

June 2019

Quarterly Commentary

Aberdeen Standard Fully Hedged International Equities

Economic and market review

“Economics, politics and personalities are often inseparable” (Charles Edison), to this you could also add global markets.

This quarter has been symptomatic of the environment surrounding the global economy over the last few quarters, with politics trumping monetary policy as the key driver of financial markets; and increasingly influencing the direction of both. From last quarter's soothing words of the Federal Reserve's and Powell's "patient" pause on the tightening cycle, to rising hopes of a truce in the US-China trade war, equity markets initially started the quarter in buoyant fashion, with a better than expected earnings season propelling global markets higher and US markets to fresh records. However, what followed in May (worst US equity returns in May since 2010) and June (best June returns since the 1930's) was a clear reflection of the current push and pull of politics and monetary policy respectively.

Since taking office, the Trump administration has been clear in its willingness to use America's global economic clout to target trade and security policy, and Twitter was busy this quarter as the policy was put into overdrive. In May, the reignition of the smouldering trade war with China and the decision by the US administration to export blacklist the Chinese telecommunications group Huawei on national security grounds took the market by surprise. Combined with the short lived threat to impose fresh tariffs on Mexico if they did not act to stem the flow of illegal migrants, the quarter witnessed a heightened sense of concern over the impact of worsening international trade relations on an already slowing global economy. The International Monetary Fund (IMF), the Organisation for Economic Co-operation and Development (OECD) and most recently the World Bank have all highlighted their concerns on this issue as they cut global economic growth prospects for 2019, citing weakening levels of global investment growth, declining confidence and moderating manufacturing and exports as key risks.

In apparent defiance of these worries, the US economy delivered a stronger than expected Q1 GDP number, with growth of 3.1% delivering the best start to the year since 2015. This has been a continuation of an improving growth rate over the past 18 months as the supporting jolt from tax cuts fed through to the wider economy. With unemployment levels at 50 year lows supporting wage increases of 3% and the US consumer's willingness to continue spending, the economy looks set to push on into record territory, with July marking this economic expansion as the longest in US history. However, little about this decade old expansion has been what you could call normal, and this looks set to continue being the case. Having been supported by higher inventories and lower exports due to tariff concerns the sustainability of this Q1 growth rate is being called into question. The initial adrenaline rush from the tax shot is also likely to fade. The path of least resistance would therefore appear to be for growth rates to ease back towards levels that has marked this expansion as not only the longest but also one of the lowest. Indeed, recent data from leading economic indicators, ISM data and Manufacturing Purchasing Managers index point to moderating growth. When combined with a trigger happy trade policy there is clearly concern that the uncertainty it instils in corporate board rooms and consumer confidence could turn a potential slow down into something more challenging.

The pivot undertaken by the Federal Reserve since December, has clearly returned the comfort blanket back to global equity markets. Further soothing words were applied in June with the removal of "patience" from prior communications which had the desired effect, providing some preventative medicine in the face of rising growth concerns. However, the path ahead is becoming increasingly challenging as they navigate the tightrope of credibility in the face of being seen to be acting on the back of rising political or market pressures. Despite this, the outcome of the June meeting appeared to strike the right balance, with everyone getting a little of what they wanted. Though the cautious narrative reflected by 10 years yields dropping below 2% for the first time since 2016 and the yield curve

continuing to flirt with inversion jars somewhat with the optimism of equity markets. Either way at least two 25-bps rate cuts by the end of the year are now thoroughly baked in. With the Federal Reserve now firmly back on an easing footing, the troika of central banks are now back in synchronisation. Though the European Central Bank (ECB) and BoJ would clearly favour having the added interest rate flexibility afforded to their US peers. For the ECB the spluttering export centric German economy and declining inflationary pressures encouraged Mario Draghi to surprise the markets with hints of further monetary easing. This propelled German interest rates into record negative territory and a record \$12.5trn of global bonds into negative yields. While this had the impact of adding fuel to the dovish liquidity fire supporting equities in June it also sparked the Trump administration's ire around currency manipulation concerns. With Germany, Italy and Ireland three of nine countries currently sitting on the US's currency watch list, it may be tweaking the tiger's tail. Having postponed a decision on potential auto trade tariffs by six months in May, any negative outcome could apply further pressure to a key element of the German and Eurozone economy already suffering from weak global auto demand.

