SKERRITTS VIEW – JULY 2018

Is The Bubble In Complacency Still Inflating?:

In November last year we began our monthly report by suggesting that a bubble in complacency had inflated. After a year of synchronised global growth, markets everywhere had risen and volatility as measured by the VIX index was at an all-time low. Passive funds were outselling active funds by a healthy margin which is often indicative of a mature bull market. If you buy a passive fund you are actually making an active decision to "buy everything", which one supposes that you would only do if you had confidence that "everything" was going up for a long time.

Possibly unsurprisingly, markets faltered in February, and again just recently, largely against the backdrop of trade tariffs, first threatened – then real, levied by Donald Trump against his perceived foes and allies, the defining lines between each being somewhat blurred. But faltered is all the markets did. Despite certain levels of hysteria displayed by the press, alarmist vocabulary such as "plunge", "sink" and "swoon" to describe the behaviour of stocks was hardly merited. Indeed, one wonders what words will be found when stocks truly do swoon, sink and plunge, as they inevitably will at some point.

We're not complaining. Everyone except the most bearish benefit from resilient and rising markets, yet is the apparent indifference from markets to the initial rounds of the trade war masking a more worrying scenario that complacency has failed to recognise?

How Do You Trade A Trade War?:

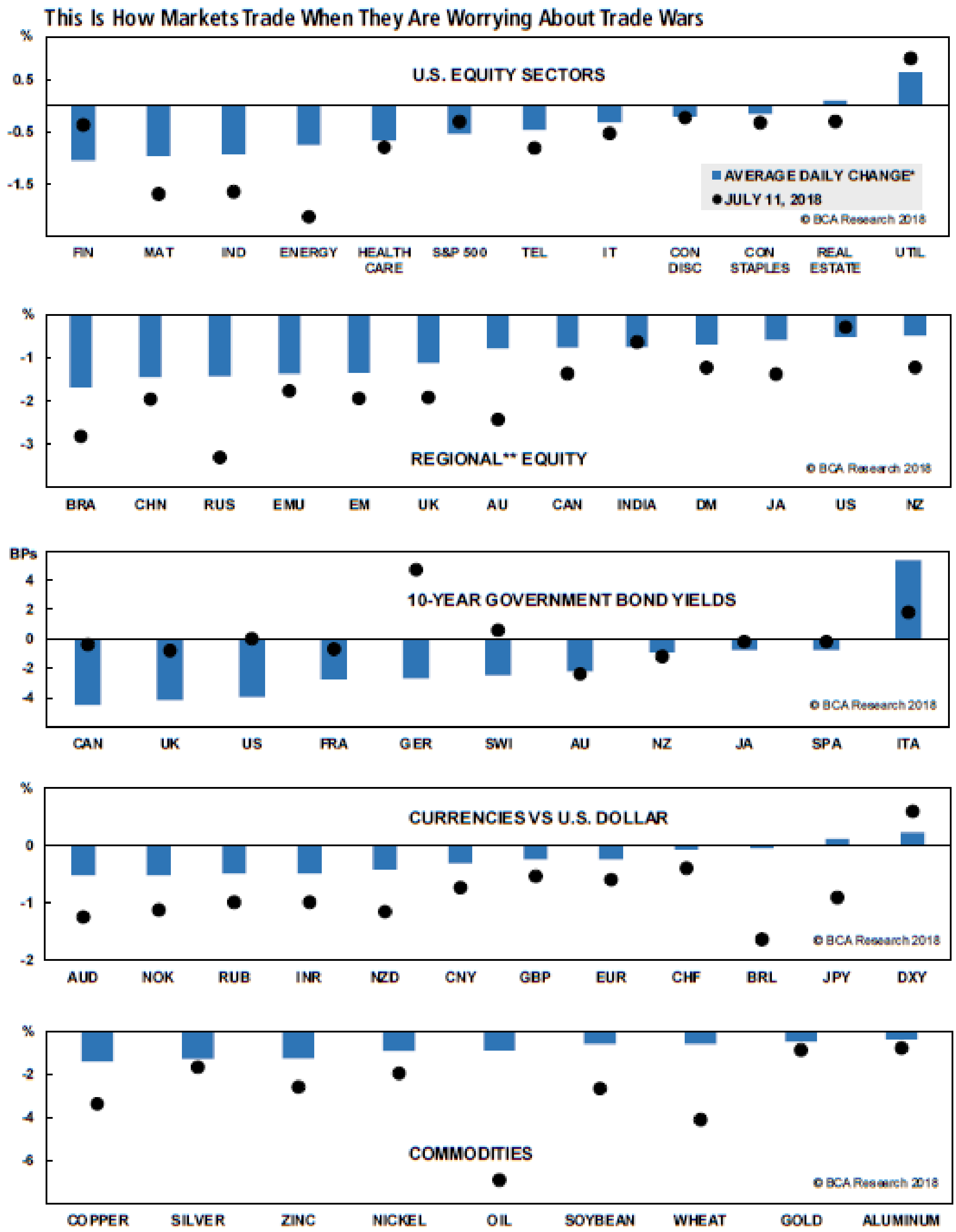
So how do you trade a trade war? This very much depends on your investment horizons. If you are an institutional pension fund investing on behalf of thousands of members on a 25 to 30 year time horizon you don't care a jot. Short term concerns are an irrelevance. If, however, you are investing on behalf of someone who has entrusted you with their lifetime savings, or who is approaching retirement, or who maybe has accumulated a sizeable ISA pot which will supplement income when no more regular remuneration is forthcoming, then how potentially serious threats to the security of these pots of capital are handled is extremely relevant.

