

Investment Update – August 2019

Addicted to monetary policy

Markets have been fuelled by a decade of bailouts and dovish monetary policy. It's hard to ignore the importance of this fact and how it has characterised the current economic expansion. Just recently the Federal Reserve (Fed) has cut its main interest rate by 25 basis points, the first reduction since the financial crisis, and signalled that it was prepared to ease monetary policy further if necessary. In its policy statement, the US central bank suggested the monetary easing was justified by "uncertainties" stemming from weakness in the global economy and simmering trade tensions. Adjusted for inflation, the Fed's benchmark rate is now just a quarter of a percent and the cost of borrowing has rarely been closer to free, but the dependency for easy money keeps growing. With trade wars threatening the global economy, Fed officials say rate cuts are needed to keep the slowdown from spilling into the United States, and to prevent doggedly low inflation.

Wage growth is also preoccupying policymakers. Last year, Mr Powell and other Fed officials assumed that wages would pick up as the US economy barrelled towards full employment, feeding through to higher prices and inflation. This dynamic would be the trigger for rate rises. But it did not turn out that way. Now Mr Powell launched a review of the Fed's policy framework, and changes to the way officials look at inflation rose quickly up the agenda.

Many Western economies are facing a similar ominous backdrop following the global financial crisis of 2008. Since then central banks have responded aggressively to every hint of a downturn, making money ever cheaper and more plentiful to try to juice growth. Yet, in this expansion, the United States economy has grown at half the pace of the post-war recoveries and inflation has failed to rise to the Fed's target of a sustained 2 percent. Meanwhile, every new hint of easy money inspires fresh optimism in the financial markets, which have swollen to three times the size of the real economy.

Trade negotiations on twitter

US President Donald Trump said the US would place a 10 per cent tariff on \$300bn of additional Chinese goods, escalating the trade war between Washington and Beijing in a new threat to the global economic outlook. The announcement shook financial markets, sending the yield on the 10-year Treasury note to its lowest level since 2016 and pushing down stock prices after they had risen earlier in the day.

In a series of afternoon tweets, Mr Trump shattered a tenuous truce he reached with Xi Jinping, his Chinese counterpart, at the G20 summit in Osaka in late June, which had paved the way for a new round of high-level upcoming talks in Shanghai. The truce with Xi Jinping temporarily suspended his threatened imposition of duties of up to 25% on \$325bn worth of Chinese imports but leaves in place all previous tariffs imposed during the trade war. Trump also threatened in May to impose tariffs on all imports from Mexico if it did not crack down on immigration but reversed himself in June. He has delayed till November a decision on whether to impose tariffs on automobile imports, which would hit European manufacturers hard.

Global trade growth has fallen from 5.5% in 2017 to 2.1% this year, by the OECD's reckoning. The immediate threat comes from President Donald Trump's imposition of tariffs on America's trading partners and renegotiation of free-trade agreements, which have disrupted longstanding supply chains in North America and Asia.

Slowing, but resilient US GDP

In the US there have been some signs of a slowdown, with second quarter growth coming in at 2.1 per cent, a big drop compared to 3.1 per cent in the first quarter and a far cry from Trump's 3%.

However, the gross domestic product figures topped Wall Street's median forecast. Strong consumer spending helped sustain the expansion even as businesses cut back on investment. The GDP showed substantial softness in business investment, but other parts of the economy are holding up. Consumption remains strong, as is the labour market which experienced solid employment growth in June.

Brexit uncertainty is a certainty

Britain now has its third Tory prime minister since the vote to leave the European Union (EU) three years ago. Its deadlocked Parliament is refusing to back the exit deal struck with the EU, even as an October 31st deadline approaches. The uncertainty is quickly reflected in the pound, which is near an all-time low against the US and wilting at the prospect of crashing out with no deal. Steering a course out of this mess requires an extraordinarily deft political touch. Boris Johnson, socially liberal, proimmigration but more recently turned Eurosceptic, has been chosen for the tall order.

Mr Johnson may be making similar mistakes as his predecessor Mrs May. Her undoing was through making unrealistic promises about the deal Britain would get, pledges she spent two dejected years retreating from. Boris promises he will bin the "backstop" designed to avoid a hard border in Ireland, which the EU insists is non-negotiable. He claims Britain need not pay the exit bill it agreed on and he says that if the EU does not roll over, it would be "vanishingly inexpensive" for Britain to leave with no deal. Mrs May found the contact with reality hard enough, for Mr Johnson it could be brutal.

Getting the support of parliament is an additional complication for Mr Johnson. The Conservatives' hold a narrow majority, with plenty of rebels on both the Brexit and Remain wings. So, doing a deal would probably mean working with Labour, whose price is a second referendum and unlikely to be acceptable to hard-line conservatives. In the Brexit saga uncertain is a certainty.

Australia regionally positive

Since the Federal election saw the unexpected return of the centre-right Liberal/National coalition government there has been a period of stabilisation in Sydney and Melbourne property markets. The election result removed the prospect of significant changes to taxation arrangements for property investors which could partly explain the modest recovery that the recent house sales volumes and numbers suggest.

Summary

Familiar triggers for recession are still absent which suggests that the (moderately) good times can roll on. The trouble with this logic is that, just as the economy has changed, so have the risks and it is inevitably hard to identify exactly what might go wrong. Dependency of growth on monetary policy cannot be sustained indefinitely and political risks such as Brexit and US China trade tensions remain on the horizon with potentially disastrous consequence.

The good news: households and firms in developed markets can borrow at exceptionally low rates, unemployment is low, labour income continues to grow, and business cost pressures are visible but modest.

A balanced and diversified approach to investment remains appropriate.



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