January 27th, 2020

The World has its Challenges

- **China's virus an unknown quantity a key worry for markets**
- **Davos debate shows concerns about the legacy of the past unbridled capitalism**
- **Big tech in the sights of the regulators**
- **The UK leaves the EU and crucial trade talks begin**

The spectre of severe acute respiratory syndrome (Sars) has fallen across financial markets in the wake of the outbreak of a new strain of coronavirus. The virus previously unknown to science is wreaking havoc over the Chinese New Year. As a template for impact, investors are looking to the outbreak of Sars in 2002 when 774 people died out of 8,098 people infected. It is too early to judge just how widespread the virus has or could spread. However, the most recent efforts of the Chinese to contain the outbreak by effectively putting whole cities into isolation only serves to highlight the gravity of the situation.

Equity markets have sold off and are still vulnerable, given the gains from a relatively strong start to the year. Much will depend on how much the virus has spread. Disruption to the Chinese economy is one thing, but if it starts to create problems in Europe and the United States, there could be a more substantial hit to the markets. Wuhan is one of China's "motor cities''. General Motors, Nissan Renault, Honda and Peugeot are among several companies that have large manufacturing plants. Luxury goods companies have also sold off as the Chinese New Year buying seasons has been damaged by the virus outbreak.

Davos talking points

As expected, President Trump virtually stood alone in Davos on the issue of climate change. But the climate change debate was never going to be the substantive given entrenched positions. However, we do note that other aspects of economic policy that were discussed are gaining more notice. There is firstly a genuine building concern about the future of capitalism, and secondly, there are concerns about the dominance of big tech. Many resonate with points we have recently made about structural challenges for the next decade

Gung-ho capitalism has left a legacy of profound inequality and indebtedness that many worry will lead to a backlash from the electorate when times are tougher in the global economy. The fact that socialist Bernie Sanders is currently in the lead in the Democratic caucuses is an example of how more left-wing candidates are resonating with the electorate. Between Bernie Sanders and Elizabeth Warren, they account for 40% of the vote in polls. Jeremy Corbyn may have abjectly failed to win the UK general election, but the fact is that his more extreme form of socialism was still able to garner 32% of the national vote. It may only be a matter of time before left-wing politicians see far greater support from the electorate. Polls show that the new voters from the Gen Z cohort aged below 23 are substantially more likely to vote for left-wing political parties than even the Gen Y.

Big tech – Tech companies remain on the back foot concerning if, and how they should be regulated. The Davos debate was just that, lots of talking but still no consensus on whether the companies need individual attention from governments, or whether the technology itself needs regulating. Companies were prepared to concede that AI needs a global framework so that the individual regains control of their own information. In the coming weeks, the EU is set to announce its thoughts on how AI should be regulated. Tech companies dominate the performance of the US equity market in part, their growth has been unencumbered by regulators. One senses that it is about to change. However, for the moment, the lack of a global consensus means that any changes will be incremental.

The UK and EU – Back to negotiations

The UK is finally due to depart from the European Union this coming Friday, forty-seven years after it joined and almost three years after triggering Article 50 of the Maastricht Treaty. It is a huge leap into the unknown with a tough trade negotiations ahead. The large Tory Party majority in the UK parliament and the change of leadership at the EU seems to have reduced the tensions between the two sides. UK Prime Minister Boris Johnson looks to project a much stronger profile and confidence than any of his recent predecessors in negotiating with Europe. That perception has already flowed into higher business and market confidence supporting sterling. There has been a revival in business confidence with stronger new orders and a coincident revival in the London residential property market.

So far so good, but what can we expect from the negotiations on the long-term relationship between the UK and EU? Negotiations are certainly likely to be less high volume than those on the Withdrawal Agreement. However, discussions will have a far-reaching impact. We would first suggest three things that are unlikely to happen. First, the UK may be disappointed in seeking to gain traction from running parallel trade talks with the US – in a US election year it is unlikely to be a priority for the Trump Administration. Second, the UK's efforts to simultaneously negotiate a comprehensive EU trade deal involving all economic sectors is unlikely to prevail – there will have to be some form of prioritisation and sequencing. Finally, we still think it is improbable that Prime Minister Johnson will seek an extension to the trade talks beyond the end of December.

So, that sets up the second half of the year for a frenzy of horse-trading. The British government's priority will be to safeguard its service sector's access to Europe; for the EU27 it will be to secure its £90 billon plus annual trade surplus with the UK in manufactured goods. All the arguments over level playing fields, equivalence, fisheries and farming will pivot around these two axes. At this very early stage, it looks as if a trade agreement is feasible involving financial services, fisheries and the manufacturing sector with concessions on both sides to get it across the line. Phase-in arrangements and interim settlements in other areas are inevitably required, but this will unsettle the EU. The very last thing they desire is the UK becoming another Switzerland rather than a Canada with the former covered by multiple sector agreements that Europe feels gave the Swiss advantageous terms. If Brussels digs its heels in, there is the risk that what is finally agreed is a bare-bones free trade agreement with significantly reduced access for the UK into the single market. That would inevitably see 2021 start on a far less buoyant note with a negative knock-on impact on sterling and domestic-linked UK assets.

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