

A holiday gift for markets: Increased economic policy certainty

Weekly Market Compass: The UK election and US-China trade deal promise to provide more clarity for businesses next year

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Two developments last week suggest that we have entered a period of improved economic policy certainty. Both the UK election and the US-China Phase 1 trade deal promise to bring far more clarity for businesses as they plan for 2020 and beyond. If so, this could be a welcome gift for the economy and the stock market as we enter the holiday season.

A Jan. 31 Brexit looks likely

Thanks to a Conservative Party landslide in the Dec. 12 UK Parliamentary election, we expect Brexit can be completed by the end of January, but trade negotiations on the future relationship of the UK and the European Union may be stretched out beyond December 2020. At this point, it looks possible that the UK may exit the EU's single market (which allows for the free movement of goods and services among the different countries in the EU), but remain in or align with the customs union (which establishes a common system of tariffs and import quotas for trading with non-members).

As the details solidify, I would expect to see a gradual and sustained recovery in investment and a reversion to a higher growth rate that is somewhere between that of the eurozone and that of the US (even if it is slower than pre-Brexit economic growth). If so, sterling is likely to consolidate some further gains, but still at a discount to pre-Brexit levels. Gilt yields could move somewhat higher still. Equities are likely to rise significantly. With uncertainty easing, the Bank of England might even attempt to catch up to the global easing frenzy with a rate cut.

A Phase 1 trade deal could provide significant benefits

The day after the UK election, it was announced that the US and China have agreed on the first phase of a trade deal - a development that I believe should be very positive for a number of industries.

This Phase 1 deal includes several items that could benefit US industries:

- China has promised to ease pressure on US companies in terms of technology transfer, which should be very positive for the tech sector, if it comes to fruition.
- The withdrawal of tariffs threatened to be imposed on Dec. 15 should also benefit US tech companies (laptops and cell phones would have been subject to those tariffs) as well as some US retailers (who would have had price increases on imported goods from China that they sell, from personal care products to clothing to household goods).
- The agriculture, energy, and manufacturing industries should also benefit - if China does in fact purchase additional goods, as is currently part of the Phase 1 deal.
- The partial rollback of the September tariffs (from 15% to 7.5%) are also part of the current deal. That should benefit US retailers, given those tariffs were focused on consumer goods.

Going forward, the rollback of additional existing tariffs over time is expected as well - although this is far from certain. If these rollbacks were to occur, one likely beneficiary is the auto industry (US and German auto companies).

Overall, the Phase 1 deal should be positive for business investment because it reduces economic policy uncertainty, and increased business investment should benefit the global economy. I expect this to create an upward bias for stocks globally - especially for Chinese equities, which in my view have been unfairly beaten down in the last several years.

Neither development is a 'done deal'

While increased certainty around Brexit and a Phase 1 US-China trade deal are both very positive developments, nothing is a "done deal."

- There remains some uncertainty on the approach UK Prime Minister Boris Johnson will take going forward. Commentary over the weekend was divided on whether or not Johnson will soften his Brexit stance. Some argue he will because he is no longer beholden to the ERG (an alliance of pro-Brexit Conservative Members of Parliament) and Nigel Farage (leader of the Brexit Party). On the other hand, others argue he will want to stick to his promise of ending the transition period by the end of 2020).
- The Phase 1 deal has not been signed, and there is still a possibility that the agreement in principle could be derailed:
- China has thus far only confirmed a few details of the agreement - that it will increase its purchases of US goods but does not appear willing to meet specific quotas. It has not confirmed that it will ease technology transfer requirements that US companies have been subject to.
- China is laser focused on getting the US to continue to roll back existing tariffs - and has made that an important condition of negotiations. However, the US has thus far been very reluctant to roll back tariffs without gaining any major concessions, so it is unclear whether it will give up any more ground than it already has.
- While the US and China have come to a truce on tariffs, they appear to be engaged in other skirmishes. Last week, the Financial Times reported that China has ordered its government offices to remove foreign computer equipment and software within three years, replacing it with Chinese equipment and software. This would negatively impact US tech companies that supply such goods to China. This appears to be in retaliation for a recent directive by the Trump administration to curb the use of Chinese technology by the US. Large-scale replacement of US equipment by China is expected to begin next year, suggesting the relationship between the two countries remains tense and there is a real risk that it could deteriorate and possibly negatively impact trade negotiations.

In conclusion, last week's developments are very positive. However, until Brexit is completed and a Phase 1 trade deal is signed, there is the potential that uncertainty could spike again. In our view, this means that while maintaining a diversified portfolio with adequate exposure to risk assets is important, it's also critical to plan for the potential for higher volatility in the short term.

Happy holidays

In celebration of the holiday season, Weekly Market Compass will not publish for the last two weeks of the year. We'll be back on Jan. 6. Happy Holidays to you and yours!

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

Brexit refers to the scheduled exit of the UK from the European Union.

UK gilts are bonds issued by the British government.

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