



Quarterly Newsletter / Summer 2018

Lacomp plc is an independent investment management company providing portfolio management services to private investors worldwide.

Markets

In contrast to the market calm and momentum-driven gains in 2017, the first half of this year has seen a return to more 'normal' levels of volatility with markets actually responding to potentially disruptive news flow rather than treating such factors with indifference.

There has, as always, been an abundance of geopolitical issues to attract attention – the bombing of Syria by a US led coalition, the sudden volte face in the US standoff with North Korea and the subsequent summit meeting of Presidents Trump and Kim in Singapore, not to mention a steady deterioration in Russia's relationship with the West. Momentous as these events were in their potential for either positive or negative market disruption, none has caused as much reaction as the rather more mundane subject of US trade policy.

As with most aspects of his administration, President Trump has taken a rather different approach to trade, abandoning the consensus view that the ideal situation is one in which trade flows freely between nations according to the pressures of comparative advantage to the ultimate benefit of all. Instead, the President appears to have resurrected the principles of mercantilism (popularised by among others, Louis XIV's Finance Minister, Colbert, in the seventeenth century).

The mercantilist view is that trade is a 'zero sum game' in which one party to a trading relationship can only benefit at the expense of the other. In this sense, it is a war for control of resources and wealth in which there can only be one victor. The President's Twitter account abounds with references to a 'winnable' trade war and to the 'unfair' trade policies of others. The US, he claims, "has been ripped off by other countries for years on trade."

Underlying this claim is the undeniable truth that the US has a massive trade deficit with China – the difference between how much it exports and how much it imports – which stood at \$375bn last year. That much is clear, not least because the US has shown an insatiable demand for cheap Chinese goods driven by the incidence of low US interest rates. Whilst the US consumer was clearly not forced to buy imported goods, in mercantilist theory such a negative trade balance would suggest a threat to national wealth and power. It is perhaps indicative that the recent steel tariffs were justified on grounds of national security considerations.

The theory of comparative advantage implies that, logically, countries that are good at producing cheap consumer goods will do so and not try to compete with countries whose skills lie elsewhere, in the production of technological goods, for example. Trade flows are ultimately determined by demand levels in the importing market with each trade partner benefitting from the other's skills and productivity in order to buy what they need – the richer economy sells high-end goods and imports cheaper items which it could not economically produce itself.

Over time, earnings from exported goods lead to an enrichment of the hitherto low-value producer and a gradual expansion of its own technological capabilities. In the case of China, the President argues that this has been a direct result of unfair practices and intellectual property theft which certainly has an element of truth but conveniently ignores China's spectacular economic expansion which has enabled the country to emerge as a technological rival to the US.

This is an important point – politics lies at the heart of this and the trade war approach is arguably an attempt to preserve the political pecking order rather than being based purely on dubious economic logic. Much as the Detroit motor industry was hit by Japanese productivity and 'cheap' imports in the 1970s, the blue-collar voters who propelled Trump to the White House once again feel threatened by 'foreign' goods and are expecting him to deliver on his 'America first' policies to make them feel 'great' again. It seems to have escaped their notice that more expensive imports can only make them poorer in real terms.....

In a now predictable manner, the President has responded to this domestic pressure by imposing tariffs on steel and aluminium imports from Mexico, Canada and the European Union on the grounds of protecting national security. This has provoked an inevitable tit-for-tat response from these supposed friends and allies who have in turn imposed a range of tariffs targeting such quintessentially US goods as orange juice, Levi jeans and Harley-Davidson motorcycles.

When the G7 met in Whistler, Canada, at the end of May the President found himself the target of considerable anger and frustration from the other delegates, prompting Bruno Le Maire the French finance minister to christen the meeting as “G6 plus one”. The President was the last to arrive and the first to leave the summit meeting.

In addition, the US has announced a range of tariffs against China with a further \$200bn worth of goods to be targeted in the coming weeks. Not only has this threatened the positive economic and trade talks that Commerce Secretary Wilbur Ross had been holding with Vice Premier Liu but has also attracted Chinese retaliatory measures against US agricultural products which, coincidentally, hit those very voters who support the President by making US agricultural exports more expensive.

The US/China trade is clearly very lop-sided with China buying \$130bn worth of goods from the US whilst exporting \$505bn. Because of this, it will be difficult for China to simply match the scale of US tariffs on a like-for-like basis but it does have a range of non-tariff tactics to draw on. In previous spats with Japan and South Korea there has been extensive use made of bureaucratic blocking of agreements, cancellation of orders or organisation of consumer boycotts. In addition, China could allow the currency to slide in value thus boosting the attractiveness of its exports or even move to the ultimately self-harming policy of unloading some of its enormous holding of US Treasury bills. This latter move is extremely unlikely but highlights the fact that this dispute has the potential to get rapidly out of hand unless common sense prevails. When the US first announced plans for the steel and aluminium tariffs against the EU back in March the reaction of Jean-Claude Juncker exemplifies the farcical nature of the situation: “If Trump can be stupid, we can be stupid too.”

