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SKERRITTS VIEW – JUNE 2019

"Beautiful Tariffs"….Really?:

May has been the first negative month for equity markets this calendar year so perhaps a bit of a dip is neither unexpected nor unwelcome. However, it's the cause of the pull back that is causing consternation. There had been a hope and expectation that the rumblings of the trade war between the US and China had dissipated and that relations between the US and Mexico/Canada had eased. Markets had actually re-traced their Q4 decline in 2018 to hit a new high on April 30th for the S&P 500 when, wham, the self-confessed "Tariff Man" did it again. On June 1st, President Trump confirmed what everyone suspected, that he found tariff to be "a beautiful word". Beauty, it seems, is very much in the eye of the beholder.

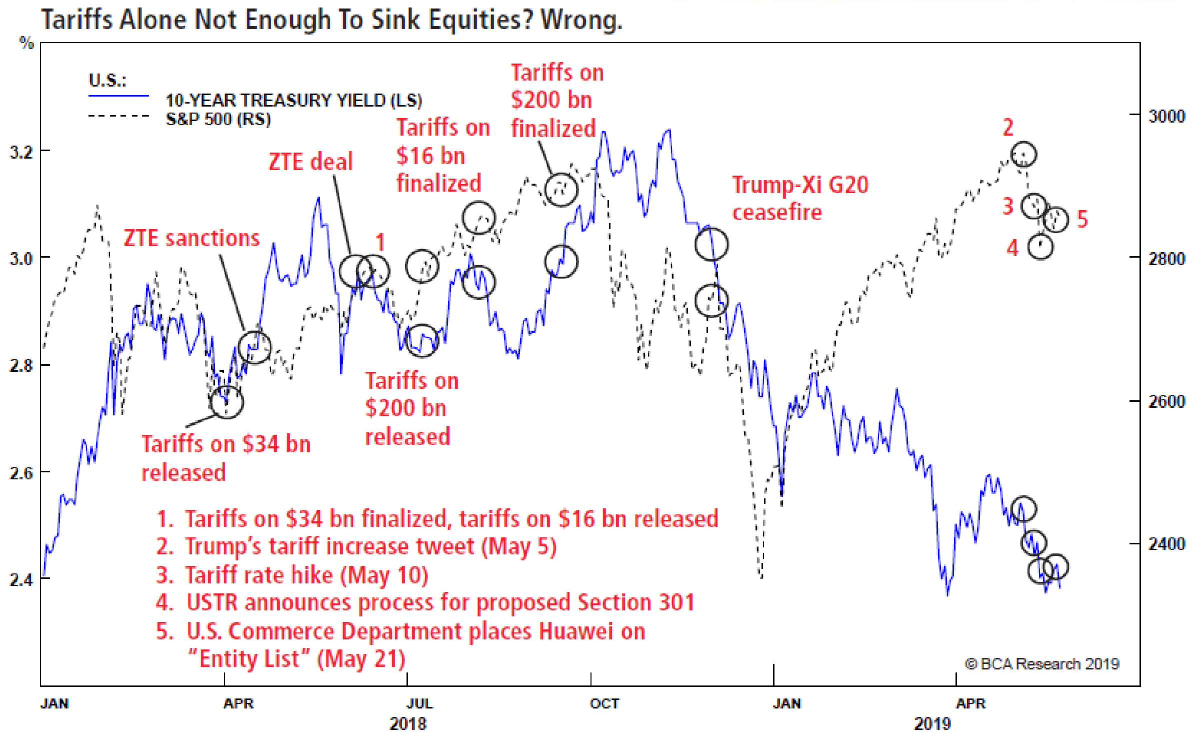
The tariff timeline through the month ran like this….May 5th tariffs announced on $200 billion (that's a big number) of Chinese goods; 17th May the removal of tariffs on Canadian and Mexican aluminium and steel; 31st May imposition of tariffs on most things Mexican until the migrant stream abates at their border.

Apart from weaponising tariffs, as well as upsetting US millennials who suddenly face paying more for their tacos and smashed avocado, these latest moves underlined the unpredictability of US policy. For investors, it marks a period of uncertainty as we move into summer, with the 20% falls in markets prompted by trade war fears last autumn all too fresh in our minds. At the time of writing, markets appear to be more relaxed this time around, but is this complacency justified?

