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INVESTMENT POLICY NOTES

NOTZ STUCKI INVESTMENT MEETING OCTOBER 9TH, 2018

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2018 has been a difficult year in financial markets with almost every equity and bond market suffering, with the notable exception of the US stock market. A further complication for investors has been that this has not been caused by a serious deterioration in economic fundamentals. Instead markets have been driven by political risks and uncertainties. Ultimately the question for investors is whether this is just a painful correction, and therefore a buying opportunity, or is this the start of a reversal in markets, signalling the end of the US bull market. The presentation considered three causes of the setback in markets since April/May, and then how far these issues might develop or revert. Anatole made a case that the bull market would resume, but cautioned that others in Gavekal were more cautious.

The MSCI World Index ex-US has fallen back 12.5% from the peak. However much of this loss is the result of currencies falling against the dollar. In local currency terms the damage is much less, and Europe is only down about 5% - hardly a disaster. The greater focus of concern has been in Emerging Markets (EM) where a real sense of panic has been evident in currencies, bonds and equities. Investors have worried that the problems of Argentina and Turkey will spread. EM equities have dropped 22% from the peak. This is a serious decline but EM are more volatile and nasty as this fall is, it is equivalent to similar sell-offs in 2012 and 2016 when EM equities fell about 30% before quickly recovering. These declines need to be viewed in comparison to 'proper' EM bear markets which occurred in 1998, 2002 and 2009 which suffered declines of around 60%. Underwriting the view that this is a buying opportunity rather than the edge of a precipice is that the fundamentals still seem pretty good. There are pockets of genuine weakness (e.g. Argentina) but no sign of secular stagnation. For the last eight years the global economy has achieved a growth rate exactly in line with the average since 1974. Even the Eurozone's economic performance has been respectable. It is closely following the recovery pattern that the US managed after the crisis, with a lag of six years. Herein lies the opportunity. An unprecedented gap has opened up between the performance of the US and the rest of the world. This gap is likely to close by the means of the non-US markets catching up the US.

What are the prime causes of this year's volatility? The main changes have been politically related: the US/China tariff disputes, the oil price which has risen following sanctions on Iran, and the dramatic changes in European politics catalysed by the Italian election. Taking these in turn the US/China dispute is probably largely priced into markets. With the US economy at full capacity it cannot replace China in producing the goods it is placing the tariffs on. Production could be shifted to other countries, but China looks well able to brazen this one out. The likelihood is that Trump will have to back down, and will do so by doing a deal that he can make appear a victory for him. In the case of oil the Saudis will do everything they can to keep production up and the oil price capped. The question is how much spare capacity is there in the oil market. The financial community believes there is little, but the oil industry has indicated that supply can be increased. In 2019 a lot of US production will be released as pipelines are completed which will bring inland production to the coast, and therefore world markets. So the first two issues that have been overhanging markets will probably dissipate. The alarming issue is Italy. The consequence of the left and right joining forces

is combining the worst policies of both – more spending and cutting taxes in an already parlous fiscal situation. On top of this some of the reforms that had taken place have been reversed. The danger here is that it could be contagious, and these bad habits spread to the rest of Europe. The risk of contagion in the European financial crisis was cured by extreme monetary stimulus. But a political contagion is far harder to contain. There is likely to be a big cloud over European assets until at least the elections in May 2019.

Anatole also reviewed the rise in bond yields this year. If the US 10-year yield breaks towards 4% then a re-think will be needed, but for now it has probably reset between the 3 and 3.25% range, and if it settles here that is a comfortable backdrop as far as other markets are concerned. The support for the view that this will happen is that far lower rates still prevail in Europe and Japan so anything above 3% in the US Sovereign represents an extremely attractive return for many investors. Inflation is still contained and after years of false forecasts of inflation the bond market will only react when it sees firm inflationary evidence over several quarters. Moreover the 30-year yield is only 3.5% which indicates a tremendous reluctance for yields to rise. However if the strength of the US economy does push US yields higher Europe and Japan yields can still remain low. For US equities this would trigger a rotation away from tech/growth stocks and into cyclicals. The danger level for US yields would be 4.5 – 5% which could precipitate a recession given the large amount of debt in the economy.

The conclusion is that this is a buying opportunity. Assets are cheaper than six months ago, and the basic underpinnings of the bull market are intact. There is no sign of a recession in the US. The Fed has made clear that it will increase interest rates in a steady and predictable way over the next eighteen months. The opportunity lies more outside the US by virtue of the catch-up potential in Japan, Europe and EM. However given the shadows hanging over Europe, EM and Japan look safer.