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Leaders in Wealth Management

Chartered Financial Planners

Booms and Busts Report

We publish these reports on Economics and Markets several times a year. We produce other even more detailed, in-depth reports, for clients only.

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Before getting into it, as a tennis player, I have to say how magnificent was Murray again this year! Jamie, that is. And of course Johanna Konta. The other Murray... not so much.

In the **April Booms and Busts Report** I reiterated the beginning of massive hikes in UK Buy-To-Let taxes. Sure enough, as envisaged, there are already increasing numbers of anecdotes of BTLers looking to offload their assets. It's still unrushed but as the market slows, more and more will likely do the same. By next year I wouldn't be surprised to see much much higher numbers of BTL properties marketed for sale... with far fewer buyers around.

And the taxes continue to rise right up to 2020. This is a growing issue and a nightmare for those BTLers who thought they were genius property magnates. What goes up...

The icing on the cake would be the rising probability that we see a recession in due course. Then we'll be looking at a flood of properties for sale, nationwide, as prices fall c 25% (as can be expected in a recession).

Problematically, for long-in-the-tooth BTLers, with long term rising capital values, those who remortgaged and remortgaged to 'buy' more and more properties, they now have inherent large CGT liabilities. However, due to high levels of mortgage debt, little or no net capital in the assets. And THAT ASSUMES prices don't fall. I assume they WILL fall yet the debts will not and there will still be CGT. Oops...!

Everybody knows I have been warning about residential property as a long term investment for years.

On verra.

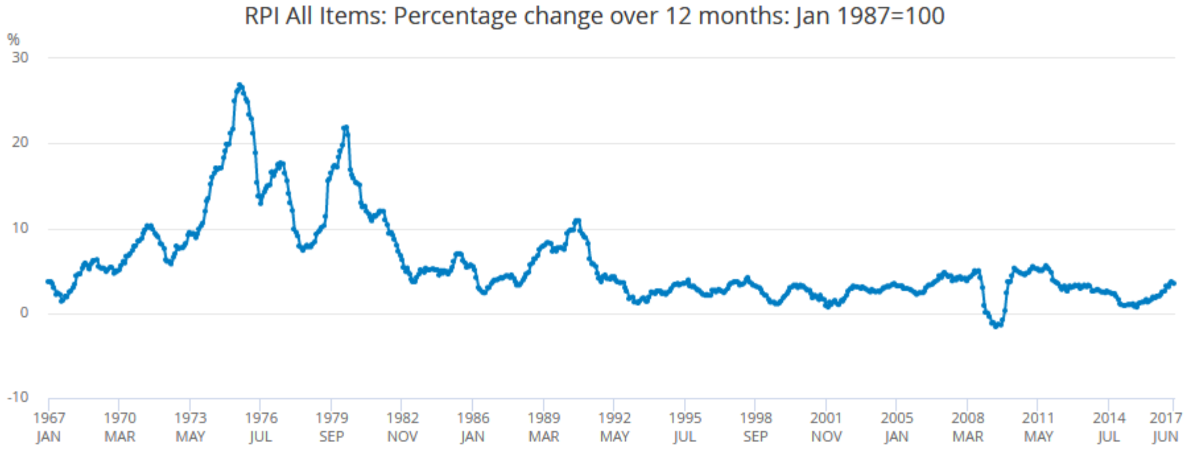
In this Booms and Busts Report I'm going to take a wide-ranging view of where we are, from where we've come and to where we might be heading.

I always appreciate your comments. So, keep them coming.

Where we are is inflation.

Last year, at this time, we were at 0%, or so, inflation. Now we're at c 2.5% CPI (or 3.5% RPIX - which is inflation in 'old money' ie what we used to use as the standard for inflation, and is a truer reflection of the annual changes in the costs of living - though still highly flawed).

Here is a chart of **RPIX over the last 50 years:**



Inflation, clearly, has been, relatively, subdued for most of the last 25 years and, particularly so, the last several years. But it's rising now.

Why is it rising?:

1. US Dollar
2. Oil
3. Minimim wages
4. Chinese Yuan, to name but 4 reasons.

The US Dollar is the global reserve currency. In other words, the bulk of global trade is settled in US Dollars.

If you're a Brazilian cattle rancher and the US Dollar falls, you will want more US Dollars for your beef, and vice versa. Thus, a falling US Dollar leads, normally, to inflationary tendencies and vice versa.

The US Dollar (against a basket of major currencies)

The sharp fall in inflation in 2014 (see the inflation chart above) coincided with a sharply rising US Dollar. The US Dollar has now been flat, essentially, for the last 2 and a half years. However, from the high in the horizontal channel, it has fallen since the beginning of the year to now, having fallen to the bottom of the channel.

A flat, or falling, US Dollar, has contributed to rising prices.

Similarly, the **GB Pound**

A falling Pound Sterling, for Brits, imports inflation because, quite simply, we have to spend more Pounds to buy 'stuff' from abroad.

The above chart - GB Pound against the US Dollar - is a longer term chart than the US Dollar chart above.

NB The media still bangs on about how the £ suddenly fell after the referendum vote. Total nonsense. The Pound has been falling for years and the fall on 24 June 2016 and then in October was a) the continuation of the very long term trend and b) Mark Carney, Governor of the Bank of England, cutting the Base Rate (for no reason whatsoever).

I could have shown how the Pound has been falling for decades, indeed for a century, but it would serve little purpose. The fact is the Pound has imported inflation for many many years. Had we a strengthening currency (like, for example, Switzerland) we would have, actually, deflation which would be great for us all as business and living costs would fall, consistently.

Unsurprisingly, the sharp fall in the Pound, particularly since mid 2014, has seen inflation *start to* rear its ugly head again. As you would expect, it is a slow process to reverse from zero inflation (practically deflation) to inflation. However, were inflation to take hold, we would expect to see it rising more sharply year on year. Look again at the inflation chart. In the 60s we had very little inflation, in fact very similar levels to what we have experienced for years until now. But gradually, it grew and grew then erupted by the mid 70s.

It's intellectually difficult for people to change their wholesale perception of sustained low inflation/deflation to sustained inflation.

