thenavigator

Summer 2019

SORRY WE DIDN'T TAKE OUR OWN ADVICE

For the first time in a long time, we temporarily reduced our equity weighting in portfolios from an overweight stance. Whilst we still don`t subscribe to the consensus view that we are in the latter stages of a cyclical bull market (we still believe there is significant room both in terms of duration and percentage gains for much longer than most anticipate), there are some current issues which give us pause.

The recent US threat of tariffs (now removed) on Mexico for purely political (immigration) purposes not related to economics has, we believe, led to an increased weaponisation of the tariff tool. The fact that this move led to no censure of the President by either Congress or the Republican party really gives us cause for concern that Presidential powers remain unchecked (rather dangerous in a democracy).
The recent loud calls for interest rate cuts by the Federal Reserve (by TWEET)[1] and the talk of a demotion of the head of the Federal Reserve to be replaced by someone who presumably will do what is told, again sets up a very dangerous precedent of undermining the independence of the largest central bank in the world.

We are also concerned about the use of tariffs on named currency manipulators (currently going through the consultative process) as this leads to another area of uncertainty.

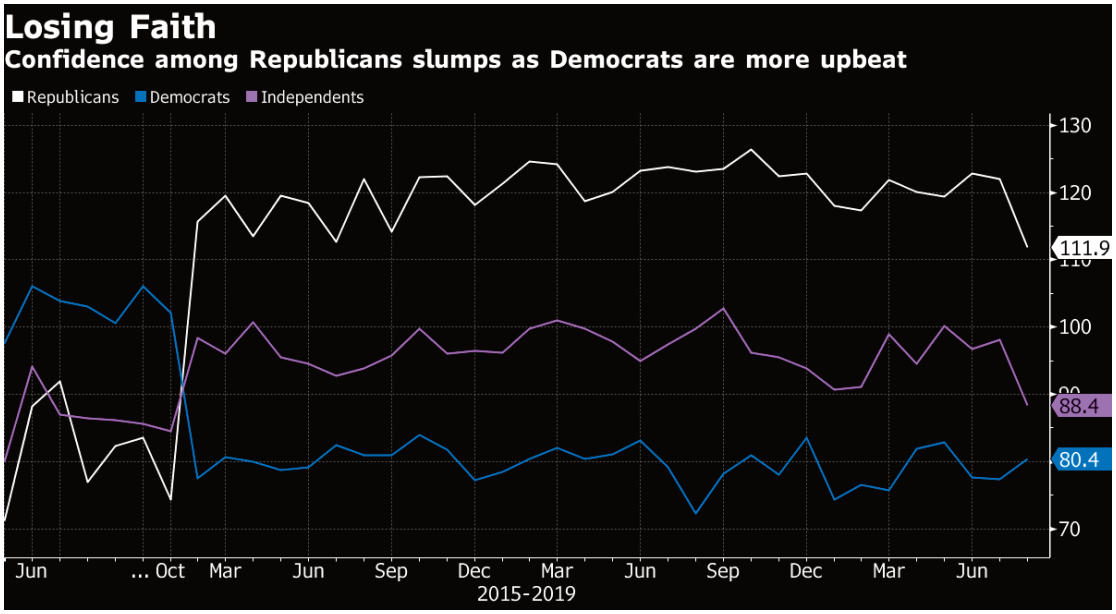
To put it in simple terms, think of the walking pattern of a toddler which is highly unpredictable and erratic. This pattern in equity markets makes us nervous; While we have no problem taking risks if the odds are in our favour, with so much depending upon binary outcomes, with the odds of 50/50 at the moment on many major issues, makes us cautious and leads us in the short term to have less conviction.

WAR, WHAT IS IT GOOD FOR? ABSOLUTELY NOTHING

... so goes the song by Edwin Starr. Originally written to protest against the US-Vietnam war in the late 1960s, it could equally well apply to the current US-China war-like trade disputes. In reality, despite the roller-coaster of escalation, de-escalation and re-escalation, the end result for both sides has been a big, fat zero with neither party able to claim a victory or an easy win. More troubling has been the disruption to global financial markets and to businesses that this egotistical battle has caused. Many companies have delayed capital expenditures due to uncertainty, and, as a result, we have seen a decline in global manufacturing activity.

