Seven issues for investors to watch in September

Weekly Market Compass: Trade deals, the Italian budget, emerging markets pressure and more

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Trade tops the list of issues facing markets this month, as the US is threatening to kill the North American Free Trade Agreement (NAFTA) and leave the World Trade Organization (WTO). And that's just the tip of the iceberg. Here are seven things for investors to watch in September:

Trade issues may worsen from here

First and foremost, the current NAFTA talks have gone off the rails. Canada didn't meet the US' deadline of last Friday to join its new agreement with Mexico. US President Donald Trump made some strong threats about Canadian trade if Canada didn't sign on to the US-Mexico agreement.

The good news is that the law is on investors' sides, as Congress must be given a 90-day notice of a new US trade law before the president can sign any agreement. The US wanted a preliminary deal by Aug. 31 so that it could complete the 90-day notice period before the new Mexican President Andres Manuel Lopez Obrador (AMLO) takes office on Dec. 1. The Trump administration notified Congress last Friday that he will sign a bilateral deal with Mexico in 90 days – and that Canada can join if it wants – but he is moving forward regardless. The administration has until the end of September to send the details of the deal to Congress.

I believe it would be a mistake for the US to move forward with a trade deal with just Mexico, as Canada is an important trade partner. (In fact, as the US Chamber of Commerce has noted, 99.9% of US exports enter Canada duty-free under the existing NAFTA pact.[1]) NAFTA worked; of course, like anything else, it could certainly benefit from some improvements and should also be modernized for the 21st century. In an age of globalization, I believe countries should avoid bilateral agreements and instead strive for multilateral agreements, which are more efficient and typically more supportive of global economic growth. But here's what I see as the positive: There are many obstacles to the US moving forward with a bilateral deal with Mexico. NAFTA was a trilateral deal that needed Senate approval in order to be enacted. And so updating this trilateral deal would only need 51 votes; however, arguably a new bilateral deal would need 60 votes from the Senate in order for the US to ratify it. So we are a long way from seeing the US and Mexico's "agreement in principle" become an actual "signed, sealed and delivered" trade agreement.

But that's not all. Trump has also threatened to leave the WTO even though it is akin to a United Nations for trade – it is an expensive tool that the US has invested in for years in order to prevent even more costly problems. In fact, in May, the Cato Institute's Policy Analysis No. 841 warned that, "Globally, a failure by the WTO to continue to provide the framework for rules-based trade would lead to a dangerous accumulation of economic disruption and confrontation as more and more countries emulate the United States and fall back into self-defeating acts of trade restriction and trade discrimination of all kinds."[2]

Finally, there is also the heightening tension with China as the US moves swiftly to apply tariffs to an additional $200 billion in Chinese goods as early as this coming Thursday. All in all, I expect the trade situation to get worse before it gets better. And that may impact the economy and markets in a variety of ways, as I've noted in previous blogs.

Italy seeks to balance its needs with the EU's

Italy announced last week that its budget will "calm investors." These soothing words from Italy's deputy finance minister helped to assuage concerns after more aggressive rhetoric in recent weeks from Italian officials, and Italian sovereign bonds made gains. However, it's hard for me to understand how Italy will be able to reconcile its needs and wants with the rules laid out for fiscal prudence by the European Union (EU). In short, I expect risk premia to rise for Italian sovereign debt in September.

Emerging markets feel the pressure

Several emerging markets countries with the greatest vulnerabilities are coming under increasing pressure, particularly Turkey and Argentina. Indonesia is feeling substantial pressure, with the rupiah falling to its lowest level in more than 20 years.[3] Turkey's central bank seems to be indicating that it will raise rates. However, Argentina has raised rates and its currency still sank, so we need to recognize that central bank tightening is no panacea and may not alleviate any pressure at this juncture. In the shorter term, I believe the situation is likely to worsen, especially given expectations that the Federal Reserve (Fed) is very likely to raise rates at the end of the month, which could place more pressure on emerging markets. However, I expect bargain hunters to be out sniffing around soon given the potential for serious mispricings as the entire region may be painted with the same brush.

Tech regulation may be on the horizon

Trump is also focusing his attention on the technology sector, threatening to regulate companies such as Google. The great irony about these threats is that the Trump administration has helped boost gross domestic product growth as well as business sentiment through the great wave of its deregulation efforts. Threatening to crack down on tech companies in such a heavy-handed way may have the opposite effect. While it may just be campaign rhetoric, we will want to follow this situation closely as the tech sector has been such an important part of the bull market in recent years.

UK hurtling toward a Brexit deadline

September will be a critical month for the UK in its efforts to get a Brexit deal done. The pound is under pressure, and I expect that to continue. The economic policy uncertainty created by the Brexit vote and the poorly managed negotiations process is starting to show up in the data, with the UK Manufacturing PMI hitting a 25-month low.[4]

Will investors become risk off?

The recent investing environment has not been "risk off," but rather "risk aware." This has driven investors to US assets such as US stocks, which they perceive to be safer than non-US assets, as opposed to just eschewing risk assets altogether. I expect this environment to continue in September, meaning that the chasm between US and non-US assets is likely to continue as well. But we will need to follow this closely. There is always the potential for investors to move from "risk aware" to "risk off," which could lead to an abandonment of risk assets in general.

US dollar strength may continue

I expect relative US dollar strength in September as a result of expectations about economic growth and policy divergence, as well as the trade situation. We will be getting the August jobs report this Friday, and I expect it to be strong. But having said that, I still believe it's getting less likely that the Fed will raise rates a fourth time this year, as I expect cracks will begin to show in the economy as a result of trade tensions and monetary policy tightening – and the Fed may begin to worry about the pressure it is placing on emerging markets. And because expectations about Fed policy tend to have a big impact on dollar strength, I don't expect the dollar to remain as strong as it finishes the year.

Source

[1]US Chamber of Commerce, "Trade Rumors (NAFTA Edition)," July 31, 2018

[2]CATO Institute, "Policy Analysis No. 841: Was Buenos Aires the Beginning of the End or the End of the Beginning? The Future of the World Trade Organization," James Bacchus, May 8, 2018

[3]Bloomberg L.P., Gulf News, Sept. 3, 2018

[4]IHS Markit

Important information

The UK Manufacturing PMI (Purchasing Managers' Index) is produced by IHS Markit and is considered an indicator of economic health for the manufacturing sector. It is based on survey responses from senior purchasing executives.

All investing involves risk, including risk of loss.

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