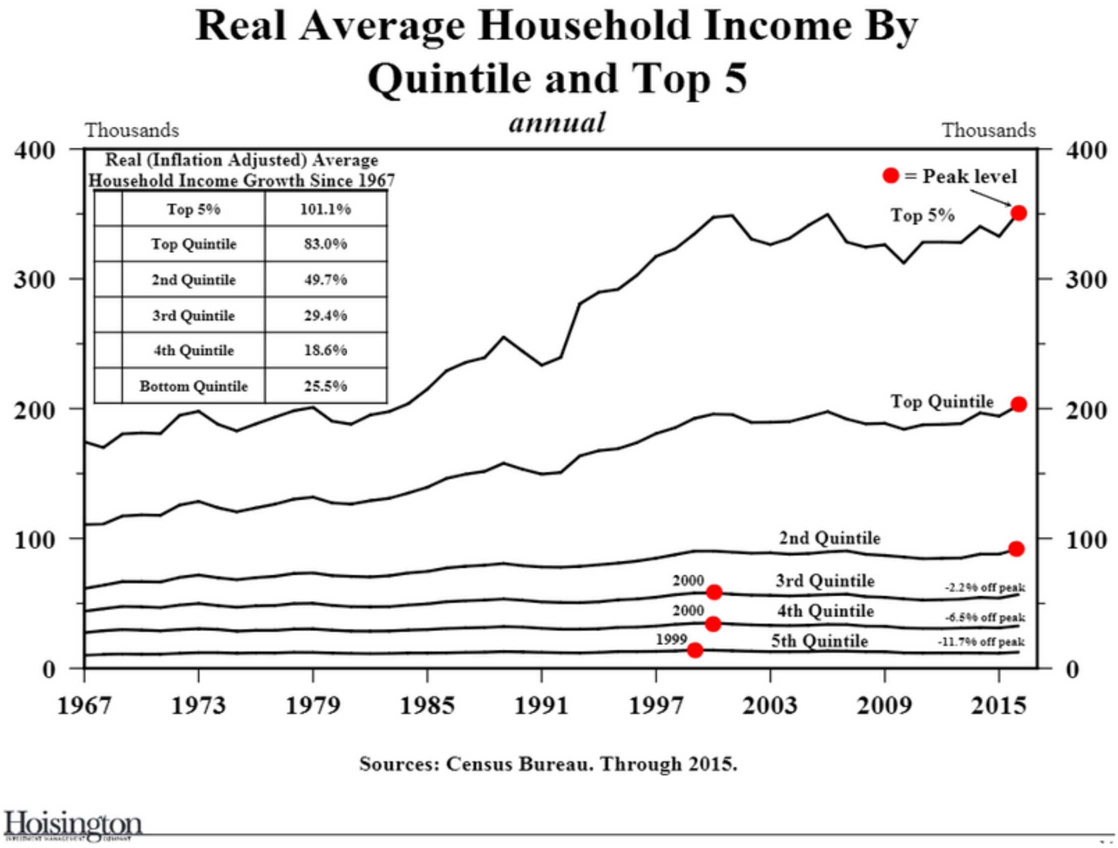
Most folk consider what has been recently and extrapolate for ever.

The change is likely to come, over years, and it will be by imperceptable steps.

The global oil price plummeted from mid 2014 to early 2016, from c $110/barrel to just $26. This too occurred with the soaring US$. Oil plays a major role in Western inflation. Then, oil doubled to early this year, to the low $50s. It's been $40-$50 since. Depending on its direction we are likely to see a similar move in inflation. It is more likely we see $50-$60 than below $40.

Minimum wages across the Developed World have risen. Inflationary.

Having said that, look at the long term of **earnings rises**, adjusted for inflation.



This is for the US but it is similar right across the Developed World.

The bottom 60% of income earners have seen their earnings - against inflation - **fall** since 1999 or 2000. Any economic growth has largely gone to the top 20%. (See the more detailed analysis in the top left box. In fact, growth has really gone to just the top 5%.)

Finally, the Chinese Yuan has risen some 10% against the US Dollar (and risen against other currrencies) the last few years. Thus, we, in the West, need more Dollars, Euros, Pounds etc to buy 'stuff' from China. Thus China has been exporting inflation.

The longer we have before the next recession, the higher and higher inflation is likely to go. And along with it, eventually, higher interest rates.

The US Federal Reserve has already had 4 Base Rate rises, with more to come. This is proving hard for small and medium sized businesses and US households. Obviously.

Of course, if we have a recession sooner than later then inflation will subside again. Hardly something to look forward to though.

EITHER WAY IT ISN'T A PRETTY OUTLOOK: Higher inflation and interest rates or we "turn Japanese" ie we have a deflationary, low inflation depression. (NB. We can't slash rates).

In inflation, invest in inflationary assets. In deflation, invest in deflationary assets. So that's what we do.

