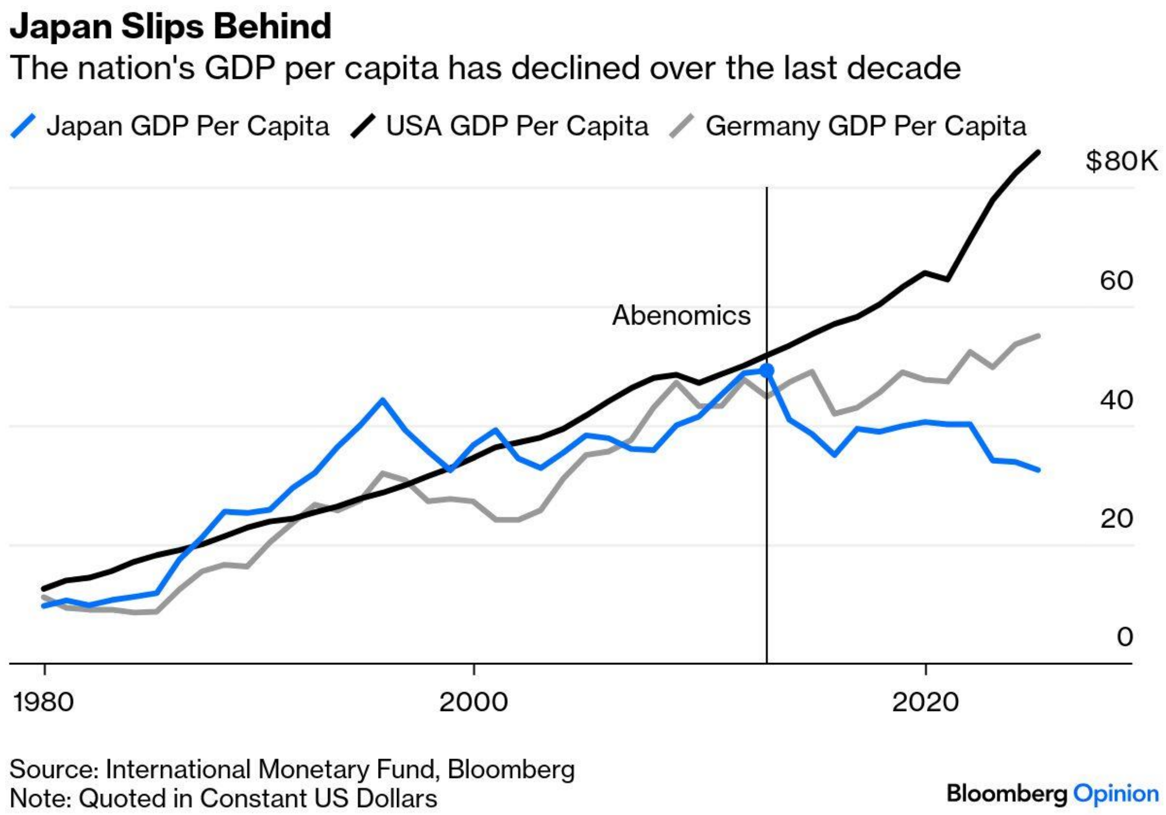
A Rising Sun? From Autocracy to Auto-crazy

Over the weekend Japan’s ruling LDP party did indeed cede seats to more fiscally loose alternatives, leaving Japan’s traditional hegemonic party without control of either chamber of the legislature for the first time since 1955.

The party was founded post-war-post-occupation to be America's loyal yet independent agent in a newly democratic Japan. With the US bringing its post-war excessively-ally-friendly policies to an end, national priorities and domestic economic agendas are being reciprocated.

While the country recently celebrated its stock market finally reaching and eclipsing its 1989 peak, the electorate has not fared so well, as illustrated in the graph below. It is therefore no surprise that they are following many other developed economies in seeking political change.