Whilst the consumer in the US and China has been strong, recent surveys have shown that trade war fatigue could be setting in and once lost confidence will be hard to regain.

US CONSUMER CONFIDENCE VIA PARTY 12 MONTHS

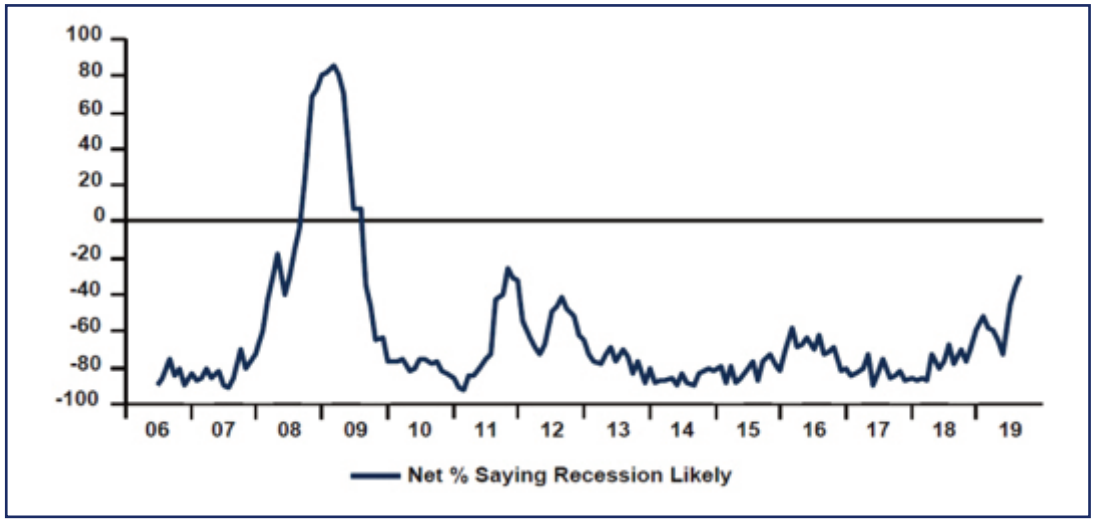


Source: Bloomberg, University of Michigan Consumer Sentiment Surveys, 31/5/2015–31/08/2019.

The recent University of Michigan consumer confidence survey showed the second-lowest reading since just before the 2016 US election.[2]

It's not just consumers who are worried but also those in the financial services industry.

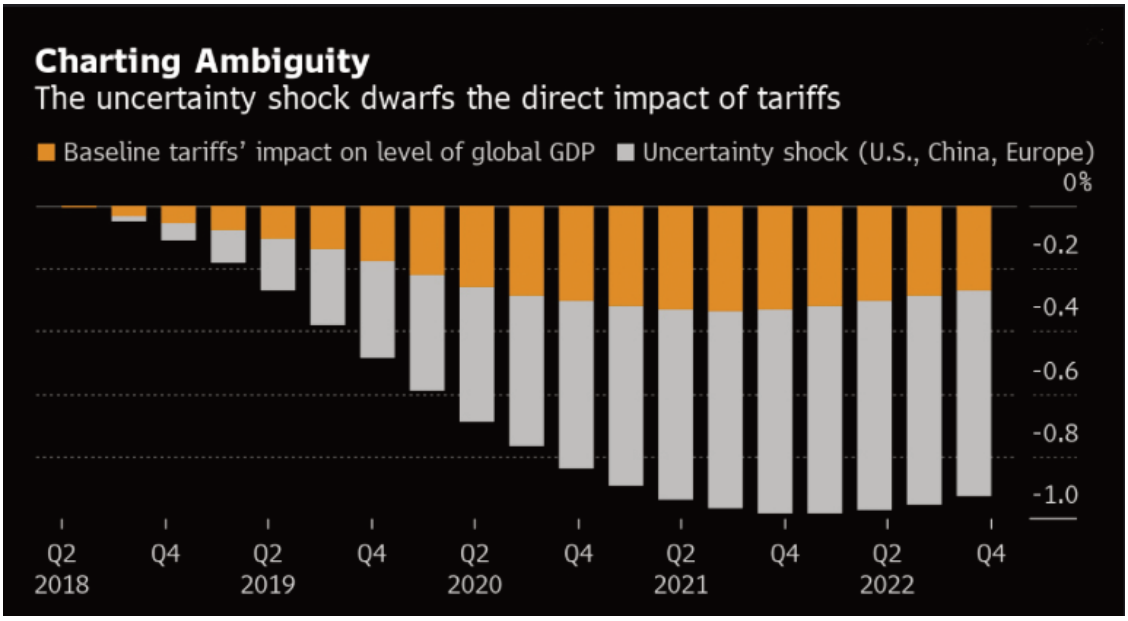
When asked how likely a global recession is over the next 12 months (see chart below), asset managers put the probability at the highest level since 2011! Remember, that was the height of the Eurozone crisis and also the nasty US budget standoff, which severely rattled investors. We should, however, also remember that 2012 and 2013 were some of the best performance years in global markets in recent times.



