weekly digest

momentum

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Curve watching

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I had planned to write about dark pools and their potential benefits for active managers in this week's blog but some things require urgent comment and the inversion of the '2s10s' point of the US yield curve is one of those. While the inversion (short term yields higher than longer term yields) of the 2 year and 10 year point of the yield curve has always preceded a recession in the post war period, there are two major factors worth keeping in mind – namely the role of central banks and the role of market participants – and hence we have not elected to cut risk further on the back of this development.

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The direction of travel has been clear and hence we were not surprised when yields on these particular maturities finally crossed each other last week, albeit fleetingly on Wednesday before moving apart again the next day. Having watched the deterioration in macroeconomic data in the second quarter and yet seen markets continue to climb, we had already taken the opportunity to reduce risk at the end of July. Now that we have passed what some consider the Rubicon signalling a recession, we do not see the need to reduce risk further at present, although we are responsive to changes in both market prices and economic data and hence this view may change.

There has not been a recession every time the 2s-10s part of the US yield curve has inverted and it will come as no surprise to learn that we take many more factors into account in forming our outlook. The world is in a manufacturing recession and the problems are clear, with the usual headliners of Trump, China and Brexit. But the much larger service sector is still doing well and consumers are in good shape, with employment continuing to rise in the US along with wages. There is never a zero chance of recession and indeed the odds are somewhat elevated today in our view, but nor is it guaranteed.

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Timing has been shown to be critical when heeding the signals of the yield curve. On average there has been a recession 21 months after the yield curve inverted based on data compiled by Deutsche Bank. This raises the question of what to do in the intervening period? Again, a simple analysis of the numbers would suggest that the point of inversion remains a good time to own equities, with the S&P 500 rising 15.7% on average 18 months after the yield curve inverts, according to a report from Credit Suisse. There has only been one instance since 1978 when markets have gone down over 18 months and this was in 2000 when equity valuations were far higher than they are today.

Can yield curve inversion become self-fulfilling? Maybe on Wall Street, where market practitioners are oft to look at their peers in the bond market and wonder, *'what am I missing? There must be a recession coming!'* But not on Main Street – interest rates are down, whether at the front end of the curve or further out, leaving borrowers with the option of refinancing their debt at the lower rate and spending the difference. Whether the signal of lower long term interest rates will discourage capital formation and investment is best judged by looking at companies' spending plans rather than the yield curve.

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Markets are being distorted by central banks currently, who continue to own large parts of the longer end of the curve which serves to artificially depress yields. Similarly, market participants are adaptive: investors are well aware of the historical relationship between the yield curve inverting and recession, and hence we do not see the kind of exuberant behaviour that typical precedes a stock market crash. History tells us that even when there is a yield curve inversion there are still good returns on offer for investors and hence we believe it is right to stay invested and broadly diversified today as we work towards delivering on our target outcomes for clients.

Market Focus

- The US 2s10s yield curve inverted for the first time in 12 years
- Germany reported a contraction of 0.1% in their economy
- Brent crude returned 0.2%, ending the week at $58.6 per barrel
- Gold rose 0.9% ending the week at $1513.0 an ounce

US

- The inversion of the yield curve stole headlines prompting talks of a looming recession. However, the inversion was only short lived and by the week end the spread between 10- and 2-year yields was positive again.
- Stocks recorded a third successive week of losses as trade and growth concerns unsettled investors.
- Donald Trump delayed the proposed 10% tariffs on some Chinese products until mid-December.
- US equities finished the week negative, falling 1.0%.
- US Treasuries gained 1.4% during the week, with investment grade bonds gaining 1.2%.

UK

- The unemployment rate ticked up 0.1% to 3.9%, the first rise since 2017.
- Wages increased at their fastest pace since 2008 over the last quarter.
- UK equities declined 1.5%, bringing their decline this month to 5.5% so far.
- UK gilts gained again in the past week rising 1.5%, while investment grade bonds returned 0.3% for the second week.

Europe

- Growth concerns in Europe put equities under pressure and subsequently they fell 0.5%.
- Germany's economy contracted in the second quarter and it was announced that the broader Eurozone economy grew by only 0.2%.
- Eurozone exports fell by their quickest rate in more than six years.
- In a volatile week for equities emerging Europe suffered, falling -4.2%.

Rest of the World/Asia

- In Argentina market-friendly president Macri lost the primary election to populist and protectionist Alberto Fernandez. The result sparked a sell off in Argentinian assets and the peso sold-off nearly 17.0% against the US dollar on Monday. Markets have priced in a 75% chance the country will suspend debt payments in the next five years.
- Chinese industrial production in July was confirmed at 4.8% year on year, well below the expected 6.0% and its weakest reading since 2002.
- The Hang Seng fell 2.1% on Tuesday to its lowest level in seven months amidst ongoing political and social unrest in Hong Kong.

