SKERRITTS VIEW – SEPTEMBER 2019

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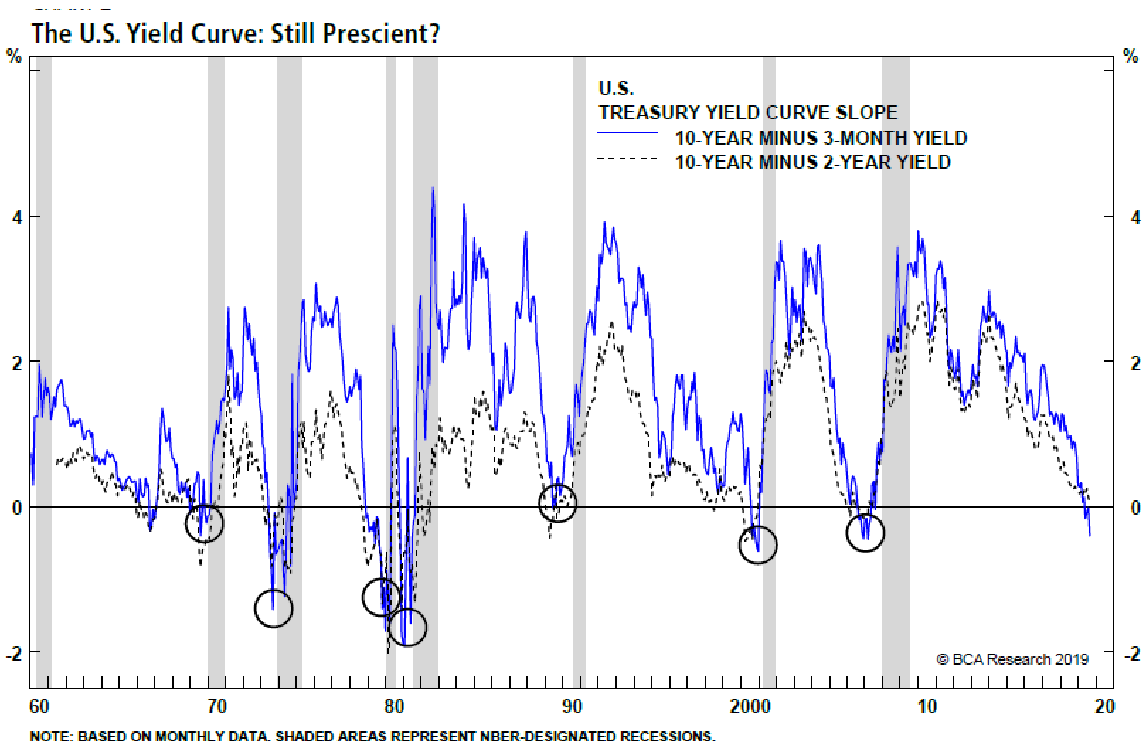
6 Reasons Why We're Not Panicking…..Yet:

Well that's been a lively past couple of weeks! On the back of worsening trade war rhetoric the week before, with the Chinese currency seemingly being used as a weapon for the first time in the dispute, we also saw the situation in Hong Kong deteriorating to the extent that the Chinese military have moved a step closer to intervening; the risks of a hard Brexit increasing as Parliamentary figures try to come up with ways of avoiding a default no deal exit on October 31st; the Argentine stock market falling by an eye-watering 48% in one day as their reform-minded President was trounced by his left wing rival in primary elections; and Italy's coalition government collapsed. Just a normal fortnight, then, in this geopolitically charged world in which we live.

The biggest thing that got investors agitated though was ***the yield curve inverting***. Why? If you look at the chart below you'll see. The grey vertical bands are recessions. Every time that the yield curve has inverted since 1960 it has been the siren call for a forthcoming recession. Hence, a market panic.



But Corporal Jones from Dad's Army may be calling it right. There are several reasons why it may be too early to panic. Yet.

Reason 1:

An inverted yield curve, though consistently a good forecaster of recessions, is not so good when it comes to telling us ***when*** the recession will arrive. If you just miss a bus, you know that if you wait long enough another will be along. You just don't know whether it will be straight away, or the next morning. So it is with recessions. The next one will always be coming. But the yield curve is not the only indicator to watch for. When it is in conjunction with others, such as The Conference Board Leading Economic Index® decreasing and central banks tightening monetary policy (remember; expansions don't die of old age, the Fed kills them) you can probably narrow the arrival time down from 18-24 months to the next 6 or 9. We're probably not in the latter stage yet as we can only tick off two out of the three signals.