Source: BofA Merill Lynch Global Fund Manager Survey, Probability of global recession according to asset managers, 2006–2019.

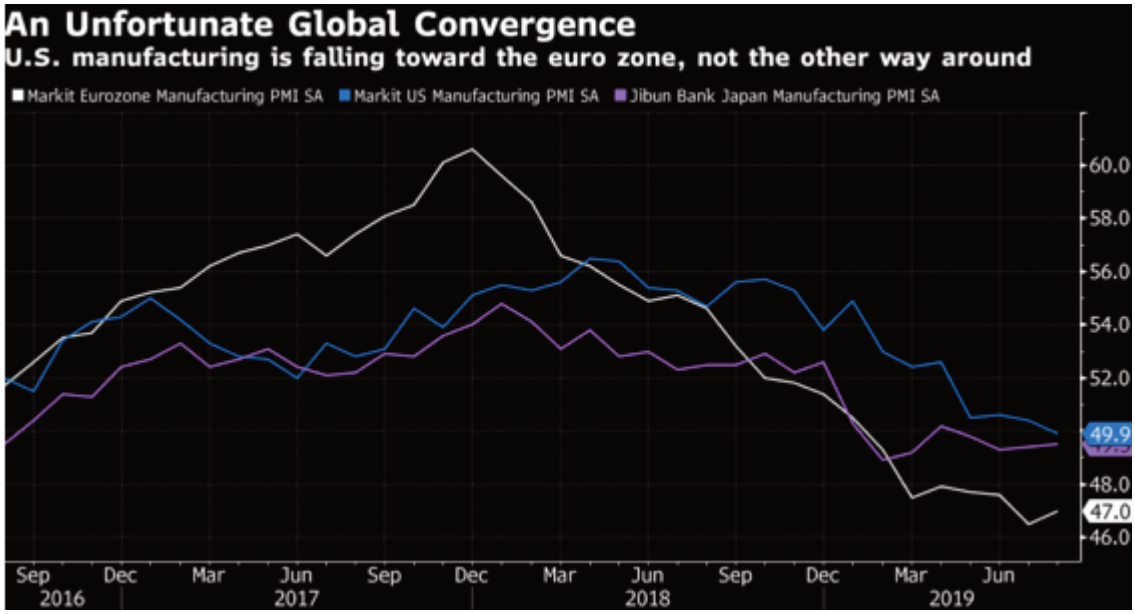
CASINO DISMAL

The continued gambling by both sides in the US-China trade war has led to heightened volatility and the increased chance of an accident. It seems to us that at this point in time both sides have misread each other. Whilst the current new increased tariffs by the US are in economic reality not that large, sentiment remains extremely fragile. Head-spinning uncertainty about trade poses major drag on global growth. As below analysis by Bloomberg Economics suggests, a tweet is mightier than the tariff, with a bigger negative impact coming from uncertainty than the protectionist measures themselves.



Source: Bloomberg Economics, NiGEM, The cost of uncertainty, Q2 2018–Q4 2022.

GLOBAL ECONOMY ON SUICIDE WATCH – YELLOW ALERT!



Source: Bloomberg Data., Comparison of the Eurozone/US/Japan Markit Manufacturing Purchasing Managers Index (PMI), 09/2016–06/2019.

Global manufacturing is perilously close to recession including the USA, where manufacturing is at its lowest level since 2009.[3]

Whilst we have discussed the inversion of the US yield curve before (shorter-term bonds yielding more than longer-term bonds)[4], the previous signals were false as they referred to different parts of the bond market. This time, we have had an inversion of the 10-year US Treasury versus the 2-year, which is the correct part of the bond market to look at as it has been a pretty good indicator of upcoming US recessions. We would guess that the current risks of a recession are somewhere between 30–40% and would significantly rise should 25% tariffs be imposed on China for a period of time or if the US decided to impose tariffs on Europe.

