Weekly Digest

19 August 2019

The weekly insight into world stock markets

Investec
Wealth & Investment

Invert-igo

Last week was punctuated by two events that brought decade-or-so long runs to an end. The most important for the three Cambrian members of the desk was that an in-form Wales side replaced New Zealand as the top ranked team in the world according to World Rugby, corroborating years of their outlandish claims. Proof that even the most unlikely predictions can come true, if you give yourself a long enough time frame.

The second event, somewhat more notably for financial markets, was that 10-year government bond yields fell below two year government bond yields in both the UK and the US for the first time since 2007. Generally speaking, long-term yields are higher than short-term ones as investors expect to receive a 'term premium' to reward them for locking up their capital for longer. The rare cases when this isn't the case – when yield curves are 'inverted' – signal that the market is expecting short term rates to fall, which, broadly speaking, signals a weakening economy.

You would have had to have been eagle-eyed to spot it in the US, as the anomaly only persisted for a few hours (non-Welsh rugby fans are no doubt expecting a similarly rapid reversion…). However, the brief inversion has attracted a great deal of attention from market strategists because of its uncanny ability to forecast a recession. There have been seven periods of recession in the US since 1970 – each one has been preceded by the yield curve inverting. This hit sentiment in an already weak market, with global equities performing poorly globally last week.

So, time to batten down the hatches ahead of the inevitable recession? Well, we think it's worth taking the indicative power of the inverted curve with a pinch of salt. For a start, the signal comes with an important caveat: historically it has successfully predicted a recession 'within 36 months'. Ten years into an economic expansion which is now the longest in history, this shouldn't necessarily come as news. The choice of the 2-year / 10-year rates also feels arbitrary given other benchmark tenors have been inverted for months now.

That's not to say we're completely sanguine about the economic outlook, particularly looking at events to the East. Well over a million people attended protests in Hong Kong over the weekend, a whopping 20% of the total population. Hong Kong enjoys a disproportionately important place in the global economy because of its role as a 'superconnector' between China and the rest of the world. With its well-developed capital markets and legal infrastructure, it acts as the valve through which foreign capital can be funnelled into China (and vice versa).

At the best of times, China is prickly about perceived threats to its territorial integrity, as fashion houses Versace and Coach have recently found. Both made the faux pas of implying Hong Kong is a separate country (on a t-shirt and a website respectively), drawing the ire of Chinese social media users. In that context Donald Trump's Twitter comment, directing China to treat Hong Kong protesters 'humanely', seems almost designed to annoy Chinese leaders.

The US and China are the two great engines of the global economy, so the market remains hyper-sensitive to perceived progress in trade talks. An announcement from the Chinese government last week, that it would retaliate if the US raises trade tariffs as expected in September, sent markets sharply lower. Trump's mixed, but broadly more conciliatory comments over the weekend have done the opposite this morning, marking another week of tit-for-tat statements that have been a feature throughout the dispute. While economic self-interest should dictate that a solution can be found, a cynic would note that the US electoral cycle provides little incentive for Trump to do much before the autumn next year. It looks as though trade-dispute driven volatility is likely to remain for the time being.

That being said, global shares tend to be particularly sensitive to wider geopolitical and macroeconomic news in August. There's a dearth of corporate news, and lower-than-usual market liquidity, with much of Wall Street and the City away on holiday. That combination makes markets especially febrile during the late-summer silly season. Taking the last decade as an example, the FTSE 100 has only risen twice in August, with average monthly draw-downs (the biggest peak-to-trough fall over the month) higher than for any other. In that context, this month's drawdown (so far) of around 7% is reasonably high compared to the average of around 5%, but not extraordinarily so.

Those looking for positive news need look no further than the US. Although the data are more mixed than earlier in the year, they continue to show that the American consumer (responsible for over 70% of US GDP) remains in rude health. Initial jobless claims remain close to multi-decade lows, earnings growth and productivity growth both look healthy, and softer indicators like restaurant sales all tell much the same story. The bulls will find succour in this continued strength, as it's one of the few bright spots in the global economy at the moment.

The coming week will again be dominated by macro news. Boris Johnson's first outing on the World stage as Prime Minister at the G7 meeting in Biarritz, and the annual Jackson Hole central bank symposium are the highlights (depending on your definition of highlight…). Minutes from the latest US and Eurozone central bank meetings will also be released.

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FTSE 100 Weekly Winners

Admiral	4.8%
Unilever	2.8%
United Utilities Group	2.7%
Reckitt Benckiser	2.3%
Diageo	2.0%
Vodafone Group	1.2%
SSE	1.1%

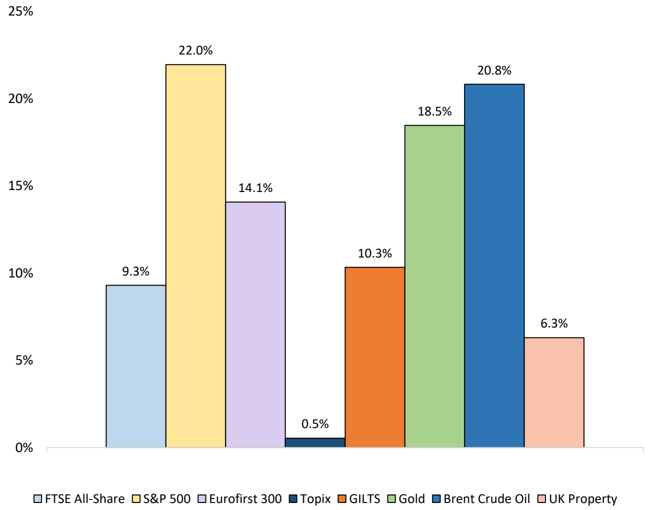
Source:FactSet

FTSE 100 Weekly Losers

Evraz	-11.9%
EasyJet	-10.2%
TUI	-9.3%
NMC Health	-8.5%
Hargreaves Lansdown	-8.1%
Anglo American	-7.8%
Royal Mail	-7.8%

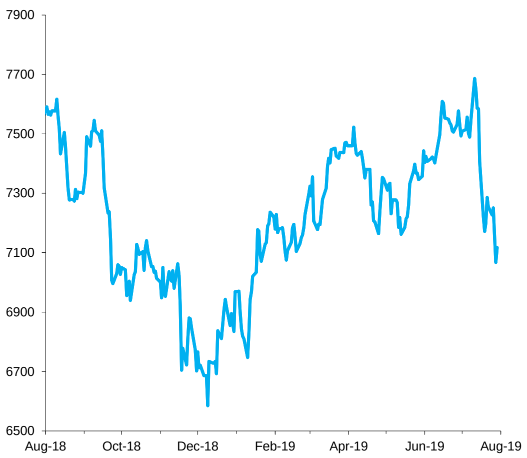
Source: FactSet

Year to Date Market Performance



Source: FactSet

FTSE 100 Index, Past 12 Months



Source: FactSet