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From a May Day signal to a summer of discontent.

Highlights:

- **The first half of the year represented the strongest such period in global markets since 2007. Markets more than recovered their May losses in June and, particularly in the US, displayed solid year to date returns.**
- **The US Fed reacted to trade war concerns and persistent low inflation by instituting its first rate cut in 10 years at the end of July (25 bps).**
- **However, markets were hungry for more and promptly sold off – leading to a spike in equity market volatility and a flight to safety.**
- **This flight to safety led to a collapse in government bond yields and a spike in government bond volatility, as well as negative rates and an inverted yield curve in the US. This traditional recession bell-weather sparked further recession and slow growth rhetoric and market continued their slide throughout August**
- **Geopolitical flashpoints over the period included Hong Kong, where pro-democracy protests became increasingly violent and disruptive, Argentina, where a surprise primary victory for the opposition led to a collapse in those markets and the UK where odds of a no-deal Brexit increased with the ascent of Boris Johnson as Prime Minister. Sterling fell against most major currencies as uncertainty continued to percolate.**

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Current macro snapshot

Brexit . .odds reverse and No Deal Looms

The ascent of Prime Minister Boris Johnson over the course of the summer, led to a dramatic shift in the rhetoric, and the stakes, surrounding Brexit in the UK and the prospects for a no deal. Markets responded by selling off Sterling (-4.2% in July and flat in August v. the USD) and equity markets in the UK were subdued, losing 4.1% over the month of August. As news sources jostle for supremacy

of messages of fear v. resilience ("bumps in the road") there remains a lot of space between now and the October 31 deadline

Euro-fication clouds growth prospects

For years the phrase Japanification has been applied to any economy that looked to be on the brink of a sustained era of low rates, low inflation and low growth. This moniker has so frequently been applied to Europe that another phrase – Euro-fication has been adopted. In late July the Euro hit a two year low as the ECB signaled future stimulus while a rate cut seemed to be on the horizon for September, and possibly a rate cut, as the outlook seemed "worse and worse" (per Mario Draghi) due to ongoing weakness in international trade affecting the euro area manufacturing sector. With negative rates now percolating throughout the EU, out to 15 years in Austria, Belgium, Finland, France, Sweden and Japan, this has important repercussions for financials as well as savers (in late August Germany tested the issuance of a 30-year bond with zero coupon). Indeed globally, it has been a brutal summer for investment banks with nearly 30,000 jobs cut due to falling interest rates, weak trading volumes and automation.

Negative interest rates would seem to be a harbinger of deflation and, indeed, inflation is stubbornly low, such that 2020 growth forecasts for the Eurozone have been reduced to 1.4% for 2020 according to the European commission. Germany also seemed poised to enter a recession as the summer saw a dramatic slow-down in imports (again, the effect of global trade uncertainty)

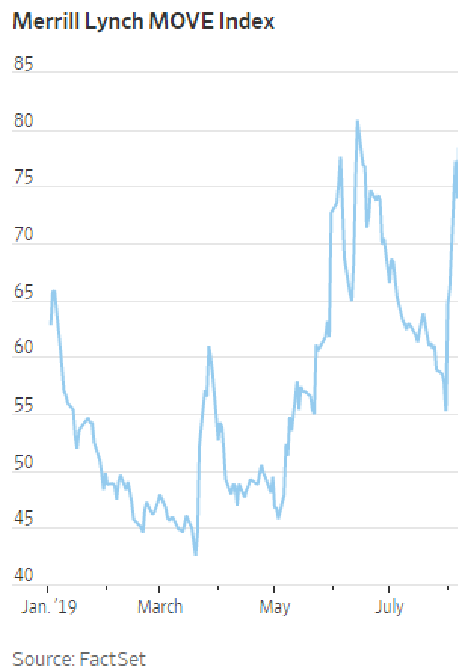
Ruffled Feathers, grounded planes and the Curious Case of Greenland

Donald Trump labeled China of as a currency manipulator in early August, after it had allowed it currency to depreciate against the dollar following the latest round of tariff threats. It should be noted that this occurred after the only time that the Chinese did not intervene to artificially prop up its exchange rate which has been pegged to the dollar for years. This was considered to open up another "front" in the two year spat between the two nations (the other two fronts being international trade and advanced technology) and was likely to further increase tensions between the two. Meanwhile pro-democracy protests in Hong Kong escalated in intensity as tear gas was fired on street protestors and occupation of the airport led to mass disruption and grounded flights. The eyes of the world have now been trained on this situation and what it means for China's rule of law and Hong Kong's distinct identity.