After eight years in charge, Mario Draghi looks set to leave the ECB with the dubious accolade of having never presided over an interest rate rise, which speaks volumes of the pressures and inherent frictions that remain in the Eurozone. Indeed, Japanification is a term that is increasingly being used to describe the circumstances facing the Eurozone as low inflation, debt and a problematic banking system limit domestic growth potential. However, fiscal flexibility is one big difference between the two. This quarter we witnessed the tensions of the Eurozone's centralised monetary and national fiscal policy continue to bubble under the surface. Matteo Salvini, the more popular partner in Italy's populist coalition government, has had a rolling battle with Brussels over budget bursting plans to cut taxes and raise spending to shock the stagnant Italian economy back to life. Tensions are likely to ratchet up following the strong showing for his La Lega party in May's European elections and the EU's threat to level a €3bn fine over Italy's high debt.

From La Lega's European election success, in the UK we witnessed the farcical situation of the electorate being asked to participate in European elections, two months after the initial Brexit date and five months ahead of the latest revised exit date. Unfortunately the political stalemate shows little sign of ending soon, with the Conservative party changing leader and the recently constituted Brexit party threatening to upend the historic Labour Conservative dominance if no agreed Parliamentary decision is forthcoming. With this ongoing uncertainty around the UK's future relationship with the EU, the Brexit hangover finally caught up with the economy as GDP in April shrank by 0.4%. This has raised expectations that UK growth will now flirt with contraction in Q2 as pressures in the global auto industry and Brexit inventory build unwind.

In contrast to Europe, the political election calendar in Asia passed off with little noise as India and Indonesia returned

incumbent governments. This was welcomed by the respective equity markets, providing a sense of continuity as the leaders of both nations have been granted five more years to progress their reform agendas.

While India has been involved in its own ongoing trade skirmish with the US, it is the ratcheting up of trade and technology tensions between China and the US that is front and centre of regional concerns and investor's minds. The black listing of Huawei is a case in point, with technology now being brought into the equation. The semiconductor industry is indicative of the added uncertainty this brings. Having set their stall out for an improvement in H2 demand, supply and inventory dynamics, company after company within the sector has poured cold water on prior expectations. With 20% of their exports derived from memory chips, South Korea's run of six consecutive months of contracting exports reflects the near term challenges this presents. For the Chinese authorities, with a further \$325bn of trade under the threat of tariffs, already moderating growth has encouraged further moderate easing actions in the form of the People's Bank of China cutting reserve requirements by 1%, fresh lending targeted at small businesses and infrastructure and stimulus plans aimed at the consumption of eco-friendly consumer goods.

Outlook

As highlighted last quarter, politics and national self-interest look set to remain key themes in 2019 and as we move into quarter 3 of 2019 the development of trade disputes will continue to challenge market expectations. While the near term development of tensions between China and the US will lead to a healthy market in analysing the social media runes, the uneasy tension between the US and Europe continues to lurk in the shadows. The added opacity this brings to the direction of economic activity has raised the stakes for future central bank policy. As we have experienced over the past six months the likelihood is that global monetary policy is going to continue erring on the side of caution over the coming quarters. The question is will it be cautious enough to meet market expectations?

From a corporate perspective, while looser monetary policy, stimulus plans and a relatively resilient consumer provide a supportive earnings back drop. The heightened risk of rolling tariff disputes, deteriorating balance sheets, fading comparative tax benefits and the ageing of the economic cycle merits caution from an investment perspective. Indeed, with equity markets reacting positively to guidance of an increasingly accommodative stance by the Federal Reserve, valuations have expanded again as investors have rediscovered their willingness to pay for earnings growth in a low growth, low inflation environment. As a result of this, our expectation remains that the market will continue to be increasingly susceptible to disappointments and higher periods of volatility. In line with our investment approach we view such periods as opportunities for disciplined investors.

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