CROSSMONTHLY

September 2019

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WEAKNESS IN EQUITIES

August is perceived as a holiday month in the US and Europe when many market participants are assumed to be away from work. It is therefore associated with vulnerability to sharper and more erratic market price moves. Equity moves supported the perception as the S&P 500 suffered two of its largest one day falls for the year. Despite a final week rally in many markets, equities had a poor month across the world.

We were not on holiday, and whilst the equity portions of our portfolios declined last month, our absolute return focus for portfolios has provided positive returns. Our portfolios have a range of risk profiles and are showing gains to end-August from 7.4% to 14.9%.

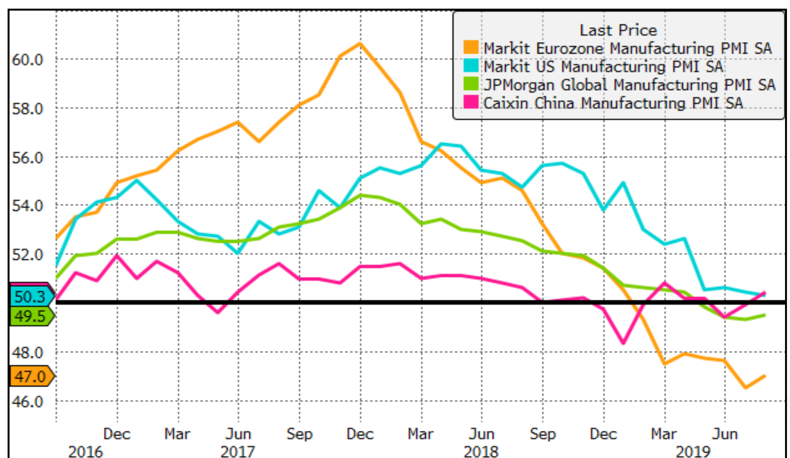
Last month we wrote about the increasing uncertainty facing investors, and the falls in equity prices, and the falls in bond yields bore that out. It is worth reminding ourselves that the US/China trade war, started by US President Trump, is now about 1.5 years old. When this started, we held the view that (1) the US had legitimate concerns about Chinese trade practices; (2) the Chinese would not succumb to “bullying” tactics; and (3) both sides would quickly realise that a trade war was not in either of their interests and it would therefore be at least partially resolved within a few months. We now know that this story took a different turn, and the war has escalated.

On his way to the G7 Meeting in France, Trump talked about a national emergency and ordered US companies to “find an alternative to China”. His rapid response to the Chinese announcement of increasing tariffs, and uncertainty about the legality of Trump’s comments, spooked markets.

On 1 September, the latest increases in tariffs came into effect as the US imposed a 15% rate on $110bn of goods and the Chinese added between 5%-10% on $75bn of US goods. In an apparent realization that tariffs do affect US consumers, Trump has delayed, until 15 December, the imposition of additional tariffs on a further $165bn of goods.

Economists may disagree on the extent to which the trade war directly impacts the global economy but there is an increasing realization that business confidence is being impacted. This is having a secondary impact on global GDP and there are signs of weakness in manufacturing. Fig 1 shows the Purchasing Managers’ Indices (PMI) and on a global level the data shows a gradual decline over the last 18 months. Readings below 50 are negative for the economy. Data from HSI Markit showed that US Manufacturing PMI had fallen to its lowest level since 2009.

Fig 1. PMIs



Source: Bloomberg

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Outlook

The Institute of Supply Management's (ISM) latest manufacturing report also showed that new orders have fallen below inventories (Fig 2). This would also support the view that the economy is slowing. Further support for this case is seen in Fig 3 which shows that the ISM Manufacturing data is a lead indicator for GDP, albeit with a time lag.

Much hope has been placed with the US consumer who appears to be in much better health than the manufacturing industry. The August Consumer Confidence figure of 135.1 was down 0.7 on the month but still represents a very strong level. US Durable Goods rose to +2.1% for the month although this was boosted by aircraft demand with Boeing. That said, July Personal Income was +0.1% was a disappointment and was the lowest figure since September last year.

