CANACCORD Genuity
Wealth Management

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Investment
market update

A trade war, politics and the next recession - the three big questions

In this month's Investment Market Update, CIO Michel Perera answers the three big questions on investors' minds.

1. How far can the trade war go?

To answer this question, a lot depends on two things: whether there is an objective which once met, will stop the fight; or whether the spirit of the conflict is so enthralling that, like an addicted gambler, it can never stop. The jury is probably still out on that, but there is one other clear factor today: the US mid-term elections on 6 November.

The party in power generally loses heavily during the mid-terms and it seems obvious that President Trump wants to buck that trend by scoring strong wins ahead of the polls. His claim to have successfully de-nuclearised the Korean Peninsula is testament to this. A trade win against China - not to mention the EU, Canada and Mexico – would suit him well.

In practice, we will have to wait until after the mid-term elections to find out whether President Trump's trade war is tactical or 'dyed in the wool'. We can only assume that it is the former, as the latter would plunge the US into a recession, feed into inflation and sink the stock market, which President Trump is so fond of quoting as his success gauge.

The dispute about intellectual property rights and their alleged theft by China is subtler. China has acquired US technology by all means fair or foul, but trying to redress this situation today is like locking the gate after the horse has bolted. It also runs the risk that China will accelerate its domestic technology projects so that they are less dependent on the US or the West in general, backfiring on the US massively.

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2. How much will politics impact my investments?

Most investors use political events as a trigger to make changes in their portfolio and yet we are not convinced that you can trade on the back of political headlines with any effectiveness. True, had you properly forecast the outcome of the Brexit referendum, you might have made quite a bit of money on the currency, but this extraordinary event is a one-off. History is littered with examples of market miscalculation of political events. When Donald Trump scored an upset victory to become US President, many market participants assumed equities would sink. Equities did so for a couple of hours and then proceeded to rally strongly. Likewise, European political risk has picked up sharply this year and yet the valuations of European equities and their US equivalents on a sector-by-sector basis show no daylight between them.

The latest developments are in the UK. The headlines show PM Theresa May fighting on three fronts simultaneously: against the Brexiteers, the Remainers and the EU. Yet sterling rallied after the resignations of two senior Cabinet Ministers last week and the FTSE is actually ahead of European markets year-to-date.

The mid-term elections in the US are another source of political uncertainty. Historically, however, markets have rallied after the polls regardless of who has won, simply relieved that the uncertainty has been removed.

Furthermore, we recently reviewed our investment in Indian equities, and despite the huge risks to the markets when there is an election upset, we discovered that Indian stocks performed equally well under different governments and coalitions over the decades. Why trade on the back of a headline when you can buy a good growth story?

Markets love to fret about political events but over the long run, politics don't matter and won't affect corporate returns or performance. Better to concentrate on picking the right investments and let politicians come and go in the meantime.

3. Should I be worried about an 'inverted yield curve' and the onset of a recession?

This is a more technical market aspect. Normally, long-term interest rates are higher than short-term interest rates set by central banks, as there is more uncertainty over longer than shorter periods – so investors demand more of a return on their money.

So whenever short-term rates have been higher than long-term rates (a so-called 'inverted yield curve'), a recession has generally ensued. This makes sense, as fixed interest investors flock to buy longer-dated government bonds to protect themselves against the upcoming recession - with the popularity of the longer-dated bonds forcing the yield to go down.

Right now, despite a US economy in rude health (and its long-dated bond yields therefore at a respectable level), the concern is that the yield curve is flat and about to become inverted. Why is that? Well there are different long-term yields around. German 10-year and Japanese bond yields are low at 0.3% and 0.1% respectively but US 10-year bond yields are near 3%. Naturally, global investors are flocking to buy the 3% US bond which is in turn bringing its yield down. So much so that they might bring the long rates below the short ones. Once again, the automatic market reaction does not allow for much thinking about the reasons why something is happening.

It's natural for news headlines to raise questions but it's important to keep a sense of perspective.

"The automatic market reaction does not allow for much thinking about the reasons why something is happening."

This article was written for you by Michel Perera, our Chief Investment Officer

Our investment views as at July 2018

The view in this table refers to our balanced, risk profile 5 model portfolio. This risk profile has a benchmark with 61.5% in equities, 22.5% in bonds, 13% in alternatives and 3% in cash.

Indicative positioning of £ 'balanced' portfolio.

Asset class positioning	--	-	=	+	++	Outlook	
Alternatives							Viewed as a way of moderating portfolio risk at a time of high volatility in equity markets and rising bond yields.
Bonds (Govt)							Yields have risen and may become interesting at some point, but overall returns are not attractive compared to other asset classes.
Bonds (Other)							Greater returns appear to be available for strategic bond managers, but we should be aware of the additional risks taken to achieve them.
Commodities							Industrial metals are reacting to trade war fears and this is also starting to impact energy.
Equities							Equity markets should continue to be supported by solid economic fundamentals despite rising interest rates and trade war headlines.
Property (direct)							Yield, rather than capital growth, should be viewed as the primary reason for investment.
Cash							Cash levels have been reduced.

Equity allocation	--	-	=	+	++	Outlook	
Emerging markets							Emerging markets have struggled in 2018, offer good value and sound fundamentals. We also reiterate our LT India play.
Europe							Growth moderated in Q1, although this was partly driven by adverse weather. Stock specific opportunities are present.
Far East							Valuations appear cheap; China and global trade are key to the region's outlook. Chinese debt levels and housing bubble are a concern.
Japan							Stock market offers value and some sectors of corporate Japan are in good shape. Macro data slowly improving. Leveraged to world growth.
North America							Economic and earnings momentum and aided by fiscal stimulus. Have added to tech and small caps recently.
Sector specific							Healthcare remains a long-term theme; we have added technology as well.
UK							Economic fundamentals are not compelling in comparison to other areas, although opportunities in small and mid caps may be evident.

Currency allocation	--	-	=	+	++	Outlook	
US dollar							The dollar has bounced from an oversold position, but the bulk of the adjustment may have been seen. Should drift lower over medium term.
Euro							Would expect euro to push higher relative to the dollar, as economic growth differentials diminish.
Sterling							Sterling's prospects remain heavily dependent upon the Brexit outcome and hence is in a binary situation.

'=' Weighting within 1% of benchmark. '+ / -' Weighting between 1% to 5% away from benchmark.
'- - / + +' Weighting in excess of 5% away from benchmark.

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