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Global Economics and Markets Newsletter

US Equities Make New Record Highs Despite Global Risks

November 2019

This Month's Big Themes

Foreign Direct Investment

One side effect of the trade war has been a substantial drop in cross-border direct investment, also known as foreign direct investment (FDI). According to recent OECD data, the global volume of FDI fell 20% in the first half of 2019 versus the last 6 months of 2018. This decline accelerated in the second quarter when global FDI was down 42% from the same period a year earlier after a decline of 5% in Q1. In the first half of 2019, inbound FDI into the US fell 25% from a year earlier, FDI into the EU fell, while FDI into China increased by 5%. Notably, FDI from China to the US fell more than 90% over the last three years. That decline comes as higher tariffs have caused bilateral trade between the US and China to decline by about 10% in the past year. It's not only the US-China trade dispute that has had a negative impact on global cross border investment, Brexit uncertainty has played a role as well. The OECD reports that inbound FDI into the UK fell by more than 50% in the first half of 2019 versus a year earlier. This follows a decline of 33% in the previous year. Evidently companies that previously looked to the UK as a gateway to Europe are looking elsewhere. While the overall decline in global flows of FDI likely results from trade restrictions and uncertainty, other factors likely played a role. These include investor pessimism about the state of the global economy, the evident slowdown in global growth, and the possibility of a recession in the next year.

Source: http://www.oecd.org/investment/FDI-in-Figures-October-2019.pdf, https://www2.deloitte.com/global/en/insights/economy/global-economic-outlook/weekly-update.html

Country Updates

1. Japan

Retail sales rose 9.1% in September compared to a year earlier as households bought retail goods ahead of the value-added tax (VAT) increase on October 1st. This is the biggest increase in retail sales since March 2014, which was the month before the last increase in VAT from 5% to 8%. Vehicle sales and durable items such as white goods (kitchen appliances for example) were up 16.9% and 7.1% on the previous month. The concern is that in October, retail sales will collapse like they did in April 2014. This is one of the reasons why the government took steps to offset the effects of the VAT increase, such as offering a subsidy on goods - effectively keeping the VAT rate at 8% - in retail outlets (such as convenience stores) if customers were to use cash-less payment methods. If there were to be a collapse in retail sales in the following months, either from a direct result from the VAT increase or through a decline in consumer sentiment from a combination of a domestic economic slowdown and a worsening external environment then a fall in retail sales will be felt through a decline in consumer discretionary stocks but also the effects may be felt on real estate, in particular retail real estate but also logistical real estate that is used especially for online retail.

The VAT hike has very little on goods prices. Headline inflation remained at 0.2% year-on-year, the same as in September and core inflation rose only 0.4% y/y, a little higher than the 0.3% in September. It appears the government's attempt to reduce the immediate economic impact of the VAT price worked to limit a rise in prices, unlike in April 2014 when headline inflation rose to 3.4% y/y, up from the 1.6% in March the same year.

In October, Japan's exports declined 9.2% year-on-year, the biggest drop in three years. There was a significant decline in shipments of final products to the United States as well as declining shipments of components to China.

rSpecifically, exports to China fell 10.3%, to the US fell 11.4 %, and to Asia fell 11.2%. Meanwhile, imports fell 14.8% which indicates that demand is falling, pointing to weaker consumption and investment. Declining trade is a global issue due to the trade conflict between the US and China as well as to the slowdown in the global economy. This comes as Japan is about to enter into a limited trade agreement with the US, as the Lower House of the Diet, approved the trade agreement, before sending it to the Upper House for ratification, and ascension into law.

a) Japan GDP Data

Japanese GDP slowed to 0.1% quarter-on-quarter in Q3 2009, the slowest pace in a year. The biggest impact has been from external pressures related to the US – China trade war as exports contracted 0.7% q/q. It is not clear how much of the value-added tax (VAT) increase in October effected private consumption which grew 0.4% q/q as consumers may have increased their spending in September ahead of the tax increase. The big positive surprise private nonresidential investment which grew 0.9% q/q. Although domestic demand looks to be holding up, there is a risk that the full effects of the VAT increase may be felt in Q4. Furthermore, if the US and China cannot reach even a small trade deal and with some roll-back of tariffs, then exports will continue to suffer, as will business investment. There is a risk that growth will contract in Q4 this year and combined with the weak GDP growth experienced in Q3, the Bank of Japan may be prompted to add additional monetary easing coinciding with the fiscal stimulus package ordered by Prime Minister Abe which is meant to offset the negative effects of a global slowdown, declining trade, and a higher sales tax that was implemented in October as well as some of the damage from recent weather related events. In addition, the government and the Bank of Japan worries that Japan will face an economic and real estate downturn after Olympics-related spending ends following the summer of 2020.

