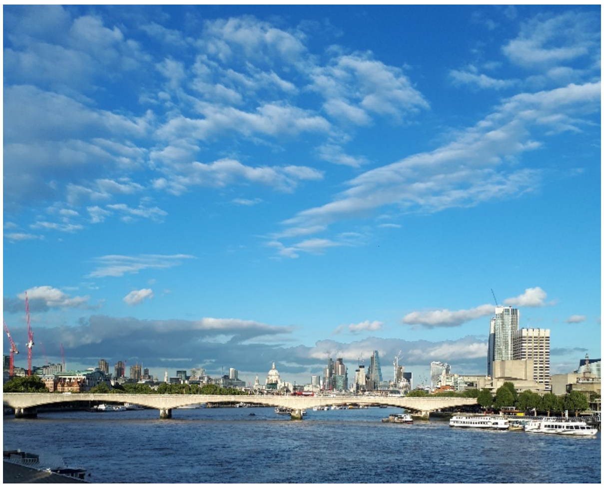
FACETOLOGY

August 2018

Summer in the City



As the heatwave hits, it's been a quiet time on the stock markets. But while there is plenty to worry about, the underlying indicators are still pretty good.

There are few things the markets hate more than uncertainty, and this year has been more volatile than most. High profile bankruptcies, European jitters and the prospect of a global trade war have had many predicting disaster. So why do the markets look comparatively benign?

Tricky times

The year started with the markets feeling nervous about the prospects of inflation leading to a bond crash. Now, all the talk is of President Trump, international conflict and trade wars. Indeed, the benchmark US Treasury 10-year yield, at 2.8%, is where it was in February.

President Trump has been ramping up tensions with the EU, Canada and the next biggest economy in the world, China. In May he slapped tariffs on Canadian steel exports, and they responded with retaliatory tariffs on US products. He threatened to impose tariffs on European car imports, prompting them to reply in kind.

His biggest conflict, though, may be with China. He's threatened to impose 25% tariffs on $200bn worth of Chinese goods as he attempts to pressurise China into changing some of its practices.

Brexit continues to cause a headache. Theresa May faces the seemingly impossible task of finding a deal which will please the US, UK businesses and the various factions within her party. The prospects of a no deal Brexit have been rated 'uncomfortably high' by the Bank of England and Liam Fox has suggested it is now the most likely outcome.

2018 has also been a busy year in the world of regulation. MiFiDII, PRIIPS and other new pieces of legislation have all forced businesses to re-examine their business models. GDPR, meanwhile, has enormous implications for any business which shares data across multiple jurisdictions. Fines for serious breaches could be eye-wateringly high involving sanctions of €20million or 4% of turnover.

In addition, this year has been a big one for high profile corporate collapses, particularly in the retail sector. House of Fraser is currently in administration. Claire's, the US parent of Claire's Accessories, filed for Chapter 11 protection from its creditors in March, while Maplin and Toys R Us both went into administration in February.

Tesla's struggles, which have seen it post a record net $710million loss, and seen Tweets by Elon Musk investigated by the SEC. This is putting the company under severe operational pressure and casting a shadow over the tech sector as a whole.

Calm waters

Given all this chaos you the markets could be forgiven for doing what they do so often – panicking. But there's no real sign of that. Right now, the US stock market index is touching the record high it reached back in January.

Over here, Sterling may have fallen around 10% from the peak against the US dollar but this has boosted the exporter-heavy UK large cap stock market. The mining sector has been a notable performer even as the US and

China get ready for trade talks. Therein lies a clue. Experts may be worried about the prospects of an all-out trade war, but they still believe it will all work out in the end.

That's our assessment also. For all the rhetoric floating around, we believe that all parties are more or less rational and will act to safeguard their long-term economic interests. President Trump may cause spasms of anxiety with every late-night Tweet, but the infrastructure of the government remains robust.

While the consequences of a trade war, for everyone, should not be downplayed, President Trump's mooted tariff rises are as much about politics as international relations. The midterm election are in early November and things are looking worse for the Republicans in light of today's news that ex-Trump campaign chief, Paul Manafort, has been found guilty on charges of bank fraud, tax fraud and failure to disclose foreign bank accounts.

This may not distract President Trump from continuing to talk tough against international partners. It plays well with his supporters and targets some genuinely unfair practices.

China may not like it, and they may reply with fresh threats of their own – and yes, China has enough clout to do some damage if it chooses – but they are also realistic about their own economic fortunes. Given the size of their trade surplus with the US, a trade war will be a serious threat to their own economic objectives. Both sides are aware of this and makes some compromise all the more likely, in our view.

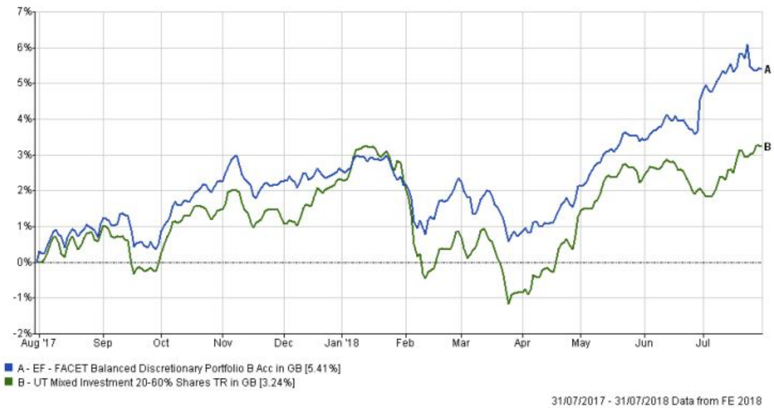
Already we've seen positive signs. The July meeting between Juncker and Trump put hostilities on hold with both sides agreeing to work towards zero tariffs. The US held back from its threat to impose 25% tariffs on car imports, while the EU agreed to buy billions of dollars more of US soybeans and liquefied natural gas.

Can the good times last?

The global economy has been expanding for the last ten years and it's only natural for investors to ask themselves how long the cycle can last, However, while there are evident risks to the economy the outlook is more like a mid-cycle slowdown rather than anything more sinister.

Global and regional economic 'surprise indices' are falling, but these only indicate whether the economy is accelerating or decelerating – not its underlying growth. For the most part economic indicators look good.

Chart 1 Courtesy of FE Analytics



The Eurozone is growing faster than expected, despite all the trade jitters. Growth was revised up from 0.3 to 0.4% between April and June. Monetary policy may be tightening but it is still accommodating and fiscal policy is expansionary, especially in the US. As the recent surge in M&A activity demonstrates, businesses still feel confident about the future.

Stock market valuations may compress and sentiment may remain shaky, but as long as the underlying US economy remains strong, global equity markets will ultimately follow the longer term outlook of earnings growth. Those who are patient will see the benefits in the long term.

Our EF FACET Cautious and Balanced funds are now close to fully-invested and have made positive gains this year better than their benchmarks (See chart 1). Our overall strategy of managing investments for the long term is always our primary objective, we stand ready to make strategic changes if market volatility provides opportunity that more than justifies the risk.