Elgin asset management

investment commentary monthly

Monthly Commentary 3rd September 2019

August was not a good month for equities but a great one for bonds. World equities, as measured by MSCI World fell by 2.2%, with the FTSE being the worst major market, tumbling 5%. At the same time US Government Bonds returned a very impressive 3.59%, while UK Gilts did even better at 3.76%! An almost-6% drop in the price of US crude oil led commodities lower, with gold bucking the trend by rising more than 7%. The USD continued its march higher and is now at a multi-year high.

Bad news everywhere

There is no doubt that there has been a lot of deteriorating data on the economic front, be it a drop in German second quarter GDP, continuing slowdown in China's manufacturing sector, a much lower than expected rise in India's GDP and reduced corporate spending in the US. Add to that some toxic geopolitics such as the US trade war with China, Brexit uncertainties, tension in Japan-Korea relations, Kashmir etc etc, and one would be forgiven for reducing investment risk.

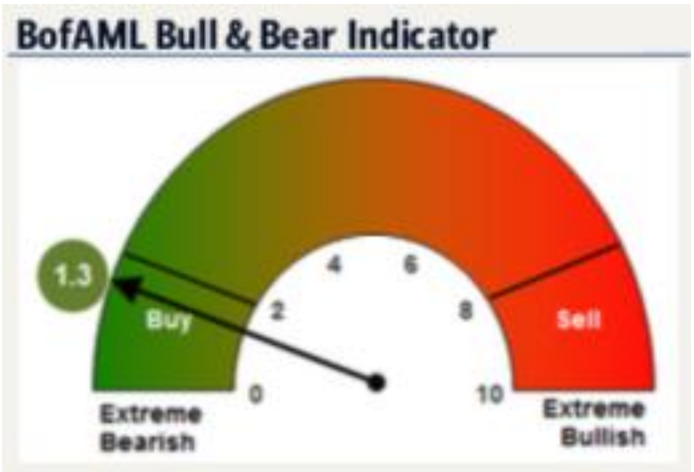
The biggest elephant in the room, and which worries most fund managers, strategists and even the Federal Reserve is the US-China trade war. So when one tries to forecast where the markets are going, it very much depends on their opinion of what happens in the trade war. While one may argue that $650 billion of trade between the two economic superpowers is "only" 3% of US GDP, and as such should not be that damaging to the US, it is the effects on corporate behavior and sentiment that matter. For example, companies with supply chains exposed to China might delay capital spending until there is more clarity on trade. This lack of spending might lead to lower productivity in the future, which in turn will lower economic growth. Another worry is that the new round of tariffs will finally start to hurt the US consumer, who is the main driver of corporate profits, and by extension the stock market.

But is it all doom and gloom?

The bond markets are usually a reliable predictor of recessions, and the dramatic recent falls in yields across the board might be telling us that a recession is indeed around the corner. But one may reasonably argue that there is a flip side to lower rates in that they decrease the debt-servicing burden for countries, companies and consumers. Not a bad thing. And with the price of oil & gas having fallen substantially lately, consumers should have more disposable income. Not a bad thing.

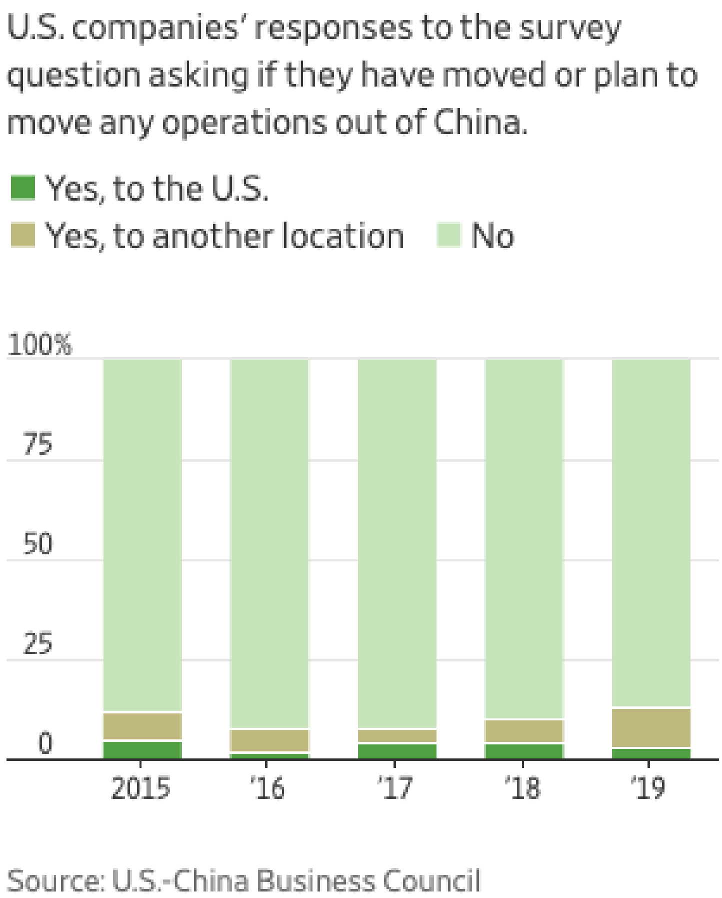
Is it all doom and gloom (part 2)?

Bank of America Merrill Lynch tracks investor sentiment through its proprietary "Bull and Bear" indicator. On a scale of 1 to 10 (max bearish to max bullish) it measures a multitude of factors by using fund flows, positioning and market technicals to quantify **investor sentiment**. When levels are extreme (below 2 or above 8) Merrill uses it as a contrarian indicator to predict where the markets might go in the near term. Last week, the indicator, shown below, fell to 1.3, indicating a lot of investor bearishness, which in Merrill's view, is a contrarian "buy" signal. The median 3-month gain for world equities after a "buy" is triggered has been a not-insignificant 7.6%. The indicator has a pretty good track record.



Is it all doom and gloom (part 3)?

With all the talk of a trade war and tariffs being imposed, American companies that are surveyed with regards to moving their operations out of China, seem to have similar responses this year to those they had back in 2015, before the trade war rhetoric was anywhere close to today's levels. The chart on the next page shows that back in 2015, 88% of US companies surveyed had no intention of moving operations out of China, while in 2019, 87% still do not intend to move out. Even more pronounced is that in 2015, 5% of companies intended to move some of their China operations to the US. In 2019, despite the US president's push for American companies to move production back to the US, only 3% said they intended to do so. What gives? We suspect that the China market is just too big - and with further huge potential - for US companies to ignore.



The Elgin Analysts' Team

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