SIGNIA TALKING POINTS

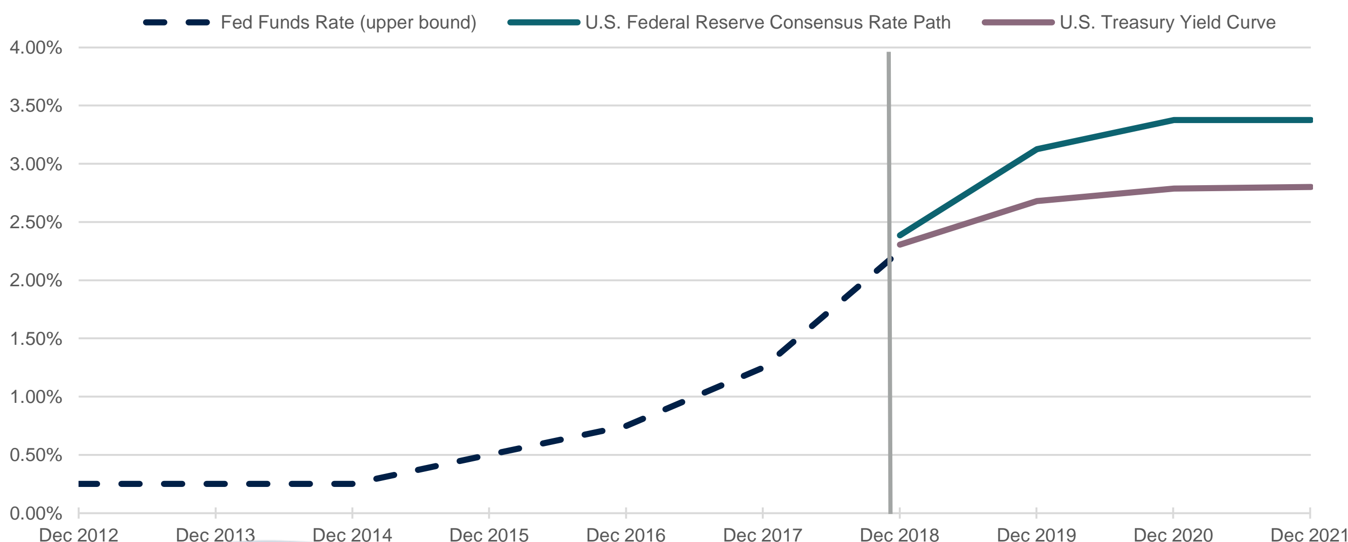
November 2018

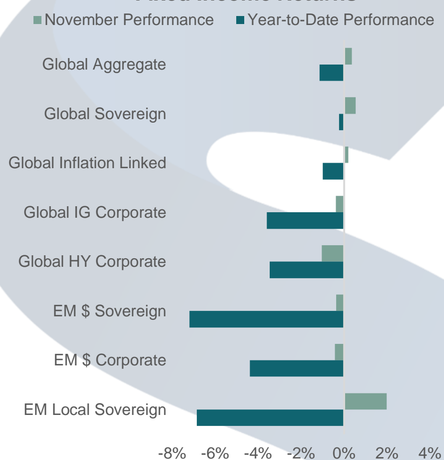
SIGNIA

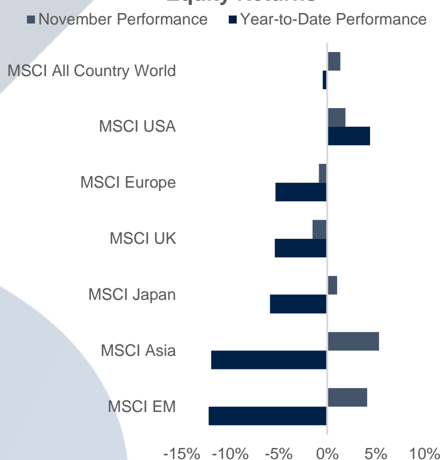
Beautiful Normalisation

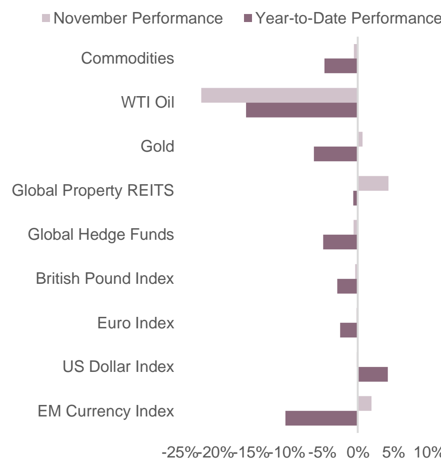
In December 2015 the U.S. Federal Reserve raised its benchmark interest rate by 25 basis points from a record low of 0-0.25%. It was its first rate hike in the post-financial crisis era and by doing so it embarked on a highly delicate and experimental program of tightening monetary policy from its historically accommodative extremes by lifting interest rates back towards a 'normalised' or 'neutral' level. Three years, eight rate hikes and one chair person later, the Fed has arrived at a critical juncture in its tightening cycle: how do they manoeuvre a perfect 10 policy dismount whilst maintaining both optionality and credibility with minimal market impact? Beautiful normalisation will not be an easy task.

This was painfully illustrated on October 3rd, the last record high for the S&P 500 equity index, when Fed chair Jerome Powell unexpectedly said "we may go past neutral, but we're a long way from neutral at this point, probably", indicating an elusive neutral destination with potentially many more rate hikes to get there. The S&P 500 index subsequently declined -11% in October whilst the Fed has spent November back-pedalling on Mr. Powell's comments. This is hugely important as it sets the scene for 2019 as potentially a year where the Fed learns a valuable lesson and the U.S. 