iguard
... a new way of thinking

Smart[im]: Weekly Market Review

15 June 2018
Smart Investment Management

The week to date as at 12 p.m. Friday (GMT).

Markets and Key Events

Central Banks trump Trump

Last weekend's G7 meeting, the historic summit between President Trump of the United States (US) and Kim Jong Un of North Korea, and perhaps even the imposition of trade tariffs by the US on Chinese exports, expected to be announced today, were relegated to a sideshow this week, as interest rate policy from the three key central banks: the US; Europe; and Japan; dominated markets. A slightly more hawkish (tighter policy) Fed, and a more dovish (looser policy) ECB (European Central Bank) set the scene, whilst the Bank of Japan held steady. The US dollar strengthened in response, Emerging Markets fell 0.9% and European equities rose 1.7%. The US Standard & Poor's 500 index was broadly flat, rising 0.1% over the week, although technology stocks recorded a fresh new high, with the Nasdaq Composite index rising 1.5% over the week, having risen over 13% year to date.

Dovish ECB leads to a fall in bond yields

Developed market government bond yields tightened, as the ECB successfully communicated the expected end of its bond purchasing programme at the end of December, whilst simultaneously appearing more dovish, by signalling any rate rise was unlikely before the end of summer 2019. The 10-year German Bund yield, which was trading around 0.50%, fell to as low as 0.38% (yields move inversely to price), before settling around 0.40%. This dragged all major government bond yields down with it, with the 10-year US Treasury yield falling from 2.97%, down to 2.93%. This was despite the Fed raising rates by 0.25% this week, with the Fed Funds rate now at 2.0%, and signalling a further two rate rises this year. The Euro weakened sharply, falling from $1.183 to the US dollar, now trading at $1.160.

"…special place in hell…"

The US's relationship with its international trading partners soured further over the week. It began with the US refusing to sign a joint G7 communique over the weekend of broad goals and principles of trade as Trump tweeted that Justin Trudeau, Canadian Prime Minister was "very dishonest and weak". This was followed up by Trump's trade adviser, Peter Navarro, quoted as saying "there's a special place in hell for any foreign leader that engages in bad faith diplomacy with President Donald J Trump". By the end of the week expectations were running high that the US is about to impose trade tariffs on $50bn worth of Chinese exports to the US, further escalating the trade war, having imposed tariffs on steel and aluminium imports already.

China promises to retaliate

This led to a particularly miserable week for Chinese stocks, with both the Hong Kong Han Seng index and the Shanghai Composite index falling 2.2% and 1.5% respectively. China is expected to strategically retaliate against any tariffs imposed by the US, hitting US states and sectors deemed to be sympathetic to President Trump, with US Soya bean exports having been singled out.

No change for the Bank of Japan

The Bank of Japan announced no changes to monetary policy for the foreseeable future, currently running an interest rate of minus 0.1%, and targeting a cap on 10-year government bond yields around zero, as well as ¥80 trillion of asset purchases a year.

Issues under discussion

Difficult start to the year despite good growth

It has been a difficult start to the year for markets as concerns about rising US inflation and therefore interest rate rises, have been compounded by the growing threats of a global trade war, political concerns in Italy and more recently, a sudden slowdown in German economic growth. However, the US economy continues to perform strongly, as does China, and although inflationary pressures are rising, they are yet to show serious signs of acceleration that would be problematic for central banks.

Are we closer to the peak in US interest rates than the Fed is suggesting?

The US Federal Reserve increased its expectations from one to two interest rate rises for the remainder of this year, but that is all but priced into markets, and the 'dot plot' suggests a further three rate rises in 2019. But, many economists and strategists are flagging an expectation that the effects of President Trump's fiscal boost, consisting of tax cuts and increased government spending, will start to fade throughout the second half of 2019. This is raising question marks over the Fed's guidance for rate policy in 2019, with many predicting only one rate rise.

Casting around for opportunities in fixed income

Having held a very defensive position in fixed income for some time, we are beginning to cast around for opportunities should bond markets be pricing in a significant proportion of US rate rises already. However, the direction of the US dollar is likely to remain key for the remainder of the year, as a strengthening dollar sucks liquidity out of financial markets and puts undue pressure on emerging markets.