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# Thesis Market Commentary

## The Hunt for Red October

As the third quarter ended and beckoned in the first trading day of October it would be fair to say that the dive klaxon had started to sound.

Just as First Officer Borodin said in the movie 'The crew know about the saboteur. They are afraid', Jerome Powell, chairman of the US Federal Reserve (Fed), sounded out market fears when he suggested that the Fed could raise rates significantly before finishing its rate hike cycle. This saw the yield on 10-year US Treasury Stock spike meaningfully above the psychological 3% level which appears to be a rate of return investors are willing to start actively questioning whether risky equity assets are going to deliver commensurately more and what higher rates will mean to companies' financing costs and profit margins. The S&P 500 therefore started October on a down day and followed with a negative close for five straight days, its longest losing streak since February's correction.

As often is the case, it probably was not this one singular factor that sparked the sell-off but more a combination of events.

> *"Just as First Officer Borodin said in the movie 'The crew know about the saboteur. They are afraid'"*

Arguably the falls had started a few days before the US joined the party when European markets reacted to Italy's populist coalition government agreeing a sharp increase in public spending – one which they seemingly cannot afford – and one that risks putting Rome on a collision course with Brussels and unnerving financial markets. Continental markets and the UK therefore then found further reason to sell down when the US did and thus, by mid-October, European exchanges had fallen more heavily than the US.

The singularly worst day of October came on the 10th starting with Asian markets where the stock indices in Shanghai and Shenzhen both tumbled more than 5% and the tech heavy Taiwanese market down close to 7%. At the time some analysts said that the decline on Wall Street did not appear to have any catalyst, including the ongoing trade friction between the US and China.

At times in the past year, protectionist threats and actions have sent stocks modestly downward, but investors have been all too willing to ignore the threat after the mildest of rhetoric suggesting a calming of such trade fears. For example, earlier this year after US-China trade worries first reared their head and depressed markets globally, all it took was Chinese President Xi Jinping's conciliatory speech at the Boao Forum in March to reverse the downward stock market trajectory. Realistically, this asymmetric reaction to trade developments where there is an

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overreaction to positive trade news and underreaction to negative trade news proved unsustainable. In addition, negative consequences from the ongoing US-China trade conflict had not yet appeared in economic data, especially in the US where the economy is accelerating, giving markets another reason to discount the threat. But that has started to change as the International Monetary Fund (IMF) downwardly revised its estimates for global growth, as well as growth for China and the US, as a result of the escalation in trade tensions.

In addition, companies are beginning to report that tariffs are impacting their businesses. US-based industrial supply company Fastenal recently reported earnings in particular, stating that tariffs are "directly impacting the North American supply chain for our customers." This disruption of global supply chains has been a major concern for economists and strategists. As the Cato Institute explained in a commentary earlier this year, "Whereas in the 20th century, most of a company's production and assembly took place in one location, often under one roof, the factory floor has since broken through those walls and now spans borders and oceans. Taxing imports today is therefore akin to putting up a wall right in the middle of that historic assembly line, impeding production and raising costs in similar fashion. That helps explain the preponderance of opposition among US manufacturers to Trump's trade tack. US tariffs raise their costs, and the resulting retaliation from foreign governments will reduce their export revenues, squeezing profits from both ends."

Thus, it was that as investors headed into the second half of October with markets pricing in a change in the macro environment, they then switched their focus once more; this time to the micro as the US's 3rd quarter earnings season moved into full swing. Many believe that current stock valuations, particularly in the technology (and now communications) sectors, are extremely high leaving them little margin for error should earnings not match or exceed expectations. Of the FANGMAN (Facebook, Amazon, Netflix, Google (parent company Alphabet), Microsoft, Apple and NVIDIA) stocks, Alphabet and Amazon were the first to report, since the reporting timeline aligns with the alphabetical order. Their fortunes were, however, mixed as Alphabet's numbers were an outright miss of consensus quarterly earnings estimate for the first time in two years whilst Amazon's numbers beat 'The Street'. Both companies' share prices were punished though, with ironically Amazon taking the greater hit. This was because, like Fastenal, their announcement guided on prospects for this quarter where they lowered expectations for revenues over the all-important holidays season. Four days later Facebook came in with flat revenues quarter-on-quarter but unlike Alphabet or Amazon, did not see its stock price punished on the day as it had already been dragged down 15% prior to their results. Indeed, on the day, Facebook shares actually closed up 10% as Wall Street breathed a big sigh of relief that users in the US did not flee the social network in droves after a string of scandals.

