Heartwood Investment Management

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Investment Insight

Weekly Insight

March sees renewed market volatility

Recent market volatility stands in sharp contrast to the becalmed environment of 2017. Selling in the last few days has been led by the technology sector, prompted by threats of industry regulation in response to concerns around Facebook's oversight and control of data provided to third parties. The tech-heavy Nasdaq 100 has declined 7.8% in sterling terms in the month-to-date (-5.7% in US dollar). While these developments have been sector specific, they have also come on top of growing worries about US trade policy, a softening in global growth momentum and a modest deterioration in US financing conditions, as seen through the rise in three-month US dollar rates (a benchmark used to price inter-bank funding costs).

Do these forces threaten our positive economic outlook for this year?

We expect that the cyclical upswing enjoyed by the global economy since the first half of 2016 should be sustained this year. A key driver will be US activity, which is expected to firm as a result of US tax cuts and infrastructure spending. While acknowledging that global manufacturing surveys have moderated in February and March from peak levels, particularly in Europe and Japan, they still remain at multi-year highs. Our sense is that some unwind of euro and yen currency strength versus the US dollar would be helpful to Europe and Japan, but either way we still expect the growth outlook to be supported. Global capital expenditure is rising and consumption remains supported by strong labour market momentum, with developed economies continuing to see ongoing job gains and falling unemployment rates.

What are the challenges to this more positive assessment?

There are two key risks: the impact of tighter financing conditions and the potentially larger risk of US trade policy.

1. Tighter financing conditions: We do not think that the rise in three-month US dollar libor rates is a statement about the health of the global financial system; rather it seems to be a function of higher levels of short-term bond issuance from the US Treasury, a pressure which should subside in the near term on seasonal factors. Moreover, broader financing conditions remain accommodative as developed economy central banks are tightening monetary policy very gradually, with Europe and Japan yet to get started. In the event that higher US libor rates persist, we would expect US Federal Reserve policymakers to issue more measured language which would help to support confidence, and therefore market sentiment.

2. US trade policy: The 'America First' agenda was not an issue in 2017, but President Trump seems to have shifted tack, tilting the balance of his administration in favour of appointing officials who are considered to be more 'nationalist' than 'globalist'. Announcements of US tariffs on Chinese imports and measures to restrict Chinese investment in key US technologies have contributed to the market's disquiet.

While not dismissing any of these US policy risks, we believe that a full-blown trade war is an unlikely prospect at this point. We think it would be wrong to take the headlines at face value. With an eye on the mid-term US Congressional elections later this year, Trump's tariff announcements, so far, appear to present more showmanship than substance. Indeed, their economic impact is likely to be

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dwarfed by US fiscal policy easing. The trade measures are also in keeping with how Trump negotiates deals: seizing the headlines before peddling back towards a more pragmatic position. This tactic has been deployed in re-negotiating the North American Free Trade Agreement, which now appears to be making some progress. Treasury Secretary Mnuchin is hopeful that a deal can be reached with China soon, while China's response to date has been somewhat measured and tempered.

Are we taking any action in portfolios?

We are monitoring events very closely given their fluidity, but we do not feel it is necessary to take any action at this point. One or more of the following would help to underpin market sentiment: a few positive economic data surprises, some weakening in the euro and Japanese yen, supportive central bank language, and/or progress in reaching bilateral trade deals.

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