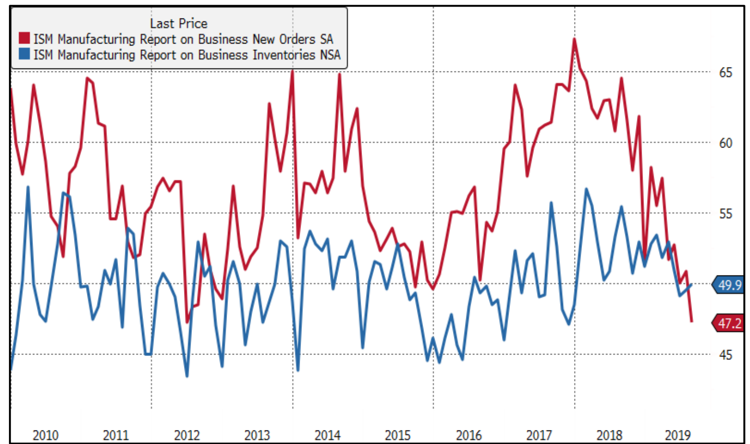
The US 2Y/10Y yield curve has inverted and is another lead indicator of recession. The 3M/10Y yield curve first inverted in Q1. Fig 4 shows the 12 month returns of major indices following the first date of curve inversion. The major equity indices have tended to fall in this time period, with two notable exceptions, in 1989 and 2006. However, as Capital Economics pointed out, even for those two occasions, the equity markets eventually fell, it just took longer.

Our investment approach is to look beyond the short-term price moves but we also think it useful to recognize that markets do not move in a straight line. Fig 5 shows that prior to a recession, the S&P 500 has experienced initial gains post yield curve inversion. As such we would not be too surprised to see this happen again. The important point though is to recognize that the scale of upward move is likely to be more than undone by the potential fall.

Fig 5. S&P 500 gains post yield curve inversion

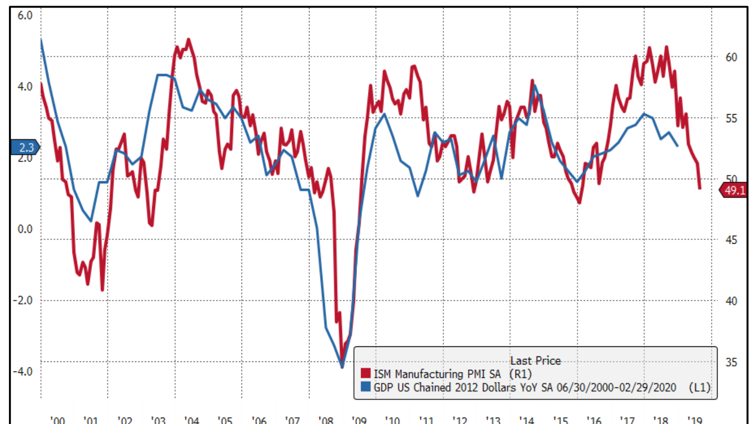
Date of Inversion	18Aug 1978	16Dec 1988	12Jun 1998	04Feb 2000	30Dec 2005
Date of Recession	Feb 1980	Aug 1990	Apr 2001	Apr 2001	Jan 2008
Return to Highest Point (%)	13.09	33.54	39.00	7.18	25.38

Fig 2. ISM manufacturing new orders index below inventories index



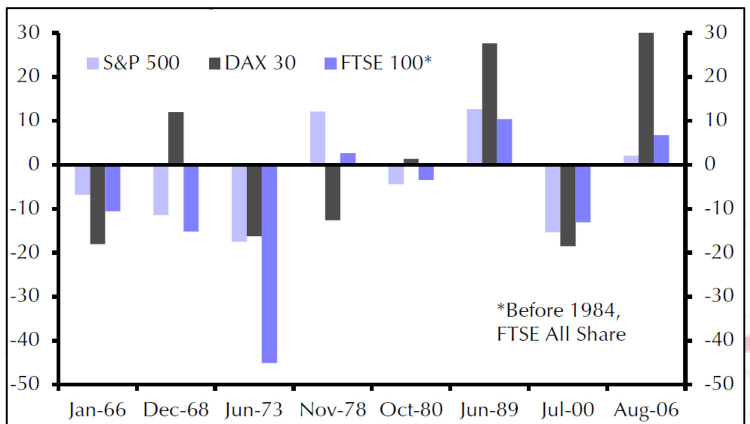
Source: Bloomberg

Fig 3. ISM manufacturing index as a leading indicator for GDP growth



Source: Bloomberg

Fig 4. Returns in the 12 months after the US Treasury yield curve first inverted (%)