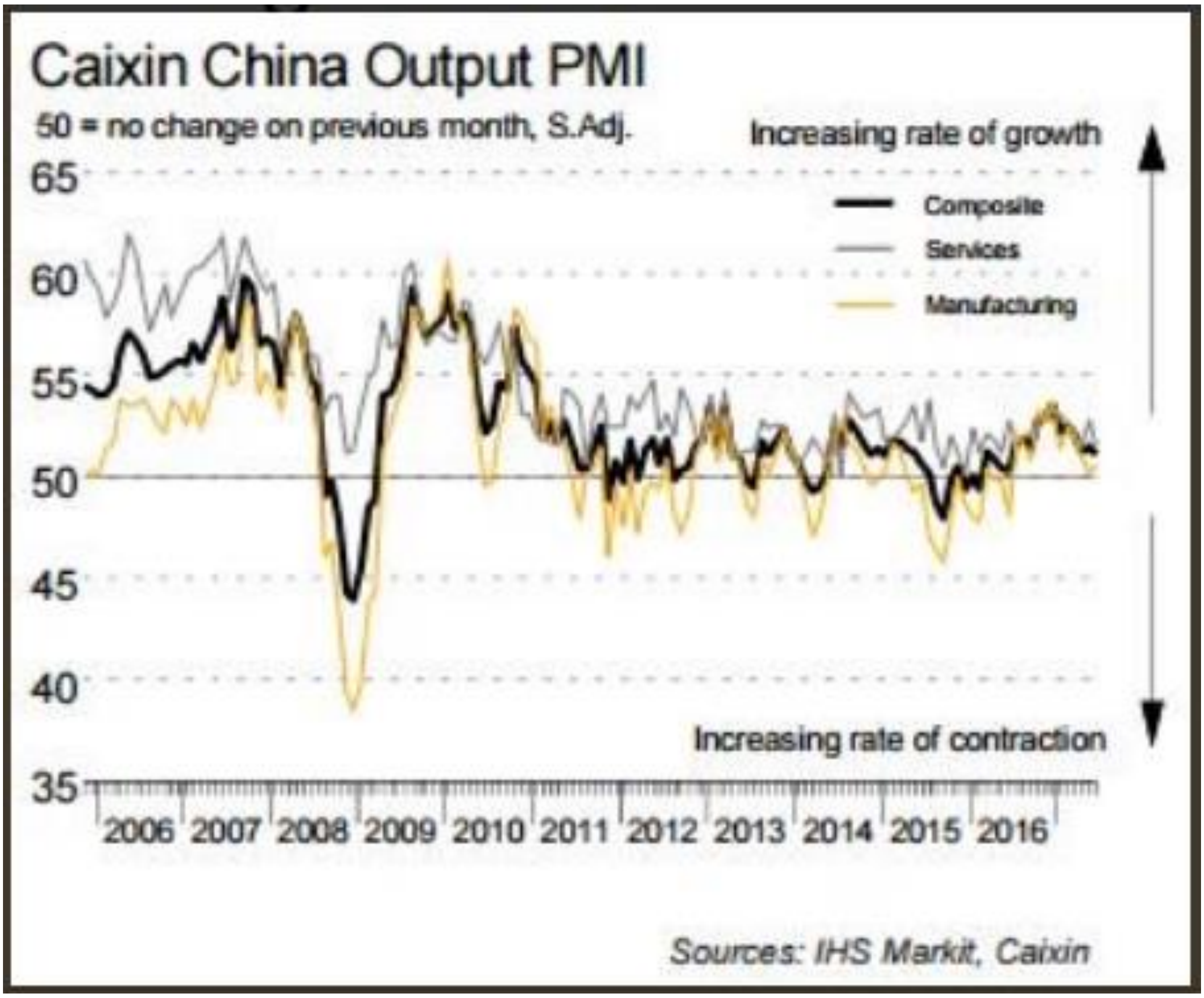
Global economy

So what's material about what is going on 'out there'?

China is now the second largest economy on Earth (and they want to be the largest and are happy to arrive there, gradually).

The plan, recently, has not gone to, er, plan.

The thick black line shows whether China Composite (Manufacturing and Services i.e. the economy) is expanding or contracting.

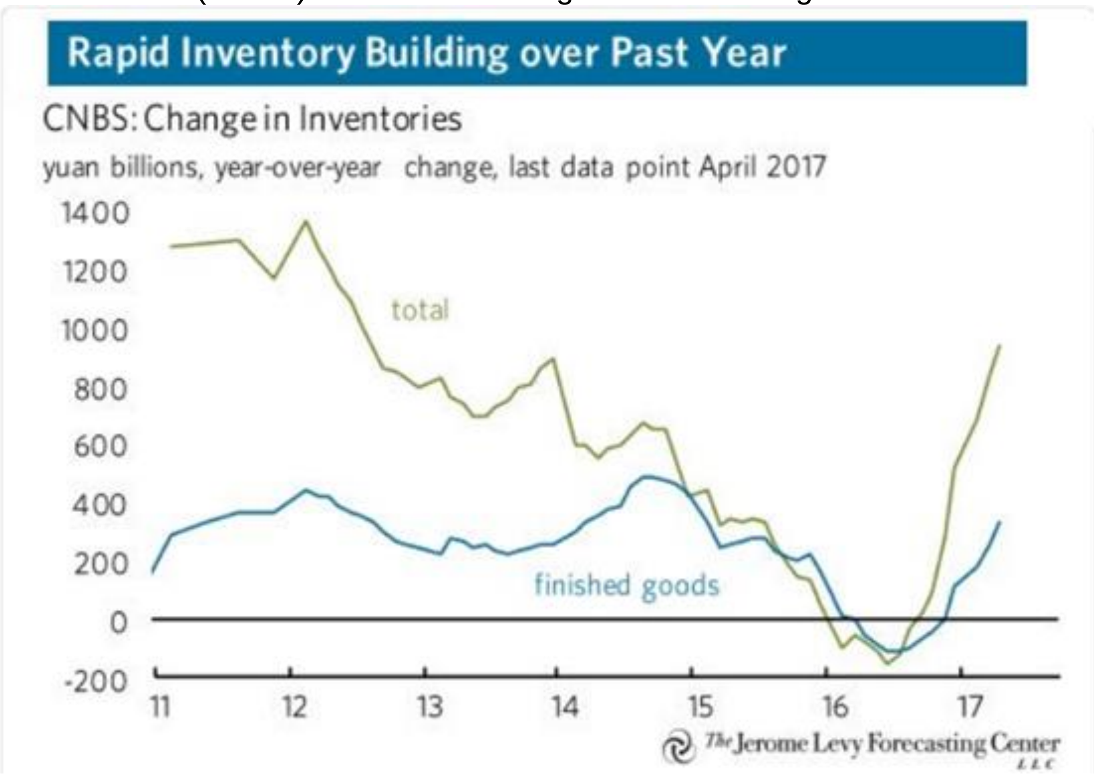


It's expanding. Just.

In fact, it's been 'just' expanding now for 6 YEARS. Where they get their 7% pa GDP growth from goodness knows.

China, as everyone knows, is the workship of the world. Yet, manufacturing (pale yellow) is barely holding its own. And has been down for more than it has been up, for 6 years. (So, does that mean the West is buying more stuff from elsewhere? Doubt it with just 1-2% pa growth.)

Chinese inventories (stocks) of manufactured goods are soaring.



So, they're making goods but selling far fewer. So stocks have risen rapidly.

So are PMIs and stocks suggestive of a strong global economy? Of course not.

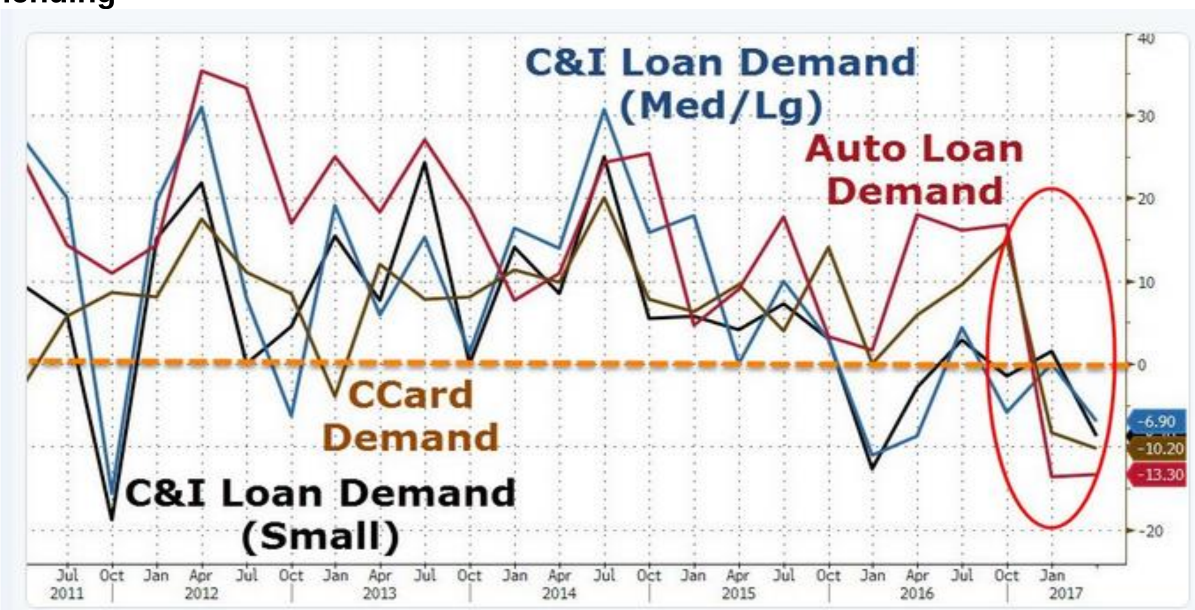
And what about Western demand?

