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August 28, 2019

Market Volatility Update

Global equity markets have sold-off in August, triggered by a surprise tariff announcement by President Trump and disappointing economic data. The MSCI ACWI index has fallen 4% for the month through August 26 and 5% from its July 2019 high. Interest rates have plunged, which has led to strong returns for bonds. The Bloomberg Barclays Aggregate Bond index has risen 2.3% in August.

What Happened?

On August 1, President Trump announced that he intended to place a 10% tariff on a further $300 billion of Chinese imports on September 1. China's retaliation was swift, ordering state-controlled entities to suspend purchases of US agricultural products. In addition, China allowed the renminbi to depreciate against the dollar, a move seen by many as preparedness on the part of China to "weaponize" the exchange rate. The US Treasury responded by formally designating China a currency manipulator. While the label is mostly symbolic, it was a further sign of the deterioration in US/Chinese relations. Since then, the US administration has delayed some of the tariffs until mid-December and has scheduled new talks with China, although this provided only limited relief to markets.

The latest trade escalation has added to nervousness over the economic outlook. Trade uncertainty has contributed to the slump in business investment in 2019. And it has come at an inopportune time as global growth is undergoing a cyclical slow down. Manufacturing purchasing manager's indices are in contractionary territory in much of the world. Growth in China still shows no evidence of turning up.

Bond yields have reacted by moving sharply lower. The US bond market has priced three additional rate cuts by the Fed in 2019, which would take the target rate down to a range of 1.25% to 1.50%. The US 10y Treasury fell towards 1.5%, a level last seen in mid-2016. On August 14, the closely watched US 10y-2y spread, a historical indicator of recessions, inverted for the first time since the lead-up to the financial crisis.

Implications for Investors

Mercer does not advise any urgent actions for investors. Following a 17% rebound in global equities in the first half of the year, a 6% drawdown is not surprising in consideration of downside trade, economic and earnings surprises over the past month. We have noted in the past that late cycle environments tend to produce bouts of equity volatility. This is the sixth 5% or worse drawdown in equities over the past four years. Equities have gone on to fall more than 10% in four of these, so it wouldn't be surprising to see further downside over the short-term.

Mercer will continue to watch for signs that the economic outlook is turning more negative. We will also be on the watch for opportunities should the market sell-off more significantly in the coming weeks and months.

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