Stanhope Capital Fortnightly Bulletin

Period ending 15th August 2019

Tactical Positioning

August is traditionally a holiday month and often a volatile one for markets, because stock market trading volumes are typically lower than normal, meaning that transactions have a disproportionate impact on prices. This month markets have certainly been volatile as investors worry from to tweet to tweet about whether the US/China trade war will escalate.

Portfolios have suffered from the recent setback, but have still performed strongly over the year as a whole, primarily boosted by expectations of lower interest rates. Monetary policy is set to get looser from September and the anticipation of interest rate cuts by the Federal Reserve and further Quantitative Easing by the European Central Bank offers support to prices, that could easily recover from the recent setback if Presidents Trump and Xi reach an accord.

Market Moves

	Equities *(incl. Dividends)*						
15 -Aug -19	World ($)	US ($)	Europe[1] (€)	UK (£)	Japan (¥)	EM ($)	Asia ($)
Last 2 Weeks	-4.7%	-4.4%	-4.9%	-6.0%	-5.0%	-5.0%	-5.4%
Year to Date	11.5%	14.6%	11.7%	8.7%	1.4%	3.5%	5.7%
	Commodities			Currencies (vs. USD)			Gov't
	COM[2] ($)	Gold ($)	WTI Oil ($)	EUR	GBP	JPY	UST 10Y[3]
Last 2 Weeks	-2.8%	7.7%	-7.0%	0.3%	-0.6%	2.5%	-49 bps
Year to Date	1.5%	18.8%	20.0%	-3.1%	-5.2%	3.3%	-116 bps

Note: [1]Europe excluding UK; [2]Bloomberg Commodity Index; [3]US Treasury 10 Year Yield shows absolute, not percentage, change in yield; Source: Bloomberg

Markets were sharply lower over the period, driven by uncertainty over an array of issues with recession fears and escalating trade tensions at the top of the list. Significantly, the 2-year/10-year US curve briefly inverted, meaning that for a short time, on Wednesday 14th, the yield on 10-year bonds (at 1.58%) was below the yield on 2-year bonds at (1.60%). Although other measures of the US yield curve have progressively inverted during recent quarters, market participants were particularly concerned by the inversion in this part of the curve as it appears to have a strong track record in predicting recessions. Indeed, every recession since 1956 has been preceded by this kind of inversion of the yield curve, although not every yield curve inversion was swiftly followed by a recession, more on which below.

The ongoing feud between the US and China was largely to blame for the risk-off sentiment. Throughout the fortnight, trade-war related headlines and tweets caused big gyrations in risk assets while bond yields raced lower. At the beginning of the month, President Trump roiled markets with his announcement of new 10% tariffs on $300 billion worth of imports from China. The Chinese government reacted by allowing its currency to weaken to above 7.0 per dollar, considered a key psychological level, prompting the US Treasury to name China as a currency manipulator. The Trump administration then announced it would delay the tariffs on certain Chinese products until mid-December to avoid impacting the Christmas shopping season. Regardless, the Chinese are adamant that the latest tariff announcement violates their previous agreement and the State Council Tariff Committee has stated that China “has no choice but to take necessary measures to retaliate”.

As Deutsche Bank economists pointed out this week, “the inherent problem for markets with these trade headlines is the predictability of how unpredictable they are, both with regards to timing and substance”,

making life difficult for market participants. That said, asset pricing suggests investors are braced for a global downturn. It is most evident in investor appetite for safe-haven assets. Bond yields globally are hitting lower and lower lows. In Germany, interest rates are negative all the way from overnight deposits to 30-year bonds while in Switzerland negative yields extend all the way to 50-year bonds. Long-term mortgage rates in Denmark are being offered at zero and Austria's 100-year bond is trading at a yield of 0.62%. Commodities pricing is reflecting the same with gold at a six-year high and copper prices, a proxy for industrial health, down sharply. Despite Iran's seizure of an oil tanker in the Gulf, oil prices have sunk to below $60 a barrel. Meanwhile global equity markets ended the period 4.7% lower and are now 6.3% off their July high, although this should be seen in the context of a double-digit year-to-date return.

The trade war wasn't the only thing that the market had to worry about, with domestic political turmoil in Hong Kong, Argentina and Italy all adding to the risk-off sentiment. In Hong Kong protests continue, with the city's airport being brought to a standstill during the week. The local Hang Seng Index has fallen into negative territory for the year – one of the few equity markets to have done so. In Argentina and Italy, election-related fears took hold. Meanwhile in the UK, sterling continued to weaken as the scheduled Brexit date draws nearer. Labour leader Jeremy Corbyn wrote to MPs on their holidays, calling on them to support a "strictly time-limited temporary government" led by himself as Prime Minister, with the purpose of getting an Article 50 extension and calling a general election. This may prove a difficult vision to realise.

Economic Updates

As discussed above, market pricing appears to portend a global recession. The median length of time from an inversion of the curve at the 2-year/10-year point to a recession is 17 months, though in the 1960s the yield curve inverted for a month and it was 4 years until the recession struck. Encouragingly, the Fed remains highly sensitive to global and trade developments and is on track for another "insurance" rate cut in September. Arguably, no more aggressive action than that is currently justified by the economic data. Consumer confidence remains elevated and the tight job market shows few signs of easing. There are still far more job listings than job searchers. Employers are in fact struggling to retain workers, offering them pay rises to discourage job-hopping. Lower oil prices should encourage further consumer spending too.

However, if trade tensions continue to escalate and Trump follows through with the 10% tariffs on remaining Chinese imports, the global economy's growth engine is likely to downshift considerably. New tariffs would apply mostly on consumer goods which would likely be passed onto the consumer, crimping demand.

Economies in Europe are faring less well than the US. The UK, Swedish and German economies contracted in the second quarter of the year. If growth stalls in Q3, those three economies will enter technical recessions. This is not impossible, given that expectations for the German economy have slumped to their lowest level since the Eurozone debt crisis, eight years ago last week. The US-China trade spat and the prospect of a messy no-deal Brexit at the end of October have certainly taken their toll on the export-orientated economy. Industrial production dropped by a larger-than-expected 1.5% month-on-month in June. The latest fall meant that industrial production was 5.2% lower than a year ago.

Data from China has also been coming in weaker than expectations. Credit data, which is viewed as a key leading variable for the broader economy, was weak. Industrial production in July was confirmed at up 4.8% year-over-year which was well below expectations for 6.0% growth and also the weakest reading since 2002 while retail sales also came in at 7.6% year-over-year versus 8.6% expected. A lot appears to be hinging on trade negotiations between America and China, President Trump's re-election prospects included.

JONATHAN BELL, IVO COULSON & MARY ANN HOGAN
15 August 2019

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