'normalisation cycle' comes to a beautifully quiet and market friendly end. Are we nearly there yet? The Fed now thinks almost (U.S. Federal Reserve Dot Plot Consensus Rate Path – green line) and the market thinks yes (U.S. yield curve - purple line).









Source: Bloomberg, Signia Wealth. Data as at 30/11/2018.

Global Agg: Bloomberg Global Aggregate TR Hedged GBP; Global Sovereign: Bloomberg Global Treasury TR Hedged GBP; Global IL: Bloomberg World Govt Inflation Linked Bonds 1-10Y TR Hedged GBP; Global IG: Bloomberg Global Corporate TR Hedged GBP; Global HY: Bloomberg Global High Yield TR Hedged GBP; EM$ Sov: Bloomberg Emerging Markets Sovereigns TR Hedged GBP; EM$ Corp: Bloomberg EM USD Corporate 10% Cap Hedged GBP; EM Local Sov: Bloomberg EM Local Currency Govt TR Unhedged USD; Equities: MSCI indices reflect net total returns in local currency, except Asia and EM in USD; Commodities: Bloomberg Commodity TR Index; Global Property REITS: FTSE EPRA/NAREIT Global Index; Global Hedge Fund: HFRX Global Hedge Fund Index; British Pound: Bloomberg British Pound Index; Euro: Bloomberg Euro Index; US Dollar: Bloomberg US Dollar Index; EM Currency: JP Morgan Emerging Market Currency Index.

