Falco Private Office Limited
City Pavilion, 27 Bush Lane, London EC4R 0AA
Tel: 0203 946 7356

Have Markets Over-discounted the Good News?

- **Equity markets and risk assets rise as the global economy weakens**
- **The good news of a possible trade deal may prompt the Fed to tighten**
- **Market at least today prices little risk of higher rates**
- **Emerging markets to draw confidence from a trade deal and with room for better performance**
- **Environment, Social and Corporate Governance (ESG) investing - increasingly popular**

The ongoing strong performance of equity markets and higher risk bond markets, in essence, is saying the macroeconomic data is wrong and that things will get better. Since the start of the year, global equity markets have risen 11% while the global economic data has mostly disappointed. The market has taken it at face value that an agreement on trade between China and the United States may be at hand. However, our medium-term concern is that if you take away the trade war, you give the Fed one less excuse to leave interest rates unchanged. Also, we remain concerned that more deep-rooted structural challenges are holding the global economy back from stronger growth.

As a measure of how disappointing global economic data has been, recent data releases from South Korea have been particularly weak. South Korea is often a good bellwether of the momentum in the global economy. It has close trading ties with China and is a significant supplier of semiconductors to the world. Hence, it is somewhat disturbing that the recent flow of economic news has been so poor. The rate of change of the lead indicator for the South Korean economy has fallen to the weakest since 2012. Last week's trade report showed that in the first twenty days of February, exports fell 11.7% year-on-year coming after the 14.6% fall in January. The timing of Chinese New Year is distorting the data to some degree; however, exports have been weakening since October last year. Manufacturing sentiment has fallen to a three-year low, and recent labour market data showed a massive rise in unemployment to a nine-year high of 4.4%. Employers have reacted badly to the 11% rise in minimum wages.

Investor worries about the poor shape of the global economy have been put to one side as the news that the Fed was not so minded to tighten monetary policy, the US government was back to work, and the US and Chinese might not have a trade war after all.

We will hear much 'Fed speak' this week with Fed Chair Powell due to testify before Congress and the Senate and other Fed members due to make speeches across the US. Given how noisy and inconsistent the Fed has been in its communication recently, any speech from Powell can materially move markets. Given that the markets are pricing little in the way of further rate rises this year the only worry would be if the Fed Chairman suddenly announced that the Fed saw signs of strength in the economy and inflation. However, at least for the moment, the backdrop of US economic data has been poor and the Fed's preferred measure of inflation, the PCE deflator, due to be reported this week remains lower than the target of 2.0% at both a core and headline level.

The markets have received better news on the trade war front. Over the weekend President Trump and the Chinese press talked about the substantial progress that had been made in recent negotiations. We may hear more about the progress on talks between the two sides when Robert Flightier, the US lead trade negotiator, testifies before the House Ways and Means committee on Wednesday.

Would an agreement between the US and China lead to further good gains from risk assets like equities? Not necessarily. We would expect any deal to lead to a knee jerk improvement in industrial confidence around the world. Trade flows that had been patchy might be restarted, and some degree of normality might return to the world's shipping lanes. However, such an outcome would lead to the resolution of one of the factors that have held back the Fed from increasing interest rates. Remember at this stage the market discounts the prospect of no further rate rises; indeed, it prices a small probability of a rate cut early next year. If the market were to price higher policy rates this year it could lead to a wave of profit taking on equities and high-risk bond markets.

Irrespective of the noise from the Federal Reserve US Treasuries have maintained their strength and lower yields in recent months. The US 10-year government bond yield at 2.64% is towards the lower end of the range. Over the past three months, the five and ten-year bond yields have fallen over 40 basis points. Should the Fed come into play we would be more concerned for corporate credit than government bonds. The markets have tended to take the view that were the Fed to raise rates this would only lead to more marked weakness in the global economy and hence lead to lower long term interest rates.

Emerging markets have quietly outperformed against their developed market equivalents. Emerging market equities are up close to 8% over the past three months against global equities up 5.5%. Emerging market bond spreads have narrowed 45bps over the same period. The flow of economic data remains constructive for further emerging market outperformance. The economic surprise index for the emerging markets has improved led by a better data flow from China and Brazil. Chinese equities have had a reasonable rebound from their lows but could have more to go. Of all the major emerging markets Chinese equities are still showing heavily negative performance over the past twelve months (13.7% for the Shanghai composite).

A trip to Thailand this past weekend reminded me of the fundamental need for investors to invest in the sustainability of the planet and to discourage waste and destructiveness in corporate behaviour. Visiting Jim Thompson's House in Bangkok, we tourists were reminded that Buddhists build a small temple whenever they build a new house to apologise to the Gods for disturbing the earth. It is one small example of an ancient appreciation that whatever footprint we leave on this planet it must not be destructive and if it disturbs, we should find ways of making amends.

ESG (environmental social and corporate governance) investing is becoming more mainstream as each year passes. ESG investing as at 2016 accounted for $22 trillion of assets (according to Global Sustainable Investment Alliance). An article in last week's FT pointed to the increasing influence of ESG factors on the credit rating decisions. Fitch recently announced plans to show transparently how ESG factors influence credit scores, S&P include ESG assessment in their analysis as do Moody's Investor Services. Investors increasingly see ESG considerations as more important than investment returns. A survey last year showed that almost three-quarters of Dutch investors were prepared to forego some investment return for their investments to score well on ESG criteria.

Gary Dugan – *Investment Committee Member*
Bill O'Neill – *Non-Executive Director & Investment Committee Chairman*
25th February 2019

The information contained within is for educational and informational purposes ONLY. It is not intended nor should it be considered an invitation or inducement to buy or sell a security or securities noted within nor should it be viewed as a communication intended to persuade or incite you to buy or sell security or securities noted within. Any commentary provided is the opinion of the author and should not be considered a personalised recommendation. The information contained within should not be a person's sole basis for making an investment decision. Please contact your financial professional at Falco Private Office before making an investment decision. Falco Private Office are Authorised and Regulated by the Financial Conduct Authority. Registered in England: 11073543 at City Pavilion, 27 Bush Lane, London, EC4R 0AA