Source: https://www.esri.cao.go.jp/en/sna/data/sokuhou/files/2019/qe193/gdemenuea.html

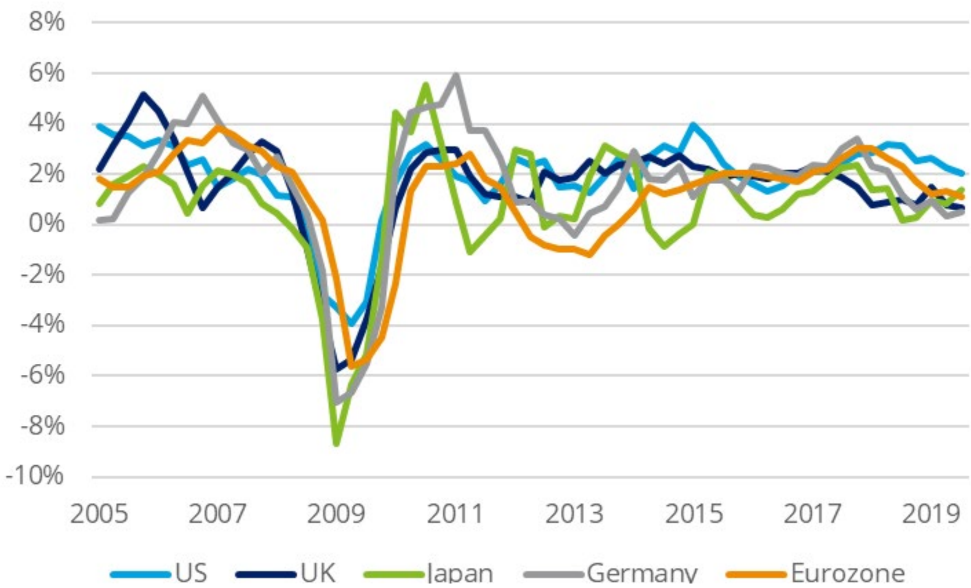
2. United States

a) US GDP Data

US Q3 2019 real GDP data grew at an annualized rate of 1.9%, slightly down from the 2% growth in Q2. The drivers of growth were strong consumer spending growth (2.9%) and a revival of housing investment (5.1%). However, non-residential investment (-3%) and exports remained weak (0.7%). Going forward one potential problem is that the increased tariffs on China which were implemented earlier this year will ultimately work their way through the pipeline, leading to higher consumer prices and lower consumer spending power. On the other hand, if the Federal Reserve further eases monetary policy (beyond what they did today), and if the trade war does not worsen, there could be a basis for a rebound in business investment.

Source: https://www.bea.gov/system/files/2019-10/gdp3q19_adv_0.pdf

Selected G10 Real GDP Growth Rates (year-on-year, %)



Source: Bureau of Economic Analysis, Office of National Statistics, United Kingdom, Cabinet Office of Japan, Federal Statistic Office, Germany, Eurostat.

3. China

Online retailer Alibaba Group Holding Ltd's sales for its 24-hour Singles' Day shopping event hit a record USD 38.4 billion, more than US rival Amazon.com Inc's entire online sales for the last quarter. Sales growth on the day fell to 26%, the weakest growth rate since the annual shopping festival began in 2009. The reasons for the slowdown, despite record sales is a slowing economy, in part driven by slowing private consumption. In comparison in 2018, Cyber Monday, a US online shopping event took USD 7.9 billion.

Source: https://ca.reuters.com/article/technologyNews/idCAKBN1XK0HD-OCATC

Alibaba Group Holdings Ltd completed the world's biggest share offering so far this year, placing as much as 575 million new shares at a price of around USD 24.01 in a listing on the Hong Kong Stock Exchange, raising as much as USD $13.8 billion.