US consumption growth falls to lowest pace since 2009. on.ft.com/2oSM3VR

US consumption growth level is at its lowest since... the last recession. It's practically flat year-on-year.

What about US lending to households and businesses? (Normally, an excellent gauge of economic growth or otherwise.)

US lending

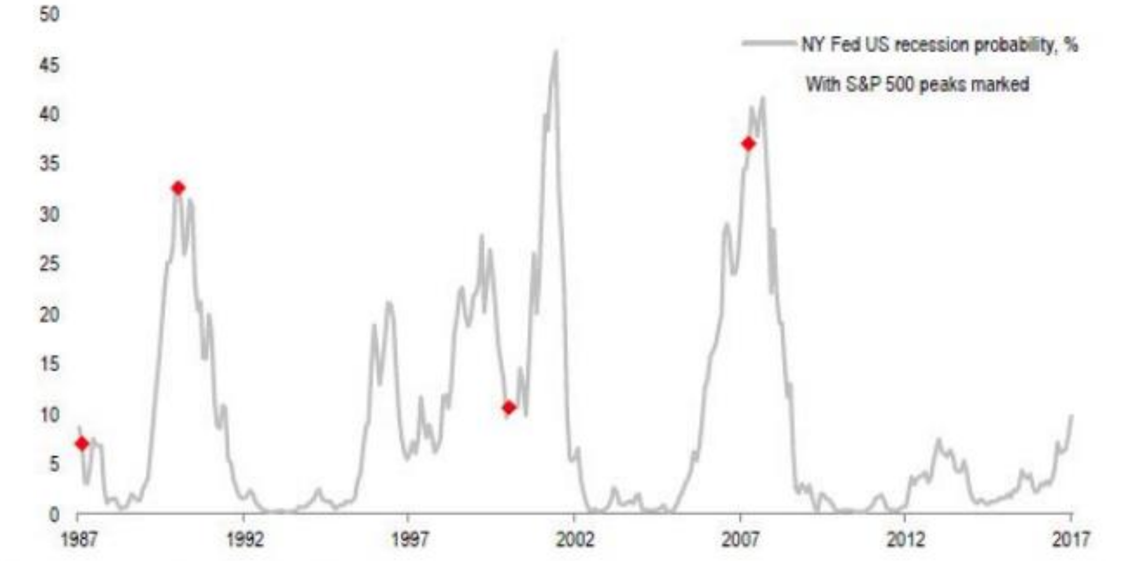


Bank lending in the US is plummeting, whether to small or medium-sized businesses, credit cards or car financing. Down c 10% since last year and trending down, further.

No wonder Chinese manufactured goods' stocks are rising.

And then, we wonder, what do the authorities say? (Normally they pretend all is well until it is blatantly obvious there's a problem.)

Figure 74: The NY Fed's recession probability is at 10%



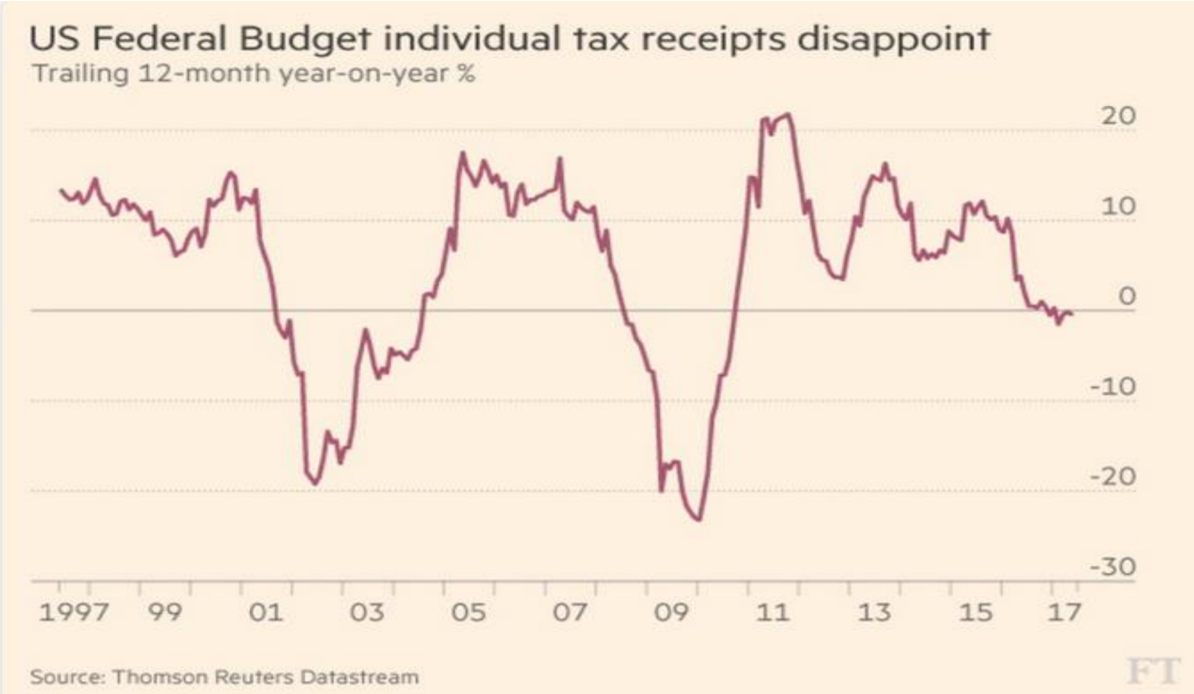
Source: Thomson Reuters, Credit Suisse

The Federal Reserve's expectation of coming recession has risen from zero to 10%. Thus, they put it as unlikely.

The red dots are when the US stock market peaked and we then saw recessions. Note the FED Probability of Recession didn't see the Dot Com (2001/02) recession until long after Dot Com stocks had crashed.

The FED Probability of Recession indicator is rising.

