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Market Update

05 Aug 2016

The Bank of England Governor, Mark Carney did what was expected on Thursday, and then some, by cutting the Bank of England's benchmark lending rate and promising to plow tens of billions of additional dollars into the country's financial system.

The BOE stands ready and willing to take whatever action is needed to achieve monetary and financial stability as the United Kingdom adjusts to new realities as it moves forward in seizing new opportunities, outside the European Union. Mark Carney's main goal is clear, keep investor confidence high as the Bank of England transitions into unknown territory. By acting early and comprehensively, monetary policymakers can reduce uncertainty, bolster confidence, blunt the slowdown and support the necessary adjustments in the economy. Governor Carney met market expectations for a quarter per cent cut in the key borrowing level, taking it to 0.25 per cent. It is the first drop since the 2009 financial crisis and marks a historic low for the bank prime lending interest rates rate. Mr. Carney left the door open for further lending rate cuts if economic conditions merit such actions, but ruled out moving into negative territory. The former head of the Bank of Canada, who joined the BOE in 2013, also announced an "exceptional" stimulus package valued at 170 billion pounds (US $223 billion). This includes another 60 billion pounds in purchases of U.K. government bonds, taking the existing Asset Purchase Facility to 435 billion pounds, along with a new plan to buy up to 10

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billion pounds in corporate bonds. The combined program goes further than previous efforts and exceeds what many economists and market players had anticipated. As well as the much larger buying effort, the BOE plans to loan private banks as much as 100 billion pounds in a move to ensure that lenders have enough liquidity to continue funding households and businesses in the fallout from the June 23 referendum that showed voters narrowly in favour of the United Kingdom exiting the European Union. It is important to note, that even with all this monetary stimulus the United Kingdom could still head into a recession.

The BOE, however, is not yet at the point of accepting a recession is inevitable. Even as it acknowledges business investment, consumer spending, and including house purchases, will likely weaken both this year and in 2017. Still, policymakers insist growth will reach 0.8 per cent next year, down from the previous estimate of 2.3 per cent, while the forecast for 2018 has been lowered to 1.8 per cent down from an earlier forecast of 2.3 per cent. According to the National Institute of Economic and Social Research, based in London, it’s likely the United Kingdom will experience a downturn over the next 18 months. The independent think-tank estimates the economy could begin to contract by about 0.2 per cent in the third quarter of 2016.

BEFORE the referendum, economists were in near unanimous agreement that a vote to Leave would hit the economy. And as predicted, the past three weeks have been torrid. The pound has fallen by one-tenth against the dollar; the FTSE 250, an index of domestically focused firms, is down. Alongside the now familiar turmoil in financial markets, there is growing evidence that the real economy is slowing. It is not easy to assess the economic impact of Brexit, because official data are published with a long lag. The first official estimate of GDP growth in the third quarter will not come out until late October.

But there is a smorgasbord of other indicators of economic activity in particular, data scraped from the internet which occur at a higher frequency than official data are published. None of the observations are robust on its own. But together, they hint at how the British economy is doing after Brexit.

It is not all doom. Consumer spending seems to be holding up. OpenTable, a restaurant-booking website, showed a drop in reservations during the referendum, as people made time to vote or watch the coverage. After the next weekend, however, reservations were back to normal. Shoppers have not been too affected, either. Sales at John Lewis, a department store, which has published weekly figures to July 9th, are up on previous years. The number of people entering shops, a decent proxy for retail spending, has not much changed since the referendum, according to data from Footfall, a consultancy. Supermarkets are not aggressively discounting, finds mySupermarket, a price-comparison site. Tesco, Britain's largest supermarket, had 23.7% of products on promotion on July 8th, down from 24.8% just before the referendum.

