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INVESTMENT MANAGEMENT & STOCKBROKING

MARKET COMMENTARY

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Another Thing To Worry About ...

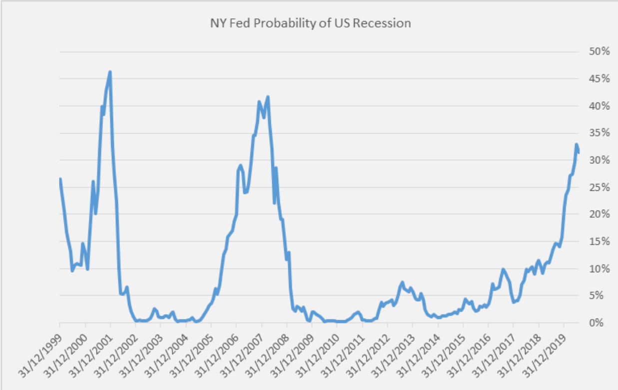
July was a mixed bag for equities, with the US slightly higher, the Eurozone broadly flat and emerging markets lower. The UK was the notable bright spot, helped by a further 4.2% fall in the pound – a weaker sterling is good news for companies with overseas earnings, many of which feature heavily in the index. The real action has been in the bond markets with government bonds in developed markets having another strong month. Index-linked gilts are now up an astonishing 12% over the last year – returns of this magnitude are rare. All eyes have been on the Fed and at the end of the month interest rates were cut by a quarter point, as most expected. Further cuts look likely but how soon and how heavy is difficult to call, with Fed Chief Powell seemingly mixing his message.

In part this has led to the so-called inversion of the yield curve, and it deserves comment. Technically, this is the situation whereby longer term government bonds provide a yield that is lower than equivalent bonds of a shorter maturity. The relevance of this becomes clearer if one thinks about it in terms of a short-term mortgage deal, because buying a government bond is in principle the same as providing a loan to the government. Both transactions involve an initial outlay of cash, under an agreement that at the end of the term the mortgage holder/government pays back an agreed sum. It stands to reason that the mortgage rate or bond yield will tend to be higher for a longer maturity loan. The longer the loan is outstanding, the higher the probability something will go wrong and result in default, thus a higher return is demanded to compensate for this risk. In other words the mortgage rate or yield curve should be upward sloping over time - the longer the time to maturity, the more the investor is rewarded with a higher yield.

The yield curve is constantly shifting, but the drivers of its shape differ across the maturity profile. The short end of the curve is determined by monetary policy and the actions of the central bank. A lowering of base rates will cause the short end to shift down and the entire curve to become steeper, all else unchanged. The longer maturities are driven by market forces and fiscal policy. For example, excessive demand for longer dated bonds will push prices up and yields down, leading to a flatter curve provided the short end remains stable.

So why are inversions concerning? Dating back to the 1950s, each US recession has been preceded by a yield curve inversion, as shown in Chart 2. The favoured benchmark, the US 2-10 year yield spread, indicates investor nerves surrounding the near-term outlook of the US economy. In other words, they believe the risks in the coming two years exceed those of the longer term. Hence they want a higher yield for the 2-year bonds than 10-years as compensation. Essentially, the inversion indicates the market believes there is a higher risk of recession in the coming two years, a belief mirrored by the New York Fed in their recession probability index which now shows a figure of 31% for July 2020 in Chart 1 above.

Chart 1 - NY Fed Says 1 in 3 Chance of Recession.



*Source: New York Federal Res*erve

So why did the curve invert on August 14th? There are several inter-related reasons, but in short investors are anticipating that interest rates will be cut very soon, increasing the demand for bonds, particular those with a longer term to maturity. This flight from stocks to bonds can arguably be caused by fears of escalating trade wars, a rise in the perceived risk of recession and a gut feeling that equity markets are due a sell-off.

