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Q3 2019 MARKET REVIEW – 14 October 2019

After a strong performance in the first half of the year, stock markets were more volatile in the last quarter as the trade dispute between the US and China escalated and the risk of a disorderly Brexit rose. On the other hand, measures taken by central banks to reduce interest rates in order to support the economy, reassured investors. The direction of markets over the next few months will depend on the outcome of the current trade negotiations between the US and China and the Brexit negotiations. A negative outcome in either situation risks triggering a market sell-off but conversely any signs of a positive outcome should sustain risk assets.

Reduced effectiveness of Central Banks policies?

Central banks have reduced interest rates to close to zero or below zero across the developed world. We are now in an unusual environment where 30% of investment grade debt (debt of government and companies with good credit), worth $17 trillion, yield negative interest rates. The US was the only major economy with interest rates above the rate of inflation last year. After the market downturn at the end of 2018 and the increased signs of a global economic slowdown in 2019, the US Federal Reserve had to reverse its policy and lower interest rates twice in the last few months. The current yield on US Treasury bonds implies that investors expect further rate cuts in the US.

Low interest rates at this point in the cycle, when the global economy is still doing well, leave little room for interest rate cuts in case of a recession and therefore limit policy tools available to central banks. The level of debt accumulated as a result of low interest rates means that it has become more difficult for central banks to raise interest rates without triggering potential defaults and a credit crisis. There is also increasing concern that negative interest rates can have unintended consequences as it can reduce investor confidence. Instead of promoting additional investment as intended, negative interest rates may have the reverse effect as investors increase their savings. Central banks are increasingly aware that the current negative interest rate environment may have unintended side effects. It is not clear whether they will change their approach and adopt new policies.

Increased political risk in the US and the UK

Political risk has increased markedly in the US and the UK with the impeachment inquiry against President Trump and the risk of a disorderly Brexit in the UK. The current US and UK leaderships are following divisive strategies stoking up tension between the ‘people’ and the establishment including the Congress in the US, Parliament in the UK and the judicial system. It seems that both governments are following similar strategy and are ready to undermine their country’s democratic institutions in order to achieve short term political gains. In the UK, there is an increased entrenchment of views which make compromises difficult. Given the binary options offered by Brexit, the current divisive policies adopted by the UK government risk creating social unrest or at best long-standing resentment which may have a negative impact on future negotiations with the European Union who will remain the UK main trading partner after Brexit. The uncertainty caused by the political crises in both countries risk spilling out on the economy through lower business and investor confidence.

US ‘America First’ policies risk isolating the US and leading to a partition of the global economy

The trade dispute between the US and China and to a lesser extent between the US and its traditional allies such as Japan and the European Union risk isolating the US, weakening the global trade order and may lead to a reversal of globalisation and the partition of the global economy in different blocs. Recent policies taken by the US and China may force countries to align with one of the two powers. Most Asian countries are now more dependent economically on China than the US and may have to reluctantly join a Chinese sphere if forced to make a choice. The European Union and Japan have recently signed comprehensive economic and strategic partnership agreements creating the world’s biggest trade zone and increasing security cooperation. The agreement is partly in response to America First policies which have undermined relationships between the US and its closest allies and partly in response to the rise of China as a global economic power. A more competitive global trade environment risks slowing international trade and would have a detrimental impact on global economic growth through higher trade barriers.

Low interest rate environment – implications for long term investors

There is a consensus emerging that we are now in a persistently low interest rate environment due to low inflation linked to technological improvements, low demographic growth in developed markets and higher level of savings. The low growth, low inflation and low interest rate environment implies lower returns for long-term investors.

Until the 2008 financial crisis, investors could invest their money in savings account or safe short-term government debt and generate returns above inflation. This is not the case anymore. In order to generate returns above inflation, investors need to take additional risk such as credit risk by investing in corporate or emerging market bonds which have lower credit quality than US government bonds or market risk by investing in equities and property. Long term investors will need to adapt to this new environment and adjust their return expectations.