Sources: Capital Economics, Refinitiv, ECRI, NBER, ACM, CE

Brexit, Italy, Hong Kong

The honeymoon period, of Boris Johnson's election as leader of the Conservative Party, and subsequent appointment as Prime Minister, was short lived. His initial touring of the UK raised suspicions of early election planning. His subsequent meetings with Chancellor Merkel and President Macron were affable but limited in substance. His attendance at the G7 reinforced a belief that he and Trump can get along, and all the while he has stressed that the UK will leave the EU on 31 October "do or die". However, his decision to prorogue the UK parliament met with anger, even from within his own party, and served to unite the opposition parties who have now passed a Bill demanding an extension of EU membership until January. Johnson has thrown out 21 of his own MPs (another one defected to the Liberal Democrats) and is now in charge of a minority government. His attempt to call an early general election failed as opposition parties distrust him and do not want to risk that he uses an election period (when parliament is not sitting) to pursue a no-deal Brexit.

The British Pound (GBP) had traded under 1.20 versus the USD but has since recovered to c.1.2350 as a no-deal Brexit appears to be at least temporarily off the table. However, an election before year-end is surely inevitable and the outcome is far from certain. Markets may prefer that the UK either stays within the EU or leaves with a deal, but if that were to be accompanied with a Labour Party government, there would be major worries about the left-wing policies which Jeremy Corbyn wants to deliver.

Matteo Salvini, the populist leader of the Northern League party, and until recently Deputy Prime Minister of Italy, has been another thorn in the side of the EU. He has been very critical of the latter and has expressed a desire to break with EU budget rules. This has led some to fear for the future of the EU and has seen Italian bond yields higher as well as negatively impacting the Euro. Encouraged by the success of his party in the recent EU elections, he decided to bring down the coalition government of which he was a part, calling for a new national election.

Much like Boris Johnson appears to have over-played his hand in the UK, Salvini's plan has backfired. To the surprise of many the Five Star Movement and the centre-left Democratic Party have formed a new coalition government with Giuseppe Conte returning as Prime Minister. History would suggest that Italian governments are often short lived, and it is certainly true that the two coalition parties have been fierce opponents of each other, but for now pressure is removed from Italian bonds and the Euro.

Protests in Hong Kong have continued with increasing outbreaks of violence and some days of the airport being closed. The impact on trade and tourism has been significant and the Hang Seng Index closed the month down 7.39%. It has been difficult to foresee a positive resolution to the issues, but on 3 September, Hong Kong Chief Executive, Carrie Lam, announced the formal withdrawal of the extradition bill that had sparked the protests. The stock market responded positively with a 3.9% rally but it appears that the protestors will not be appeased. More will have to be done for the troubles in Hong Kong to ease.

Bond Yields Weakness

The 30Y US Treasury bond yield hit an all-time low below 2% whilst the 10Y yield closed at 1.4961%, although it traded as low as 1.44% (about 12bps above the low point of July 2016). The weaker manufacturing data, together with inflation numbers below the 2% target, may mean that the Federal Reserve will cut interest rates by 25bps at its next meeting on 17/18 September. However, based on the public announcements of some Fed officials, there is unlikely to be unanimous agreement on a cut.

In Europe, the German IFO Business Climate Index hit a 7-year low of 94.3 last month, and the 10Y Bund yield closed the month slightly lower at a negative 0.7%. There is an expectation that the ECB will cut rates by 10bps at its meeting later this month.

Bond yields have fallen very sharply and some fixed income investors, including PIMCO, believe that this has happened too fast. We note at the time of writing that the bond yields have risen in early September and this may be considered a reasonable reaction to the relentless fall in yields in recent months.

Many market commentators suggest that rate cuts are needed to stimulate the economy but we believe that the Law of Diminishing Marginal Returns should not be overlooked. With Developed Market interest rates already so low, and even negative, it is difficult to see how further cuts will have significant impact.

Given this thought, it is no surprise that many countries are looking at fiscal stimulus to encourage demand (India announced such measures in late August). The recently agreed increase in the US budget ceiling has left open the door for spending in America but the major animosity between the Democrats and Trump may make that difficult. In China we have seen a slow but steady series of both monetary and fiscal stimulatory moves. Whilst the scale of action is not as large as either after the GFC or the 2016 slowdown, it is likely that the Chinese are "playing a long game" as they anticipate an extended trade war and the need to reserve some fire power. Germany is one quarter away from a technical recession and, having the wherewithal to spend more, is regularly identified as a candidate for increased fiscal spending. For the moment, Germany has resisted these calls as it has its so called "black zero" which avoids deficit borrowing, and its "debt brake" which is a constitutional provision (post-GFC) that limits public borrowing. Nevertheless, there is increasing talk in Germany that at least the voluntarily imposed "black zero" could be relaxed.