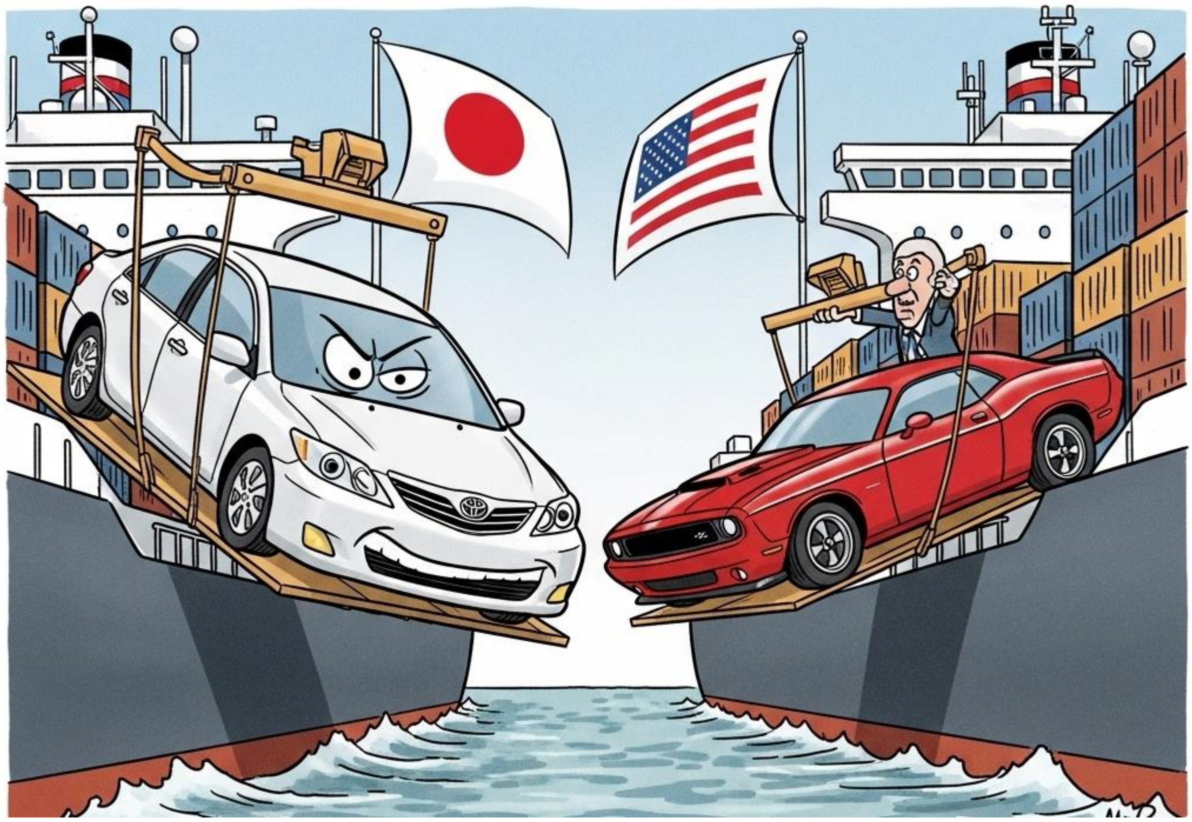


A resulting propensity for higher fiscal spending could compel the Bank of Japan to recommit to its yield-curve control framework, keep short term rates ultra-low and cap 10-year government bond yields, to offset potential rising bond issuance. The Yen was relatively unmoved on the results having already weakened last week in anticipation.

These intricacies were overshadowed by the trade deal struck by Japan and the US which has provided a significant boost to Japanese equities. The new tariff rate of 15% on all goods imported from Japan is far better than the previous 25% that was expected on the 1st of August.

It puts Japanese automakers in an interesting position, one in which they appear to now have an advantage over US automakers in their own market. While US domestic producers will incur up to 50% tariffs on steel, 50% on copper, and 25%+ on imported parts, the Japanese can flood the market with vehicles at an all-in 15% tariff.

President Trump has yet to enlighten us as to how this dynamic will be resolved, only to hail the deal as a victory, emphasising the $550 billion of Japanese investment commitments into the US and the opening of Japanese markets to American vehicles and agricultural products.