Other geopolitical firestorms included the surprise primary election in Argentina which saw a surprisingly wide margin for the opposition candidate. The peso promptly collapsed and the country saw multiple credit downgrades as the stock market saw its 2nd largest ever drop and bonds fell by a degree not seen in 18 years. In other surprises, President Trump called off a trip to Denmark in response to the Prime Minister there dismissing as "absurd" his reported interest in purchasing Greenland.

Volatility on the rise – not just for stocks

After the US Fed rate cut in late July, markets were greedy for more stimulus and threw their toys out of the pram. August saw a significant jump in volatility as a result and the Merrill Lynch MOVE Index, which measures volatility in government stocks spiked by 42% in August, suggesting a meaningful flight to safety.



The backdrop of creeping higher duration for fixed income securities detailed in the fixed income section below, also creates a climate for increased fixed income volatility, while volatility in CBOE crude oil ETFs have risen in August to their highest level since January. Recent swings in the Yuan-dollar currency pair serve as indicators that maybe investors should be bracing for big swings in markets and increases in currency market volatility can be expected over the next months.

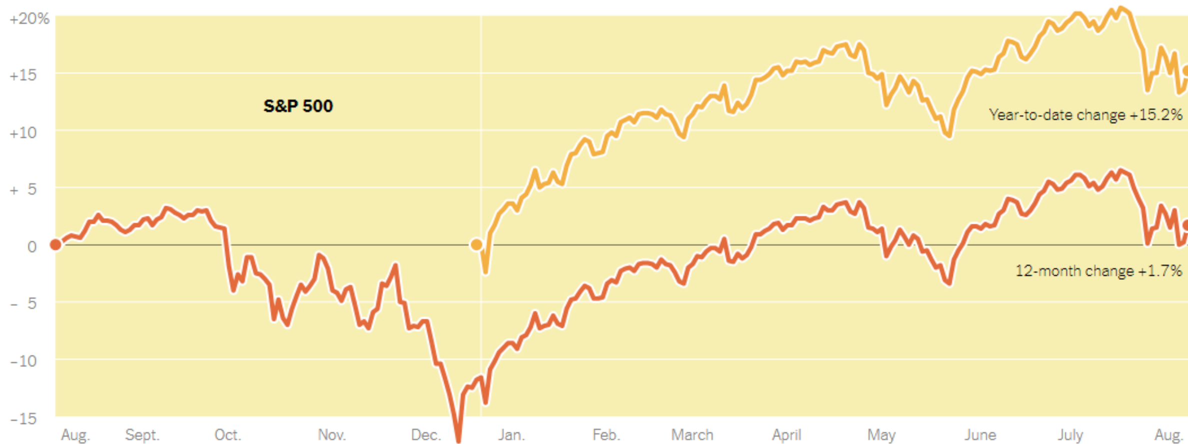
Individual Asset Class Performance

- Equities
- Fixed income
- Non-traditional Investments: Spotlight on Impact Investing

Equities: Breaking records on the road to nowhere

After the doldrums of May, June was strongly positive in markets, and coupled with the strong extension of the Q1 rally in April, it led to an overall positive result for the second quarter. The S&P reversed all of its May losses to deliver 7% for the month, which was the best June for the index in 64 years, while for the Dow it was the best June in 81 years. July saw a slowing of the strong momentum of June, but it was nonetheless a positive continuation of an exceptional year to date for risk assets. Financials were strong in the US but weak in Europe as the grip of negative rates became very real (at least for Swiss account holders) and rumbles of "Japanification" (a prolonged era of low rates, low inflation and low growth) accelerated. August was broadly negative across global markets as trade war fatigue set in and markets most severely affected were Hong Kong (-7.1%), the FTSE (-4.1%), financial indices (-4.1% and -6.3% for S&P 500 Financials and DJ Stoxx 600 Banks), while the broad US and European indices were also weak (-1.3% for the DJ Stoxx 600, -1.6% for the S&P 500, and -2.5% for the Nasdaq).

