchoring everyone's expectations to the worst possible outcomes. Suddenly results that would have seemed inconceivably negative relatively recently are greeted with relief. The key point is to remove some of the uncertainty that has been hanging over economies and markets. Investors like to deal in weighing the probabilities of certain outcomes. Company bosses like to know the legal and regulatory environment in which they will be working, as well as how competitive their currency base might be. The sharp slowdown in investment and capital expenditure is testament to the lack of certainty. So far this has not fed its way through to consumer confidence, thanks to a falling unemployment rate and reasonably decent real wage growth, but there is growing concern that this leg of the stool will start to wobble. That would leave only government spending keeping us upright, and even though there is a growing consensus that fiscal stimulus is "the next big thing", there is also a feeling that it won't be fully unleashed until the hands of finance ministers are forced by a sharper slowdown (this is certainly the case for Germany, for example).

John Wyn-Evans
Head of Investment Strategy

FTSE 100 Weekly Winners

Lloyds Banking Group	13.6%
Barclays	12.3%
Royal Bank of Scotland Group	11.9%
BT Group	11.7%
GVC Holdings	10.8%
TUI Group	9.7%
International Consolidated Airlines	9.7%

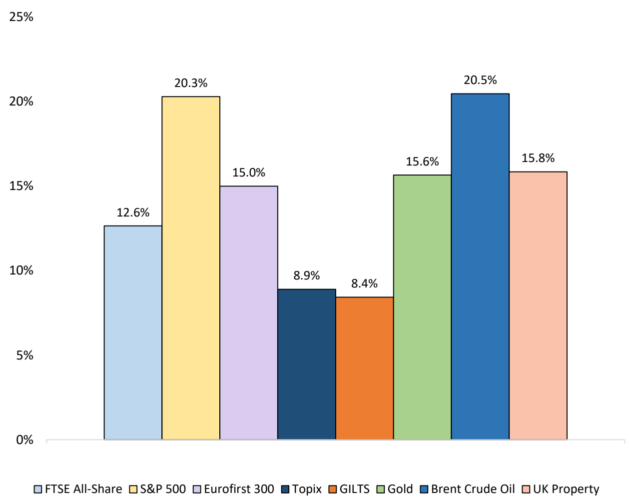
Source:FactSet

FTSE 100 Weekly Losers

Flutter Entertainment	-5.5%
Fresnilo	-4.7%
WPP	-4.4%
Pearson	-4.1%
British American Tobacco	-3.3%
Unilever	-3.2%
Diageo	-2.4%

Source: FactSet

Year to Date Market Performance



Source: FactSet

FTSE 100 Index, Past 12 Months

Source: FactSet