RISK ON THE HORIZON

PERPETUAL INVESTMENTS
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The convergence of a number of significant issues present challenges for markets and investors. These matters have yet to play out on the global stage. For many, there are no precedents and no telling how their resolution may impact economies, markets and investors. The importance of rigorous analysis and sound investment principles is exemplified during such 'interesting times.'

In a moment of absolute clarity and disarming honesty at Jackson Hole a few weeks ago, Dr Philip Lowe, the Governor of the RBA, let slip a few truths central bankers rarely speak.

"We are experiencing a period of major political shocks. Political shocks are turning into economic shocks. Monetary policy cannot deliver medium-term growth. We risk just pushing up asset prices."

It seems a long-held belief that politics is a mere slave to global economic forces in the era of the 'great moderation' and ever-expanding global trade, could be wrong; in fact, the reverse could take hold. It was an admission that monetary policy is exhausted and impotent, a decade after so much faith was invested in it to carry the entire global economic recovery.

Ironically, investors may be about to be tested by some of the biggest political shocks yet.

Firstly, we are fast closing in on a Brexit showdown. Anything could yet happen, but this is the most concerted effort by the Brexiteers and Remainer factions to bring the issue to a head. Prime Minister Boris Johnson has pledged his credibility on leaving the EU by 31 October, deal or no deal; at the same time, Remainers in his own party have sided with the opposition to make unprecedented moves to gain control of the parliamentary agenda and stop a no deal exit.

Parliament and the courts may force the government to seek an extension to Brexit, but there is no guarantee the UK would even get an extension from the EU, as Brussels is starting to tire of the whole Punch and Judy show of UK politics.

It's very messy and uncertainty could skyrocket in the last two weeks of October, especially if the government suffers a no confidence vote and the Parliament cannot agree on a new Prime Minister. This is to say nothing of the uncertainty should there be a messy departure from the EU, which would almost certainly constitute the biggest shock that Lowe has referred to.

The Europeans must be breathing a sigh of relief. Take away Brexit and Europe itself is in an even bigger mess; Germany is on the economic skids and extreme anti-euro parties are threatening to take control of several countries, including Italy, which has the largest (and unsustainably high) public debt in the region. That could make Brexit look like a picnic.

The other issue that could tip things over the edge is the ongoing Sino-American trade war. Although tensions have eased somewhat in recent weeks, promising negotiations have been derailed several times before. Indeed in May it came down to differences over text in the final agreement. When Trump campaigned on the trade deficit in 2016, many saw his long standing protectionism (which extends back decades) as an aberration among policymakers. Some saw it as simply a campaign tactic, quickly to be discarded. His campaign however, ignited latent issues in the electorate and body politic.

While Trump's worries about trade seemed a fringe issue three years ago, it has gradually become mainstream as security agencies and companies have buttressed concerns. Analysts have sharpened their focus on Xi Jinping's rising global ambitions and the implications of – and means by which – 'Made in China 2025' would be achieved. It has the potential to gut much of the US's tech leadership, much like it stripped the US's industrial might over the last 25 years.

Critics will suggest Trump continues to overstep the mark with raging tweets, although his 'mad man' approach to North Korea may yet pay dividends. There are also theories that he doesn't want a deal; it's just a tactic to strongarm the Fed into lowering rates ahead of an election year or maybe even an excuse to have a kind of 'khaki election' or (trade) war election.

There would be a perverse logic to this, especially if the economy is already tanking as the US votes. Trump cannot control the economy, but he might be able to control the narrative around a trade war. Whereas previous Presidents dropped bombs to get voters to rally around them, Trump would be dropping more tweets and tariffs during a campaign.

But we're still a long way from this. Both countries have signalled a willingness to get back to the negotiating table although inking a deal with tangible commitments will be very hard. The longer the hostilities continue, the greater the cost. Moody's estimates suggest it has already cost 300,000 US jobs as consumers pay billions per month in higher tariffs. Tariffs appear to have weighed most heavily in the mid-west where key manufacturing and farming businesses are located. This is not sufficient to cause a recession on its own, but with the US economy now in its longest ever expansion, rising risk and uncertainty cannot be great this late in the cycle.

Xi Jinping's speech in late 2017 and Vice President Pence's response late last year were much more profound than realised by many at the time. Like the US and Russia post 1945, it appears the strategic interests of China and the US may have sharply diverged after an 'era of co-operation' that could well be over. While we may already be in the early stages of a new type of Cold War, it's worth remembering that even in that post 1945 period the global economy boomed for decades.

Many things have been taken for granted by markets and investors – ever expanding global market access, unfettered trade links, open architecture information technology and exchange across countries. This could all be disrupted by the new realities. Despite this, markets continue to trade near all-time highs, with low volatility, conditioned by a decade of massive and unconventional stimulus. Indeed, markets remain remarkably sanguine about these and other risks on the horizon. The business of investing for clients goes on, but investors need to be on the lookout for the re-emergence of risk and be invested accordingly.