GUARDIAN CAPITAL

Reflections & Insight

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"How did you go bankrupt?" Bill asked.
"Two ways," Mike said. "Gradually and then suddenly."
Ernest Hemingway – The Sun Also Rises

These last few months have left many market observers feeling like unwilling participants in a TV reality show, with all the drama and narcissism but little of the editing which spares the viewer from the worst bits. Three months ago, we were concerned that the era of low volatility was coming to an end, as markets began to reflect the headwinds in the global economy and the rise in geopolitical tension. In reality, volatility has settled down, while political developments have taken a turn for the worse.

It is hard to tick off the political events which capital markets have faced since the last review, but two stand out. The first is the breakout of what looks like a trade war, most particularly between the US and China, but with the capacity to unbalance the whole container ship of international trade; the second is the latest eruption of populist anger in Europe, as reflected in the election of an unedifying coalition of populists and racists in Italy. This brought back memories of the Eurozone crisis, albeit briefly, and has thrown some of the underlying tensions in the European project into stark relief.

To identify only two such events is not to belittle such seminal moments as the challenge to the post-war international order represented by the friction between the US and its G7 partners, the cartoonish summit with Kim Jong Un, and an escalation of conflict threat in the Middle East. Put all this lot together and you would expect to be looking a bear market in the face. In fact, markets have taken most of these events in their stride, and while they have not risen, the declines (with the exception of the emerging markets) have largely been muted.

Markets in general don't like having to deal with politicians. This is an inherently unpredictable bunch and has become immeasurably more so over the last couple of years. The reaction seems to be to wait until evidence of something concrete comes out of all the posturing. What markets do know is that earnings growth and corporate pricing power are strong, both in the US and elsewhere. There is a large fiscal stimulus in the US in the shape of tax cuts, even if this is at a time late in the economic cycle where

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it risks igniting inflation, and monetary stimulus remains powerful in Japan and the Eurozone. Countering these tailwinds are a number of headwinds – the likelihood of rising interest rates, a possible trade war, a strong dollar and high energy prices. It is perhaps not surprising that markets have not moved much, as yin and yang are in balance.

Some readers who live in the real world will counter that's all very well, but isn't the world going to hell in a handcart? Others will say it's about time that the US stopped being pushed around by China and that the rest of world started to pay its way for its defence and isn't the EU a dastardly socialist plot? Yin and yang. The point is that market participants simply don't know. They don't know how much is bluster and even what the long-term objectives might be. The resulting behaviour is therefore to ignore what's going on and hope for the best.

"It seems inevitable that the heat in the kitchen will rise...

What might change? A lot of the geopolitical rumbling of the last quarter will take a long time to unfold, but one area where action is already afoot is on the trade front. A series of tit for tat tariffs have been introduced, initially on steel and aluminium broadly, with a more recent escalation on a range of Chinese goods. It seems inevitable that the heat in the kitchen will rise but it is not yet certain that a fire will ignite. Given the speed with which events are unfolding, and the volatile nature of one of the protagonists, a real fire cannot be ruled out.

This raises the question of how a trade war works and who might win it. The answer to the second question is easy: nobody wins, everybody loses. Tariffs are taxes on the passage of goods across borders. The immediate impact is to raise prices above where they would otherwise be and in due course depress demand, affecting both the supplier and the consumer. Washing machine prices in the US have already risen by 20% or so to reflect existing tariffs. In situations where manufacturing supply chains cross and re-cross borders, as in the automobile manufacturing industry, for example, the effects can be devastating. The tariffs currently in place and mooted to come will not have a significant direct effect on economic activity in the US or China, although growth forecasts will be shaded down.

Trade wars, though, are not just about tariffs. As those of us in the UK have seen, a shock like BREXIT affects the economy through a drop in business confidence, which leads to a fall in investment, which in turn affects consumer confidence and the feedback loop repeats. A trade war is no different and the same dynamics will play out. In addition, a trade war will likely trigger non-tariff barriers. The most famous example of this was when the French authorities required all imports of video recorders from Japan to be routed through an understaffed customs office in Poitiers. In the modern era, these would take the effect of slowing down licences, holding up investment proposals and so on.

The economic effects of the trade war will play out across the world. One of the professed goals of tariffs was to improve the current account balance in the US and so improve job growth – probably not a sensible aim when unemployment is at historic lows. In practice, so far this year, the dollar has strengthened by about 10% on a trade-weighted basis, a factor which will almost certainly more than cancel any expected improvement in the current account. The Chinese authorities have allowed the Yuan to decline so as to offset the direct effect of tariffs and will almost certainly retaliate to any unilateral US action.

"... only two thirds of the value of China's exports to the US [...] originate in China.

The strength of the dollar has had an immediate impact on a number of highly indebted emerging markets, particularly those where governments or companies had large amounts of dollar borrowing. The most vulnerable currencies and markets include Turkey, Argentina, Mexico and Chile. In Asia, weaker Chinese exports feed through the supply chain to other Asian economies. This is a result of the fact that only two thirds of the value of China's exports to the US (which account for about 4.5% of Chinese GDP) originate in China. The rest reflects goods exported to China from

Taiwan, Malaysia, Singapore and so on, which are then re-exported to the US. Weakness in China will therefore be visible across the region and has already caused downward pressure on many Asian currencies, with the Indonesian Rupiah being especially hard hit.

In this way, it can be seen that the way trade works is complex and that the win/lose proposition which seems to inform a lot of political decision-making is missing the point. There is inevitably some truth to the accusation that China has gamed the process of acquiring Western intellectual property, but the Administration there is playing a long game and is untroubled by electoral cycles or appealing to a specific base. It seems likely that China will outlast the pressure and the crisis may indeed accelerate its transition to a modern knowledge-based economy.

Meanwhile, electorates in the EU continue to lurch in an anti-immigrant, populist direction. The usual game plan of dealing with a crisis by kicking the can down the road seems to be reaching some sort of limit with tension rising in the German coalition and the real prospect of migrant camps being built across Europe. This pressure is not helped by the apparent breakdown in commitment to international institutions and disputes between Brussels and a number of member states who are pursuing anti-democratic policies. In the banking sector, a number of systemically important institutions remain vulnerable to shocks, as the damage from 2008 lurks just beneath the surface. As has been the case in previous crises, it will no doubt prove wrong to predict the demise of European institutions such as the Euro, but there is no doubt that a testing time lies ahead.

It would be great to be able to say something positive about the UK, but BREXIT remains a dog's breakfast. The only bright spot is that the equity market is one of the lowest valued of any developed market, notable as the largest UK companies are a proxy for the global economy rather than offering domestic exposure.

"... Markets may be complacent about the risks of an all-out trade war ...

Putting all this together, the return outlook for equities has not improved since the last review, but has not deteriorated that much either. Markets may be complacent about the risks of an all-out trade war, but earnings remain robust and valuations have descended from orbit. Nevertheless, headwinds can be expected to strengthen in the year ahead as the Fed will be reluctant to move away from the path of raising rates. This is the result of wage inflation accelerating and spending following, even if these factors are muted by trade effects. On balance, this is likely to push the dollar still higher and cause further trouble for emerging markets, which at least have the virtue of being cheap. China will need to manage the impact of any trade war, and apart from encouraging the currency to weaken, other measures may include traditional stimulus, despite structural difficulties caused by already high debt levels and existing overcapacity.

Portfolios remain weighted to equities but the outlook is gradually darkening and given high valuations in most fixed income assets, the search for non-correlated assets continues.