
Global markets: Five issues to watch

Weekly Market Compass: Turkey's woes continue, the US and China will talk about trade (again), and more

Aug 20, 2018 | Kristina Hooper, Chief Global Market Strategist

From the crisis in Turkey to upcoming remarks by the Federal Reserve (Fed) Chair, there is no shortage of issues for investors to watch this week. Below, I highlight five key areas that markets will be monitoring.

Will Turkey's woes spread across emerging markets?

The crisis in Turkey continued last week. Last Wednesday, Qatar pledged US\$15 billion in investments for Turkey, which boosted the lira temporarily - even though Turkey needs far more in the way of investment than what has been promised by Qatar. On Thursday, a senior finance official in the Turkish government tried to reassure markets that Turkey would not impose capital controls and that it would do what is necessary to remedy the crisis. But the lira sank again as Standard & Poor's and Moody's downgraded its credit rating. In addition, the crisis is becoming more complicated as Turkey is attempting to tie the release of the detained American pastor to major fines that the US wants to impose on a Turkish bank for involvement with Iran. I believe it is unlikely this crisis will end soon, given the Turkish government's unwillingness to take the measures necessary to resolve it.

And there's always the risk of "copycat panics" in other emerging markets countries. I continue to believe there is little chance of direct spillover from Turkey, given the unique issues facing the country. However, as is often the case with a crisis in one emerging markets country, some or all emerging markets countries are treated the same way by investors. Some economists and strategists are particularly worried about the potential for contagion spreading to other emerging markets, such as Indonesia and South Africa, which were two of the Fragile Five during the 2013 Taper Tantrum. It is true that sovereign credit ratings of some emerging markets countries have dropped sharply in the last year and a half with more now rated below investment grade, so we will need to follow emerging markets debt closely. That is particularly so given the changed role of the US in emerging markets from calming force to disruptor - that includes the liquidity squeeze being created by the Fed. However, it is important to stress that not all emerging markets can be painted with the same brush; this is a time for investors to understand the fundamentals on a country-by-country basis.

Low expectations for US-China trade talks

Helping buoy stocks last week was news of a new round of US-China trade talks later this month. However, I have very low expectations for the meeting and believe we will see something of a repeat of previous US-China trade talks this year where the stock market reacted positively to news of the talks, only to see them go nowhere.

It appears that these talks will focus on how China can prevent the devaluation of the yuan. In my view, this is unlikely to be a fruitful pursuit given that market forces, including the US' aggressive stance on tariffs as well as the modestly decelerating Chinese economy, have most likely caused this year's devaluation of the yuan. So while I expect China to defend its currency if it trades through the key psychological level of seven yuan per one US dollar, I don't expect the Chinese to do much more.

Quite frankly, I don't expect China to make many concessions in any trade talks with the US for a few reasons:

- First of all, South Korea is a cautionary tale of a country that attempted to avoid US tariff retaliation by voluntarily agreeing to quotas - only to find a very inflexible and onerous set of requirements that has curtailed steel exports from South Korea to the US. The US simply did not reward South Korea for playing nice in the sandbox, so there is no incentive for other countries to do the same.
- In addition, I would argue that, contrary to conventional wisdom, China holds the upper hand in a trade dispute with the US. Its currency is decelerating, helping to compensate for the tariffs imposed on it by the US. Moreover, it has the ability to spend in order to compensate for any reduction in growth caused by the tariffs.

On the topic of trade deficits, which appears to be an important area of focus for the Trump administration, I believe it is unlikely that China will agree to reduce its trade surplus with the US. In my view, this is a somewhat nonsensical demand by the US given that trade surpluses are a function of market forces - something that is normal and to be expected of a wealthy, consumption-based economy. The US has routinely run trade deficits with other countries since the 1980s, which should be no surprise given the nature of the US economy. And, while mine is a minority view, I expect China would ultimately win a trade war with the US, which suggests China will be less likely to make any serious concessions.

In short, I don't expect any accomplishments to come out of the talks. It looks like China may not expect much progress either - the government appears to be preparing to support its economy from within by recently encouraging Chinese banks to lend more for infrastructure spending. Investors have shown again and again this year that they want to believe the tariff wars will subside rather than intensify, so be prepared for some downside volatility if they fail.

The bull market is poised to break records

This week, the US stock market should break the record for the longest bull market in modern financial history, which ran from Oct. 11, 1990, through March 24, 2000. The current bull market began on March 9, 2009, and if the US stock market makes it to Wednesday without a significant plunge (which I'm quite sure it will), it will take the record.

This bull market has been breathtaking, with stocks having risen over 300% since the start.¹ Some strategists are beginning to issue warnings about a major sell-off in the offing. I agree that valuations in general have become stretched; however, corporate earnings have been strong, and I believe US stocks are likely to continue to outperform in the shorter term given the strength of the US economy and the perceived safety of US stocks in the midst of trade wars. My expectation is that we will see greater volatility for stocks in the coming year, including another sell-off or two of between 5% and 10% (not dissimilar to what we experienced in February). In my view, diversification and active management remain critical strategies for mitigating risk on the downside.

The 'fear trade' continues to favor Treasuries

The 10-year US Treasury yield is indicating some fear among investors, finishing last week at 2.86% despite data suggesting strong global growth.² US Treasuries continue to be the perceived safe haven of choice for most investors, at the expense of other historical safe havens such as gold.