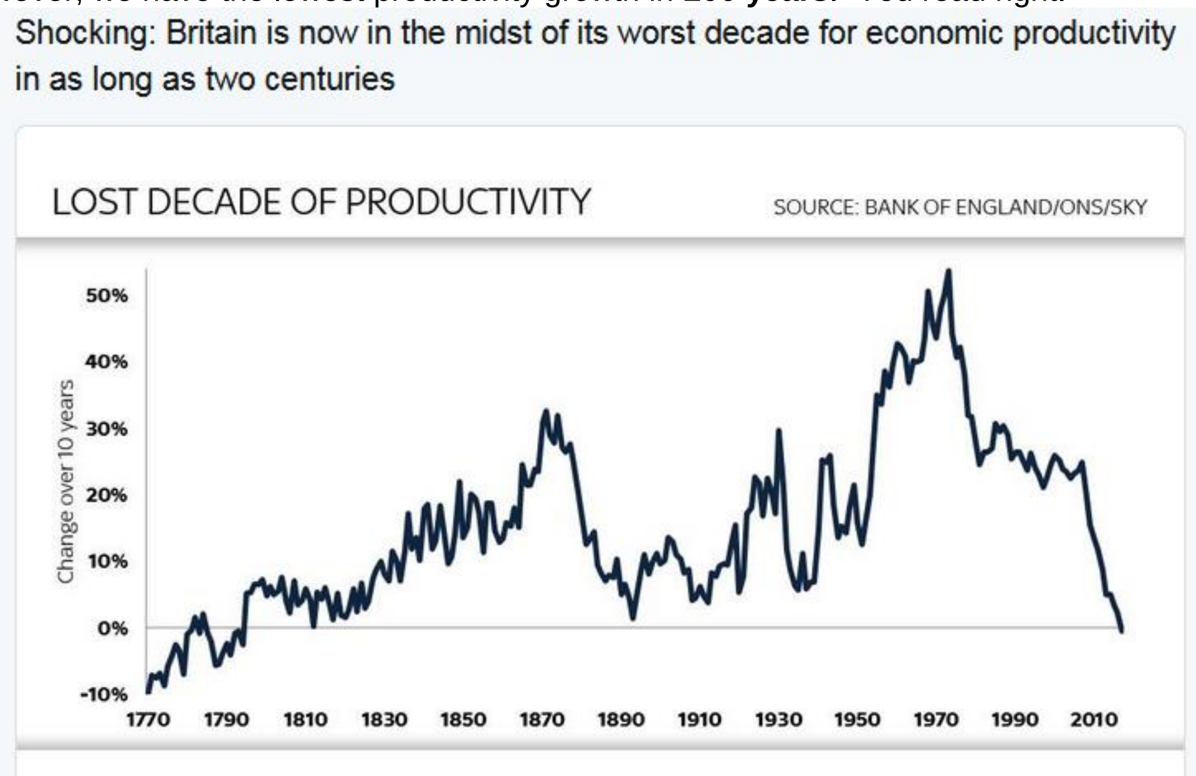
Look at **Federal tax receipts.**



Federal tax receipts are flat year on year. The last time they went negative was 2008. The time before that was 2001. The two last recessions.

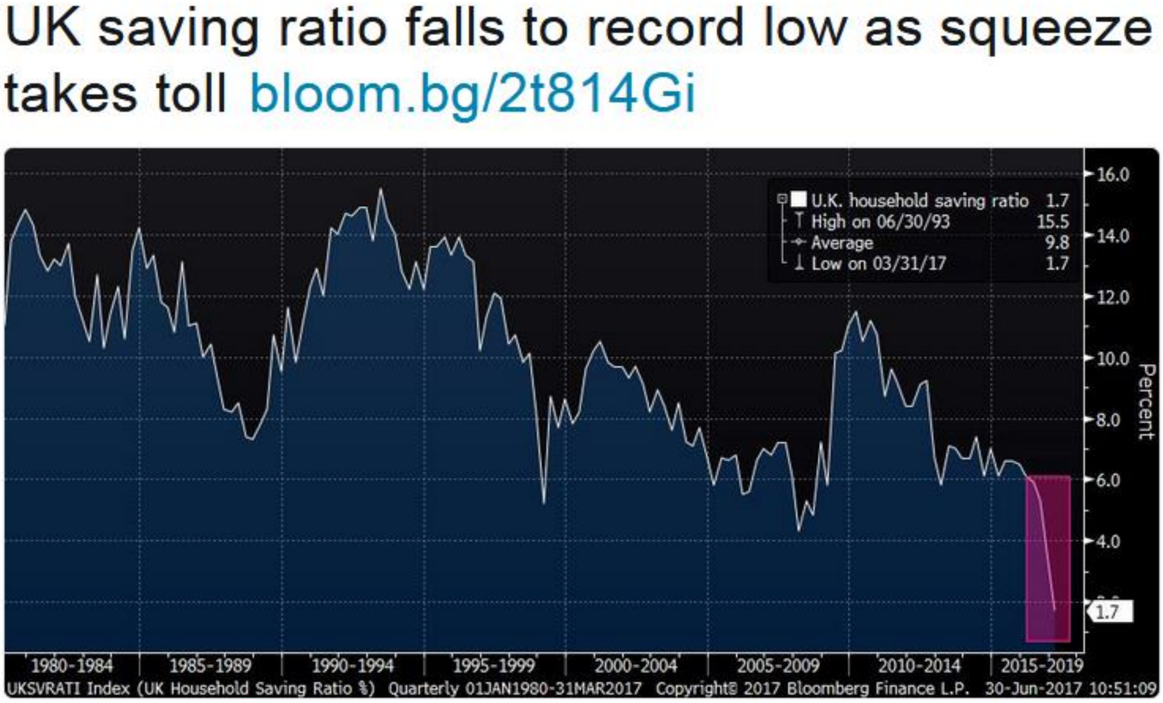
You may have read that the UK unemployment rate has fallen to just 4.5% - of the lowest in **40 years**. Yippee!

However, we have the lowest productivity growth in **200 years**. You read right.



On top, we have the lowest earnings growth in **150 years.**

On top of all that, the **UK Savings Ratio** is at All Time Lows.



The savings ratio is the ratio of personal savings to disposable income.
Just 1.7% of UK earnings is now saved. How is this positive for our future? What happens in a recession with so little savings?

Truly shocking and awful economics.

It is immaterial that unemployment is low if productivity (ie potential to earn) is so dire. It is so because we have so many doing McJobs, part-time and many more self employed 'working from the spare bedroom'.

Is any of this suggestive of a strong and strengthening economy?

Even the FED (and the Bank of England) are increasingly concerned. They get there eventually, bless them.

The point I have made, for years, is there is extreme underlying weakness right across the West. That we have some growth masks it. And any growth that we do have is going to the top.

This is not an anti-inequality rant (don't start me!). This is to say that we have no or little economic growth. Thus we remain in Depression. And nothing is on the horizon to help. Thus, it will eventually see chickens coming home to roost right across the investing sphere.