However, when we look at the shape of the stock market performance in 2019, what is apparently is that after the V shaped recover staged in the first quarter, and the further recovery of lost ground that occurred in the second one, markets have actually only treaded water for the past 12 months. See chart below.

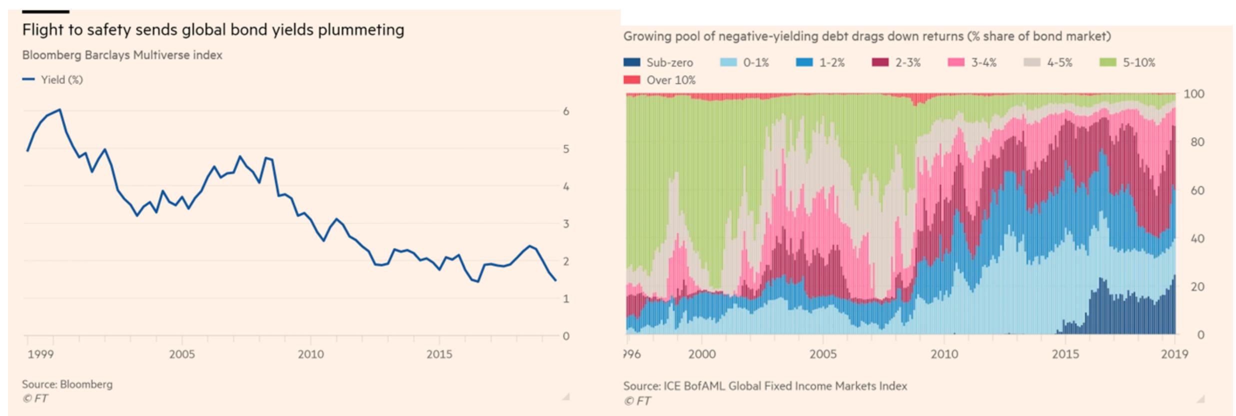


There also remain some stark disparities between how markets have performed globally as the leaders to date are the US Nasdaq (+20.9%), the Athex (Greece, +44.1%) and the S&P (+18.3%), the Shanghai Composite (+18.4%) while the laggards include the FTSE (+10.9%), the Hang Seng (+2.4%) the Nikkei (+4.7%) and the Nifty (India, 2.6%).

The growing uncertainty about the China/US relations was evident in the fact that investors pulled $2.9 bn from funds that invest in China's stock market in the past month, making the year's outflows the sharpest since 2017. Hong Kong's Hang Seng index too dropped 7 per cent in August in reaction to the unrest there.

Fixed Income/Credit: yields: lower and lower for longer and longer

The key theme in fixed income over the quarter has been the dramatic acceleration of the slippage into negative interest rates amid an unprecedented demand for government bonds. This has driven prices higher and yields lower, to the point that the yield curve has become inverted in the US at certain points. The spectacle of investors being prepared to accept less, lower yields, for longer dated credit, than shorter dated credit is a traditional recession harbinger. As the charts below show global bond yields have declined sharply over the past decade and there is a mounting number of debt trading at negative yields. This points to a steadily declining achievable rate of return (yield) for the bond market, although as long as prices keep rising returns may be enhanced.



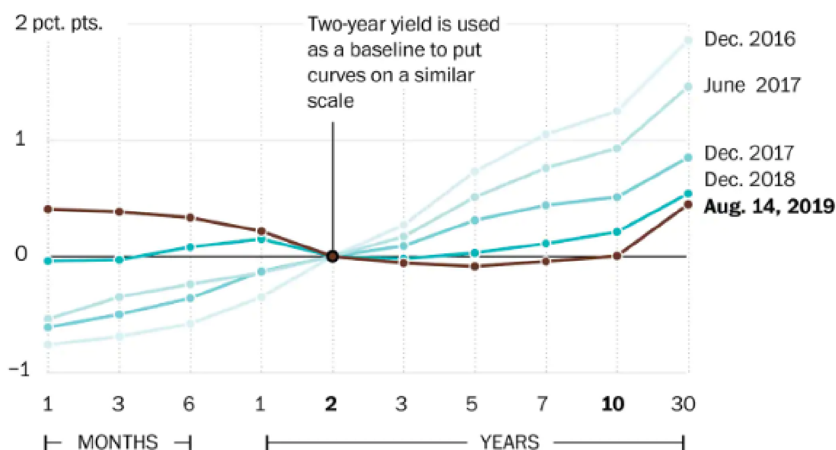
Credit performance over the past quarter was strong - particularly in July and August. In July credit had a good month, with the Euro and US investment grade returning 1.6% and 0.6%, respectively. High yield was positive but only to the tune of +0.8% and +0.6% for EUR and US. The rates rally in August led to these numbers adding a further 0.7% and 3.3%, respectively, for Euro and US investment grade. Sterling bonds were also strongly positive, while high yield continued to add modest returns. The runaway story, however, has been government bonds – in August alone UK Gilts delivered 3.8%,

