

How Scared Should We Be?:

In our February 2016 edition of this monthly bulletin, we made the cheery observation of the world that we live in: **“The last time it was like this? Just before WW2. And before that? Just before WW1”**. To be fair, we were repeating the thoughts of Marko Papić, the Geopolitical Editor for BCA Research and he was referring to the growing multipolarity that was following the retreat from the Middle East of the United States, the re-emergence of Russian nationalism, the emergence of China as an economic superpower and the migrant crisis across mainland Europe.

To clarify, this statement was made two years and two months ago. *Since then* we’ve voted in this country to leave Europe, President Trump has been elected, we’ve witnessed a nuclear stand-off between North Korea and the United States, President Xi of China has announced that he is going to remain President for as long as he wants, trade tariffs have been slapped on a number of Chinese products by the US, Russia has re-elected Putin for another 6 years (we wouldn’t bet on it not being longer) and the world has just expelled over 100 Russian diplomats as a consequence of nerve gas being used in a Salisbury Italian restaurant.

Another favourite comment of ours that we have repeated in recent months (and anticipate continuing to do so) is that when you hear the phrase “that’ll never happen” it has perhaps been the most accurate forecast for ensuing future outcomes since the crystal ball was at its peak. “That’ll never happen” was the most common response to our February 2016 article. Events have not exactly gone swimmingly since that statement was made, so how scared should we be?

A Bit of Perspective:

Let’s not forget that during the above tale of turmoil, stock markets around the world (that same troubled world that appears to be heading for who-knows-what levels of self-inflicted calamity) continued to climb to record highs, leaving many a bear scratching their heads in bewilderment in their wake. How could this be?

Keeping things simple is perhaps one of the best attributes a potential investor can have, and with the barrage of comment, opinion, newsflow, tweeting, messaging, breaking, soundbiting and groupthink babble that infuses modern society, keeping a clear head and prioritising is not always easy to do. Here are some facts that we think help with our thinking.

Globalisation, whilst having reached its peak, will not go into reverse overnight.

President Trump, despite his frequent outbursts, loves to take credit for the stock market going up. A severe trade war will send it down.

President Trump has some mid-term elections coming up this year. He wasn’t the most popular in his first eighteen months of tenure, but make some noise about being tough on China and you are being seen to keep your word by those who voted for you.

A trade war would hurt China more than it would hurt the US. For now. Expect some compromise on both sides.

A pattern is emerging of Trump making extraordinarily threatening statements to grab attention, only to backtrack somewhat a little later when detail is required. This appears to be a characteristic of Trumpomacy.

Markets and financial events tend to be more influential than politics (each of the last major downturns economically were market-driven – 2000 bursting of the dot.com bubble; 2008 the bursting of the credit bubble; 2011 the Eurozone debt crisis).

There are certain themes in play that appear irreversible such as robotics and automation, cyber security, the ageing population. They may be volatile, but they are not going away soon. Keep these as core investments.

So, all in all, there are many reasons to remain optimistic. The world is changing, undoubtedly, but the pace of change and the threats and opportunities that this change will generate means that clear thinking should still be rewarded, along with the ability to remain flexible and open to new ideas, not just the old theories and models that typify the era of *early* globalisation.

Fortune Favours The Brave:

It would be madness to ignore the numerous challenges that seem to be building, but we think it's too early to run and hide, preferring the bolder, braver approach for now. We consistently say that, in this era of low interest rates and low bond yields (which still exist despite the odd 25 bp rise from the Fed) if you can successfully identify themes that are here for years (as opposed to fads) then every correction in prices represents an opportunity to buy at a lower level than they were a month earlier. Following a thematic path also means that geography is of less importance than the theme itself, so as investors you steer clear of the trap that forces you to hold certain proportions of your portfolio in the UK. Because of Brexit, investing in the UK remains guesswork until the outcome is known.

We will start to become more worried when the next recession approaches. Hopefully, this is not for some months yet. Recessions can be caused by a number of things, but sadly they are as certain as death and taxes.

What will cause the next global one? It could be that central bankers may be the unwitting catalysts. It has been said that central bankers are like military leaders in that they tend to fight the last war but fail to spot the next battle. Having waged war against deflation after the Global Financial Crisis of 2008, their tendency will be to remain loose for longer. This may prolong the recovery but if, as has just happened in the US, we get a stimulus in the form of tax cuts to an economy that doesn't need them, the economic and financial imbalances will be all the greater the next time a slowdown turns up.

It is when the next recession hits that we will get scared of all of those factors that we listed at the beginning. An economy in a recession is all the more likely to try to protect itself by slapping ever-more punitive tariffs on overseas competitors' goods. This is, of course, entirely the wrong time to do so.

China's confidence in its ability to challenge the United States as the major global economic power is born out of the very causes of the 2008 Financial Crisis. The crisis proved that the capitalist model was not superior, and the subsequent polarisation within the US politically reinforces this view in China's eyes. They have also learned from the collapse of the Soviet Union that relaxing political control, allowing corruption within the Communist Party to take hold, and encouraging the military to

swear allegiance to the country rather than the Party are fatal errors which are to be avoided at all costs. President Xi has addressed each of these. The challenge is coming to the US and its Number 1 spot on the global stage. Graham Allison of Harvard University identified 16 occasions in history where a rising power upset the global order, and in 12 of these 16 cases, war ensued. In one of the four cases that did not involve nations that shared a deep cultural affinity, the Cold War between the Soviet Union and the United States ensued.

If a trade war intensifies, then a Cold War may be the best we can hope for. But we're not there yet and so, by keeping things simple, we'll keep backing our themes to keep us warm.

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