MARKET UPDATE

AUGUST 2019 MPU

Independence Day?

In the build up to the FOMC meeting last week, President Trump had been beseeching Federal Reserve Chair Powell to cut rates and cut big, and ideally restart QE. Ultimately, Powell cut rates by 0.25% - the minimum he could get away with.

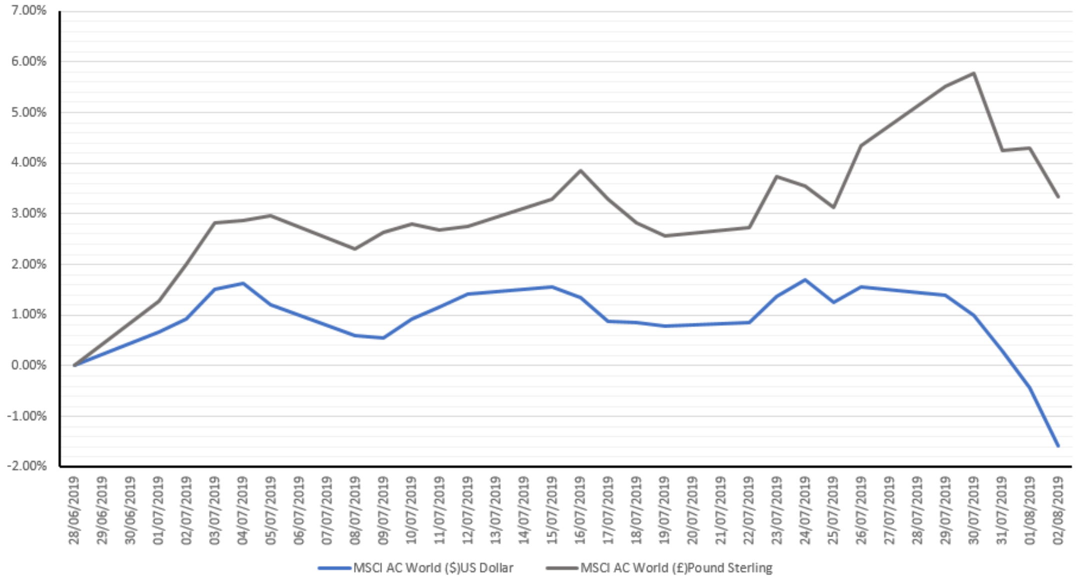
The press conference following the cut saw Powell address, on multiple occasions, the deteriorating trade (war) situation. A situation that had deteriorated just that morning as trade talks were abruptly adjourned; cynics could suggest that this took place to apply pressure on Powell to reduce rates further. This failed, however Trump had another card to play, and on Thursday announced new tariffs, sending equity markets and yields swiftly downward which, in turn, applies yet more pressure on the Fed.

In a nutshell, Powell has strongly intermated that they will act if the trade war intensifies, so Trump’s response has been to intensify it. Whether or not Trump really believes “trade wars are good and easy to win” is not the most important point here. He thinks he has found a way to basically control interest rate policy. The Fed will claim independence based on data and outlook, so Trump has given them a weaker outlook. What he will not acknowledge is how much damage is being done to both US and global GDP, and there is more to an economy than interest rate policy. We have said numerous times that Trump’s pressure on the Fed will be unrelenting until the next election. We expect he is just warming up.

War, what is it good for absolutely nothing?

Currency wars continue to be in focus as countries attempt to manipulate their currency to achieve a competitive advantage. If, as Eric Morecambe said, “they are all at it”, then not only is such a war no good in absolute terms but it doesn’t work in relative terms either. In the UK we know very well how to devalue a currency, just leave (or try to leave) a major trading block with only a sketchy plan of what comes next. The difference in UK investment returns in July was once again considerably influenced by falls in Sterling. As the chart below shows, without the currency effect you would have made nothing in global equities, and the return profile in first couple of days of August is even more extreme.

MSCI World in Sterling and Dollars



"Three dice cee-lo, three card monte"

As opposed to equities which have masochistic preference for bad economic news, bonds seem to go higher (yields plummeting) on an almost daily basis. Through a bizarre example of the greater fool theory, bond traders feel that, even with negative yields, they can sell to somebody even more foolish tomorrow and at an even deeper negative yield.

When we suggested US 10-year yields could go to zero, it was an extremely contrarian position. This is no longer the case and whilst many more are calling for a 1% floor in the cycle, it is the same people who made the case for a 2% floor. Every sovereign bond in Germany is now negative out to 30 years. Many economists who have no connection to central banks believe that the sovereign bond market is effectively broken. Why would anybody buy a German 10 Year Bund and pay the German government 0.5% each for the privilege? It's like the three-card monte street game, only crazier. In theory, it looks possible to win at three-card monte, but governments and central banks around the world are telling you up front that you will lose money - the street guys aren't quite so kind.

In the last few weeks we have had several update meetings with our bond managers. The spread of corporate bonds over sovereigns is in some cases paper thin but sovereigns are paying next to nothing at best. As an example, Chris Bowie at TwentyFour is now the most defensively positioned he has been in his career, the shortest duration and the highest credit quality. What is of ongoing concern is that nobody without a vested interest outside of central banks seems to know how bond yields can recover. So, within IBOSS, and just like Chris at TwentyFour, we remain defensively positioned. We are using our property and infrastructure holdings which are benefitting from the global yield carnage.

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