while US Treasuries added 3.6% and European Sovereign bonds added 2.5%. This brings the year to date figures for these to 11.3% for UK Gilts, 9% for US Treasuries and 10.4% for European Sovereigns, truly extraordinary figures for low yielding government debt.

What is an inverted yield curve?

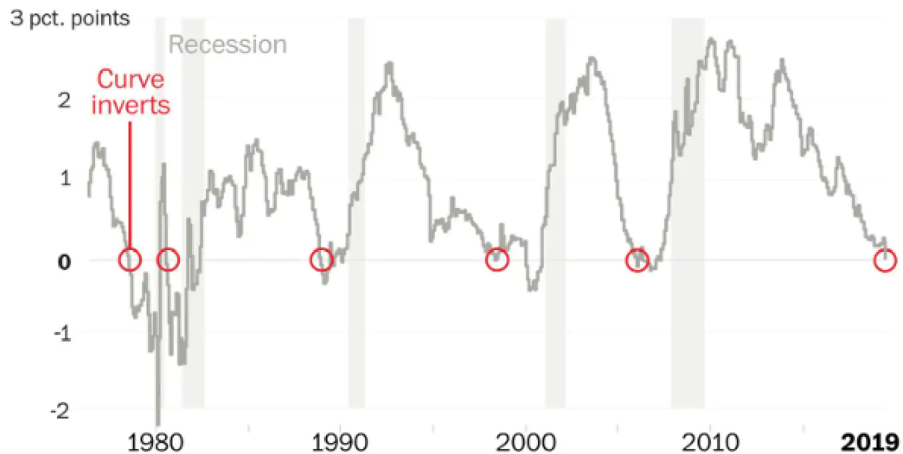
An inverted yield curve is a curve plotting bond yields against bond maturity, which typically is upward sloping (see below). It is typical that when a company or a government borrows for longer it has to pay a higher rate of interest for doing so – the so-called term premium. If the yield curve flattens or even reverses direction this suggests that the demand for longer dated bonds is such that yields there have fallen to levels lower than those demanded for shorter dated bonds. It suggests a level of concern by investors which is causing them to pile in to safer long-term investments.

An inverted yield curve is a traditional recession indicator as it has inverted before every US recession since 1955. However, it has also inverted on occasions that were **NOT** followed by a recession, at least not immediately. So while it would seem to be a necessary condition for a recession, it is clearly not a sufficient condition for this to occur. There has also been a variability in the time after the inversion of the yield curve that the recession has started. In some cases it has occurred months or years after the inversion (the average period is 18 months).



An inverted yield curve usually signals trouble

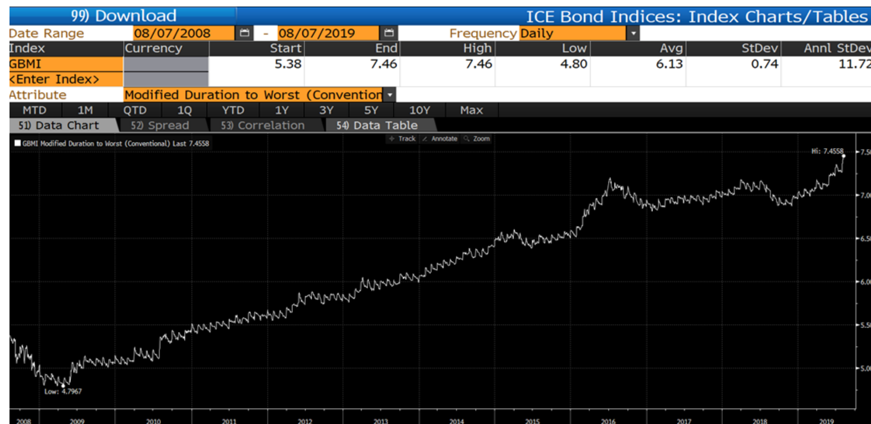
Historically, when the yield on 10-year Treasury bonds dips below the yield for 2-year bonds, a recession has followed.