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*So as the dust settles in the aftermath of a month now being dubbed 'Red October' when President Trump accused his Federal Reserve of scuttling the market - just as the crew of Red October believed Captain Ramius to have done in the film*

At the end of the worst month for the NASDAQ (-9.2%) since November 2008, it could simply have been that investors were looking for glimmers of hope. At that time the financial markets were in crisis and the tech-heavy NASDAQ was at the tail end of a six-month slump, during which the index lost more than 40% of its value. This time though it simply appeared that investors were pulling away from the stocks that have delivered the best returns in recent years, and the tech sector certainly wasn't alone in October. Eight of the 10 subgroups of the S&P 500 fell, led by energy and consumer discretionary stocks, which dropped more than the tech group. The broader S&P 500 declined 6.9% and consequently was the worst monthly fall of the S&P 500 since Feb 2009, although did fall by less in Sterling terms, down 4.9% therefore matching the fall of the UK's, FTSE 100, home index.

So as the dust settles in the aftermath of a month now being dubbed 'Red October' when President Trump accused his Federal Reserve of scuttling the market - just as the crew of Red October believed Captain Ramius to have done in the film - there are currently few signs, at least economically, that this is indeed the case. What has been overlooked given the path of markets during the past month is Jerome Powell's other comment he gave on the 3rd of October, where he cited a "Remarkably Positive Set of Economic Circumstances". Consequently the economic environment seen through the periscope still remains that of a calm sea, however, investors are now more consciously aware of what may lie beyond the horizon. This change of attitude away from 'risk-on' assets, which have served as a strong conduit to increasing one's wealth over the past number of years, towards less risky assets, with equity markets suffering a direct hit as part of the fallout, is another case of stock markets not necessarily tracking economic sentiment directly.

In his book 'The Anatomy of a Bear' Russell Napier analyses four bear markets over the last 100 years when US equities became particularly cheap. The book concentrates on trying to identify common characteristics but concludes that there is never one single cause or catalyst for bear markets. There can, however, be commonalities such as economic growth, debt and valuations. There are currently few warning signs from the first two but valuations in a few (increasingly large) pockets of global stock markets had become stretched. Some of this has now 'shaken out' with both Amazon and Apple losing their recently acquired trillion Dollar status which appears to justify us limiting exposure to the US where technology companies are increasingly dominating index composition and, up until recently, have driven the majority of the return from both the American and therefore global stock markets.

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# NEWS & VIEWS

## Summary

- Divergent performance
- Orderly sell-off
- Defensive large caps bucked the trend
- Italian budget battle
- People's Bank of China

| Indices | Value as at 31/10/2018 | % Change on month | % Change year to date | % Change over 12 months |
|---|---|---|---|---|
| FTSE 100 Share | 7128.10 | -5.09% | -7.28% | -4.87% |
| FTSE All Share | 3904.23 | -5.42% | -7.52% | -5.18% |
| S&P 500 | 2711.74 | -6.94% | 1.43% | 5.30% |
| Dow Jones | 25115.76 | -5.07% | 1.60% | 7.44% |
| Euro Stoxx 50 EUR | 3197.51 | -5.93% | -8.75% | -12.97% |
| Nikkei 225 | 21920.46 | -9.12% | -3.71% | -0.41% |
| MSCI Emerging Markets | 955.92 | -8.78% | -17.48% | -14.58% |
| UK Treasury 4.25% 2027 | 125.25 | 0.90% | -2.60% | -1.76% |
| Sterling/US$ | 1.28 | -2.21% | -5.69% | -3.91% |
| Sterling/Euro | 1.13 | 0.46% | 0.28% | -1.01% |

SOURCE: BLOOMBERG

Since March, we have witnessed a stark divergence in asset performance between the US and the rest of the world. While periods of US equity outperformance are common, the scale of recent divergence is rare historically. The nonconformity coincides nicely with the increase in trade tensions between the US and China. We think however, a better explanation for US equity outperformance is that US economic growth has accelerated on late-cycle fiscal stimulus, whilst the rest of the world has shown signs of slowing.