I continue to be surprised by the way investors have largely ignored gold in the past decade. However, the unpopularity of gold has intensified in recent months, with the level of gross short contracts on gold at its highest mark since 2001; there is now a net short position in gold.³ This is certainly at least partially a function of the strong US dollar, but it calls into question whether we are experiencing something of a paradigm shift when it comes to safe haven asset classes. We must recognize that the popularity of US Treasuries as a safe haven could be problematic going forward given that balance sheet normalization is accelerating and the US government is issuing more debt because it's running larger deficits. In other words, more supply, all else being equal, suggests prices will fall.

This may be amplified by a provision in the US tax reform legislation passed last year that rewards companies for funding pension liabilities before Sept. 15 (there is a theory on Wall Street that this has caused a spike in demand for Treasuries and that, after Sept. 15, there will be a reduction in demand for US Treasuries, pushing prices lower). However, a powerful countervailing force is the significant number of short positions being held on US Treasuries – yes, there is a lot of speculation in Treasury markets as well, and that speculation significantly increased in recent weeks, according to the Commodity Futures Trading Commission. These positions may need to be covered if the “fear trade” begins buying more Treasuries (this could be triggered by a variety of risks), which could in turn send prices higher.

What insights may come from the Jackson Hole symposium?

This coming week the Federal Reserve Bank of Kansas City is holding its annual Jackson Hole symposium, with many meaty topics to be discussed. The most anticipated speech of the event will likely be that of Fed Chair Jay Powell, who is set to deliver his remarks on Friday morning.

Six years ago at this same symposium in Jackson Hole, Fed Chair Ben Bernanke spoke about nontraditional monetary policy tools such as quantitative easing (QE) – in particular, he covered the cost-benefit framework of using such experimental tools. He noted that one potential cost of QE is that it could “reduce public confidence in the Fed’s ability to exit smoothly from its accommodative policies at the appropriate time.” I am hopeful that Powell will address balance sheet normalization given that the Fed’s exit does not appear entirely smooth, as it has created liquidity issues for emerging markets countries – so much so that the Reserve Bank of India Governor Urjit Patel wrote about his concerns in a Financial Times op-ed piece in June: “Dollar funding has evaporated, notably from sovereign debt markets. Emerging markets have witnessed a sharp reversal of foreign capital flows over the past six weeks, often exceeding \$5 billion a week. As a result, emerging market bonds and currencies have fallen in value.” If not at Jackson Hole, hopefully we will glean more about balance sheet normalization from the minutes of the most recent Federal Open Market Committee meeting, which will be released this week as well.

In my next blog, I'll highlight news from Jackson Hole, as well as any surprise news that impacts global markets.

Source

¹Bloomberg, L.P., as of Aug. 20, 2018

²Bloomberg, L.P., as of Aug. 17, 2018

³CNBC, "Gold speculators most pessimistic in 17 years," Aug. 20

Important information

Diversification does not guarantee a profit or eliminate the risk of loss.

Quantitative easing (QE) is a monetary policy used by central banks to stimulate the economy when standard monetary policy has become ineffective.

In 2013, the US Federal Reserve announced plans to taper its bond-buying program, prompting a "taper tantrum." The "Fragile Five" was the nickname given to emerging markets that were particularly hard-hit by the news: Indonesia, Brazil, India, Turkey and South Africa.

An investment grade bond is generally recognized as such if its credit rating is BBB- or higher (Standard & Poor's) or Baa3 or higher (Moody's). These bonds are judged by the rating agency as likely to meet the associated payment obligations.

A short position is a directional strategy that is designed to profit when a security declines in price. Securities are borrowed and then sold on the open market. The expectation is that the price of the security will decrease over time, at which point new securities are purchased in the open market and the borrowed securities are returned.

Safe havens are investments that are expected to hold or increase their value in volatile markets.

The opinions referenced above are those of Kristina Hooper as of **August 20, 2018**.

This document has been prepared only for those persons to whom Invesco has provided it for informational purposes only. This document is not an offering of a financial product and is not intended for and should not be distributed to retail clients who are resident in jurisdiction where its distribution is not authorized or is unlawful. Circulation, disclosure, or dissemination of all or any part of this document to any person without the consent of Invesco is prohibited.

This document may contain statements that are not purely historical in nature but are "forward-looking statements", which are based on certain assumptions of future events. Forward-looking statements are based on information available on the date hereof, and Invesco does not assume any duty to update any forward-looking statement. Actual events may differ from those assumed. There can be no assurance that forward-looking statements, including any projected returns, will materialize or that actual market conditions and/or performance results will not be materially different or worse than those presented.

The information in this document has been prepared without taking into account any investor's investment objectives, financial situation or particular needs. Before acting on the information the investor should consider its appropriateness having regard to their investment objectives, financial situation and needs.

You should note that this information:

- may contain references to amounts which are not in local currencies;
- may contain financial information which is not prepared in accordance with the laws or practices of your country of residence;
- may not address risks associated with investment in foreign currency denominated investments; and
- does not address local tax issues.

All material presented is compiled from sources believed to be reliable and current, but accuracy cannot be guaranteed. Investment involves risk. Please review all financial material carefully before investing. The opinions expressed are based on current market conditions and are subject to change without notice. These opinions may differ from those of other Invesco investment professionals.

The distribution and offering of this document in certain jurisdictions may be restricted by law. Persons into whose possession this marketing material may come are required to inform themselves about and to comply with any relevant restrictions. This does not constitute an offer or solicitation by anyone in any jurisdiction in which such an offer is not authorised or to any person to whom it is unlawful to make such an offer or solicitation.