WATCHING THE WARNING SIGNS

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Risks to the global economy are building. An unpredictable political environment in the US, the possibility of a slowdown in China and the looming prospect of an end to the long period of ultra-accommodative monetary policy are among numerous potential triggers of a market correction. And although it is impossible to predict the exact timing of a correction, we believe the current combination of risks is potent enough to justify a cautious approach.

This is not merely a matter of timing: bull and bear markets do not have pre-programmed lifespans. The current US economic expansion is now eight years old, but this does not in itself mean that it must end any time soon. Cycles begin and end because of triggers. In our view, the number of potential triggers we’re seeing are reminiscent of the leadup to the financial crisis that reached its peak in 2008.

THE RISE OF POLITICAL UNCERTAINTY

Global politics are highly unpredictable at present. The rise of anti-establishment, anti-immigration sentiment in certain parts of the world has led to some surprising outcomes, including the UK’s vote to exit the EU and Donald Trump’s election as president of the US. The UK is currently trying to negotiate the terms of its departure from the EU with a severely weakened government following June’s general election which resulted in a hung parliament. In the US, Mr Trump’s proposed policies on healthcare reform, infrastructure spending and tax relief, if implemented successfully, could extend the business cycle, boosting risk assets such as equities and high-yield bonds, and wiping value from lower-yielding assets such as developed market sovereign bonds.

However, there is doubt whether Mr Trump will fully implement his proposed domestic agenda. He has already encountered obstacles in persuading Congress to support some of his policies, and investors have begun factoring in a lower probability of the new administration delivering the mandate on which it was elected.

Mr Trump arguably poses more of a risk on the international stage, where he faces fewer checks and balances than he does on his domestic policies. His apparent determination to implement protectionist measures through a renegotiated North American Free Trade Agreement (NAFTA) and fresh tariffs on imports from Asia and Europe, for example, could have global ramifications. Mr Trump’s outwardly tough stance on national security, particularly with regard to North Korea and, by extension, China, could also inflame tensions.

MARKETS NOT PREPARED FOR A CHINA SLOWDOWN

China is a potential risk about which the market seems too complacent at the moment. Sentiment towards China tends to be herd-like: one moment everybody is crowding onto one side of the boat; the next they are on the other side. The apparent complacency is partly explained by the pattern of global growth over the past few years. In 2015, global growth was a steady but unspectacular 3.2%. Then, in February 2016, the People’s Bank of China
(PBoC) cut the reserve requirement ratio—the amount of cash that Chinese banks must hold as reserves—effectively injecting US$100 billion into the economy. As a result, global growth is expected to rise to 3.4% this year and 3.6% in 2018, and we believe that this is due at least in part to China’s February 2016 stimulus measures.

The cause for concern now is that China is applying the brakes again. The PBoC has raised short-term interest rates three times this year already, and between March and April the China Banking Regulatory Commission released seven documents revealing tighter financial regulations. In addition, some 55 Chinese cities have introduced 160 cooling measures to curb rising house prices. If we accept that the world’s recent growth spurt can be traced back to China’s stimulus early last year, it follows that we should be concerned now that the stimulus is being taken away.

Of particular concern is the fact that, based on past evidence, China tends not to calibrate its economic measures: when it touches the brake, it tends to flatten it. It is also not the only central bank in tightening mode. The US Federal Reserve has also begun tightening, while the European Central Bank (ECB) and the Bank of England look set to follow this year. Even the Bank of Japan, while officially committed to its yield curve control policy, has begun to tentatively discuss ending its bond-buying programme. Combined, these central bank tightening moves could lead to a spike in yields, potentially resulting in a wider market correction.

* Effective June 30, 2017, the Global Unconstrained Bond Strategy was renamed the Dynamic Global Bond Strategy. This is a change in name only—the people, philosophy and management approach remain exactly the same.