Source: https://www.reuters.com/article/us-alibaba-listing/alibaba-praises-hong-kong-at-start-of-retail-campaign-for-13-billion-listing-idUSKBN1XO33C

4. Hong Kong

Hong Kong fell into technical recession in Q3 as real GDP contracted 3.2% q/q, this follows a contraction of 0.4% q/q in Q2. Months of protests and riots have taken their toll on the economy and unless it lets up, the economy will continue to contract in Q4. The contraction in Q3 was broad based, compared to a year previously, there were declines in consumer spending, business investment, and exports. The tourist sector was adversely affected, with very poor performance for retailers who reported a sharp drop in sales as well as Hong Kong's flag carrying airline Cathay Pacific, who reported that inbound traffic fell 38% in September. Hotels report a sharp drop in occupancy from 86% a year ago to 63% now. This is Hong Kong's first recession since the global financial crisis a decade ago. The central bank has attempted to boost activity by reducing the required capital buffers for banks, hoping this will stimulate lending to small businesses.

Source: https://www.censtatd.gov.hk/press_release/pressReleaseDetail.jsp?charsetID=1&pressRID=4506

5. Eurozone

The Eurozone economy continues to decelerate in Q3 2019 real GDP slows to 0.2% q/q and 1.1% y/y. The last time that quarterly growth was slower than 0.2% was in early 2013. In addition, the annual figure in the third quarter was the lowest since 2014. Growth varied across Europe, with annual growth of 2% in Spain and 0.3%% in Italy.

Inflationary pressures remain weak across the Eurozone. In October, prices were up 0.7% y/y, the lowest inflation since November 2016. The low level of inflation, in part, reflected the impact of declining energy prices which were down 3.2%. Inflation varies by country within the Eurozone. In October, annual inflation was 0.9% in Germany and France, 0.2% in Spain and Italy, and -0.2% in Greece. In the Netherlands, prices rose 2.8%. Core inflation which removes the volatile items such as food prices and energy were up 1.1% in October y/y. This underlying rate of inflation remains well below the ECB's target of 2%. A combination of persistent low inflation and weak growth explains the ECB decision to maintain an unusually easy monetary policy.

Source: https://ec.europa.eu/eurostat/documents/2995521/10064429/2-31102019-BP-EN.pdf/231272f8-b6a4-f943-6d77-9b59ac91f44e

a) German GDP Data

The German economy narrowly avoided a technical recession in Q3 2019, growing 0.1% q/q and 0.5% y/y. Compared with the second quarter of 2019, household final consumption expenditure increased, and so did government final consumption expenditure. Exports rose, while imports remained roughly at the level of the previous quarter. Also, gross fixed capital formation in construction was up on the previous quarter. Gross fixed capital formation in machinery and equipment, however, was lower than in the previous quarter. Actual numbers of the breakdown by expenditure will be published at a later date.

In the short-term this will improve both business and investor confidence, as well as households which should support further private investment and consumption over the short-term. If Germany were to have gone into recession, it is likely that both private consumption and investment would fall because of uncertainty which would then spillover into neighboring countries, likely resulting in a loss growth or even further recessions across the Eurozone and the Europe.

Source: https://www.destatis.de/EN/Press/2019/11/PE19_436_811.html

b) European Central Bank

Christine Lagarde, former Managing Director of the International Monetary Fund, from November 1st took up her duties as President of the European Central Bank (ECB). It is widely expected that Ms Lagarde will continue to maintain the current course of dovish monetary policy. In September 2019, outgoing ECB President Mario Draghi led the led the ECB policy committee in cutting the benchmark interest rates from -0.4% to -0.5%. In addition, the ECB resumed quantitative easing (asset purchases) at a rate of 20 billion euros per month. Negative interest rates are very controversial in Germany, a country with very high personal saving rates. In protest to September's monetary policy decision, Sabine Lautenschlager the German member of the ECB's governing board resigned in protest. Ms Lagarde's political experience should help in the future when political divisions and country differences may divide the ECB monetary policy committee especially if the Eurozone were to enter into a recession, or if a banking crisis were to threaten the stability of the Eurozone.

Source: https://www.ecb.europa.eu/press/pr/date/2019/html/ecb.pr191101~8f1889db97.en.html

One of the most common criticisms of the Eurozone architecture is that, although there is a monetary union, it does not include financial integration. For example in the United States, there is a union-wide system of bank deposit insurance but in the Eurozone bank deposit insurance is provided at the national level, putting individual governments at risk given that they lack control over monetary policy tools. The largest obstacle to financial integration is resistance from Germany. The German worry that any financial union will effectively mean that Germany is most liable for any bank difficulties within the broader union as it is the blocks largest economy, with large positive domestic and external balances which means it has the resources to help other countries in need. At this time, other Eurozone countries would prefer Germany use these large positive balances to fund fiscal expenditure that would be beneficial to both Germany, and the wider Eurozone thanks to spillovers.

