16TH JUNE 2019

Global Strategy

INVESTMENT TEAM

Robert Jukes
Global Strategist
T: 44.207.523.4594
rjukes@cgf.com

Kevin Vandermeer
Managing Director, Investments & Advisory Solutions & Lead Portfolio Manager
T: 416.867.2643
kvandermeer@cgf.com

So Long Marianne

This week we lift our head out of the weeds and informally consider some of the longer-term opportunities and threats for markets going forward. One such opportunity falls out of a comparison of the current trade dispute between the US and China and a similar spat with Japan thirty years ago, because this time there are many reasons to assume the outcome will be different, and ultimately positive for Chinese equities. Elsewhere, the tech trade has taken a beating over the past few months, but there are elements of that sector that continue to offer secular growth opportunities, one of which is the video game content creators. Interest in non-cyclical growth is clear given our position in the late stages of the current growth cycle, but the US labour market may yet offer the possibility of an extended cycle. Finally, Brexit just won't go away, and with the current crop of would be Tory Prime Ministers are leaning hard to the right, we suspect that another referendum is increasingly likely making Sterling asset plays increasingly interesting.

China: It is tempting to draw parallels between the US trade war with Japan thirty years ago and China now. The US successfully contained the economic rise of Japan back then and is using similar measures to remain dominant over China today. There are crucial differences, however, and these are likely to mean that the US will be unsuccessful in seeing off the Chinese challenge to US hegemony, this is a struggle that is likely to last for many years to come. So, while the equity market seems to be pricing tail risks around the current trade dispute, the reality is that any agreement struck now, will be relatively short-lived. This conflict will likely persist for in one form or another for many years to come, and China will soon overtake the US in economic size. Long-term strategic allocations to China are essential in balanced global portfolios.

The main differences between China now, and Japan thirty years ago are the likely future pace of growth. Japan was a mature and advanced economy recovering from the ravages of war. Today, China remains an emerging economy with relatively low levels of GDP per capita – there is plenty of room for growth before maturity sets in. Back then, Japan was also much more reliant on the US, both economically and politically, making it much harder to resist US calls for a stronger Yen as a means of shrinking Japans huge trade surplus. China does not have such an asymmetric relationship with the US and is better placed to resist these (very similar) demands. Arguably, US intervention in Japan on trade was one of the reasons Japan failed to make the transition from an export led economy to one driven by domestic demand, such as the US. That is a lesson China seems to have headed with its careful attempts at rebalancing Chinese economic growth.

US Labour Market: With the unemployment rate at 50-year lows, it is tempting to see the US economy as having reached its capacity. For sure it seems likely the further employment growth will drive up wages, forcing interest rates higher, but there is good reason to expect that to happen at a slower pace than before. The U6 measure of US unemployment (those weakly attached to the jobs market) has fallen back to levels consistent with the last cycle, but there are many people that have only recently re-engaged with the labour market. Many had either stopped looking for work altogether or taken part-time positions while seeking full-time work. The fact that the rate of job creation is now strong enough to offer employment opportunities to those longer-term U6 unemployed, means that labour supply is likely to continue expanding.

Politically, this is gold, the idea that people are being sucked back into the labour market it after an extended period away. There is every reason for policy makers to want the economy to run a little hot (with more inflation than targeted to make up for the shortfall previously). People are also changing jobs more rapidly as more appropriate opportunities become available. On the economic matching model, this should also drive up productivity rates slowing the degree of wage pressure. Both effects may extend the cycle somewhat.

Video Games: I remember the wonder of seeing Pong for the first time, getting hooked on Space Invaders, and Defender eating the money I earned from a paper round. As these games moved from the arcades to the home, Manic Miner and Jet Set Willy consumed yet more of my leisure time, until I officially retired having completed Halo on Xbox. Now I simply watch as my son is drawn into the cinematic reality of Red Dead Redemption. The enduring appeal of video games is unquestionable and Esports has the potential to drive yet more revenue into this sector. Unlike those areas of tech, with business models based on accumulating massive amounts of data and which are stumbling at every turn of the regulatory screw (particularly the EU), the video games industry looks unstoppable.