Is this time different? At the risk of walking into an elephant trap and making Howard Marks wince … we think it might be. In the case of trade wars, Trump is both the arsonist and the firefighter. After starting the fight with China he has the ability to be an heroic peacemaker. It seems highly unlikely to us that he doesn't play this 'trump card' in the run up to the elections next year. In the case of both an equity market sell-off and the rising risk of recession, Trump cannot afford either if his re-election campaign is to be successful. So is it any surprise he is trying to push through all the accommodative policies he can in a bid to ensure the stock market continues to hit new highs and the economy doesn't contract.

Maybe more to the point, with each of the previous recession there have been major systemic shocks. In 2008, consumers were overleveraged in order to partake in the housing bubble, lending standards were non-existent and banks were selling and holding large volumes of toxic assets on their balance sheets. All of this while being leveraged around 33x, meaning that a 3% decline in the price of their assets would essentially render them insolvent; an event which actually happened in a number of cases. And nobody was aware of the situation until after the event. In the early 2000's, we had the US tech bubble, a curious mass-psychosis which eventually burst. As precursor to this, we had the Russian Debt Crisis, the downfall of Long Term Capital Management and Asian financial crisis.

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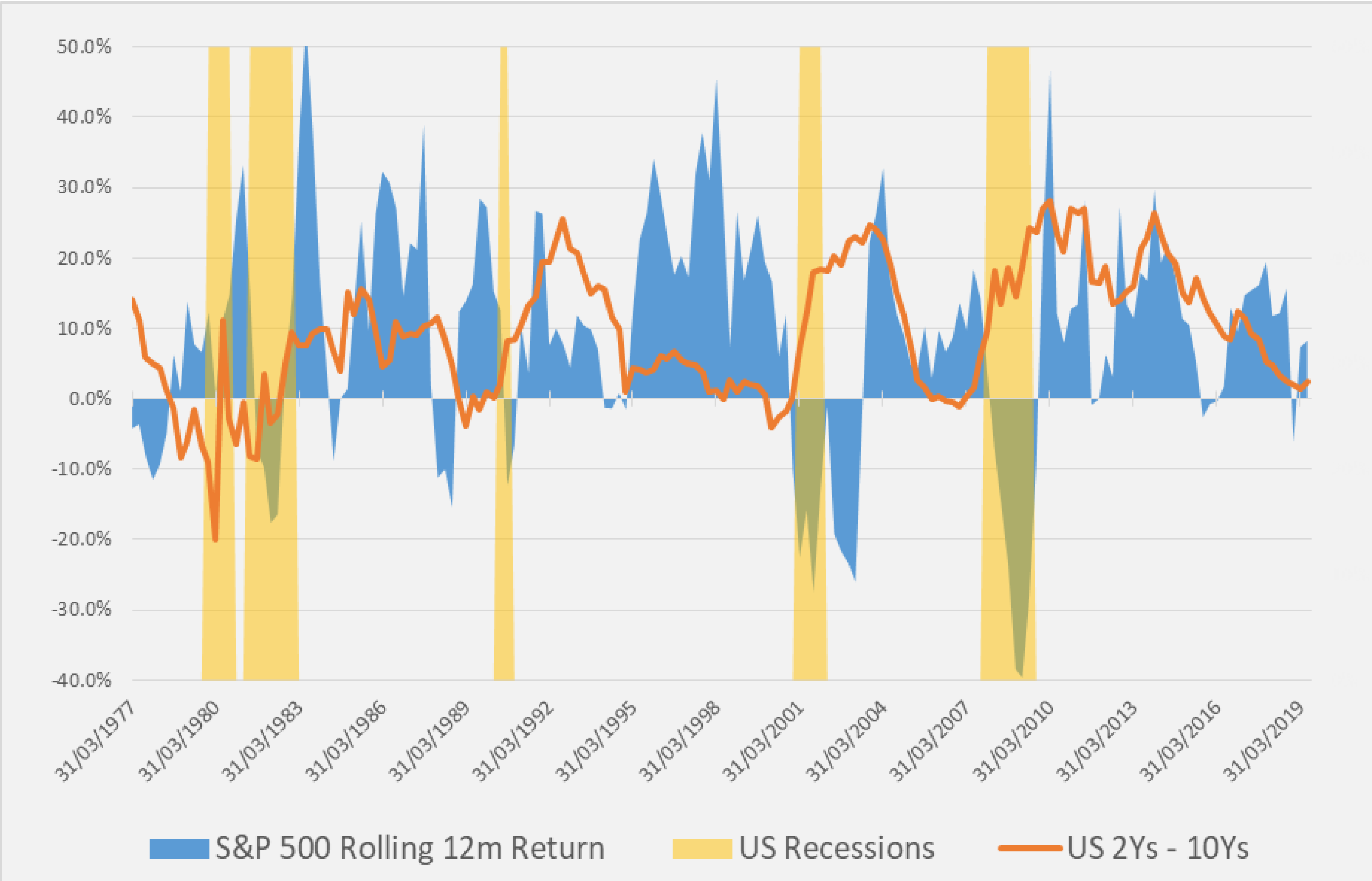
Yes, the curve has inverted (albeit briefly so far), yes it has preceded recessions in the past, but to hypothesise that a nasty, damaging recession is on its way is to predict an exogenous event as yet unseen. Well that's easy to guess at … Hong Kong protests, Tokyo earthquake, Middle East unrest, Indian economic failure, Brexit apocalypse. But that is entirely guesswork and blind instinct, not analysis.