Which makes the answer to the question which is – no-one really knows – a little perplexing. We've never experienced a situation like this one before and so anyone who predicts the outcome with any certainty should be treated with scepticism. Also, as we've mentioned in previous articles, the most consistently accurate phrase over the last decade for forecasting what is likely to happen has been "that'll never happen". The world's largest banks and insurance companies going bust; interest rates turning negative; a reality show "celebrity" becoming the most powerful man on Earth; Leicester City winning the Premier League; England winning the World Cup (well, semis was pretty close) – none of these to the average person could ever happen. So, if you hear anyone of any standing saying with confidence that a full blown trade war will never happen because of x, y or z, then bear recent history in mind.

So what to do? All we can really do is to try to sniff out clues of how certain assets have behaved previously and allow ourselves the flexibility to move between them accordingly should the situation develop in a certain way.

Sniffing Out Clues:

We are indebted to BCA Research for the following table in which the performance of various asset classes has been mapped for days on which fears of protectionism triggered a negative response, including the most recent on July 11th.



* BASED ON AN AVERAGE OF SEVEN MARKET-IMPACTING TRADE-RELATED EVENTS WHERE THE S&P 500 FELL BY MORE THAN 0.5%:
3/3/2018: TRUMP TWEETS HE WANTS TO TAX GERMAN CARS.
3/22/2018: INVESTIGATION INTO CHINA UNDER SECTION 301 COMPLETED AND TRUMP INSTRUCTS THE UNITED STATES TRADE REPRESENTATIVE (USTR) TO DRAW UP A LIST OF POTENTIAL TARIFF TARGETS.
5/23/2018: INVESTIGATION ON U.S. AUTO AND PARTS IMPORTS UNDER SECTION 232 STARTED.
5/29/2018: WHITE HOUSE SAYS IT WILL PUT A 25% TARIFF ON $50 BILLION OF CHINESE IMPORTS.
6/15/2018: USTR ANNOUNCES THAT IT WILL IMPOSE ADDITIONAL TARIFFS UNDER SECTION 301.
6/18/2018: TRUMP THREATENS TO IMPOSE $400 BILLION IN TARIFFS AGAINST CHINA.
7/11/2018: WHITE HOUSE SAYS IT WILL PUT A 10% TARIFF ON AN ADDITIONAL $200 BILLION OF CHINESE IMPORTS.
** REGIONAL ETFS: AUSTRALIA EWA; BRAZIL EWZ; CANADA EWC; CHINA MCHI; DEVELOPED MARKETS URTH; EMERGING MARKETS EEM; EURO AREA EZU; INDIA INDA; JAPAN EWJ; NEW ZEALAND ENZL; RUSSIA ERUS; U.K. EWU; AND U.S. SPY.

Pulling It Together:

Certain factors need to be borne in mind.

It could be argued that the last major round of equivalent tensions between the US and China was around the Tiananmen Square incidents of 1989-91. Since then, of course, China has developed into an entirely different proposition economically and can now be viewed as an equitable rival in global trade terms to the US. Although it is hard to see how China can win a toe-to-toe tariff war with the US (China's dependency on exports being significantly higher than the US), it is highly unlikely to just sit back and take it on the chin. If tariffs began to destabilise China internally in the shape of rising unemployment due to manufacturing jobs being lost, they would undoubtedly react. The most likely weapon that the Chinese would use would be a devaluation of their currency. People may point to the last time that they devalued in 2015 and the flight of capital from China that ensued. Their mistake then may have been to have been too timid. Peter Berezin at BCA reminds us that "standard economic theory says that a country should always devalue its currency by a sufficient amount to flush out expectations of a further decline" which is what they failed to do back then. Ironically, to use the words of Donald Trump, a currency war from China's perspective may be "good and easy to win."

Looking at the table above, it is clear to see that the Dollar tends to strengthen at such times. The Fed's on a tightening curve in any case, whereas most major currencies are not. It is virtually impossible to see how emerging markets can not be adversely affected by a rising Dollar, potentially slower global growth and a weakening background for commodities. Around 80% of EM debt is paid in USD, while outside of China, EM Dollar debt is back to levels seen in the late 1990s. Potentially, capital outflows from emerging markets simply strengthens the Dollar further.

The problem with positioning portfolios to deal with these situations is that they may not happen. If the threat of a severe trade war diminishes and empty rhetoric wins the day, markets will fill their lungs and set racing for a new summit. Our strategy, as has been the case for a few years now, is to try to allocate thematically rather than geographically, making sure that anything we invest in is traded on a daily basis to allow ourselves to change our minds quickly if need be. We've already identified vehicles into which we can switch should we need to, and we've identified currency as a route to safe haven as being more likely to help us steer through any choppy waters than the more traditional haven classes of bonds or gold.

Who knows, it may never happen. But then we've heard that before.

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