Market Commentary

July 2018

CAPITAL TOWER

The Right Advice At The Right Time

Capital Tower Ltd, 85 Yarmouth Road, Norwich, Norfolk, NR7 0HF
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Take a journey back in time
Leave the western world behind
Cross the mountains to Peking
Where the paper lanterns gently swing
The Chinese way
Who knows what they know
The Chinese legend grows
My eyes wide open
I feel a breeze
Words softly spoken
In Cantonese
Standing at the master's side
The with patience he confides
Secret knowledge - sacred ways
Pearls of wisdom from the dragon days
I could never lie
For honour I would lie
Following the Chinese way
So many years ago heroes ruled the world
(Some died for love in a cruel world)
They…
So many years ago heroes ruled the world
(Some died for love in a cruel world)
They were the only ones in a cruel world
I could never lie
For honour I would lie
Following the Chinese way
From the mountains to Peking
Where the paper lanterns gently swing
The Chinese way
Who knows what they know
The Chinese legend grows

Level 42 – 'The Chinese Way'

"If we could do high-speed rail in California just half a notch above what they've done on the Shanghai line in China, and if we had a straight path from L.A. to San Francisco, as well as the milk run, at least that would be progress."

Elon Musk

The Chinese Way? Well for this month's leading article we turn to James Anderson, joint manager of the Scottish Mortgage Investment Trust for his thoughts on China.

It's normal in life and still more in investment to be deeply suspicious of optimism. That's even more so as regards China. The next superpower is rarely popular. A century ago Scottish Mortgage was suspicious about America. Now most American investors are both ignorant and scathing in their attitude to China (usually the more ignorant then the more scathing). Even those less consumed by negativity prefer to hide Chinese exposure within a closely watched and tightly constrained 'Emerging Markets' allocation. To us this appears problematic relative to the size and uniqueness of the opportunity.

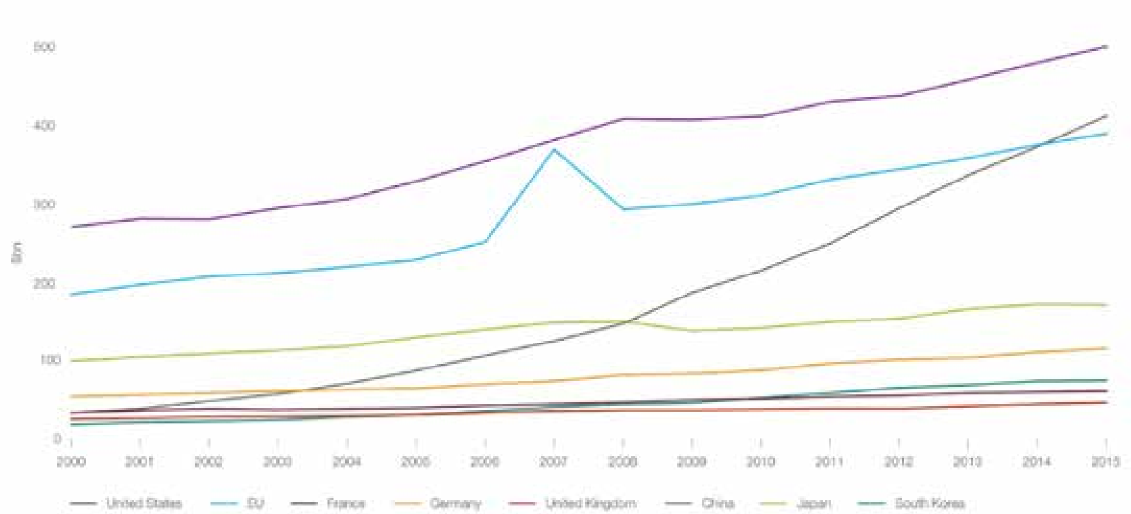
For the first time in my investing life Silicon Valley is not the cutting edge of the global narrative.