Fixed Income

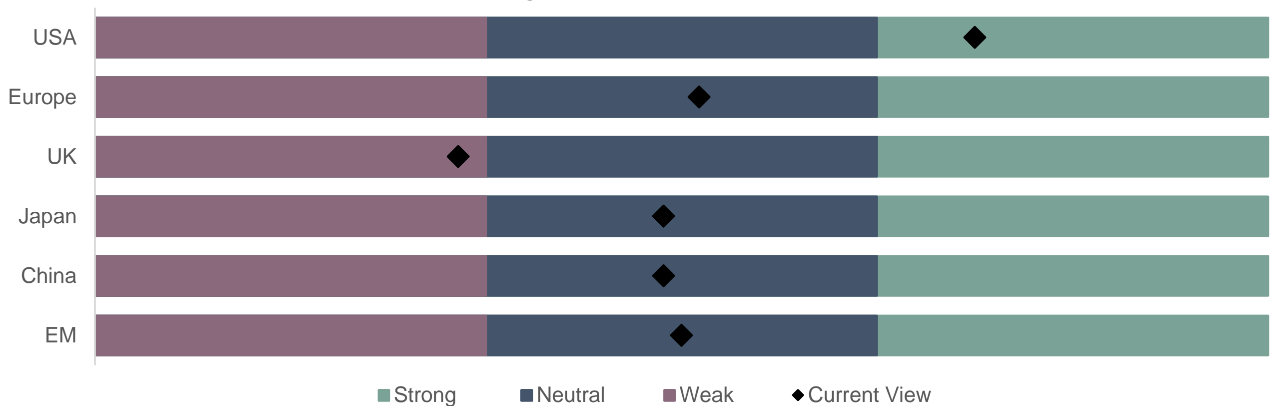
- Safe haven global sovereign bonds gained in November as investors sought their safety from the volatility in global equity markets and as markets began to price in only one U.S. Fed rate hike in 2019
- Emerging market local currency bonds were the only sector to outperform global sovereigns, driven by cheap EM FX valuations providing an unusual safe haven from the risk-off sentiment and volatility that affected most of the fixed income marketplace
- Global high yield bonds underperformed as yield spreads over sovereign bonds continued widening and oil prices suffered heavy declines

Equities

- Asian and emerging market equities were the best performers, fuelled by trade war optimism and cheap valuations
- US equities were the next best performer, rebounding from the severe sell-off witnessed during October
- Japan posted modestly positive returns for the month, as a slowing domestic economy and rising external pressures moderated gains
- Bourses in the UK and Europe were the worst performers, as Brexit and concerns around economic growth weighed on sentiment

Alternatives & FX

- Natural gas rose sharply on a colder start to US winter and the unwinding of speculative short positioning
- Oil fell on slowing global growth and continued high production levels
- The US dollar paused as many of this year's weaker currencies rebounded including the South African Rand (+7%), New Zealand Dollar (+5%) and Australian Dollar (+3%)



- USA: Tailwinds from tax cuts, fiscal easing and deregulation are easing but continue to support consumer and business sentiment in what is the second longest U.S. economic expansion in history (114 months), now in the latter stages of its cycle but still running strong. A temporary trade war truce with China was agreed at the recent G20 summit. Despite tightening financial conditions and an inverting yield curve a recession in 2019 remains unlikely.

- Europe: Leading economic growth indicators are weakening in the face of several key headwinds: a less accommodative ECB due to finish its asset purchase programme in December, an Italian budget standoff with the EU, Brexit uncertainty, and populist uprisings across the continent. Declining industrial production and real money growth is a concern for future economic growth, however, the labour market, inflation and wage growth are all in healthy shape.

- UK: Stubbornly sticky consumer price inflation above the Bank of England's 2% target prompted the bank to hike this year to the highest level since February 2009 at a time when the economy remains in a delicate state – policy next year remains tied to a Brexit outcome. Profit growth is declining and risks remain to the downside as intensifying Brexit uncertainty weighs significantly on business investment and the British Pound.

- Japan: The policy mix in Japan is changing. Fiscal stimulus from the government is increasing to help the Bank of Japan in its monetary fight against structurally low economic growth but also consumer price inflation which continues to defy rising wages and a tight labour market. Foreign workers continue to drive the replacement of the shrinking domestic labour force as immigration policies are relaxed. Corporate profit margins are at all-time highs.

- China: President Xi Jinping's government is cutting both corporate and personal taxes in an attempt to stimulate its economy and head off any trade war risks with the USA. The People's Bank of China is also helping and in easing mode to counter this other self inflected risks by the government who have been cracking down on its unregulated shadow banking sector causing credit growth and infrastructure spending activity to decline heavily.

- Emerging Markets: Brazil has elected a market friendly president, Mexico has signed a new trade agreement with the USA, and Turkey has released a politically sensitive U.S. citizen. Overall growth has slowed due to a strong US Dollar this year causing most countries to tighten monetary policy, however, with the U.S. Federal Reserve due to pause or even stop its hiking cycle next year the macro environment could turn more supportive for the EM complex.

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