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Weekly Market Flash

Melt-Up In the Making?

October 11, 2019

This past week we finalized our regular quarterly commentary, summarizing the main goings-on of the recently ended third quarter and opining as to what may lie ahead. "Lots of noise and elusive growth" roughly encapsulates our take on the global economy in the months to come. While that outlook may lend itself to intermediate-term portfolio allocation decisions on the more conservative side of the risk-return tradeoff, as we have suggested, it does not mean that the directional trend will be a one-way trip down. Indeed, there is a case to be made that a melt-up – a frenzied run-up in risk asset prices with little regard for the quality of individual names – could be in the near-term cards. Whether that happens or not will depend not so much on the underlying structural context, but on the optics of headlines, primarily those surrounding the US-China trade war and to a lesser extent some new developments in Brexit.

Exodus from Quality

You frequently hear market pundits toss around the term "crowded trade" and may wonder what they are talking about. A crowded trade is just another term for momentum, and for much of this year the momentum has been with higher-quality assets, e.g. ultra-safe government and high-grade corporate bonds, rich dividend-paying stocks with relatively predictable size and timing of cash flows. Recession-resistant consumer staples names have done well; industrial manufacturers tied to the ups and downs of the business cycle (and vulnerable to the trade war) have fared poorly in comparison.

The more crowded a trade gets, of course, the more expensive it gets. Supply and demand. At some point, the price of entry intimidates new demand, and the price of exit becomes appealing as soon as the rationale for staying in the trade looks weaker. For example, high dividend stocks are great if fixed income interest rates are hovering in the low single digits (or, even more so, in negative territory). If bond rates suddenly back up, that dividend yield play suddenly looks much less enticing.

Enter the Headlines

To an almost absurd extent, the market has been obsessing over the US-China trade war for a good part of the last eighteen months. The issue is important, of course, given that we are talking about the two largest economies in the world and what the future of global trade will look like. But the daily market moves throughout this period have tended to react in exaggerated fashion to headlines which in turn mostly emanate from the Twitter feeds of the principals involved in discussions, most of which are light on content, heavy on empty platitudes, and not infrequently outright misleading.

You are probably aware that trade negotiations are going on this week in Washington. Given how the market has been reacting, it would be tempting to think that something momentous is brewing. It's not: there seems to be a reasonable probability for some kind of modest truce, or what the pundits are calling a mini-deal, that would essentially hold off on higher tariffs for a while and help US farmers sell a few more agricultural products to China. Nothing about this truce, if it does in fact happen, will in any meaningful way address the real structural problems between the US and China that have always been at the core of the dispute. But no matter – this is all about optics, not substance. A "mini-deal" is a better outcome than a no-deal, and that's all the trader-bots need to indiscriminately fire up the buy orders.

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Tiptoeing Over the Low Bar

But wait, there's more! A melt-up is even more likely when a second piece of kindling is tossed onto the fire alongside the main catalyst. Playing second fiddle to the trade war happy talk is, of all things, Brexit. Just in the last twenty four hours evidence has emerged that the EU is ready to green-light "serious" talks with the UK to work out the seemingly insurmountable obstacle of Northern Ireland (i.e., the problem of a "hard border" between Northern Ireland, which is part of the UK, and the Republic of Ireland, which is and will remain part of the EU). The details about how this would work are not known. What is known is that UK Prime Minister Boris Johnson and Irish Taoiseach Leo Varadkar believe a deal is within reach after meeting on Thursday, and EU Council president Donald Tusk is convinced the sides are close enough to an outcome to bring the EU team back to the table. Just two days earlier, any of this would have seemed the least likely of options. But Tuesday's "chasm" turned into Thursday's "bridgeable gap."

Now, asset markets outside the UK haven't paid much attention to Brexit to date. But the general consensus is that in the scheme of things a smooth, managed Brexit would be preferable to a hard crash out of the EU. Not as good as just staying in the EU, of course. Just like a truce in the US-China trade war is preferable to another scaling up of tariffs or putting limits on US investment flows to Chinese assets. Not as good as going back to the pre-tariff world, and far short of the even more desirable outcome of a constructive solution to the actual problems at the heart of this economic relationship.

But good enough, for now. Good enough for a melt-up, perhaps. But the problems, including the more structural problem of elusive growth, are not likely to go away any time soon.

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