People ask me what or where will be the trigger for the next recession?
I start by asking: where did 2008 start from?

It wasn't Lehmans in September 2008. Nor Bear Stearns. Nor Northern Rock, 11 months before Lehmans.

It was a quiet banking collapse, in early 2007, in a country with a population of merely 300,000 that NOBODY was looking at. Iceland.

The proverbial buttterfly flapped its wings and created a hurricane 8,000 miles away.

There is a baker's dozen of potential culprits. My own guess though is that it starts where nobody is looking. Maybe it HAS started. Every time EU banks have problems they print more money and bail them out, whether legal or not.
What about the problems no-one has picked up on? The spider's web of global banking interconnectivity is immense and all-encompassing.

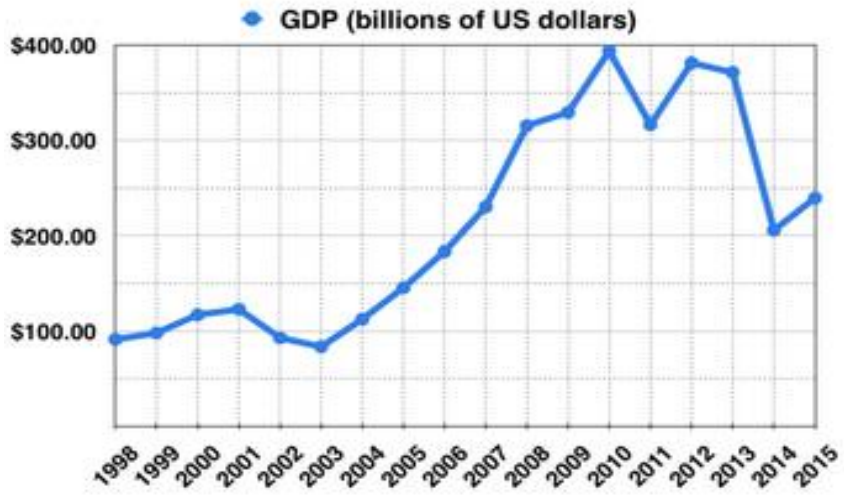
Who knows what butterflies are out there?
What we KNOW is that with vast amounts of stimuli all we get is 1-2% pa growth and nothing or negative benefit to the bottom 60%. Not conducive to general well-being.

To paper over known problems, China prints more money, every year, than one even thinks possible.
As does Japan and the ECB.
The UK has amongst the highest total debt anywhere in the world.

Evidently, the economy is not the markets.

As evidence that you can have a soaring stock market but a dire economy, take a quick look a**t the Socialist wunderkind: Venezuela.**

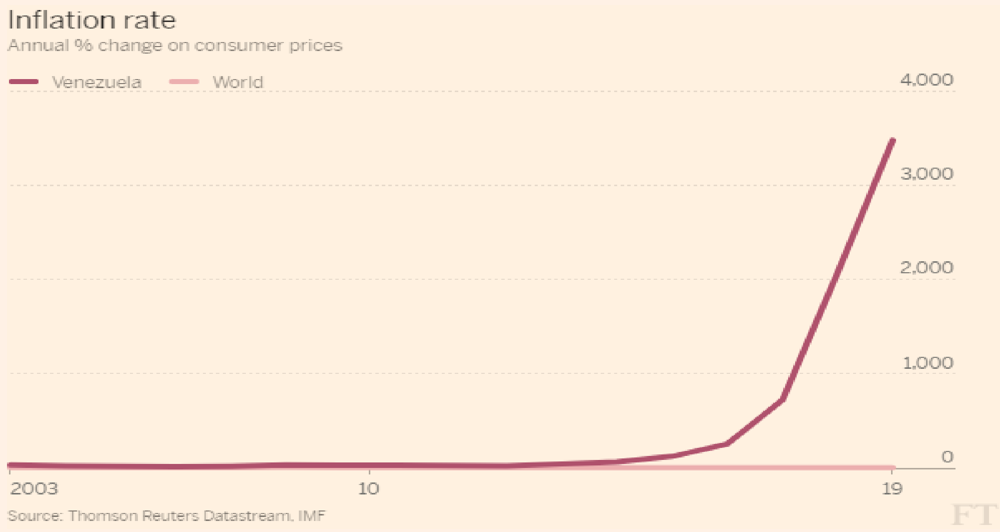
Venezuelan GDP



The economy HALVED between 2010 and 2014 (while the oil price doubled. And Venezuela has the LARGEST known oil reserves in the world!). In early 2015 the Maduro regime stopped producing national economic GDP statistics... The IMF estimates Venezuela lost a further 20% of its economy from 2015 to this year. Other Latin American countries have expanded in recent years.

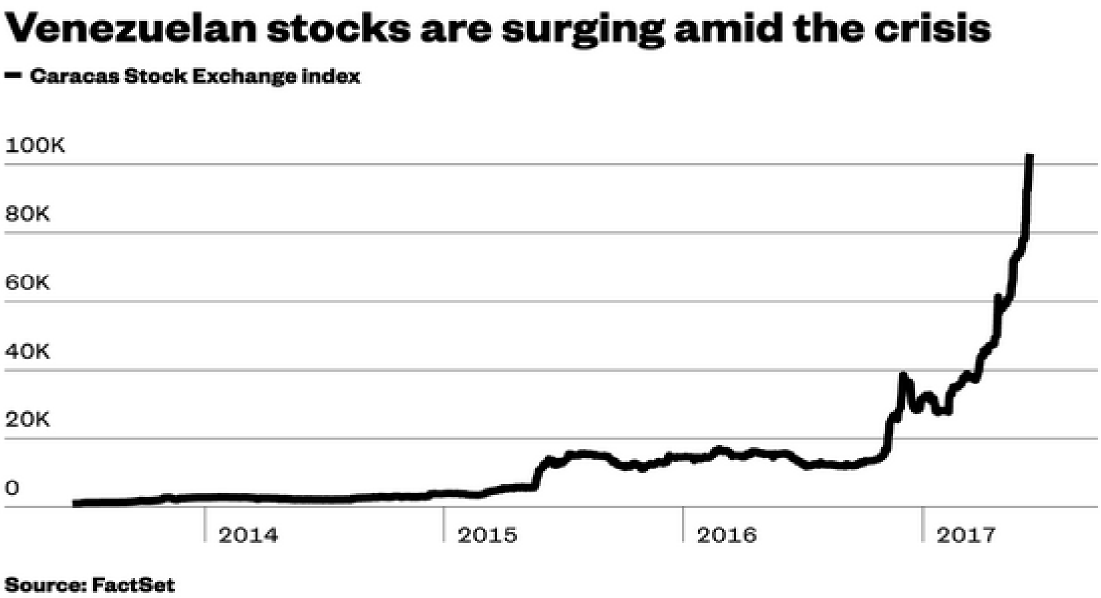
Venezuela is in hyper inflation

Venezuelans are seeing the value of their money shrink at the fastest pace in the world. The IMF estimates an inflation rate of 720 per cent for this year, skyrocketing even further in the coming years.



