Weekly Market Summary

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Markets' Focus Shifting Away from Economic Data to Politicians' Stupidities!

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Over the centuries, politics has passed through many eras: There have been periods of imperial conquest, isolationism, racism & discrimination, egalitarianism and nationalist aggression. Now, in the transatlantic sphere at least, we seem to be entering a new historical phase: The "*Era of Stupid*"! American and European politicians at the highest level appear to be engaged in a competition to see who can utter the most defiantly ill-informed, aggressively ignorant statements about precisely the issues that governments have traditionally regarded as life-and-death matters. Somehow, this bold inexperience - the shameless display of the failure to understand even the basic meanings of significant words – seems to be playing a major role in the latest markets' movements and bout of volatility, and could soon help trigger or exacerbate a serious financial crisis / market meltdown. Napoleon Bonaparte once said, "*In politics stupidity is not a handicap*". This surely never rang more true with the recent election of inexperienced and incompetent politicians!

Moving to the latest price action in financial markets, it is becoming clear that what began as first-half "*melt-up*" euphoria is now ending with "*melt-down*" fears! Investors started the year expecting to pick up easy returns from steadily rising asset prices; After all, the growth outlook for 2018 looked quite favourable, with the stars aligned for a continuation of the positive above-trend global growth, and a low but gently rising inflation. Additionally, easier financial conditions, coupled with fiscal stimulus, were certainly expected to lead to sustained economic development over the coming months (in line with a December 2017 / January 2018 economic assessment by the International Monetary Fund (IMF) and the World Bank, with both hailing the "broadest synchronised global growth upsurge since 2010", as well as a brightening outlook and a "solid cyclical recovery, reflecting a rebound in investment, manufacturing activity, and trade"). Add to that a strong message by the US Federal Reserve – at its January 31st FOMC meeting - that an expansion with "*substantial underlying economic momentum*" is in place and would sustain additional increases in interest rates this year, and you had the perfect recipe / greenlight for "risk-on" winning dealings (long equities & emerging market currencies, short G7 government bonds)!

Instead, traders and fund managers are now nursing losses on bets that had – just few months back - delivered the biggest gains from a decade's worth of buoyant liquidity. Stocks, bonds and currencies of developing nations soared over the past 2 years, despite tremors on the global landscape from Brexit to Donald Trump's U.S. presidency, not to mention coups and impeachments in their own backyards. And whilst emerging economies began the year as a market darling, they were quickly toppled by a surge in the dollar, rising benchmark US interest rates, and mounting political risks. A brewing trade war proved to be the final knock-out, dashing all hopes that a synchronized global growth would keep pumping-up equities. China, long seen as the world's growth engine, saw its stock market slipping into a bear market (a drop in excess of 20% from highs posted in late January). As a result, developing-nations' stocks are now the biggest losers of the year so far - handing investors a loss of 8.75% once dividend payments have been taken into account. Emerging-market and euro-denominated debt are close runners-up, with losses of more than 4%. Oil remains the standout winner as investors bet on tightening supply against the backdrop of the increased isolation of Iran, rising tensions in Libya and the collapse of Venezuelan output.

This volte-face was captured in a Goldman Sachs Group Inc. barometer of risk appetite - which slumped to an 11-month low in late June after signalling the most accommodative investment environment since 2000 in January. But the sea change stems more or less from the snap stock sell-off of early February, which was blamed on traders unwinding huge short-volatility positions. Since then, markets have become more vulnerable to mounting political risks as investors – unwilling to get caught again when asset bubbles go "pop" - grew increasingly risk-averse. "*We've gone from an extreme of market psychology where all risks could be ignored to one that is hyper-sensitive*," said James Athey, a senior investment manager at Aberdeen Standard Investments in London. "*The February turn, when equities suddenly started selling off, that was the moment when shock waves rippled across financial markets and people woke up to a different world*."

The million dollar question going forward is whether the turbulent first half proves to be just be the beginning, as markets continue adjusting to central bankers paring stimulus that had propped up asset prices with liquidity and low rates for the past decade, and to politicians upping the ante on future trade tariffs and wars. On the latter, President Trump is betting that Beijing will blink first in the showdown over tariffs, but such an outcome is far from assured - and it could also take a while. Economists – on their part - see an increasing risk that the world is headed towards an all-out trade war, one the World Trade Organization may be ill-equipped to respond to!

Anyone trying to gauge how markets will fare in the second half of the year may want to have a look at the demand for price protection against large swings in major global equities and currencies, which has recently approached its highest level since late February, according to the Bank of America Merrill Lynch hedging skew index. But if history is a guide, gains and losses in developing markets – in the long run - are more influenced by domestic stability levels, while the impact from external political risks gets often exaggerated. "*It's not that political risk isn't relevant*," said Charles Robertson, Renaissance Capital Ltd.'s London-based global chief economist. "*It's just that it shouldn't be overstated. Unless there's a real negative impact on economic growth, then markets won't suffer as much as some fear*", he added.

At least for now (*the second week in a row*), we continue to hope that the base case remains more "trade skirmish" than "trade war", whilst acknowledging that the risks continue to grow! As noted last week, we also pray that calmer heads and pragmatism will eventually prevail, and that positive news would soon start emerging on all fronts. Otherwise, better prepare for a tumultuous second half for 2018!

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