The market's not biting

"If you want a deal bad enough, you'll make a bad deal" – Oil and gas magnate T. Boone Pickens, July 2015

Chart courtesy of Google

When one looks back at the monthly reviews we put out each month, it's surprising how well global stock markets have held up given some of the lingering economic and geopolitical concerns. Doom and gloom over Brexit, US and China tariff wars and stagnating global growth have been filling the papers this year but the market is not biting. Indeed, US and UK stocks have pretty much recovered all the losses from the big sell-off in the 4th quarter of 2018.

Driving this recovery has been, in our view, almost entirely down to the most fundamental driver of global markets, the US Federal Reserve U-turn on interest rate policy. Last summer, the US central bank was signalling a series of rate hikes consistent with a growing economy and a pick-up in inflation. At the time, the stock market was riding at an all-time high and there was a sense that things were running a little ahead of where they felt comfortable.

As is often the case, the ensuing sell-off in Q4 wasn't down to a single event or catalyst but rather of raft of concerns which seemed to come together at once. Unpleasant though that was, clearly the Federal Reserve evidently took note. Not only did they abandon the prospect of further hikes, but they indicated a willingness for inflation to be allowed to rise above the 2% policy rate whilst keeping rates on hold. Excellent news for stocks and 4 months of good returns from pretty much day one of 2019.

The Bank of England has also kept interest rates on hold but for different reasons. The UK retail sector appeared to be struggling in Q1 and, of course, the political chaos surrounding the failure of the UK to leave the European Union all but ruled out any thought of UK interest rates rising anytime soon. Also, as we have said before, the UK housing market is much more influenced by changes in interest rates than the USA and is an additional factor for the Bank of England to worry about compared to their US counterparts.

To complete the happy scenario, the European Central Bank kicked the prospect of raising interest rates, previously the summer of 2019, into 2020. So what now?

Stock markets are again approaching historic highs but no one is hanging out the bunting. Our fund performance has been excellent, but we have recently become mindful that it would be dangerous to become wedded to this rally and have reduced our exposure to the US and UK markets. In our view, the positive news on the economy, and there is plenty of it, is mostly priced in.

The US vs China trade talks are difficult to predict and so policy risk is something we have to factor into our assessment. Perhaps there will be a resolution in the G20 summit at the end of June when the two presidents meet but there is no guarantee that it will go well and, therefore, there is little to drive markets before then.

Resolution on Brexit is now further down the line on 31st October. Again, we simply don't know what's going to happen next but there is plenty that could go wrong between now and then. Of course, this also affects the EU as well, and there is plenty going on in the Eurozone presenting risks to markets near record highs.

Returning to interest rates, we have recently seen that the 2 and 5 year US Treasury yields are looking to drop below 2.25%, which is where the Federal Funds rate is (or base rate we might call it in the UK). Historically, this is usually a signal for recession. There is a real possibility that it will be different this time because interest rates have risen from such a low level, from the Great Financial Crisis, that the "rule" won't necessarily apply. However, we know from experience that, should the short rate fall further, markets could well vote with their feet and take profits from markets at near all-time highs.

It may well be that the US economy continues to hold up. February US unemployment fell to 3.8% and UK January unemployment to 3.9%. Both are still seeing rising wages – up 3.4% annualised in the UK. However, what will matter most to investors is the all-important 3rd quarter earnings season in September when we will see how US corporate earnings have fared over the summer. That is some way off and so, again, while we are conscious that US companies are growing profits at double the rate of their European counterparts, we think a lot of this is in the price.

The decision to reduce exposure to US and UK stocks has been implemented but the longer-term investment strategy remains the same. As we enter summer, we will be watching markets very closely and, if we see any weakness, we stand ready to re-invest if we consider the opportunity outweighs the risk.

This does not constitute advice, please refer to your investment advisor regarding your individual financial circumstances. The value and the income derived from them can go up as well as down.