So, Venezuela has collapsed and is collapsing.

The stock market, however...?



In hyperinflation those who hold stocks will hold them for dear life and invest their shirts as stocks will often be an effective hedge against such rampant inflation.

The economy is not the market.

Talking of which...

Another sector that could and probably will add to our inflation woes is the cost of food. And, no, it has NOTHING to do with BREXIT. (If I had a Pound every time...)

US Agricultural produce index

As you see, agricultural prices have trended down for years. However, it seems to me there is increasing likelihood that global agricultural prices have been bottoming since around 2 years ago. They are building to rise, probably sustainably.

1. Rising food costs come straight out of the middle and working classes' pockets. Not good, therefore, for discretionary spending. You think we have high food prices now? Actually, they've been kept low by a multi-year rising US Dollar.

2. Falling discretionary spending often leads to recession. It did in 2008.

3. A falling £ makes it even worse for the UK. (Actually, I expect the £ to rally hard over the next weeks and few months. It's already up from $1.20 to $1.30 with, likely, more to come.) A rising £ alleviates this somewhat but a rising £ would be temporary in my view.

Who will benefit from sustainably rising agricultural prices?

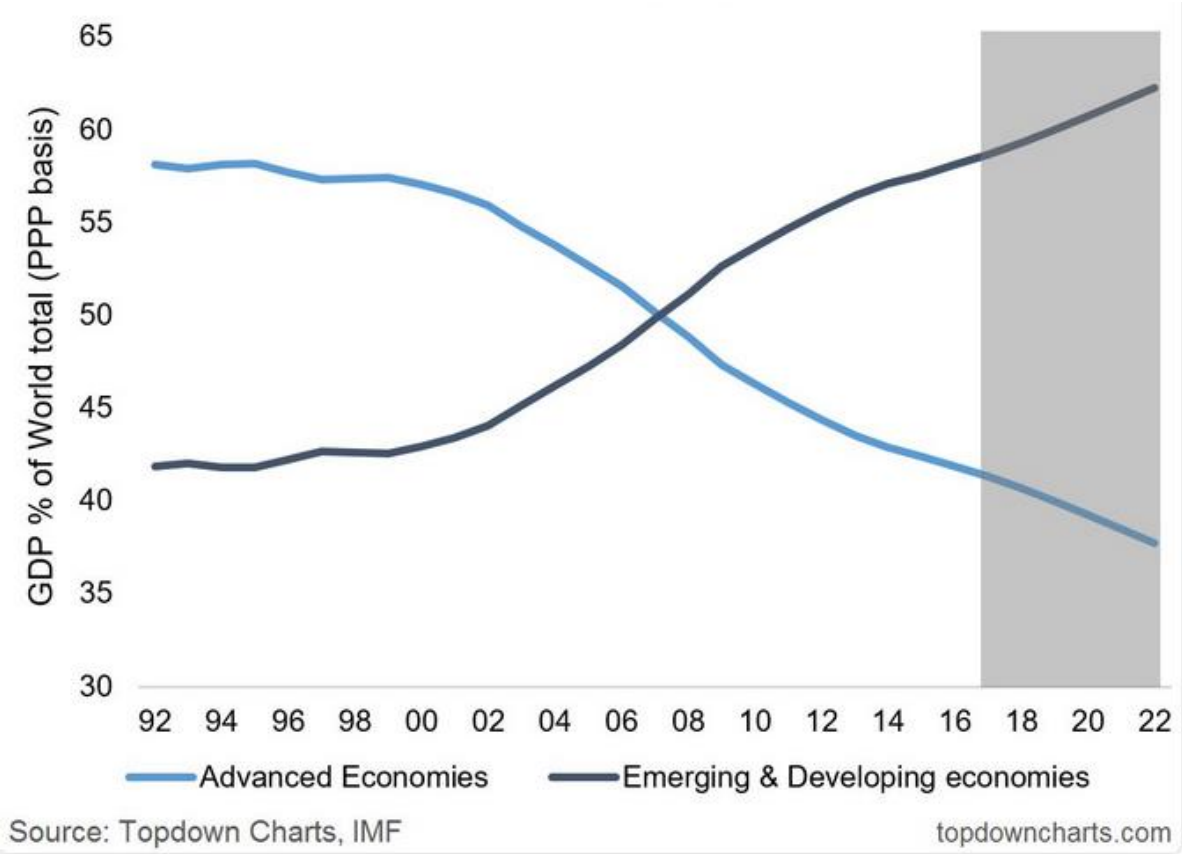
Farmers of course. Not so much in the UK and EU as they have vast central government payments (Common Agricultural Policy) so their benefit will not be so much.

Latin American farmers will do very well. African farmers too. (The latter will also do well as they will be able to export to the UK after BREXIT from 2019.) Australian and New Zealand farmers, too.

In other words, mainly Emerging Markets and 'commodity' countries.

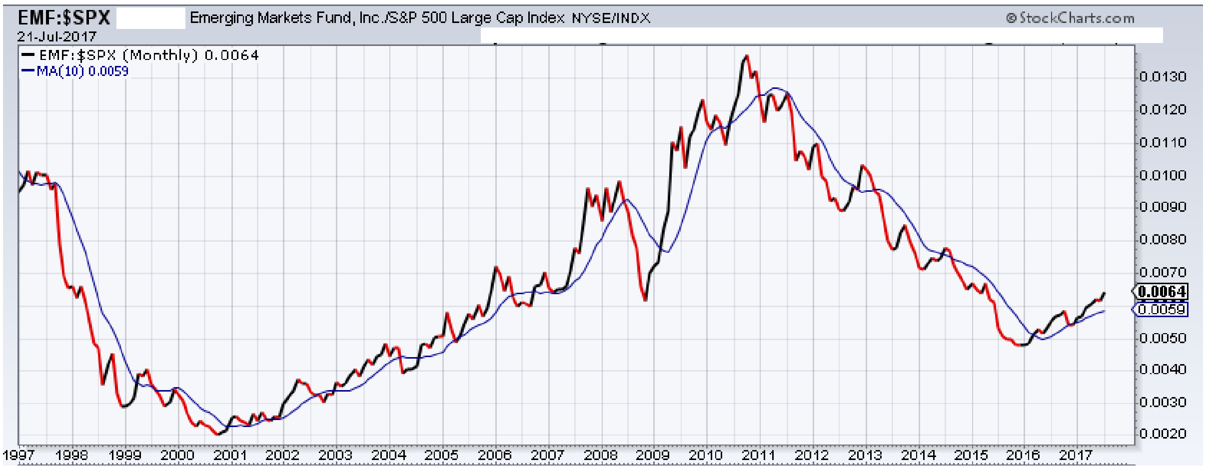
Talking of Emerging Markets, I was fascinated to see this (I had no idea!):

Emerging Markets' economies now account for some 57% of the global economy. Advanced economies, of course, some 43%.