There is the suspicion that the President has his attention firmly fixed on a domestic audience with the mid-term elections looming but trade wars are of no benefit beyond such short term political kudos and ultimately lead to a contraction of global trade to the detriment of all parties. It is to be hoped that cooler heads will eventually prevail as the ‘goldilocks’ scenario of synchronised global growth which we talked of in the December newsletter could easily be threatened were this to continue. For the present, markets have largely flat-lined over the year to date as this ‘beggar thy neighbour’ policy plays itself out.

One positive hint, perhaps, of things to come – Harley-Davidson announced (to the evident annoyance of the President) that it will move some of its production outside of the US, thus avoiding the tariffs, in order to protect its sales into Europe. So much for the mercantilist view that a trade war protects domestic jobs.

Brexit

When David Cameron announced that the UK would hold a referendum on the UK’s continued membership of the European Union in 2015 he unleashed a slow-moving (some would say glacial) process which has dominated the UK newswires ever since. It cost Cameron his premiership and may well be the undoing of his successor although, for the present, Theresa May is showing a Machiavellian talent for survival as she fends off attacks from both sides of her increasingly fractured party.

The public could be forgiven for feeling that progress towards the departure from the EU has been unnecessarily long but, as the deadline of 29th March 2019 moves inexorably closer, the debates and differing opinions that had long simmered below the surface on both sides of the political divide have become ever more public and heated. The sheer complexity of unravelling forty years of rules and regulation in a manner that will placate all factions has become painfully apparent and is fast becoming a quagmire in which any attempt at compromise is jumped on by one side or the other amid talk of ‘treachery’ and ‘U-turns’. In this febrile (the new Westminster buzz word) atmosphere we find Anna Soubry close to Labour’s Chukka Ummuna whilst Dominic Grieve and Keir Starmer, the Shadow Brexit Secretary, seem the best of friends. Strange times indeed.

In June the Government successfully side-lined the attempt of Dominic Grieve to ensure that Parliament would have the final say in any proposed deal, much to the delight of the then Brexit Secretary David Davis who regarded the proposal as an attempt to undermine the government’s ability to reach an agreement. Such a victory came with a price – Remainers seemed to imply that they had been promised far more by Mrs May (in private meetings) than was eventually announced in Parliament, thus storing up further bad feeling for the next showdown.

In 'normal' political times, the Prime Minister of such an ostensibly weak government would not have survived the succession of amendments and rebellions that have ensued but there is a clear reluctance on the part of pro-Europeans to overthrow Theresa May for fear of what, or who, might come next. Tory whips have repeatedly played the 'Corbyn card' to keep rebels in line but for many the prospect of Boris Johnson or another hardliner would be equally unpalatable. The hardline Brexit support seems far more inclined to argue its cause come what may and is aided and encouraged in this by the PM's precariously narrow parliamentary majority.

Labour is itself split on the issue and, whilst castigating May's 'dithering' and 'chaotic' policies, do not appear to relish taking up government until the dust has settled on the EU question. Two thirds of Labour parliamentary constituencies voted to leave the EU whereas recent polls suggest that a similar proportion of individual party members would prefer to remain. Parliamentarians are, as ever, caught between representing their constituents in order to retain their seat and 'voting with their conscience'. Significantly, it was Labour rebels who sided with the Government in Tuesday's crucial vote on the customs union and allowed the Prime Minister to live to fight again. The only certainty seems to be that there will be a fight!

The language of the debate has become increasingly opaque and the casual observer could be forgiven for missing the nuances that distinguish 'a' customs union from 'the' Customs Union, for example. Theresa May's arguably premature declaration of the 'red lines' during her Mansion House speech have made her a hostage to fortune and provided ample ammunition for those keen to shout 'betrayal' at the first sign of compromise. And yet, compromise she must if there is to be any hope of a deal.

The EU has seemed content to allow the UK to delay through the early summer, particularly as there were clear indications that the Prime Minister's position was softening in light of concerted lobbying from business leaders who feared that the likelihood of a 'no-deal' was increasing. The announced removal of production of the Discovery 4x4 from Birmingham to Slovakia by Jaguar Land Rover will have provided an example of what might ensue in the absence of a deal, especially as similar cautionary warnings were issued by BMW, Airbus and Honda. BMW stated that the company could cope with the imposition of additional costs in the form of WTO tariffs but would find the disruption to supply lines far more problematical. Car production is based around 'just in time' systems that have evolved over many years and which rely on a seamless passage through EU borders. The case for siting production outside of these borders is undermined by the prospect of customs delays.

