

2019 The Markets So Far and What Next.

Following a pretty bad final quarter in 2018, markets had a good first quarter 2019. The reasons for the rebound included a) the fact that markets overreacted in 2018 to growth fears and the US Fed sending too hawkish a signal, and b) the US Fed retracting its hawkish message and aligning with the Chinese and European central banks in accommodative policy. The global economy continues to cool as trade tensions maintain a damper on growth, loose monetary policy faces diminishing returns and loses some of its impact, and the natural fatigue of a long period of growth sets in.

Many factors can drive markets but only one or two do at any one time. Earnings growth may be slowing and valuations may have recovered but the U turn of the Fed in signalling policy from hawkish to dovish, and the ECB finally caving to evidence of weak Eurozone growth, together with the PBOC making large scale liquidity infusions to address slowing growth in China, all together represent significantly expansionary liquidity conditions. These have driven and will continue to drive markets higher. That growth and earnings will moderate mean that valuations will get richer and there may be more caution in the markets as it heads higher. This is no bad thing in the short term.

Since the driver of equity returns has been looser monetary policy, bonds have rallied in unison. Also, since the momentum behind returns has also been due to a rebound from an overreaction to bad news, we can explain the relative performance of certain markets. The most liquid and retail investor populated markets suffered the most volatility, fell most against their valuations and rebounded most. Chinese equities were priced for recession in 2018 when reality was a moderate slowdown. The actions of the PBOC to supply liquidity

and cut funding costs have buoyed the Chinese equity market and are likely to continue to drive that market up. European equity markets have also done well as the ECB has back tracked on its intentions to raise rates. In fact it has replaced QE with repo operations that represent quasi QE. The Indian market, which did well last year, has fared less well this year as political risks loom with the elections already underway.

Liquid credit did very poorly in Q4 2019 and subsequently rebounded strongly. The initial sell off was triggered by fears of tighter policy and slowing growth hitting both duration and credit spread simultaneously. The sensitivity of credit to liquidity exacerbated the impact. Both the ECB and the Fed backtracked on normalization. The ECB had been too optimistic on Eurozone growth and had to replace QE with a similar policy while the Fed signalled a pause in rate hikes and balance sheet normalization. The rebound was equally as sharp as the declines the past quarter and occurred in both duration and credit. As a result, floating coupons underperformed fixed coupons. The liquidity impact was also reversed. Basically, CLOs and loans suffered smaller losses and experienced smaller rebounds compared with the bond market which fell harder and bounced higher.

What does the rest of the year hold for markets?

The expectations for slower growth are well founded and telegraphed. This will validate looser monetary policy which will continue to support asset markets. However, as slower growth becomes more evident, the strength of the rally should fade. On a net basis, liquidity should beat slower growth and markets should trend upwards albeit at a slower pace. In equities, this favours more levered companies. In debt markets, this favours duration over credit. Given the extent of weakness in Europe, this theme will be more pronounced in EUR and Eurozone issuers than in USD or US issuers. Already there has been rotation from loans and CLOs to bonds and this

should continue further into the year.

A word about oil. The collapse in the oil price in 2014 was due to the Saudi's flooding the market in reaction to increased US shale production. The collapse in the oil price in 2018 was due to the Saudi's over producing beyond their quotas in reaction to the recovery in US shale production. The market is highly manipulated or managed if you are more diplomatic and strong short to medium trends can result from these interventions. In the longer run, that's 3 to 5 years, the industry hasn't invested in sufficient capacity and shortages will result. In the longer term, the rotation to cleaner energy sources will limit the demand growth for oil.

At some point the markets will turn and fall but there will be specific triggers for this. I cannot, of course, see what these triggers are, but can guess at the conditions necessary for this to happen.

Interest rates head higher. This could be because of inflation, which is unlikely, causing central banks to reassess their policy. Central banks might reassess their policy because of a rebound in growth prospects as well but this is equally unlikely. Rates could head higher if fiscal positions weaken and sovereign issuance rises relative to demand. This is more likely.

Politics could be a trigger and is always unpredictable. Europe has elections, India is in the midst of them, the US will be preparing for them. Inequality continues to sustain populism, no bad thing unless that populism takes on a lazy, cynical and later aggressive posture. Politics would have direct impact on risk assets as well as sovereign rates. The list of potential political dislocations is long and deserves separate comment.

A crisis in a specific market such as Chinese debt, US loans, corporate bonds, is unlikely. We are more likely to face a

whole host of smaller problems, although they might coincide in terms of timing. The banking system has always been the coordinating factor in financial crises and the reform and regulation of the past decade have made banks safer and less of a systemic threat to the economy.

The level of debt in the global economy is high and rising and a problem but it is a latent one. It requires a catalyst without which it is likely to grow quietly in the background. We have found various innovative solutions to funding this growing debt and avoiding a disruptive repricing. Anything that threatens the debt service, which is most sensitive to interest rates, will catalyse the repricing. So while the level of debt is a problem, it is already too big for us to worry about, we should focus on the level and path of interest rates. Given the structure and organization of the economy, society and politics, it is unlikely that the debt level will be significantly addressed or reduced for some time to come.