When you consider who benefits from inflation, you have to say investing in Emerging Markets sounds appropriate, long term.

We have been doing so for a few years and we will build on EM positions over time. There is far more investing opportunity in EMs than Developed Markets, over the next 10 years, as far as we can tell. The EM fund, in which we are invested, has grown investor assets nearly 100% since the beginning of last year.



Since the start of 2016, Western stocks have grown handsomely. EM stocks even more so.

Investing is often about relative opportunities. Why invest in A - even if growing - if B is growing faster?

Emerging Markets severely underperformed Western stocks for years into 2000. Then they massively outperformed, for some 10-11 years, with hiatus in 2008.
Next, they underperformed again to the end of 2015.
For a year and a half, to now, they have outperformed. Most folk have been brainwashed into believing US (and other Developed Markets) are the be all and end all of stocks' investing. Is this the start of 5-10 years of outperformance? Who knows? Maybe.

Markets are often cyclical.

The following map is amazing. Global population study: 50% here. 50% there.

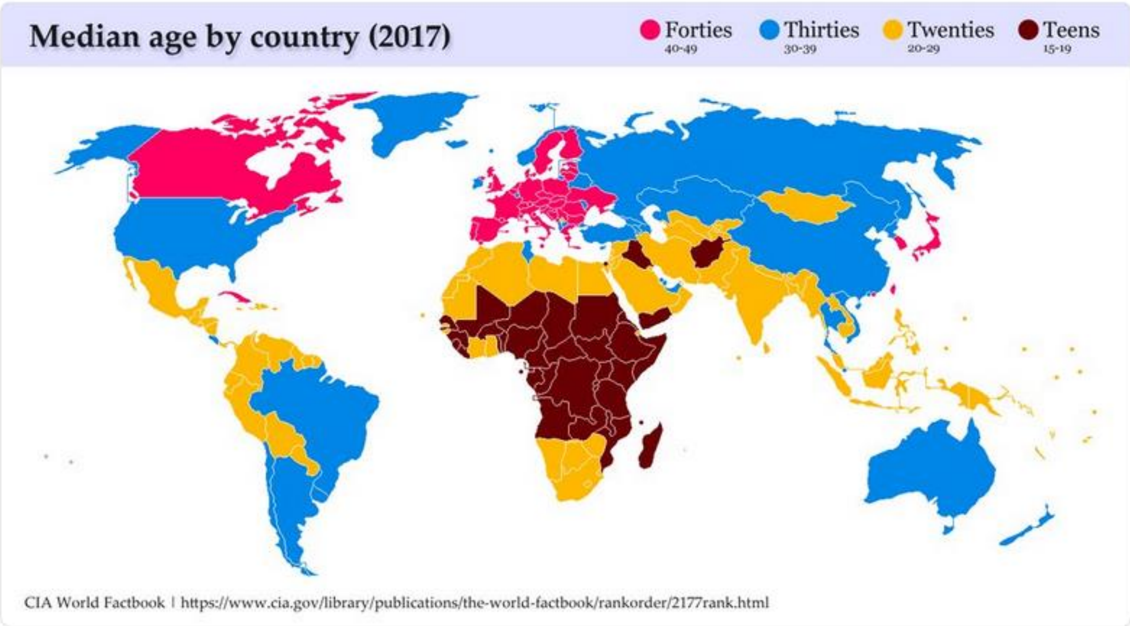
50% of the world's population is living in just c 15% of the global land mass, painted red.

For so many reasons China and India will be amongst the biggest economies sooner than later. China is already no 2.

Mexico too will be a powerful economy. Indeed, it has some more advantages than China, in that it's on the USA's doorstep. So, transportation of goods is materially cheaper and quicker.

Nigeria will be amazing. It will soon have 200m residents and the demographics are extraordinary.

Global median ages



Most of Africa's countries have a median age in the TEENS. Most of the rest of the emerging economies have median ages in the 20s.

On a long term view, for your retirement funds (which could be investing for **30-60 years**, to age 100, say) would you rather invest in older or younger economies?

And by the way, China's debts are huge yet they are smaller, as a percentage of its GDP, than anywhere in the West. There's a lot of debt growth to come, there.

What are you doing with your retirement funds and what will you do?

Do you hold more than 60% in shares and corporate bonds of companies in the UK, US, EU? More than 70%? More than 80%???!!!

Here are some quotes which may interest you:

"We will not have any more crashes in our time."
John Maynard Keynes **1927** (Keynesian Economics)

"...stocks have reached what looks like a permanently high plateau"
Prof (Economics, Yale) Irving Fisher **1929** (9 days before the 1929 peak "of all peaks")

US Stocks then fell 90% to 1932.

"We've never had a decline in house prices on a nationwide basis. So, what I think what is more likely is that house prices will slow, maybe stabilize, might slow consumption spending a bit. I don't think it's gonna drive the economy too far from its full employment path, though."
Prof Ben S Bernanke ***2005***
(Member of the Federal Reserve Board (from 2002) then **Chairman** (2006-2014)

US house prices, nationally, peaked in 2006. Then fell some 50% into 2009.

"Don't expect another crisis in our lifetimes."
Janet Yellen, Chairman, Federal Reserve **2017**

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What should you do to secure your wealth?
Don't put it off till it's self-evidently too late.

Can you benefit potentially from our advice?
We work for wealthy families and/or high earners.
We work for clients all over the UK and indeed on three continents.

Our most important and most often repeated philosophy is (as seen widely on our website):
"We advise you based on what we would do, were we in your shoes, given what we know".

Call me personally to see how we can help.

Please note carefully the following important messages:

I believe most folk do not realise, in big picture, **the sheer gravity** of our economics and markets (major stock markets, corporate bonds and property).

They will.

I think most folk also do not realise, in big picture, **the amazing opportunities** in our markets.

They will.

Click ***to forward to a friend*** if you think they could benefit from reading this.

If you have any queries over any of the issues raised do not hesitate to get in touch with me by calling me or emailing me at ***jdavis@jonathandaviswm.com***.

On Twitter, follow me ***@J0nathanDavis*** where I frequently comment and link to important commentaries on markets and economics.

Kind Regards

Jonathan Davis BA MBA FCII FPFS
Economist and Wealth Adviser
Chartered Financial Planner
Presenter of The Booms and Busts Show on *itunes*. See tweets *@boomsbustsshow*