The now infamous meeting at Chequers was held on 6th July at which a supposedly watertight policy statement was agreed in preparation for a White Paper to be issued on the 9th. The agreement started to unravel within twenty-four hours with the resignation of the Brexit Secretary, David Davis, closely followed by that of the Foreign Secretary, Boris Johnson.

Machiavelli might have admired this subtle shedding of two important opponents from the Cabinet had it not been for the fact that the ensuing compromise seems to have angered the Remain camp in equal measure. And, of course, there is the argument for keeping critics within the tent. Never one to slavishly toe the line on collective cabinet responsibility, Boris Johnson is now able to speak far more freely from the backbenches, urging that the White Paper, a "miserable document", be torn up.

And there is the small matter of the EU agreeing to the Chequers proposals, with its single market for goods (but not services) and a customs union to avoid the Irish border issue. This 'Jersey option' is criticised by Europeans as 'cherry picking' and will surely be challenged as negotiations develop.

As things stand there appear to be four possible outcomes:

- Leaving the EU with an amicable divorce based around trade which is as frictionless as possible with no hard border in Northern Ireland.
- Leaving the EU with no deal in place – this entails adoption of World Trade Organisation tariffs and customs checks when trading with Europe but frees the Government's hands to strike trade deals with other partners around the world.
- An informal agreement that leaves the Customs Union and single market in place under the jurisdiction of the European Court of Justice – tantamount to not leaving but without a say in future legislation.
- A second referendum as proposed by Justine Greening in response to the apparent parliamentary stalemate.

All of these raise howls of protest from the various warring factions and all have practical issues to overcome.

The 'backstop' solution to the Irish border proposes a temporary customs union which was carefully undefined and which left open the prospect of regulatory divergence to placate the hard Brexit lobby. But, as the French say, 'rien ne dure comme le provisoire' and a prolongation of compromise beyond the 'implementation period' would enrage those who want a clean and definable break from the EU.

A 'no deal' outcome appears anathema to large sectors of the business community and, indeed, a majority of MPs, although it is clearly a distinct possibility as the clock ticks down. Delayed investment decisions and the open discussion of relocation in the event of an exit without agreement are an important consideration for the PM who is under pressure from all directions.

The idea of a second referendum is fraught with problems. The referendum campaign was marred by distortion and fear tactics from both sides and the 'yes or no' option could be regarded as overly simplistic in light of all the complications that have subsequently emerged. The Electoral Commission's findings have added fuel to those who argue that the peoples' will expressed in June 2016 carries dubious validity as it was based around misinformation and, possibly, breaches of electoral law. The cry of 'foul' is a typical reaction whenever elections throw up a close result but this has done little to aid the cause of compromise and consensus.

The Greening proposal for a vote based on three options (accept the compromise deal, remain in the EU or leave with no deal) raises the possibility of the vote being carried by 34% in a 'first past the post' system - hardly a result that many would welcome. The inclusion of a second preference choice would help to overcome this but there is still the logistical problem of arranging a vote in the time remaining before March 29th. Firstly, it requires an Act of Parliament to call a referendum which will be difficult to agree in the current heated atmosphere. The original vote was held four months after its announcement and, whilst a certain amount of 'cut and paste' might shorten this, the Electoral Commission has recommended a six-month gap to allow adequate discussion (!) so the whole exercise might require EU consent to extend the deadline for exit. Yet more delay and uncertainty!

In any event, Downing Street has responded with an unequivocal 'no' to the proposal whilst the Labour Party would ideally have the issue decided by an election. This is yet another can of worms as only the Liberal Democrats and SNP have a clear policy towards the EU. The hapless electorate might be faced with a plethora of choice on the ballot paper if all the factions chose to stand as independents and, even if the two main parties could succeed in papering over their differences for the duration of the campaign this would leave the possibility, whatever the outcome, of future recrimination and a revival of the feuding. This could start looking more like an Italian election!

Perhaps the ideal, using 'maximum facilitation' technology to create a machine for travelling back in time, might be to simply start from somewhere else.....

Bagshot 20th July 2018

Lacomp plc

77 High Street, Bagshot, Surrey, GU19 5AH, England.

Tel: (Intl. +44) (0)1276 475123 Fax: (0)1276 475273 e-mail: info@lacomp.co.uk website: www.lacomp.co.uk

Registered in England No. 1851201

Authorised and Regulated by The Financial Conduct Authority (FCA)

Lacomp plc produces this information for private circulation. Whilst we have taken great care to ensure that the information it contains is correct we cannot be held liable for any errors contained herein or for actions taken as a result of this information.