
Investor sentiment stays positive despite geopolitical drama

Investors seem to be tuning out everything except trade wars and Fed tightening

Jan 14, 2019 | Kristina Hooper, Chief Global Market Strategist

There has been no shortage of drama across the macroeconomic and geopolitical landscape so far in 2019. However, it appears that investors may be tuning out much of the political theater around them. Which storylines are moving markets now, and which may become more integral to the plot in the weeks ahead?

The UK faces an important Brexit vote

On Jan. 15, Parliament will say “yea” or “nay” to Prime Minister Theresa May’s Brexit Withdrawal bill. You may recall this was originally scheduled for December and was postponed because it appeared likely it would fail to garner enough votes. The situation doesn’t appear any brighter for May’s plan this go-round – some even expect the vote to be postponed yet again, given its low likelihood of passage. The good news is that there is less likelihood that the worst-case scenario – a “Brexitident” (i.e., a “no deal” Brexit) – could come to pass. That’s because Parliament recently passed two pieces of legislation that would essentially punish the UK government if it incurs a “no deal” Brexit. It is also becoming increasingly likely that the actual Brexit date (currently scheduled for March 29) could get pushed back, which should be helpful as well in avoiding a “no deal” scenario.

And so what lies ahead for the UK if it is able to postpone the actual Brexit date? We could see an “off the shelf” option, such as Norway’s relationship with the UK. However, I continue to believe there is a growing likelihood of a second Brexit referendum. Over the weekend, May said that if Parliament votes down her proposal, there is likely to be no Brexit. She intended that to be a warning to British citizens; however, it may have actually served as encouragement to some members of Parliament to vote against her proposal – and then support a second Brexit referendum.

The US government shutdown makes history

In the United States, the partial government shutdown has extended beyond three weeks; it is now the longest shutdown in US history and has no end in sight. While only approximately 25% of the government is closed, the shutdown promises to have an increasingly negative impact on the US economy as it drags on. Thus far, the stock market seems to be ignoring this shutdown; that may change if US debt is downgraded by any of the rating agencies.

A national debate begins in France

In France, President Emmanuel Macron can’t seem to find a way to diffuse the significant anger that has grown towards him, which has manifested itself in a nine-week-long protest in Paris by the *gilets jaunes* (“yellow vests”). I knew his reforms would not be popular (although I thought they would be positive for economic growth), but I have been surprised to see such strong resistance.

When I was in France last November, I kept asking the people I met why there was such opposition to Macron. I was surprised to hear that it wasn’t due to his actual policies, but it was more about the way he communicated them – many felt he lacked empathy. (I remember how enraged French citizens were by a previous leader who seemed to lack empathy, suggesting that peasants eat cake when they didn’t have bread.)

Macron's new attempt at diffusing the anger toward him is a three-month long national debate – called the *grand debat* – which starts this week. This series of town hall-style meetings is intended to be a forum for open, honest discussion and feedback. While Macron has promised that no topic is off-limits, he has said that this will not impact his economic reform agenda. Not surprisingly, a recent survey in *Le Figaro* indicated that 70% of respondents believe the *grand debat* will “serve no purpose.” I worry that this initiative will further anger French citizens and increase the likelihood that Macron will soon be swept out of office. In my view, this would be unfortunate as his reform agenda was promising. In addition, he was shaping up to be the heir to Germany's Angela Merkel as the de facto leader of the European Union.

Earnings could be disappointing, but investors remain positive

Investors looking for positive news in earnings may come up short. Last week saw several high-profile downward revisions to earnings from Macy's, Kohl's, Delta, Jaguar Land Rover, Constellation Brands and American Airlines. These added to the previous week's warnings from Apple and FedEx. My suspicion is that, because the “P” (stock prices) has moved much lower, the “E” (earnings) has not received as much scrutiny. But that could easily change. Earnings season has the potential to be disappointing, so we will want to follow it closely.

But despite all of the above, investor sentiment was decidedly positive last week. My view is that investors are laser-focused on the two key risks that have been hanging over stocks in the past year – the trade war and Federal Reserve (Fed) tightening. Since those risks are in abeyance, at least for the time being, investors breathed a sigh of relief.

- **Investors were clearly encouraged by recent US-China trade talks.** While there were no major breakthroughs last week, there were reports that US President Donald Trump is eager to reach a deal, and that China's Vice Premier Liu He has unexpectedly joined the talks, signifying their importance. Trade talks are expected to resume soon, with Liu He anticipated to continue to participate – another good sign, in my view. I am becoming increasingly optimistic that a resolution is in sight, but the US likely needs to accept minor concessions, as I continue to believe there is no reason for China to make major concessions. The Chinese economy is experiencing some damage, but it would prefer to increase domestic stimulus than capitulate to the US. This was underscored last week in *The China Daily*, a state newspaper, in an editorial that made clear China will not “seek a solution to the trade frictions by making unreasonable concessions, and any agreement has to involve give and take from both sides.”
- **Fed tightening also appears to have diminished somewhat.** Fed Chair Jay Powell suggested that the Fed may revise downward its policy prescription (the “dot plot”) for 2019. He acknowledged concerns about financial markets, as well as worries about a global slowdown and a US slowdown; he also stressed that the Fed is not on a pre-set course and will be flexible. Vice Chair Richard Clarida also spoke last week and provided encouragement to markets; he said that low inflation allows the Fed to be patient. However, it is worth noting that while last week's US consumer price index release may have shown a decrease in headline inflation, it also showed an increase in core inflation (which excludes food and energy prices). What's more, that rise was broad-based in nature. While I am happy to see the Fed stressing its desire to be flexible, I worry that higher inflation may reduce its flexibility in the coming year. While substantially higher inflation is not my base case, it is a risk and we will want to follow inflation closely. What's more, I worry that the Fed does not seem to have the same flexible approach to its balance sheet. In fact, Powell reiterated last week that the Fed would continue to unwind its balance sheet because it needs to be at a “more normal level.”

I expect investors to continue tuning out the geopolitical drama and to focus on the trade war and the Fed. The news flow on those two topics is likely to largely dominate stock market performance this week, in my view. However, we will want to follow earnings season closely - this week, many major global banks will be reporting earnings, and stocks may begin paying attention.

Finally, we will also want to closely follow China gross domestic product (GDP) growth, which will be released at the end of this week. Today (Jan. 14) the Chinese government announced that Chinese exports fell 4.4% in December from a year earlier, while imports fell 7.6% from a year earlier.¹ Investors immediately began to punish any US stocks with significant exposure to China, suggesting that markets could get spooked by a disappointing GDP growth number from China. I don't expect any great disappointment with GDP growth because of China's ramp up in domestic spending, but we will want to examine the data closely.

Source

¹*The Wall Street Journal*, "China's exports take a surprising fall in December," Jan. 14, 2019

Important information

In a "no-deal" Brexit, the UK would leave the EU in March 2019 with no formal agreement outlining the terms of their relationship.

The Federal Reserve's "dot plot" is a chart that the central bank uses to illustrate its outlook for the path of interest rates.

The consumer price index (CPI) measures change in consumer prices as determined by the US Bureau of Labor Statistics.

Gross domestic product is a broad indicator of a region's economic activity, measuring the monetary value of all the finished goods and services produced in that region over a specified period of time.

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