Smart[im]: Highlights and Lowlights: what caught our eye in June 2018

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Smart Investment Management

June was yet another month where Donald Trump hogged the headlines, with three issues covered in previous notes continuing to 'run and run'. His 'on-off' summit with Kim Jong Un happened, allowing him to claim the role of global statesman, although it remains to be seen if anything concrete comes out of the discussions. However, his attack on Canadian Prime Minister Justin Trudeau after the G7 summit, calling him "very weak and dishonest", was far from most people's definitions of 'statesmanlike', and was Trump at his most abrasive. Finally, trade tensions continued to escalate, with EU retaliatory tariffs and further US action against China, so there was an obvious irony in his treatment of Trudeau given that Canada is the US's nearest neighbour and biggest importer of US goods in the world. That notwithstanding, not everything is about 'The Donald' and other issues took our eye.

Central bank announcements in June showed how differently positioned the developed economies are in the fiscal loosening/tightening cycle. The Federal Reserve raised US interest rates by 0.25% and indicated a further two rises this year, pointing to continued strengthening in the US economy and unemployment below levels normally considered to be full employment. By contrast, with the US having ended Quantitative Easing (QE) several years ago, the European Central Bank announced the end of QE in Europe will be by the end of the year. This showed how much earlier Europe is in the QE/QT (Quantitative Tightening) cycle, a statement that is explained by the unemployment figures for the two regions. Whilst both regions suffered post-crisis peak levels that were not markedly different, at 10.2% for the US and 12.1% for Europe, US unemployment has fallen to 3.8% whilst Europe has only dropped to 9.1% (source: Bureau of Labor Statistics and Eurostat), showing the much slower pace of recovery in Europe. However, whilst the figures put Europe more mid-cycle that the arguably late-cycle US, they are still ahead of Japan, with the Bank of Japan leaving its key short-term interest rate unchanged at -0.1% at its June meeting. This was widely expected, as was the decision to keep its 10-year government bond yield target around 0%. However, with them lowering their assessment on inflation and acknowledging that it would undershoot again, there is no sign of an end to QE in Japan.

All of this shows that the current debate amongst investors as to whether we are mid-cycle or late-cycle may be too simplistic and that the answer may simply depend on geography. However, in a globalised economy, it is probably wise to consider some average of the various regions because, whenever a downturn does come, it is unlikely to affect a single region alone. Furthermore, whilst we do not see evidence of any such downturn yet, it is probably wise to look to the US for the first signs of late-cycle becoming 'end of cycle'.

The oil price rose significantly in June in spite of OPEC agreeing to increase production by 1m barrels per day. It was not long ago that there was speculation that the ability of US shale producers to turn production

on and off relatively quickly may cap prices, with the suggestion that they would become range-bound as shale producers turned on production when the price reached a certain level and off again when it fell back. However, whilst the technology to react quickly exists, other factors have prevented shale from having the expected impact. During the period that oil dropped as low as $30 per barrel, oil companies cut back production wherever they could, as one would expect. However, oil service companies came under immense financial pressure at the time, with some going bust and others surviving only by reducing expenditure wherever possible. As a result, now that shale producers want to pump more oil, they find that they are unable to get the oil from point of production to market, with an acute shortage of pipeline capacity, and this may yet take some time to rectify. Therefore, the possibility that the oil price rises further from this point should be considered, as any rise from current levels would be expected to have a manifest drag on global growth, with countries that are large importers of oil being especially vulnerable.

Finally, the stock-specific event that most grabbed our attention was the announcement by Amazon that it is moving into healthcare provision in the US with its purchase of PillPack. This is not the first time that Amazon has ventured into new territory, and their purchase last June of Whole Foods Market sent shivers through the US supermarket sector. However, the argument had been made that, as healthcare is a more complex and regulated area, it was perhaps less attractive to Amazon. This has proven to be false hope and the fact that the share price falls in pharmacy chains CVS Health and Walgreens Boots Alliance, which plunged more than 8% and 9% respectively in trading the morning after the announcement, were even greater than the 6% or so falls seen in US supermarkets may reflect the fact that the 'Amazon risk' was less priced into their shares than those of the supermarkets. However, whatever the reason, any sector harbouring similar 'it won't happen to our industry' hopes may want to re-consider. That is not to say that we see Amazon launching a mining company any time soon (although it was not obvious that they would launch a cloud computing business until they did). However, if you are a retail-based industry with a readily commoditised product then it seems unwise not to plan for the possibility that they come to your sector at some point in the future.