We do not believe that China can be easily dismissed. Its debt levels seem to us to be more than balanced by assets, savings and the sovereign ability to print money. The demographic challenges seem to underplay productivity gains driven by the remarkable and continuing investment in education. In the next decade China will likely generate four to five times the number of science and technology graduates each year than the US. China is on course to overtake the US in expenditure on science research and development. It may have done so already having increased by 18% per annum since 2000. I'd be still more upbeat about the prospects of China confronting its environmental demons. Government and people know that change is needed. As the founder of our unquoted electric vehicle manufacturer, NIO, put it "it's easier to work with the grain of society than against it." In December 2017 186,000 electric vehicles were sold in China. That's 6% of registrations or more than total UK monthly sales. China installed 1GW of solar power per week in 2017. This is 60% more than predicted and is capable of replacing two coal fired plants per week.

In the next decade China will likely generate four to five times the number of science and technology graduates each year than the US.

For the first time in my investing life Silicon Valley is not the cutting edge of the global narrative. It's not possible to confine the excitement of China to one city or valley but as a symbol Hangzhou will do well. It was once described as "without a doubt the finest and most splendid city in the world." That was by the marvelling Marco Polo. Perhaps it's just restoration of the rightful economic order that Hangzhou is now the home of Alibaba.

The graph shows Gross domestic spending on R&D - in billions of current PPP dollars, 2000-2015



Source: The amount on science research and development, using purchasing power parity (ppp) exchange rates for international comparison. Reproduced from National Science Board & Engineering Indicators – 2018; Chart: Axios Visuals

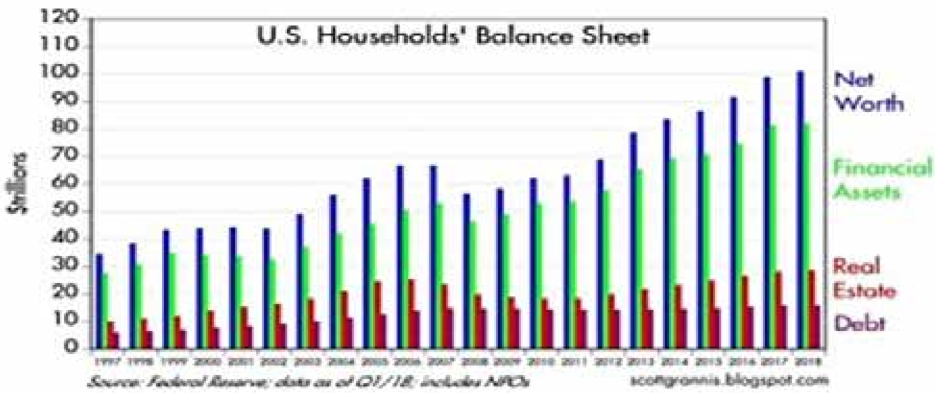
> "Don't take the bull by the horns, take him by the tail; then you can let go when you want to."
> *Josh Billings (1818–1885)*

How about this bull market that's now being described as over nine years old? In stock market years, that's like calling it a financial thrombosis-in-waiting. However, let's put a little perspective on the life and times of this bull that was allegedly born in March 2009. A bear market is generally recognised as a 20% fall from the market's peak. So, that means the US has actually seen two bear markets since 2011.

- From 2nd May 2011 to 4th October 2011, the S&P 500 index dropped 21.6%.
- From May 2015 to February 2015, the Russell 2000 fell 25%, and the Value Line Geometric Index fell 26%.

There was nearly a short bear market at the start of 2016 when the end of the world had arrived with "cheap oil" and "unbearable deflationary pressures." All this means that the US actually experienced two (and technically three) short bear markets in the last seven years, meaning this bull is nowhere near 9+ years old.

Where the US is concerned the latest Federal Reserve statements covering households support the view of increasing wealth. They tell us household leverage as a whole has not been this low for three decades. The following charts support this:



"Many of life's failures are people who did not realize how close they were to success when they gave up."

Thomas A. Edison

2017 was a big year for Norway's sovereign wealth fund, already the largest in the world. After surpassing $1 trillion in assets, the fund made an annual return of 1,028 billion kroner ($131 billion), the largest amount in the fund's 20-year history.

Last year's record-breaking performance for the fund, created to invest Norway's surplus oil revenue, was down to "unusually" strong markets, particularly in equities. This resulted in a 14% return for the fund (pdf), in which the equity holdings returned almost 20%, compared to just 3% for bonds and 8% for real estate. The fund currently invests 67% of its money in equities, but last year it decided to increase this allocation to 70%. It's not to be underestimated how many stocks this fund already owns: 1.4% of all listed stocks in the world.

