Smart[im]: Market Note

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Smart Investment Management

The current US/North Korea situation

It was clear last week that the biggest story globally was the escalating row between the US and North Korea. Whilst strained relations between the 2 countries are nothing new, especially since Donald Trump entered the White House, North Korea's threat to fire missiles towards Guam took the verbal jousting to another level. Markets sold off in response, with falls that commenced on Wednesday accelerating through Thursday and Friday. Whilst the size of market movements was nothing like the movements that we saw in the Global Financial Crisis (GFC) of 2008/9, they were still significant single day falls and the VIX, the most commonly used measure of volatility, leapt from 10 to 17 in 24 hours. Bloomberg stated on Friday that the proportional increase represented a '4 standard deviation' move, namely something with a probability of occurring of just 0.006%, or once every 43 years. However, that probably says more about how low the VIX has been recently, at around half the long term average of 20. When any statistic is low, the proportional effect of any increase in the figure will be exaggerated, and we may well see this effect within Fixed Interest if interest rates rise meaningfully (although that is for another day). For now, what the increase did show is that markets are twitchy but, as we are still below the long-term average, not yet panicked.

So what can we do in this situation or, more importantly, what do we want to do? The honest answer is very little and, as that may surprise some readers, we should explain why.

Firstly, knowing what is really going on within the political world is virtually impossible, with much happening behind closed doors. Furthermore, any public statements made by politicians are often designed to play to an audience, whether that be domestic voters or the other side in an international dispute, rather than genuinely inform. There are possibly occasions when, by reading between the lines of a carefully worded statement, investors can get some insight into the intentions of a world power like the US. However, as well as being sceptical of even that claim, we would challenge anyone to say that this is the case with the way that Donald Trump communicates. His regular use of Twitter provides insight into whatever is crossing his mind at that moment in time, but very little about the strategy being employed by the administration (we will assume for the purposes of this note that there is one!). Indeed, whilst he has threatened North Korea with "fire and fury", before deciding that this was too tame a phrase to use, US Defence Secretary James Mattis has been talking up diplomacy on Friday, stating that the work of US Secretary of State Rex Tillerson and UN Ambassador Nikki Haley "has diplomatic traction" and "is gaining diplomatic results".

Secondly, even with such aggressive posturing, markets have to focus on other issues as well, as the politics often turn out to be nothing more than a storm in a teacup. Markets recovered somewhat on Friday afternoon after figures on US inflation came in below forecasts, calming market concerns over the prospects of the Fed raising interest rates overly aggressively, and have risen meaningfully this morning after the weekend passed without any further escalation of rhetoric. The danger is that, if investors are overly focused on binary political events over which they can have no control or insight, they can miss the economic developments that drive asset prices in all but the most extreme circumstances. Of course, should war break out, this will not be the case, However, simple probability tell us that economic fundamentals will win out on most occasions.

Finally, once an issue of this sort escalates to the point of being a real concern, it can be difficult to re-position effectively. Ray Dalio, Chairman & CIO at Bridgewater Associates, one of the largest hedge funds in the world, suggested at the end of last week that investors move up to 10% of their portfolio into gold as a hedge against both current political and economic risks. However, with gold having risen over 13% YTD by last Friday and, when looked at in terms of long-term prices, only looking markedly cheap versus its dramatic spike in 2012, it is hard not to feel that there is some price risk in the asset class at current levels and it has fallen by over 0.5% morning. In reality, the only way to insulate against such events is in advance of them happening, which is why diversification is so important. We have been carrying some cash and 'pseudo-cash' assets, both of which can be deployed into other parts of the market as opportunities present themselves, which is often off the back of increased volatility. Therefore, overall, we prefer to let our portfolios work their way through such moments, notwithstanding that we monitor carefully for signs that genuinely instability is appearing in the market.

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