All this chimes with what economists predicted that consumer spending would hold up. Over half of voters plumped for Brexit, after all, so they should be happy shoppers. An economic slowdown does not immediately pinch people's pockets. Instead, the assumption was that investment would be whacked. Companies would put off big decisions on capital spending or recruitment, given the uncertainty about the future of the economy. It looks like a fair prediction. Firms already seem more reluctant to take on new staff. Data from Adzuna, a job-search website with over 1m listings, suggest that in the week to July 8th there were one quarter fewer new jobs than in the first week of June. Part time roles appear to have been particularly hit. Scotland, which was already near recession because of low oil prices, is suffering most. While some Britons struggle to find new jobs, others may be losing theirs. The Bank of England paper from 2011 analyzed Google as a window into the labor market. Searches for "jobseekers" (as in jobseekers' allowance, an unemployment benefit) have historically been correlated with the unemployment rate. In the first fortnight in July, Britons searched for that word about 50% more frequently than in May. This suggests that unemployment is now 5.3%, not the official rate of 5% (last recorded for the three months to April).

Businesses are cutting investments, too. On Funding Circle, a peer to peer loans website for small firms, the volume of lending is about 10% lower so far in July than it was in the same month last year. The number of planning applications (for permission to expand premises), is another decent proxy for investment spending. Though there is a lag in registrations, a tally of applications in London boroughs in the week after Brexit currently stands at one-third below their level a year before.

The tail off in planning may be linked to a slowdown in the housing market. Data scraped from Zoopla, a property website, suggest that of about 6,000 London properties listed from June 24th to July 11th, roughly 1,000 have had their price cut since the referendum. A survey by the Royal Institution of Chartered Surveyors published on July 14th, which accounts for the post-referendum period, shows a sharp fall in inquiries from homebuyers.

What of the export boom resulting from the weak pound, as Brexiteers predict? There is some evidence that flight bookings into Britain have risen. And the headline on NetEase, a Chinese web portal, is bullish: “Pound falls to 31-year low. Time to bargain-hunt for British homes?”. But although it is difficult to assess the overall impact on exports, there is little to suggest a bonanza is on the way. British export competitiveness has not improved as much as the fall in sterling implies, because one-quarter of the value of British exports contains imports—which are getting pricier. Analysis by The Economist of data provided by Price Stats, a consultancy that scrapes prices from online retailers, suggests annualized inflation since the vote has been above the Bank of England’s 2% target. In any case, research shows little evidence that currency depreciations lead to increased market share in exports, particularly for a country like Britain which competes mainly on “non-price” factors such as quality and customer service.

As with the United Kingdom so will Europe and the EU require time to fully asses the impact of a Brexit vote. German sentiment is down. German investor morale fell in July to the lowest level since November 12 and much more than expected, a survey by German think tank ZEW reported. The Mannheim-based ZEW institute's latest indicator of economic sentiment in Germany fell in July, to -6.8 points from 19.2 points in June. Reuters had expected the index to fall to 9.0 points. ZEW said the economic and political uncertainty brought about by the United Kingdom’s decision last month to leave the European Union (EU) was largely responsible for the decline. Europe's pains are just beginning to surface as Brexit has only accelerated the rate of economic degradation. Next for the EU and Europe is the ailing and near failing banks which are poorly funded, under capitalized. Italy has the highest concentration of near failing banks. The EU needs to step in and bring much needed liquidity. Given the current economic sentiment and general will of the people living in the EU, this will be a tall order for the ECB to complete. Britain leaving the EU will only make the needed action hurt much more as action is required.

Australia's central bank cut interest rates Tuesday, responding to record-low inflation and a slowing jobs market, while playing down the risks of fanning house-price growth. The Reserve Bank of Australia reduced its cash rate by a quarter of a percentage point to 1.5%, the first cut since May. The result was expected, with financial markets pricing in a roughly 66% chance of a cut before the decision. Official figures last week showed core annual inflation hit 1.5% in the second quarter, well below the RBA's 2% to 3% target band. Policy makers worry low inflation could feed into wage and price setting behaviours of businesses and households. Current central-bank forecasts don't have inflation returning to the band until mid-2018 at the earliest. Australia created roughly 7,000 jobs a month on average this year, compared with more than 30,000 a month in the second half of 2015. The Australian dollar fell roughly half a cent after the decision to US $0.75. The local currency has been stubbornly high in recent months, hurting services-exports industries such as tourism and education that have been helping the economy transition away from a reliance on mining to drive growth. Australia just like Canada has an exceptional economy since the global down turn of 2009. However just like Canada, Australia has had a stubbornly high currency and needs to transition away from a resource driven economy. Unlike Canada, Australia has had to contend with it largest trading partner China, entering into economic melt down. The great news for Canada is that our largest trading partner America is just gathering momentum after a long and tepid recovery. Two G7 nations have announced rate cuts in the last week. The Bank of Japan appears to have hit their limit on continued interest rate drops and is holding the line at minus 0.010%. No this is not a typo. The prime lending rate in Japan is 0.01%. Monetary stimulus has been limited to the BOJ buying negative.