The decision to up the fund's equities holdings was made in the midst of a blockbuster year for global stock markets, which experienced their best year since 2009 as the MSCI all-country world index gained more than 20%.

Norway's oil fund is invested in 9,146 companies around the world, but its biggest boost last year came from Apple. It has a 0.9% stake in the US tech company, which has a market value of more than $8 billion. Last year, Apple's share price rose 46%.

The next largest contributions to the fund's return came from Tencent, a Chinese tech company, and Microsoft. The worst-performing investments were GE, Exxon Mobil, and Israeli health care company Teva Pharmaceutical Industries.

The chart below shows the share price performance for the largest holdings of tech companies in the Norwegian fund. Even though Amazon's returns were higher than Microsoft's, the fund owns about $1.4 billion more in Microsoft stock than in Amazon.

The fund has now made more money in investment returns than was put into it. The cumulative return since inception in 1997 was 4,151 billion kroner at the end of 2017, exceeding the 3,337 billion kroner put into the fund from surplus revenues from Norway's oil and gas production. This is the second year of withdrawals from the fund by the Norwegian government.

As the amount of stocks in the fund increases, Norges Bank Investment Management, which controls the fund, is warning that there might be "substantial fluctuations in the value of the fund." Such volatility came quickly in 2018, as US stock markets briefly entered into a correction – falling more than 10% from the recent peak – early in the year. *The fund is also trying to reduce volatility by getting out of oil and gas stocks, an ironic move for a fund whose wealth comes from oil. That said, oil and gas stocks were the worst-performing sector for the fund last year.*

Market News

Trade wars escalate

Trade tensions recently escalated, with Donald Trump announcing tariffs on $50bn of Chinese imports and asking officials to identify more to be used as retaliatory measures. In reaction, the first wave of Chinese tariffs on $34bn of US goods will come into effect on 6th July, with $16bn more to be scheduled.

Furthermore, following reactions from the European Union, Trump has hinted that a 20% tariff could be imposed on car imports. This has the potential to be a much larger issue than the steel and aluminum tariffs already in place, given the size of cross border trade

"You have to show up in the World Cup, and in the World Cup anything can happen."
Lionel Messi

in the sector. However, while these threats are meant to bring trading partners to the negotiating table, the EU seems determined not to engage while such threats are used. It is therefore likely that a tit-for-tat trade war will continue.

Bank of England hints at rate rise
Although the Bank of England (BOE) disappointed markets in May by missing an opportunity to raise rates, the monetary policy committee is now hinting that a rate rise in the future is now closer than previously thought. The committee was split 6-3 in favour of maintaining the current interest rate in June, however, the move by the BOE's influential chief economist Andy Haldane to vote for an increase surprised markets and raised the probability of higher rates in August.

OPEC agree production increase
On Friday, the Organisation of Petroleum Exporting Counties (OPEC) as well as Russia agreed to increase their oil production by up to 1,000,000 barrels per day in an attempt to contain the recent rally in the price. Iran opposed the agreement as they have little capability of increasing production and are fearful of losing market share as a result of upcoming US sanctions. Saudi Arabia and Russia are likely to take the lions share of the increase as they were the ones that cut most heavily when the group was attempting to rebalance the market. Meanwhile, output from US shale has been increasing rapidly, decreasing the US' requirement for imported oil and absorbing much of the expected increase in global demand.

Summary
You can tell it's the mid-summer silly season. An ex-leader of the Tory party advocating the legalising of cannabis, an England football manager dislocating his shoulder walking in the woods, whilst also coming across as an intelligent and articulate leader, and the Bank of England getting more hawkish on interest rates.