HOWEVER ...

It has not been a good indicator in terms of timing. On some occasions a recession has happened within 3 months and on others, it has taken more than 2 years. It should also be remembered that this indicator has only worked when the yield curve has stayed inverted for a period of time – and this time it inverted only briefly.
For this reason, we would view it as a yellow alert rather than a red one given that there has probably been some downward pressure on US bond yields coming from the negative bond yields in Europe. Also, there has been likely some downward pressure due to safe-haven buying by investors along with those looking for a positive yield. This yellow alert is rather telling us that action needs to be taken by central banks in order to rectify the situation.

We fully expect them to be aggressive in their actions going forward with the US Federal Reserve cutting rates by perhaps as much as 0.5% in September, given that they are now probably behind the curve. We presume that the ECB will cut rates further along with a relaunch of quantitative easing now that they have cover from the recent contraction in the German economy. Don`t be surprised if at some point in the not too distant future the ECB starts buying equities. Whilst there is no doubt that these actions will numb the pain and restore some confidence, they are unlikely to be a full cure to restore growth.

TRADE WARS: ENDGAME

Whilst there is an overwhelming consensus among market participants that we are in a long-drawn-out trade war between the US and China with nothing occurring until after the US election, to us the set up feels very much like the UK referendum when people were assessing the possibility of a leave vote at zero despite the actual probabilities being higher.

The recent halting of US agricultural product imports by China on a scale of 1to10 is perhaps at 13 and reflects a changing strategy of doubling down and escalation. Whilst the US' recent postponement in some of the 10% tariffs could be viewed as the US having blinked.[5] Although some may argue that the Chinese will now want to wait until after the US election, we would not underestimate their pragmatism.

There is severe pressure on both parties to end this pointless brinkmanship. In the US, with the economy slowing, consumer confidence softening and stock markets becoming more volatile, the current US government is running out of time to boost both the economy and markets before the election. Just remember that no incumbent US President won re-election when the economy was in a recession. Recent polls suggesting that an overwhelming majority (64%) of Americans support free trade also adds another pressure point.[6]

In China, whilst they are quite capable of playing the long game, a resolution would help restore growth and confidence. Also, a compromise would enable them to look better on the world stage, especially given the situation in Hong Kong.

In reality, we are probably close to check in chess terms at this stage in the trade war. If the recently upped tariffs on China go ahead and remain for some time, then the US and the rest of the world economy will enter recession and Trump's re-election bid will follow suit. If the recent order for US companies to stop dealing with China goes through, then we skip recession and go straight into depression. The only way out for both sides is to get a deal done sooner rather than later before confidence erodes so quickly that it will be very hard to turn it around.

When talking about wars, there is always the unfortunate expression - collateral damage. In this case, it has to be Europe which has been especially hurt given their export orientation. We are now probably not too far off the point where we are likely to see more coordination between fiscal and monetary policy. In fact, Germany has now broken its big taboo by talking about fiscal stimulus.

With safe-haven assets (gold, US Treasuries and JPY) posting one of the biggest rallies since the 1990's[7], an expected wave of liquidity by central banks and no one believing in a good and relatively quick outcome on trade disputes, it is probably time to once again increase equities, which we have recently done in your portfolios.

The Navigator
has been written by:
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[1] https://www.bbc.com/news/business-49393198
[2] https://www.bloombergquint.com/global-economics/trump-economy-loses-luster-for-independents-in-2020-warning-sign
[3] https://www.cnbc.com/2019/08/01/gauge-of-us-manufacturing-hits-lowest-since-september-2009-raising-concerns-about-the-economy.html
[4] See «The Navigator» Spring 2019
[5] https://www.bloomberg.com/news/articles/2019-08-13/u-s-delays-10-tariffs-on-china-imports-including-phones-toys
[6] https://www.nbcnews.com/politics/meet-the-press/support-free-trade-reaches-new-high-nbc-wsj-poll-n1043601
[7] https://www.bloomberg.com/news/articles/2019-08-15/traders-have-been-gripped-by-once-in-a-generation-dash-to-safety

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