6. United Kingdom

a) UK GDP Data

In the official press release the economy as measured in basic prices Q3 GDP grew 0.1% quarter-on-quarter (real GDP 0.3% q/q), narrowly avoiding a technical recession after growth in Q2 contracted 0.2% (real GDP 0.3%). Private sector economists and the Bank of England expected the economy grow 0.4% in Q3. The weakness has been attributed to a combination of the general global slowdown and risks associated with Brexit. The economy grew 1% in Q3, down from 1.3% in Q2 (real GDP grew 0.8% y/y in Q2 and 0.7% in Q3). The annual pace of growth in Q3 was the lowest growth rate since 2010. As this is the first release of Q3 GDP, the expenditure breakdown is unavailable.

Source: https://www.ons.gov.uk/releases/gdpfirstquarterlyestimateukjulytoseptember2019

Capital Markets

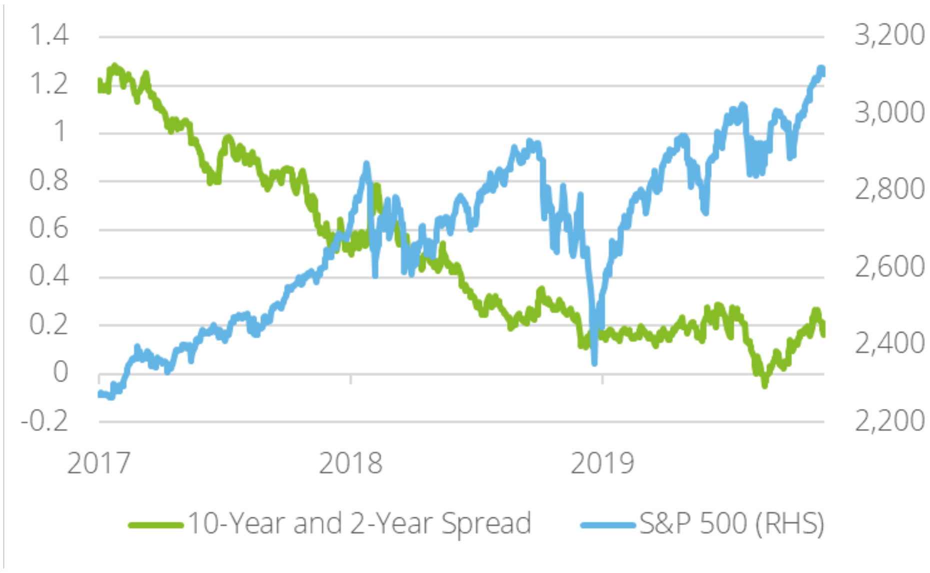
1. News of a US and Chinese Trade Deal and the Effects on Asset Prices

With the news from early November that a trade deal may be forthcoming and Chinese officials stating the at the deal involves a phased roll back of US tariffs and not just a halt to tariff increases has resulted in strong equity prices and rising bond yields. One effect has been that the US yield spread (the gap between the yield on the ten-year Treasury bond and the two-year treasury) is no longer inverted and has remained positive for several weeks. An inverted yield spread is viewed to be a good predictor of a forthcoming recession, even after the inversion ends. Thanks to the Federal Reserve cutting the Fed Funds Rate (see Interest Rate subsection below), leading to a decline in short-term rates. In addition, the yield on the ten-year bond has risen, currently at 1.9% compared to 1.5% in early October, reflecting rising optimism about growth such as the above expectations real GDP growth (among other positive data) and inflation. Still, the bond yield remains relatively low compared to the past year. It was above 2.5% as recently as May.

US equity prices in the middle of November reached new record highs: the Down Jones Industrial Average (DJIA) closed above 28,000 for the first time in history, the 11th record close the DJIA has had in 2019. The S&P 500 and Nasdaq Composite also closed at record highs, capping off more than six weeks of gains. Other positive factors contributing to the rise in equity prices and bond yields are easier monetary policy whilst the US economy still remains strong, and a better-than-expected Q3 earnings season.

