CHARLES STANLEY

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Rising volatility and falling equity markets are always challenging, even for the most experienced investor, and the month of August is proving to be a difficult one for market participants. The further deterioration in US-China trade relations has been the catalyst for the fourth material correction in global equity markets since the start of 2018. More broadly, there are now concerns that the longer the stand-off on trade goes unresolved the greater the chance that the ten-year long economic expansion we have seen since the 2008-9 financial crisis will come to an end and, with it, the positive environment for equity markets.

By way of background, the first seven months of this year were characterised by powerful and broad-based asset price reflation, with all the major asset classes delivering significantly-above-average returns. So, even without the recent deteriorating narrative on trade, the optimists would argue that some sort of pull back in markets could be viewed as a healthy correction – though not, perhaps the degree we have recently witnessed.

A few short months ago, the markets were expecting higher US interest rates and, as the US-China trade dispute dragged on, there were genuine fears that the US central bank's (Federal Reserve) policy stance could lead the US economy sleepwalking into the next recession. However, there was a marked shift in policy guidance from the Federal Reserve, signalling that rate hikes were off the table and cutting its key interest rate (Fed Funds) at its July monetary policy meeting. Elsewhere, the European Central Bank stated that the region's growth and inflation outlooks had deteriorated further and its commentary has paved the way for a number of policy-easing measures expected at its September meeting. Finally, whilst the Bank of England and Bank of Japan have not formally guided the markets to anticipate easier policy, they have not stepped in the way of markets anticipating such a move.

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10%

This shift in the interest-rate landscape resulted in sovereign bond yields falling sharply and reduced, in the markets' eyes, much of the adverse tail risks to the global economy resulting from the downshift in global growth and the ongoing trade narrative. As a result, market participants felt that future risk-adjusted returns for most asset classes to be somewhat better than they had seemed a few months ago, prompting a much more "risk-on" financial market environment.

However, after the July rate cut, interest-rate guidance from the US Federal Reserve's Chair, Jerome Powell, has fallen short of a pre-commitment to ease policy further, but rather to adopt a wait and see approach. This caused some disappointment in the market and has contributed to a significant increase to equity market volatility.

With the recent announcement by Donald Trump that the US intends to place a 10% tariff on all remaining Chinese imports (circa $300bn), we have witnessed the next round of the trade war. The background to this seems to be Trump's lack of confidence in being able to agree the type of comprehensive trade agreement that will go down well with the electorate ahead of the 2020 presidential election. Elsewhere, Trump might also have taken the view that the Federal Reserve will cushion both the economy and the markets by a much more aggressive path of rate cuts. However, the subsequent retaliation by the Chinese authorities by allowing the Yuan to weaken versus the Dollar and its ban on US agricultural purchases does raise the stakes and the potential for a policy misstep.

Let's turn our attention back to the markets. Low bond yields are a double edged sword. When market participants are in a pessimistic mood rallying sovereign bonds highlight the downside risks to growth, inflation and corporate profit growth, all of which trouble equity investors. However, the very generous earnings and dividend yield gap between the main equity markets (particularly the UK) and their domestic bond market underline the relative cheapness of equities. Moreover, low bond yields are also a function of a number of years of increasingly easy central bank monetary policy, designed to ease financial conditions and encourage responsible risk seeking behaviour on the part of investors.

Since 2012 much of the heavy lifting to support the global economy has been done by central banks and there is no evidence that they are about to shirk their responsibility. However, there is also a greater recognition that fiscal policy needs to play an increasing role, reflecting the very low cost of government borrowing afforded by the bond markets. More broadly, there is a very active debate whether the current separation between monetary and fiscal policy is now desirable, given that inflation has consistently been the dog that didn't bark (as an aside, this is a subject we will be exploring in the weeks and months ahead).

Taken together, we continue to feel that with a renewed emphasis on fiscal policy, the global economy and financial markets remain in "the bright side of the muddle through", an environment very much like the 2014-16 period, which saw moderate growth and central bank policy stimulus support reasonable investment returns and the low level of sovereign bond yields underlines the relative attractiveness of the equity market. However, investors do need to be prepared for occasional bouts of turbulence as there is some evidence that the low-volatility environment we have seen in recent years may be coming to an end.

The value of investments can fall as well as rise. Investors may get back less than invested.
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