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News versus noise: Assessing the market impact of three major headlines

Weekly Market Compass: Examining impeachment, the ongoing Brexit saga, and the US-China trade situation

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One of the key themes I have been discussing in the last several years is geopolitical disruption - and we got a heavy dose of it last week. However, one of my main points over the past few years is that investors should try to identify the geopolitical disruption that really matters for the economy and markets, and ignore the events that are just background noise (most fall into this category, in my view). In particular, issues that can increase economic policy uncertainty are what we need to be sensitive to, as they can have significant consequences for economies and markets. Below, I assess today's three major headlines and where they fall on the spectrum of "news versus noise" in relation to their potential longer-term impact on the markets.

Impeachment: Background noise, for now

The US House of Representatives has begun an impeachment inquiry into President Donald Trump following the revelation of a whistleblower report related to national security. The report alleges that Trump utilized his position to attempt to pressure the president of Ukraine to investigate his political rival, former Vice President Joseph Biden.

From my perspective, while this is a serious allegation, this development has little relevance to both the economy and markets. Stocks barely blinked on the headlines this week, moved far more by news flow around trade (which I will discuss in a moment). Now if, at the end of the inquiry, something dramatic were to happen, we could see more volatility and even a sell-off. However, nothing in the timeline of the next few months suggests developments that could heighten economic policy uncertainty. For example, in a worst-case scenario in which the president were to actually be impeached (and that is extremely unlikely), he would be replaced by a vice president who is part of his administration and would likely continue with all the same policies. In addition, the Fed would likely remain very accommodative, which should also be supportive of equities.

Brexit: Heightened economic policy uncertainty has been impactful

The Brexit drama continues, and this is relevant for the economy and markets because it has been creating a high level of economic policy uncertainty, which has historically tamped down business investment. Last week, the UK Supreme Court found that Prime Minister Boris Johnson unlawfully shut down Parliament, and it has already been re-opened. It was reported that, last Thursday, opposition parties (including Labour, the Liberal Democrats, and the Green Party) met and decided to prioritize stopping a "no-deal Brexit." They agreed to work together to oppose another election until a "crash out" of the European Union is prevented.

The developments last week have served to increase optimism that the UK will avoid a no-deal Brexit. However, there is also a recognition that the economy has already come under pressure because of a major rise in economic policy uncertainty, which has deterred business investment - and that this damage is likely to continue even if the UK does not crash out of the European Union (EU).

Michael Saunders, a member of the Bank of England's Monetary Policy Committee who is perceived as a "monetary hawk," underscored this point last week by saying that "persistently high uncertainty," even if the UK reaches a deal with the EU, will likely make it appropriate for the Bank of England to maintain an accommodative monetary policy stance and possibly cut rates further.[1] And so news about the ongoing Brexit drama could substantively impact the economy as well as UK equities, gilts, and the British pound - at least in the short to medium term.

US-China developments: Meaningful, but fluid

On Friday, Sept. 27, it was reported that the United States is considering restricting capital flows into China and limiting Chinese companies from trading on US exchanges. In particular, Bloomberg reported that the US is considering the following actions:

- Delisting Chinese companies (American Depositary Receipts) from US stock exchanges
- Limiting Chinese companies' inclusion on indexes such as MSCI equity indexes
- Limiting American pension plans' exposure to the Chinese equity and bond market (both offshore and onshore)

The trade situation matters for the economy, in my view, for the same reason that Brexit matters for the economy: It can significantly increase the level of economic policy uncertainty, which can dissuade business investment and other spending. This is why the news flow around trade developments has been moving markets. And this particular revelation had a very significant negative impact on stocks on Friday. US stocks fell significantly, but Chinese stocks were hit even harder.

However, I would caution against overreaction. As I have said in the past, I believe the US will become increasingly desirous of reaching a trade agreement as we move closer to the 2020 presidential election, although I fully expect China to only make concessions around narrowing the trade deficit - if it is willing to make any concessions at all. One bargaining tool for the US might be threats such as this one reported on Friday, which reminded me of two other unusual recent warnings: Trump's tweet in late May threatening tariffs on Mexico in order to enforce immigration policy, and Trump's tweet in August threatening to prevent companies from doing business in China. That latter warning was followed by statements from Trump invoking the International Emergency Economic Powers Act of 1977 as giving him the power to enforce such a restriction. That law is significant in that it grants the president broad powers, which could certainly ratchet up the level of economic policy uncertainty. However, it has yet to actually be utilized - and I am becoming increasingly convinced that it will not be used.

Over the weekend, US Treasury official Monica Crowley responded that the US does not currently plan to block Chinese companies from listing on the US exchanges. And as of this morning, Sept. 30, US trade official Pete Navarro referred to the entire report as "fake news," saying that the US was not considering any such restrictions.[2] And so it seems that this report, like the May Mexico tariff threat and the August China threat, was probably just a bargaining tool and therefore could be disregarded as not adding to economic policy uncertainty.

We should recognize that similar reports or threats are likely to become more commonplace given the impeachment inquiry as well as the presidential election, and so they are likely to be disregarded as well. I do believe we should remain vigilant because, if any such threat were to actually be carried out, it would dramatically elevate the level of economic policy uncertainty - with economic and market consequences.

It is worth noting that China is not taking a similar, more protectionist stance in response. Chinese regulators have recently made significant gestures to demonstrate that the government is taking steps toward financial market liberalization by removing impediments to foreign institutional investments into China. This month, Beijing removed a $300 billion cap on foreign investments to onshore Chinese equities. And so, while the US may continue to threaten more protectionist policies vis à vis China, it still seems unlikely to me that the US will actually embark on a financial decoupling from China. One reason is that too many US businesses are dependent on business in China to help fuel their growth.

My conclusion is that investors should be prepared for almost anything to be reported, given what I expect to be a growing interest by the US in reaching a deal with China (by either carrot or stick), as well as what I expect to be the Trump administration's desire to take attention off the impeachment proceedings.

Investment considerations

Looking ahead, I expect geopolitical disruption to continue and become more unpredictable. That could lead, at least in the case of trade developments, to increased volatility for stocks and Treasuries. I believe investors should expect such volatility and view it as a reminder of the importance of broad diversification. In addition, investors could take advantage of opportunities created by downward volatility in order to acquire oversold assets such as Chinese stocks. In the very near term, I expect more trade news - both positive and negative - as we move closer to the start of a new round of trade negotiations on Oct. 10.

Source

[1]Source: Bank of England, text of Michael Saunders speech, "Shifting balance of risks," Sept. 27, 2019

[2]Source: CNBC, "Peter Navarro: Chinese companies restrictions story is 'fake news,'" Sept. 30, 2019

Important information

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

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

A "monetary hawk" is someone who is more concerned with keeping inflation in check through higher interest rates than with the economic growth pressures that can arise from higher rates. Monetary hawks tend to favor tighter monetary policy, while monetary doves tend to favor looser monetary policy.

UK gilts are bonds issued by the British government.

An American Depositary Receipt (ADR) is a certificate that represents shares of a foreign stock owned and issued by a US bank.

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