Past performance is not indicative of future returns.
Source: Bloomberg, returns in local currency unless otherwise stated.

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Asset Class / Region	Currency	Cumulative returns: Week ending 16 August	Month to date	YTD 2019	12 months
Developed Markets Equities					
United States	USD	-1.0%	-3.0%	16.3%	3.1%
United Kingdom	GBP	-1.5%	-5.5%	9.0%	-1.7%
Continental Europe	EUR	-0.5%	-3.3%	13.7%	1.3%
Japan	JPY	-1.2%	-5.1%	0.8%	-9.9%
Asia Pacific (ex Japan)	USD	-0.4%	-5.9%	4.3%	-3.4%
Australia	AUD	-2.4%	-5.6%	16.3%	5.7%
Global	USD	-1.2%	-3.5%	13.5%	0.9%
Emerging Markets Equities					
Emerging Europe	USD	-4.2%	-9.0%	9.9%	12.8%
Emerging Asia	USD	0.2%	-5.4%	2.1%	-4.9%
Emerging Latin America	USD	-5.4%	-7.9%	3.9%	6.3%
BRICs	USD	-0.5%	-5.9%	6.1%	1.8%
MENA countries	USD	-0.6%	-2.9%	7.0%	6.2%
South Africa	USD	-2.4%	-11.6%	-4.3%	-6.3%
India	USD	-0.8%	-3.8%	0.5%	-3.3%
Global emerging markets	USD	-1.0%	-6.3%	2.3%	-2.5%
Bonds					
US Treasuries	USD	1.4%	3.5%	8.9%	10.9%
US Treasuries (inflation protected)	USD	0.7%	2.1%	9.1%	7.6%
US Corporate (investment grade)	USD	1.2%	2.6%	13.3%	12.8%
US High Yield	USD	-0.2%	-0.8%	9.7%	5.8%
UK Gilts	GBP	1.5%	3.4%	11.0%	10.7%
UK Corporate (investment grade)	GBP	0.3%	1.1%	10.7%	9.0%
Euro Government Bonds	EUR	1.6%	1.9%	9.9%	10.9%
Euro Corporate (investment grade)	EUR	0.2%	0.4%	7.3%	6.0%
Euro High Yield	EUR	-0.2%	-0.6%	8.0%	4.3%
Japanese Government	JPY	0.2%	1.3%	4.4%	5.8%
Australian Government	AUD	0.6%	2.1%	11.2%	14.1%
Global Government Bonds	USD	0.8%	2.8%	7.8%	9.5%
Global Bonds	USD	0.6%	2.0%	7.5%	8.6%
Global Convertible Bonds	USD	-0.7%	-1.9%	5.8%	2.5%
Emerging Market Bonds	USD	-2.7%	-1.6%	9.9%	11.1%

Source: Bloomberg. Past performance is not indicative of future returns.

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		Cumulative returns			
Asset Class / Region	**Currency**	**Week ending 16 August**	**Month to date**	**YTD 2019**	**12 months**
Property					
US Property Securities	USD	0.3%	2.3%	21.2%	10.6%
Australian Property Securities	AUD	-2.8%	-1.9%	17.2%	11.4%
Asia Property Securities	USD	0.8%	-3.3%	5.9%	7.5%
Global Property Securities	USD	0.1%	-0.2%	14.9%	8.1%
Currencies					
Euro	USD	-1.1%	-0.3%	-3.1%	-2.4%
UK Pound Sterling	USD	0.7%	-0.5%	-4.6%	-4.3%
Japanese Yen	USD	-0.7%	2.2%	3.2%	4.4%
Australian Dollar	USD	-0.1%	-1.4%	-3.6%	-6.5%
South African Rand	USD	-0.1%	-7.1%	-5.7%	-3.9%
Swiss Franc	USD	-0.7%	1.1%	0.4%	1.8%
Chinese Yuan	USD	0.3%	-2.3%	-2.3%	-2.3%
Commodities & Alternatives					
Commodities	USD	-0.5%	-4.0%	2.5%	-7.0%
Agricultural Commodities	USD	-2.7%	-3.7%	-8.6%	-13.2%
Oil	USD	0.2%	-10.0%	9.0%	-17.9%
Gold	USD	0.9%	6.2%	18.1%	28.5%
Hedge funds	USD	-0.1%	-0.3%	4.7%	-1.1%

Source: Bloomberg. Past performance is not indicative of future returns.

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