Final Remarks

We maintain our view that capital preservation should be the priority in late-cycle environments. We are conscious that equities may rally, and particularly if the US and China manage to find a resolution to the trade war. However, we prefer to position portfolios defensively, and where possible to diversify into assets which exhibit little correlation with traditional financial asset classes.

Markets

Name	30.08.2019	31.07.2019	MTD	YTD	Total Return MTD	Total Return YTD
Equities						
MSCI ACWI Index	510.88	524.35	-2.57%	12.12%	-2.33%	14.28%
S&P 500	2926.46	2980.38	-1.81%	16.74%	-1.59%	18.34%
DJIA	26403.28	26864.27	-1.72%	13.19%	-1.33%	15.15%
NASDAQ	7962.88	8175.42	-2.60%	20.01%	-2.46%	20.91%
RUSSELL 2000	1494.84	1574.61	-5.07%	10.85%	-4.94%	11.83%
Russell Top 200	699.60	711.51	-1.67%	16.43%	-1.45%	18.07%
STOXX 600	379.48	385.77	-1.63%	12.39%	-1.32%	16.02%
Euro Stoxx 50	3426.76	3466.85	-1.16%	14.17%	-1.07%	17.89%
FTSE 100	7207.18	7586.78	-5.00%	7.12%	-4.07%	10.92%
MSCI AXJ	609.01	638.47	-4.61%	2.08%	-4.36%	4.17%
Stock Exchange of Thailand	1654.92	1711.97	-3.33%	5.82%	-2.80%	8.51%
Jarkarta Composite	6328.47	6390.51	-0.97%	2.16%	-0.97%	4.43%
Philippines Stock Exchange	7979.66	8045.80	-0.82%	6.88%	-0.68%	8.46%
NIKKEI 225	20704.37	21521.53	-3.80%	3.45%	-3.73%	4.75%
KOSPI Index	1967.79	2024.55	-2.80%	-3.59%	-2.81%	-3.17%
Nifty 50	11023.25	11118.00	-0.85%	1.48%	-0.65%	2.61%
S&P BSE SENSEX 30	37332.79	37481.12	-0.40%	3.51%	-0.25%	4.56%
Straits Times Index	3106.52	3300.75	-5.88%	1.23%	-4.97%	4.80%
Hang Seng Index	25724.73	27777.75	-7.39%	-0.47%	-7.06%	2.39%
Shanghai Comp	2886.24	2932.51	-1.58%	15.73%	-1.46%	18.41%
SHANGHAI A SHARE	3023.71	3071.73	-1.56%	15.79%	-1.45%	18.47%
S&P/ASX 200	6604.22	6812.56	-3.06%	16.96%	-2.13%	21.45%
MSCI AC ASEAN Index	778.79	815.74	-4.53%	2.55%	-4.04%	5.34%
MSCI EM Ex. Asia Index	1321.11	1435.75	-7.98%	1.24%	-7.73%	4.19%
MSCI EM Asia Index	495.88	516.28	-3.95%	2.16%	-3.74%	4.14%
MSCI EM Index	984.33	1037.01	-5.08%	1.92%	-4.86%	4.16%
Fixed Income					**MTD bps**	**YTD bps**
US10YT Yield	1.4961	2.0144	-25.73%	-44.26%	-51.83	-118.81
US2YT Yield	1.5040	1.8721	-19.66%	-39.54%	-36.81	-98.38
Bunds 10Y Yield	-0.7000	-0.4400	-	-	-26.00	-94.20
Global Investment Grade	514.43	504.18	2.03%	7.42%		
Global Hight Yield	1360.27	1381.77	-1.56%	8.24%		
Forex						
EUR	1.0982	1.1076	-0.85%	-4.23%		
JPY	106.28	108.78	-2.30%	-3.11%		
SGD	1.3872	1.3743	0.94%	1.78%		
GBP	1.2156	1.2159	-0.02%	-4.69%		
AUD	0.6733	0.6845	-1.64%	-4.48%		
US Dollar Index	98.916	98.516	0.41%	2.85%		
China RMB Spot Currency	7.1560	6.8844	3.95%	4.03%		
Offshore Deliverable CNY	7.1623	6.9099	3.65%	4.25%		
Gold/Oil						
Brent Crude	60.43	65.17	-7.27%	12.32%		
Generic 1st Crude Oil, WTI	55.10	58.58	-5.94%	21.34%		
Gold Spot Price	1520.38	1413.78	7.54%	18.55%		