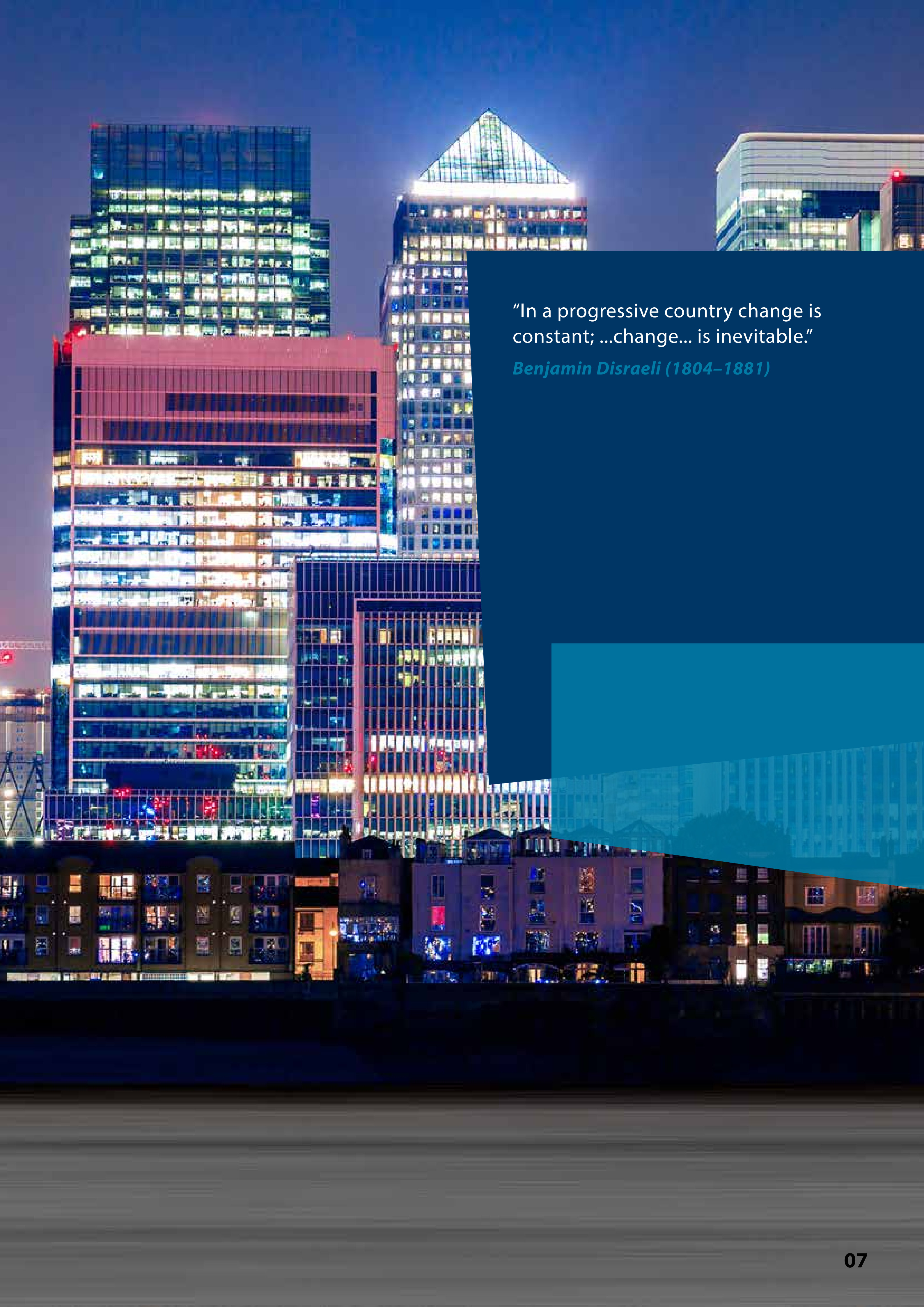
The government has just announced a big boost to the NHS budget (funded by higher taxes apparently), and the Defence Ministry is feeling sufficiently emboldened to seek funding above the 2% NATO minimum commitment. The mood music has changed and austerity appears to be over.

But then there is the car crash that is Brexit…

Yet three members of the Bank of England MPC clearly feel the outlook is buoyant, and we should add monetary tightening to an economy with slowing growth. Let's try and determine the strategy at play here. Should rates rise to support sterling through the uncertainty caused by Brexit? Maybe. Or is it that the US is raising rates as part of normalisation, and as we want to be part of the club it's worth the risk? After all, the US economy is roaring ahead…

As for Brexit, the short term now appears very binary: a hard Brexit or second referendum. Both main political parties are so divided on this issue, a second referendum on a deal / no deal ticket could actually save both May and Corbyn. If there is a sniff that public opinion has shifted towards remaining, it could help save many political careers...

The noise (and it's getting louder) is clearly creating greater volatility in markets, but to date, the fundamentals have not changed, and we therefore remain….



“In a progressive country change is constant; ...change... is inevitable.”

Benjamin Disraeli (1804–1881)

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