Spotting the next big thing in the video game sector is lucrative for sure, and Fortnite was instructive in that regard. Perhaps the biggest challenge, however, has been female engagement. Pac-Man seemed to capture more of the female market than Space Invaders, and Cooking Mama certainly grabbed my daughter's attention for a while on the DS handheld, as did Just Dance on the Wii, but we have yet to see that killer console game that lures female players into what remains largely a male pastime. The answer may be found in the development of AI. To date, computer driven opponents have been inferior alternatives to online multiplayer. Maybe the industry needs something more intelligent or convincing to draw more kinds of people into the pastime in the way that Hollywood has developed genres that appeal to a broader audience. Either way, this industry remains a source of non-cyclical growth, that will likely remain attractive to investors as distribution costs continue to fall and platforms converge reducing development times.

Brexit: The rush to the Tory right in this leadership race to be the new Prime Minister is sad to see, and hopefully not a prologue to the dystopian post Brexit Britain depicted in Watch Dogs Legion. The government has been unable to deliver Brexit, and logically more not less flexibility on the way forward might seem appropriate. Instead the most likely successors have hardened their approach to appeal to the right wing of the party. Boris Jonson won the most support in last week's first round election and remains the odds-on favourite to win. He wants to renegotiate with Europe, even through they have repeatedly said that will not happen. He has also made the end of October this year a hard deadline, saying that kicking the can further down the road will end up in his party effectively kicking the bucket. Further deadlock seems likely.

Sterling has fallen sharply since May's resignation and remains close to the lows of this year. As the election process continues, it will likely fall further as candidates heat up their rhetoric and stir anti-EU sentiment for domestic gratification. Ultimately, however, Parliament is unlikely to allow a no-deal exit, and Europe is unlikely to negotiate well with a hostile interlocutor. That all points towards another peoples vote, which if the recent opinion polls are to be believed, will produce a narrow win for "remainers". The path for Sterling therefore seems to short-term weakness before medium-term strength. Should the Brexit situation resolve in anything like we suggest it might, UK equities will rally hard, alongside the currency. This might be a great opportunity to position into UK assets.

"Come over to the window, my little darling. I'd like to try to read your palm." So, sang Leonard Cohen on his debut album, and appropriate really, as we sift through the economic tea leaves for some opportunities in the future. Chinese equities were severely punished last year and remain hyper sensitive to the near-term twist and turns of trade negotiations. The opportunity lies in the longer-term, such as with the three-step approach from MSCI this year, increasing the weight in that index of Chinese equities. That is a trend that is likely to continue in the years to come, and passive index trackers will have to replicate these changes swiftly. We could be wrong, however, and China might go the way of Japan, but we think that is unlikely. We won't be right about everything for sure, and it will soon be, "...time that we began to laugh and cry and cry and laugh about it all again...."

All information is given as of the date appearing in this document and Canaccord Genuity Wealth Management (CGWM) does not assume any obligation to update it or to advise on further developments related. All this information has been compiled from sources believed to be reliable, but the accuracy and completeness of the information is not guaranteed, nor in providing it do CGWM assume any liability.

All views expressed in this document are provided for informational purposes only and does not constitute an offer or solicitation to buy or sell any securities. The statements expressed herein are not intended to provide tax, legal or financial advice, and under no circumstances should be construed as a solicitation to act as a securities broker or dealer in any jurisdiction. All views are intended for general circulation to clients and do not have any regard to the specific investment objectives, financial situation or general needs of any particular person.

Forward-looking statements and past performance are not guarantees of future results. To the fullest extent permitted by law, neither CGWM nor its affiliates or any other person accepts any liability whatsoever for any direct or consequential loss arising from any use of the information contained in this document. Canaccord Genuity Wealth Management in Canada is a division of Canaccord Genuity Corp. Member – Canadian Investor Protection Fund and the Investment Industry Regulatory Organization of Canada.