Global equity markets and sentiment have been buoyed by the news and further deals are expected to follow and build this momentum in the run-up to the August deadline. Could the sun be rising on global economic outlook again?

The European Central Bank left interest rates unchanged this week, not unexpected but significant in that this would appear to be the end of its current rate-cutting cycle. The bar for a further cut in September is now quite high and would require a notable deterioration in economic or inflation data. Economists expect no further cuts over the next 18 months opening the door to a convergence with the US should Federal Reserve Chair Jerome Powell's replacement look to ease monetary conditions.

The picture is not so rosy for the UK, with increasing concerns over fiscal sustainability driving Gilt yields even higher and talk of crisis bubbling at the more extreme outer fringes of the media. A raft of weak economic data points has plagued the outlook this week, with Rightmove reporting its largest monthly fall in housing asking prices, retail sales disappointing again, and service purchasing managers' indices tumbling unexpectedly, albeit not into contractionary territory.

With more or higher taxes on the horizon but not imminent and with those potentially incurring a collection time lag - for example, IHT and pension taxes may not be triggered immediately, Chancellor Rachel Reeves may look to temporarily plug the gap by raising £5bn from the sale of cryptocurrencies that have been seized by UK law enforcement. Reminiscent of Gordon Brown and gold maybe…

The Global economic environment can be summarised thus:

The US is resilient but prone to fiscal excess which has markets concerned over the future value of the dollar as global central banks continue to look for alternative reserves and reduce exposure to the currency where economies have built up significant unchecked exposure.

The UK’s bond markets are prone to regular attack as fiscal sustainability is of greater concern while the government is not garnering any confidence in its ability to deal with the issues, all the while inflation has remained sticky.

Europe has seemingly managed to get inflation under control which has allowed government borrowing costs to come down, so fiscal sustainability is less of a concern, a situation which has been helped by Germany’s reluctance in the post-war era to exhibit fiscal excess.

That dynamic has given sufficient headroom for a significant unlocking of government expenditure, predominantly into defence and infrastructure, which is expected over the next decade.

Japan’s situation is similar to the UK’s but in reverse. The country’s central bank has historically held interest rates very low so there was little concern over fiscal sustainability due to much lower borrowing costs. Instead, the currency has weakened dramatically, and the population has become much poorer.

Monetary policy is likely to be normalised in due course, but while that could right-size the currency, higher borrowing costs will give rise to fiscal sustainability concerns at a time when populist politics will increasingly be calling for the government to spend more.

Yet despite more favour towards these countries’ currencies and their equity markets, the US appears to have a hold over the greatest driver of economic growth in the decade ahead, Semiconductors and Artificial Intelligence.

Emerging markets have far greater supply chain exposure to secular growth trends and have developed out of their reliance on developed markets so provide reasonable diversification benefit while also having exposure to raw materials which may have greater scarcity value in the decade ahead.

We wait for crucial insight into the outlook for China's economic trajectory with the culmination of the ongoing trade war.

One final insight: It has been suggested that retail investors having largely been holding up equity markets this year in the place of “smart money” institutional investors. While I would caution drawing too many conclusions from that data, what is interesting is that the Financial Industry Regulatory Authority is preparing to change the Pattern Day Trading rules to reduce the minimum margin requirement for regular traders to $2,000 from $25,000, which could increase the capacity for overall retail leverage.

What could possibly go wrong!?

Where are markets up to?

The rolling 12 month % cumulative returns in local currency from various indices is shown in the following chart:

Where are the portfolios up to?

The portfolio performance, net of fees, to close of business on Thursday is as follows:

	1 week	1 month	3 months	12 months
Cautious	+0.01%	+1.43%	+5.46%	+4.10%
Balanced	+0.20%	+2.73%	+8.88%	+5.05%
Adventurous	+0.27%	+3.42%	+10.64%	+5.54%

As ever, if you would like to discuss any aspect of your portfolio, please do not hesitate to contact us on service@blythefinancial.com.

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