December 2nd, 2019

Drifting to the Left

- **November sees muted returns from most asset classes**
- **Watch for more left-wing drift of global politics – Germany the latest example**
- **The US 'gives thanks' with good levels of retail spending**
- **Japanese consumers don't spend but the government will – positive for equities**
- **Asian economy shows improvement and international investors fund China**
- **Climate change a focus of central bankers**

Financial markets are drifting-into the year end. Investors look like they will have to wait until the new year before we see the next phase of government and central bank stimuli to boost growth. Over the past two months global economic activity has been on the softer side of consensus forecasts but not sufficiently so to unnerve investors.

November has closed out with some modest gains for equity markets and close to zero returns on government bonds and higher-quality credit. By sector technology (+3.9%) and healthcare (+4.3%) stocks have led the way in global equity markets. The US (+2.4%) and India (+1.6%) led gains in the developed (+1.8%) and emerging markets (-0.9%), respectively.

European politics shows signs of moving to the left

One of our themes for the next decade is that of a likely swing in political thought to the left. Income and wealth inequality are likely to make left-wing policies more attractive to the voting populations the longer that incumbent governments don't address the issues.

Hence evidence of a shift to the left by one of Germany's major political parties is noteworthy. The SPD's new leadership of the Walter-Borjans and Esken are said to favour taxing the rich, boosting welfare spending and abandoning Germany's balanced budget. There are fears that they will leave the CDU-SPD coalition that currently leads the government.

Left wing politics is also very evident in the UK. Many in the UK would like to wish away the chances of Jeremy Corbyn led Labour party ever getting into government however opinion polls have swung to some degree in his favour in the past week. The Labour party advocates wholesale tax increases on the rich and those with non-domicile status. A Labour government would raise corporate taxes. Even with the taxes raised, the government would need to borrow heavily from the markets given aggregate sending plans of £833 billion that equate to around 30% of GDP! **If it were ever to come to pass that the Labour party were able to enact any of these policies, UK gilts and equities could suffer significant losses.**

It's easier to look at political developments in Germany with a more favourable eye. The new SPD leadership are only pressing for changes that might be more broadly welcomed across Europe. For some time, many economists have argued that Germany should help support both domestic and pan-European growth through some fiscal expansion. Germany's economy has approached recession-like conditions in recent quarters. The spending focus of the SPD measures is to combat climate change and education.

At this stage, political developments in Germany look more palatable to the markets than a Labour-led government in the UK. We doubt that the SPD will abruptly leave the CDU-SPD coalition. In any case, the SPD's position on spending at least opens a broader discussion about an increased level of support for the German and eurozone economies from German government spending.

US on-line retail spending appeared alive and well through the first part of the holiday weekend, although slightly below expectations. According to Adobe Analytics, consumers spent $7.4 billion online, up $1.2 billion on Black Friday 2018. Thanksgiving transactions broke records with $4.2 billion in online sales. Adobe tracks sales in real-time for 80 of the top 100 US retailers.

Japanese equities hoping for policy support

Judging by the weakness of economic data, you might be worried about Japanese equities. However, there is every sign the policymakers will come to the rescue. October's retail sales were down 14.1% as the imposition of a higher sales tax and the typhoon weighed on spending. The fall in retail sales was the worst in 10 years. Industrial production was also down 4.2% at annualised rate month-on-month. The weak data leads to greater confidence that the government will react with a larger than expected fiscal easing in the new calendar year. The government will also be encouraged that despite the plunge in retail sales, consumer confidence is relatively upbeat. In November consumer sentiment rose 2.5 pts to an index level of 38.7 continuing the rise off the low of 35.6 in September.

We remain sympathetic to the view that Japanese equities could see some outperformance in 2020. The past twelve months have been poor with a capital return of 4.6% for the Nikkei. In 2020, we expect significant fiscal loosening and a further round of support from the Bank of Japan. The economy will also benefit from the spending and publicity from the Olympics and Paralympics. Quite frankly, there is not much more you can throw at an economy to support GDP growth and the performance of the equity market.

Asian economic activity improves

Elsewhere in Asia, current trends in economic activity appear to be improving. In the past week industrial production reports from Korea, Taiwan, Thailand Singapore were ahead of expectations. Supply lines appear to have adjusted to the disruption from trade wars. Companies ran down in inventories due to worries about future orders – this now seems to have passed. The Taiwanese government revised up their forecast for third quarter growth to 2.99%. Indeed, the technology sector appears to be playing a significant role in the rebound in activity. The global information technology sector has risen 11.4% in the past three months, a marked outperformance over global equities up 7.9%. Elsewhere in Asia policymakers showed an intention to support their respective economies. In Thailand the government announced spending of 100 billion Thai baht ($3.3 billion) to spur growth, while in the Philippines the head of the central bank indicated that a rate cut was possible before the year-end.

China issues USD debt to follow successful EUR notes

Last week saw the issuance of $6 billion of Chinese government bonds in the global market, across the yield curve in 3, 5, 10 and 20-year maturity. The issuance came at 40 basis points above US government bonds of the same maturity. From the point of view of pricing as well as investor demand, this issue was a success. It follows an equally successful EUR-denominated placement of EUR 4 billion earlier in November.

The good pricing level for both rounds of bond issuance can be attributed to the strength of the government's financial position – this debt is directly government-backed – as well as strong demand from global investors who are hunting for yield but becoming gradually more discerning about quality. In this context, it is worth noting that the Chinese government's efforts to revive a flagging economy is not having as much success as earlier in the cycle. There are clearly some corporate sectors in China that are beginning to show some strain. In the bond market, this has led to creeping higher of credit spreads. By establishing a blue-chip pricing point for government bonds, the Chinese government is helping the market. However, beware of the weaker areas of Chinese credit. The additional transparency from an international benchmark for Chinese government debt will be insufficient defence against a further deterioration of corporate balance sheets.

Indian asset markets robust in the face of economic weakness

Foreign buying of Indian equities has provided a key support for the relatively good performance of Indian equities in November at a time of marked weakness in the economy. The third-quarter GDP report was below expectations at an annualised rate of 4.5%. Industry was the weakest component at just 0.5% contrasting sharply with the 7% achieved in the last calendar quarter of 2018. Manufacturing and Construction output growth has weakened dramatically, indeed the contribution of the manufacturing sector fell in the quarter. Industrial heartlands appear to be suffering from the weakness in lending by the banking sector and retrenchment in the secondary banking industry.

Policy makers and most investors face up to climate change

The institutional pressure for policies that arrest climate change continue to mount. Christian Lagarde continues to push a refreshing new agenda at the ECB. In the past week she pushed for climate change to be part of the strategic review for the ECB. The crux of the debate is the degree to which the ECB will make it even more difficult for old 'climate damaging' industries to get funded.

We are pleased to see that sceptics of sustainable investment are becoming an ever more dwindling number. In a study of institutional investors by Schroders, they found that those investors who did not believe in environmental, social and governance investing amounted to just 12% of the total down from 29% in 2017. 19% of investors said they don't invest in sustainable investment funds. Asia-Pacific investors remain the most sceptical, with only 67% believing that ESG investing will grow in importance compared to 84% in Europe.

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