American corporations added 179,000 jobs in July, a steady gain suggesting that hiring remains healthy after a sharp fall off in the spring. Payroll processor ADP said Wednesday that last month's job growth was driven by services companies ranging from retailers to shipping firms which added 185,000 positions. Construction companies, by contrast, cut jobs. Manufacturers added a meagre 4,000 positions. The report showed that many businesses are still hiring even as economic growth has remained sluggish. The additional jobs could help keep Americans spending and support an acceleration of the economy in the second half of the year. Solid gains occurred in both higher paying and lower paying industries, extending a trend of greater hiring at the upper and lower levels of the pay scale. Financial services firms added 11,000 jobs, and professional and business services, a category which includes upper income positions such as engineers and architects, as well as low paying temp jobs, added 59,000. ADP figures cover only private businesses. They often diverge from the government's official jobs reports for the same month. Economists have forecast that the government's employment report for July, to be released Friday, will show a gain of 175,000 jobs and that the unemployment rate will dip to 4.8 percent from 4.9 percent. Job gains are below June’s sizzling gain of 287,000 jobs. However it does underscore the notion that hiring has recovered after plunging to just 11,000 added positions in May and a modest 144,000 in April. Even so, this year's sluggish economic expansion has raised concerns about the health of the broader economy. Growth slowed to an annual pace of just 1 percent in the first six months of the year, half the already-tepid 2 percent pace of the seven year old recovery. Still, the unemployment rate may keep falling. Most analysts estimate that the economy needs to add just 85,000 a month to absorb population growth and keep the unemployment rate steady.

Since May 2014, Canada’s economy has expanded 1.2 per cent. That’s the slowest two-year pace outside a recession in at least six decades, according to Statistics Canada monthly data back to the early 1960s. Until recently, the country typically mustered growth of least 5 per cent over two years. Over the past 10 months, Canada's economy has stalled altogether with zero growth. That's mostly due to Alberta wildfires in May shutting down oil production. But there appear to be deeper forces at play. Averaging GDP over three months in order to reduce the effect of the wildfires still produces the same result: the worst two-year expansion outside a recession in decades. Given the magnitude of shock the Canadian economy has sustained in such a short period, it is remarkable that our nation has not entered into an economic recession. The driving concern is how will we come out of the red hot real estate market. Such over activity in real estate markets leads policy markers to make knee jerk decisions which ends up crippling economic growth. Bad fiscal policy always leads to recessions. The Bank of Canada must step in and make them selves clear around interest rates and lending practices. It is not solely foreign buyers driving up real estate prices but lacks lending rules that allow excessive borrowing. Canadian lenders in the past have steered away from "B" lending (high risk customers). Due to the ultra low interest rates in the last 12 months banks have jumped in happy taking on bad risk in return for higher interest rates. B lending rates start at 6 plus % for a 2 year term and go up as high as 14%. The banks want higher return for the dollars they lend and are eager to take on the risk. What is even more disturbing is Canadian banks have eased the requirements to extend lending to foreigners. These are individuals with no Canadian credit history. No Canadian credit history and 35% down will get you all the debt you need from our banks. Does this make sense? Banks fuel real estate booms by providing easy money. Investors are only taking advantage of the boom. Fortunately, in Canada CHMC insurance protects from an American style housing collapse. It does not protect current buyers for over paying as much as 30% for homes due to multiple bidding wars which could see a price correction of 15%. This would leave recent home buyers not realizing property gains for years to come.

So were does this leave our clients and the modelled portfolio's. Despite all the market turbulence, July's performance ranged from 2.4% to 2.70% for the month for the respective mandates. All the mandates are North American centric will a further consolidation away from Europe and increase exposure to American corporations. I see this trend continuing as the influx of capital to North American shores has not crested. July was an active month for investment and August looks to be shaping up the same.

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