Tax cuts and government spending in the US have added rocket fuel to an already healthy business cycle and supercharged equity returns. Whilst third quarter results continue to show exceptionally strong earnings growth on the back of this stimulus, we think it is wise to pay particular attention to forward guidance, as company management look at what might lie ahead, especially tied to the trade/tariff skirmish with China. October's sell-off was particularly acute among companies with high exposure to China. A few companies have already highlighted pockets of weak demand, and some warned their operations will be impacted.

## US

GDP growth for the third quarter beat expectations and grew 3.5%, with strength in consumer and government spending offsetting fixed investment and net exports, which dragged on growth slightly. Weak housing data, however, showed that new home sales declined 5.5%, and existing home sales fell 3.4%. This seemed to trigger a rethink on the strength of the economy, which, together with the Federal Reserve (Fed) saying there would be no let-up in its rate-raising cycle, sent US equities into a tailspin. While the current decline is not pleasant to go through, it is not out of the ordinary for any given year. We see the drawdown as being rather orderly, with many of the themes you would expect to play out in the market doing so. We saw large cap stocks outperform mid and small cap stocks; value style outperforming the growth style across all market cap segments; and defensive sectors outperforming cyclical.

> *"The summit ended with Donald Tusk, the European Council president, rejecting Theresa May's Chequers plan. Despite the political noise, the UK continues to deliver resilient economic data."*

## UK

The UK market was driven lower along with global markets as concerns around the escalating trade war between the US and China continued. A number of defensive large caps bucked the market declines and as a result the FTSE 100 held up relatively well. The UK Budget was brought forward to October in order to avoid a clash with Brexit negotiations, and the Office for Budget Responsibility

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(OBR) published its revised growth forecasts for the UK economy. The OBR now forecasts GDP to grow 0.5% in Q3 2018 and 0.4% in Q4 2018, and expects annual GDP growth of 1.3% in 2018 and 1.6% in 2019. The Budget itself caused little movement in the UK stockmarket.

## Eurozone

The European Central Bank (ECB) kept rates on hold and reiterated it would end its asset purchasing programme by year end. ECB President Draghi also said interest rates would be on hold until next summer, with his cautious tone reflecting some weak data including manufacturing PMI which dropped to 52.1, its lowest reading since 2016. The rise in headline inflation from 2.1% in September to 2.2% in October was in line with the consensus forecast. It reflected a combination of higher energy and core inflation, which more than offset a decline in food inflation. October also witnessed some developments in the ongoing Italian budget battle, with the European Union rejecting Italy's draft budget and then asking them to submit a new one within three weeks or potentially face fines.

## Japan

Japanese equities fell steeply during October, ending the month 9.1% lower. Those areas of the market most exposed to external demand fell furthest, while the more domestically driven and less economically sensitive areas held up better. Economic data released during the month was somewhat mixed, with industrial production much weaker than expected but much of this is a result of a typhoon and an earthquake that disrupted supply chains and suspended production for a number of large manufacturers. The Bank of Japan's regular policy committee meeting resulted in no change to monetary policy, but it did take the opportunity to trim its inflation forecast in the latest sign it has failed to make headway towards its 2% target despite years of massive monetary easing.

## Emerging Markets

Emerging market equities have struggled in recent months in the face of a strengthening Dollar, rising funding rates and geopolitical risks. Latin America stood out as the only region to finish in positive territory in October. This was down to a strong rally in Brazilian equity markets following the victory of Jair Bolsonaro in the country's presidential election. In China, Q3 GDP growth slowed by more than expected to 6.5% year-on-year and equities continued their decline as tariffs on US-China trade dampened sentiment. Chinese authorities have already taken action to counteract slowing growth, with the People's Bank of China cutting the reserve requirement ratio for banks by 250bps this year, and the government has authorised local bond issuance to fund infrastructure projects.

*Jair Bolsonaro*

## Fixed Income

Fixed interest markets did not provide the protection that we typically see from the asset class. US government bonds were negative for the month as yields increased, whilst the premium over government bonds that companies need to pay to borrow (the credit spread) also increased. Within corporate credit, broad high yield underperformed higher quality credit. Outside the US, government yields mostly declined. UK 10-year yields fell from 1.57% to 1.44% and in Europe, German Bund 10-year yields fell from 0.47% to 0.39%.

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