Source: https://www.wsj.com/articles/global-stocks-edge-higher-on-u-s-china-trade-deal-hopes-11573812514

US Equities reach record highs on less negative global economic news



Source : Factiva, investing.com

2. Is Saudi Arabia's Aramco about to have the world's largest IPO?

Aramco, the state owned oil-company could be valued up to USD 1.7 trillion according to a price range published alongside an initial public offering (IPO) prospectus and press statement. The Saudi Arabian government intends to sell a 1.5% stake in Aramco, which is about 3 billion shares. The indicative price range for the shares is 30 Saudi riyals (USD 8.00) to 32 riyals, valuing the IPO up to as much as 96 billion riyals (USD 25.60 billion) — at the top end of the range. The IPO next month has the potential to be the world's biggest IPO could beat the record USD 25 billion raised by China's e-commerce firm Alibaba when it debuted in New York in 2014.

Aramco cannot sell its shares directly to investors in the United States and other markets, as the IPO will be restricted to Saudis and those foreign institutions permitted to invest in the kingdom's stock market.

Source: https://www.reuters.com/article/us-saudi-aramco-ipo/saudi-aramco-valuation-set-at-up-to-1-7-trillion-no-overseas-roadshows-for-ipo-idUSKBN1XR07J?il=0

3. Interest Rates

In late October the Federal Reserve cut Federal Funds rate by 25 basis points to 1.75%. The vote of the policy committee was not unanimous, with two of the ten members voting to keep rates unchanged. Analysts have interpreted the accompanying monetary policy statement to mean that the Federal Open Market Committee (FOMC) is reluctant to cut the Fed Funds rate further. The Fed noted that, while investment and exports are weak, consumer spending remains strong. This likely influenced its caution. Given that employment continues to grow faster than is needed to absorb new entrants into the labor force, and given that wages have grown faster than inflation, some Fed leaders are evidently concerned that there remains room for an acceleration in inflation. Consequently, they are reluctant to ease monetary policy too much according to the minutes of the meeting. On the other hand, the Fed is also concerned about external headwinds and trade tensions, both of which have hurt investment and exports. These factors, in turn, mitigate against any tightening of monetary policy. The Fed does not see a need for the US to implement negative interest rates. It said that "the evidence on the beneficial effects of negative interest rates abroad was mixed, and that it was unclear what effects negative rates might have on the willingness of financial intermediaries to lend and on the spending plans of households and businesses." It also indicated that, because the US financial system has some unique attributes, negative rates in the US could have more significant negative consequences than is the case in Europe and Japan. However, the Fed "did not rule out the possibility that circumstances could arise in which it might be appropriate to reassess the potential role of negative interest rates as a policy tool."

Source: https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20191030.pdf

4. Foreign Exchange

Thailand, despite modest economic growth, is running a large current account surplus, holds large foreign exchange reserves, and has low inflation, low interests rates and a strengthening currency. The Thai baht has appreciated 7% in the past year and this has the government worried that it will hurt export competitiveness and tourism. Tourist expenditure accounts for 20% of GDP and inbound tourism is expected to have fallen this year. Exports have fallen 2% y/y but it is likely some of this is attributed to the general slowdown in global trade. The Thai government is said to be worried that taking steps to depreciate the currency will run afoul of the US government which could label Thailand a currency manipulator. Already the US has removed some Thai products from preferred tariff status. In any event, the central bank has cut the benchmark rate to 1.75%, eased capital controls thereby allowing Thai residents to send more money overseas, and allowed exporters to keep a larger volume of foreign currency. All of these moves are meant to put downward pressure on the currency.

Useful Resources

Investing	Economic Data	Economic Analysis
· investing.com	· United States: Bureau of Economic Analysis	· Deloitte Insights: Economics
· MarketWatch	· United States: Bureau of Labor Statistics	· Deloitte Weekly Global Economic Update
· Yahoo! Finance	· Cabinet Office of Japan	· International Monetary Fund
· Federal Reserve Board	· European Commission: Eurostat	· Project Syndicate
· Bank of Japan	· United Kingdom: Office for National Statistics	· Organization of Economic Cooperation and Development
· European Central Bank	· National Bureau of Statisitics of China	· Central Intelligence Agency: The World Factbook
· Bank of England	· Federal Reserve Economic Database	· Aon: Political Risk Heatmap
· People' Bank of China	**News**	
	· Reuters	

All of resources presented above are publically available. The inclusion of these resources is not an endorsement, nor a guarantee of their accuracy made by Deloitte Touche Tohmatsu Limited.

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- Family enterprise consulting;
- Succession Advisory Services
- Cross-border Succession and Reorganization Support
- Family Governance and Council Support for Owner Family

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