At present banks are significantly better capitalised with leverage ratios in the low teens, labour markets are at the tightest levels for decades, workers are experiencing wage growth and households carry much more manageable levels of debt. So while systemic risks we believe are low, a recession could be just the result of the ebb and flow of the economic cycle. There is however no rule that recessions happen every 10 years say. Australia hasn't had one in 28 – it has come close a few times, but narrowly avoided it due to a combination of fiscal prudence, economic policy coherence and maybe by the nature of the abundant levels of natural resources at its disposal.

Our conclusion is as follows; stick to the thesis – buy the dips. As investors, our objective is to maximise real returns on portfolios, with regard to underlying risk. So while investors' concerns are heightened on the back of recent events, we turn to Nick Train who perfectly articulated our thinking in a recent interview; "So the rational way to deal with these sorts of concerns, it may not be the correct thing, but the rational thing is to ignore them and be invested in fine businesses".

Chart 2 - Recessions, Returns and the Yield Curve.



Source: Bloomberg ®, Albert E Sharp.

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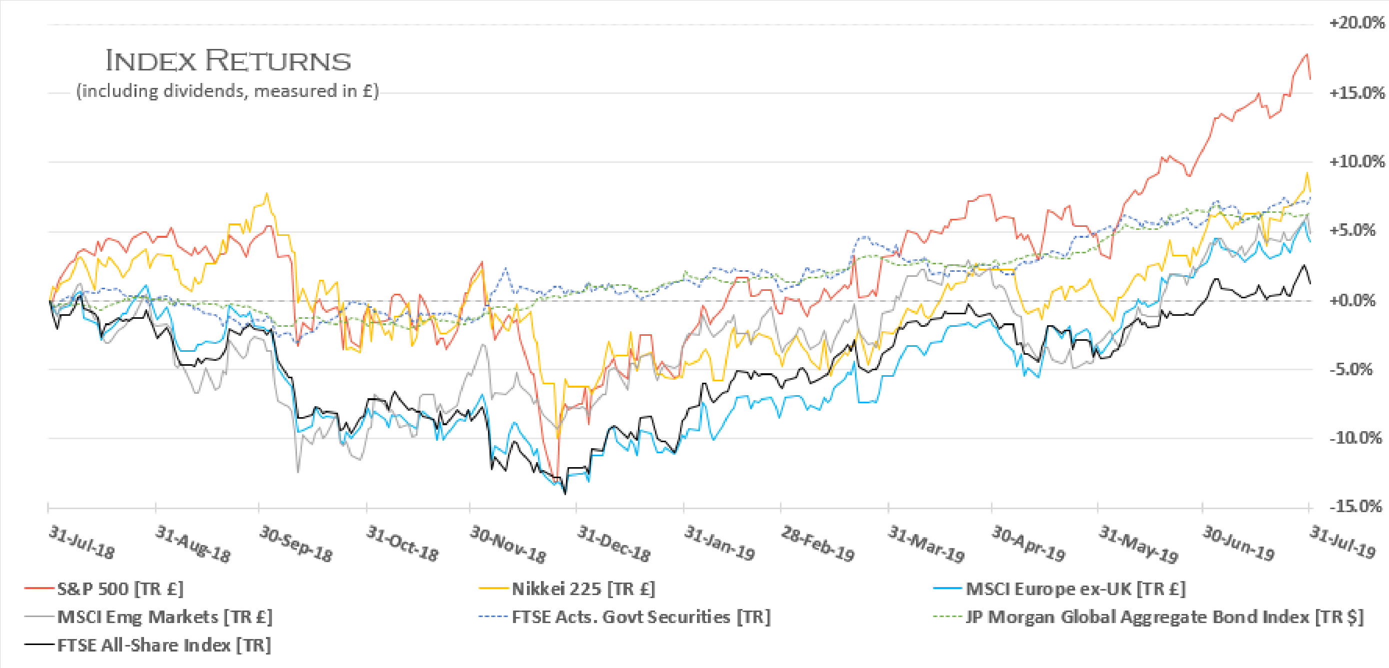
INDEX RETURNS