Note: Only the first inversion preceding a recession is marked.

Source: St. Louis Federal Reserve, Wells Fargo Investment Institute THE WASHINGTON POST

This movement in longer dated yields is accompanied by a growing increase in duration. See charts below.



Global fixed income duration as measured by a broad index including corporate bonds and government bonds has increased by **more than 50%** since 2009 from 4.79 to 7.45. This steep increase in duration across the broader index suggests that movements of yield will have a significantly higher impact on price than in the past – leading to a more rate-sensitive and ultimately more volatile fixed income asset class in the future.

To remain on the topic of fixed income just a little longer, President Trump has also embarked upon a campaign of browbeating the Federal Reserve[1] to take more radical action to reduce rates to bolster the economy, proposing rate cuts of as high as 100 bps, combined with quantitative easing. These types of measures are traditionally reserved only for recessions, and the current rhetoric is still some way from that, so it remains to be seen whether they will bow to pressure or will maintain somewhat of an independent course. Is this yet another sign of the end of central bank independence?

[1] With references in July to their "faulty thought process", the "heavy weight of the Federal Reserve anchor wrapped around our neck" and the suggestion that the Fed "raised rates too soon, too often" and "doesn't have a clue" and had "horrendous lack of vision".

Commodities, currencies and other movers
Commodities were universally strong at the beginning of the quarter but showed some negative movement in August as global growth concerns accelerated. US WTI rose in price by 9.3% in June, bringing its year to date to 28.8%, but then lost close to 6% in August, while gold added 8% as noted previously and a further 7.5% in August, is now up 18.5% for the year. A rapid rise in the price of gold is often a harbinger for less confidence in sovereign issuance, so this would seem to be a puzzle given the rise in demand for government debt, but perhaps investors are reaching for yield anywhere they can. Ongoing positive data from the US and the dearth of it elsewhere caused the dollar to strengthen meaningfully in July (+2.7% against the Euro and 4.2% against Sterling) after some pull back in June. Performance in August against these currencies was more or less flat, but it did have some gains against the CAD and the AUD.

Outlook

So where do we go from here?

The remainder of the year is bound to be gripping as the Brexit deadline nears (October 31) and the battle lines of the US 2020 election come into focus. The stakes seem to be mounting for the 10 year expansion too, as talk abounds of rather more desperate measures to shore up the US economy (e.g., payroll tax cuts or 100 bps rate cuts). The spectre of a no-deal Brexit does present an unprecedented challenge for the European area and it is likely that the prevailing uncertainty will cause growth and investment to stall. Trade uncertainty is likely to continue too, as no agreements seem on the horizon at this point.

Looking ahead to the remainder 2019, we have the following outlook:

- **With new leadership in place the tone has changed in UK politics and as time runs out uncertainty will mount.** A game of brinkmanship[2] continues to play out between the new conservative administration and Europe, and the outcome could lead to many different implications – although this may depend on whether a no-deal outcome is truly perceived as "dangerous". Markets are likely to be extremely pessimistic as certainty eludes them and this is likely to target the pound Sterling and UK markets.

- **Trade disputes will continue to wreck global growth plans.** The initial victims of the Trump/China trade spat have been export led countries while another global trade disputes, between South Korea and Japan is hampering production in each of those countries. It is likely that the prolonged uncertainty will now trickle down to less open economies such as the US, as the impact is felt by farmers dependent on Chinese demand, say, for soybeans. As in the case of Brexit, though, uncertainty can stymie growth, and this will likely lead to a sluggish economic backdrop in Europe and Emerging Markets for the rest of the year.

- **The US will use every measure it can to hang on to its strong economic streak, and more partisan bickering is likely.** With re-election prospects seemingly inextricably wedded to economic growth and market performance it seems likely that President Trump will do everything possible to shore up the recent performance. However, as this becomes ever more challenging, it is likely that more partisan bickering and attacks on democratic candidates will unfold.

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September 2, 2019

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Defined as the activity, especially in politics, of trying to get what you want by saying that if you do not get it, you will do something dangerous.