Where's The Catalyst?:

The bond markets have had a remarkable rally, responding to the likelihood that interest rates are more likely to fall than rise (what a difference a few months make) as well as offering safe haven status to nervous equity investors. The chart below [Source: BCA Research May 24th 2019] suggests that either bond yields have fallen too low, or equities remain too high, as things currently stand. What is the most likely next move? We tend to think that a move in any direction requires a catalyst. Is there an obvious (or indeed less obvious) catalyst that is likely to see bond yields begin to move sharply higher? We've already mentioned that the next expectation for interest rates in the US is down, not up, which is hardly a reason for bond yields to rise. With an escalation in the trade war, is it more or less likely that global growth is going to surge, taking inflationary expectations with it and triggering a rise in bond yields? A surge from here would definitely be contrary to expectations.

The most likely cause of bond yields rising is boredom – boredom of the markets with low returns from bonds and the potential for higher returns from depressed equity valuations. But we can see that equity prices have not come close to last winter's "depressed" levels, yet. So where are the catalysts for an equity move one way or the other?



Trade Truce At The G20?:

One catalyst would certainly be a trade truce announced, say, at the G20 Summit scheduled for June 27th and 28th. One of the reasons that equity markets have perhaps become more sanguine to tariff talk is that they have become accustomed to the Trump tactic of aggressive rhetoric followed by compromise, but is this a given? Possibly not.

The mid-terms in the US, as well as the continued chatter about his association with Russia, have led President Trump to have fewer levers to pull at home. He was unable to repeal Obamacare and the political maths make it unlikely that he will be able to deliver much more than the tax breaks which have already been delivered. This means we can expect foreign policy to become more assertive as the 2020 election approaches. It's highly unlikely that he will want to bring on a recession before then as no US President has been re-elected in a "recession year" since 1830. So, maybe a bit of tough talking now, followed by market-lifting compromise later in the year is the tactic of choice, but this is a dangerous one to pursue with China.

Both Presidents Xi and Trump need to play to their domestic audiences. A partial climb down by either side may smack of weakness, and so hardened lines may be being drawn unintentionally, making a truce harder to come by. Think of it as planning a mates' weekend away. Between you, you and your pals may have hatched the perfect plan for a fun and relaxing break, but it may not be quite so easy to sell the idea of leaving the kids behind when you get home. A domestic damper may well be poured on best laid plans. Theoretically, it is easier for Xi to sell any deal to the Chinese audience as he faces no election in the coming months, yet his strength at home needs to be maintained. We still have not seen any major retaliation from China yet, and the markets appear to have forgotten this for now.

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Chinese Stimulus?:

But the Chinese can stimulate the global economy, right? Yes, they can, and in our view this is one of the more likely catalysts that we may see to growth resuming its upward trajectory, but will it happen soon? Don't forget that in 2015 there were serious issues relating to flight of capital from China which acted as a sharp reminder that there are consequences to playing fast and loose fiscally. It's possible that China can see 2020 on the horizon and can play more of a waiting game this time around.

Escalation With Iran:

The dispute with Iran took a 6 month break with the announcement of sanctions waivers last October, which saw the oil price plummet. The dispute is back, and is in danger of escalating. This fits perfectly with the foreign policy thesis previously posited, but is hardly a catalyst for an improving scenario for equities. A direct conflict between Saudi and Iran is increasing in probability (each side backed by opposing forces on the wider global stage) and, although the increase in trade war tensions and its threat to global growth is currently trumping supply problems from an oil price perspective, this could easily flip around in the coming months. Rising tensions in the Middle East is hardly an obvious catalyst for strong equity performance in the short term.

May Goes Away In May:

That old ditty about selling in May and going away appears to have been taken personally by our Premier of the same name as she bows inevitably to the pressure that was heaped upon her. The European elections and the subsequent leadership election have done nothing to enhance the chances of any Brexit progress before the revised October deadline. Although Brexit is not a major issue in comparison to what else is going on in the world, it is still hardly a catalyst for the good in terms of UK equities and so is yet another negative when searching for immediately obvious good news.

Summary:

All in all, the short term outlook is bleak, although we would be surprised if markets took quite such a dramatic turn for the worse as they did through Q4 2018. However, whether or not Einstein was the originator of the definition of insanity as "doing the same thing over and over again and expecting different results" (there is some doubt to the true origins) we tend to agree with the sentiment, and so we have moved our funds and portfolios more defensively in the last few weeks in the expectation that things may get worse in the short term before they get better later in the year, in the absence of any clear catalysts to the contrary. You'd be mad not to!

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