Index	Region/Asset Class	31 Jul 2019	1 Month Change	1 Year Change	2 Year Change
UK 100	UK	7,586.8	+2.2%	-2.1%	+2.9%
UK Mid Cap	UK	546.0	+1.6%	-5.3%	-1.4%
UK Small Cap	UK	5,543.3	-0.5%	-5.7%	-2.8%
Dow Jones Ind Avg	USA	26,864.3	+1.0%	+5.7%	+22.7%
S&P 500 Index	USA	2,980.4	+1.3%	+5.8%	+20.6%
NASDAQ Comp.	USA	8,175.4	+2.1%	+6.6%	+28.8%
Nikkei 225	Japan	21,521.5	+1.2%	-4.6%	+8.0%
Euro Stoxx 50	Europe	3,466.9	-0.2%	-1.7%	+0.5%
CAC 40 Index	France	5,518.9	-0.4%	+0.1%	+8.3%
DAX Index	Germany	12,189.0	-1.7%	-4.8%	+0.6%
Milan Index	Italy	21,398.2	+0.8%	-3.7%	-0.4%
MSCI Emg Mkts (£)	Emg Mkts	593.7	+2.7%	+4.8%	+9.9%
IBOVESPA Index	Brazil	101,812.1	+0.8%	+28.5%	+54.4%
IMOEX Index	Russia	2,739.5	-1.0%	+18.0%	+42.7%
S&P BSE SENSEX	India	37,481.1	-4.9%	-0.3%	+15.3%
Shanghai SE Comp.	China	2,932.5	-1.6%	+2.0%	-10.4%
Hang Seng	Hong Kong	27,777.8	-2.7%	-2.8%	+1.7%
UK All Property	UK Property	132.8	-0.3%	-1.0%	+5.4%
UK Conv Gilts	UK Gilts	3,858.5	+2.1%	+7.4%	+8.8%
UK Index linked Gilts	UK IL Gilts	5,472.7	+3.6%	+12.0%	+16.0%
JPM Glob Agg. Bond ($)	Global Bonds	596.2	-0.2%	+6.4%	+5.9%
iBoxx Non-Gilt	UK Corp Bonds	363.1	+2.0%	+7.9%	+8.0%
WTI Crude ($/barrel)	Oil	58.6	+0.2%	-14.8%	+16.8%
LMEX	Base Metals	2,813.7	-0.2%	-7.6%	-5.5%
Gold Spot ($/oz)	Commodities	1,413.90	+0.3%	+15.5%	+11.4%
S&P Agri & Livestock	Agriculture	675.79	-3.1%	-8.3%	-16.0%
£1 = US$	Currencies	1.22	-4.2%	-7.4%	-8.0%
£1 = €	Currencies	1.10	-1.7%	-2.2%	-1.6%
£1 = Yen	Currencies	132.26	-3.4%	-9.9%	-9.2%



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