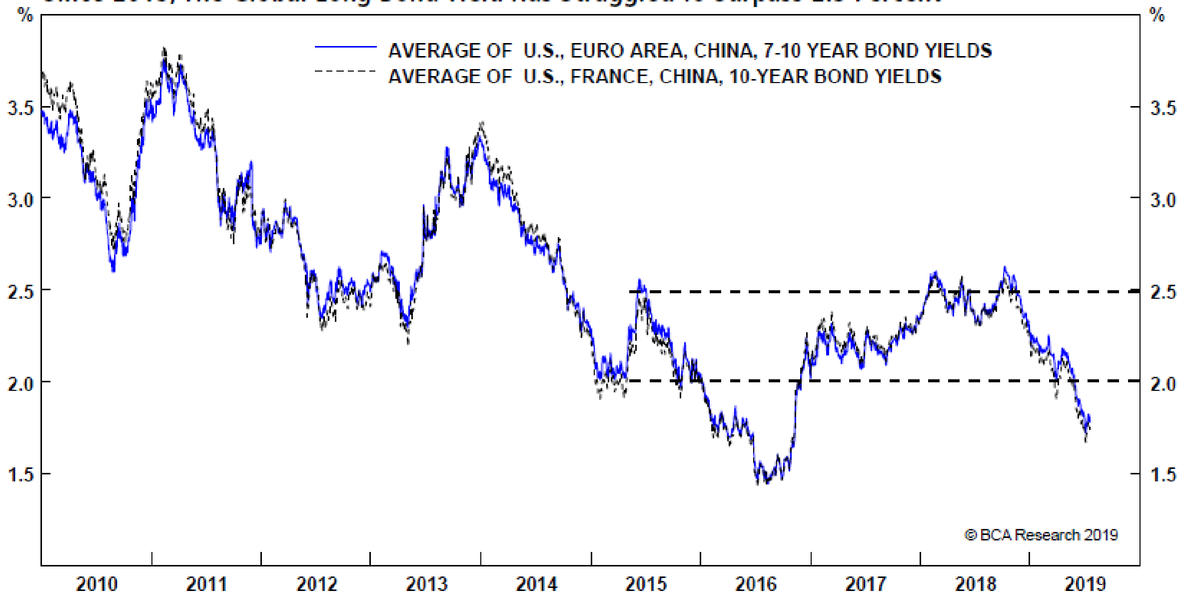
Reason 2:

"The European Central Bank should come up with an "impactful and significant" stimulus package at its next meeting in September" [Olli Rehn *New York Times* and *Bloomberg* August 15th 2019]. Indeed, one of the key reasons that the yield curve is where it is, is because of the ultra-dovish policy emanating from just about every central bank in the world right now.

Reason 3:

TINA. There is no alternative. With yields this low, and central banks due to ease further, there are few alternatives to stocks for investors seeking a positive return over the medium to longer term. We used this chart last month, but it's worth repeating. Global aggregate bond yields below 2% have been supportive of equities in recent times, just as yields at 2.5% have been triggers for market sell-offs. We've gone significantly lower than 2% in the past week. It feels like a floor is close to being reached.

Since 2015, The Global Long Bond Yield Has Struggled To Surpass 2.5 Percent



Reason 4:

Inverted Yield Curve Obsession. It may be significant that each of the recessionary periods highlighted in the earlier chart occurred before the Great Financial Crisis of 2008 – an event that arguably changed the world from an economic perspective. QE has seen bond term premia hit negative territory. This had not happened in the 50 years before '08 so can we translate rules founded in one era to another? As Peter Berezin of BCA Research points out: "Today the US 10 year term premium stands at -1.2%. In late 1994, when the yield curve almost inverted, the term premium was 1.9%. Had the US term premium in the mid-1990s been anywhere close to present levels, the yield curve would surely have inverted, causing yield curve-obsessed investors to miss out on the biggest equity bull market in history."

Reason 5:

The global manufacturing cycle. These cycles typically tend to last three years…..18 months rising and 18 months falling. The last downleg began in early 2018 so absent a serious decline in trade war relations, we expect to see an upturn in manufacturing activity by the end of the year. The decline in global growth could be bottoming.

Reason 6:

Trump backtracks. The tweet that announced that tariffs were being delayed until after Christmas was a clear indication that President Trump is very aware of the almost certain risk that if the US economy was allowed to slip into recession prior to the November 2020 election, the Chinese will be dealing with a new US President after that date. The shot from Beijing across the lawns of the White House in the form of "currency manipulation" in early August appears to have been heeded by President Trump. China, for their part, don't necessarily want to inflame the trade war any further themselves and can afford to wait until after the election to see who they will be dealing with at that time. There has been some further inflammatory talk in the past few days but we're not sure how much of an appetite both sides have for ratcheting up the trade war just now. It may make sense for China to hold fire until they know who is occupying the White House after November 2020, while the current President wants to make sure that it will actually be him.

6 reasons, then, to feel a little more upbeat than many investors currently are feeling.

This does not mean that we are complacent though. Far from it. But for now, we feel there are enough reasons not to join the panickers. Yet.

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