

Market Update

Seeking calm in a sea of trade unrest in 2018!



Reed Smoot and Willis Hawley: Two Villains of 20th Century History?

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The Voice for Reason

Comments and Views for the Individual Investor

(March 31, 2018)- One is reminded of late of the lessons learned almost a century ago at the start of the 1930s when the US Congress passed the Smoot-Hawley Tariff Act which orchestrated the imposition of over 900 tariffs on imported product into the United States. This legislative bill was enacted under the Republican controlled Senate and House under the presidency of Herbert Hoover. Today historians are almost universal in their belief that the Smoot Hawley Tariff Act of 1930 promulgated a protectionist wave that quickly spread globally and eventually lead to the Great Depression of the 1930s.

As we come to the end of the 2nd quarter of the year, the Trump Administration's attempt to negotiate better trade terms through hard knuckle tactics of unilateral announcement of import tariffs on steel and aluminum products on March 1 as well as the March 22 announcement to impose tariffs on 1,300 product lines from China will surely meet with retaliation from the Chinese side. One can only hope that the recent trade tensions stoked by the Trump Administration will not lead to a longer more prolonged sequence of protectionist actions and tensions.

We live in a less than perfect world when it comes to trade policies in most countries. The Theory of Original Sin applies; no country on the planet is a saint! However, the progress made on free trade, negotiated in global forums on a multi-lateral basis and spirited by the WTO accords (which China joined in 1995), has resulted in freer modern trade world than ever existed before. The prosperity of the world has gained enormously from freer and fairer trade over the past three decades. However, the digital and information age revolution still has left many behind. With an ever expanding gap between rich and poor, educated and poorly educated, urban and non-urban in every country, it would be a pity if global GDP drops as a result of increasing trade protectionist actions. Nobody wins a trade war.

What investment opportunities should one look for in the coming months? We have enjoyed a wonderful decade of bull markets in the equities. Since 2009, the S & P 500 has expanded by an annual average of 17.0%. However, the combination of trade tensions as well as the shifting away from low interest rate environment will likely unsettle the equity markets and create more stock market volatility. In the first quarter of 2018, the sectors of information technology, financial, and healthcare stocks have been the best performing sectors. Higher borrowing rates will eventually impact companies that are too highly leveraged. Stick with companies who have sound balance sheets and are sector market leaders.

Also watch the US Treasury 10 year yield. It has been below 3% for the past several years. However, yield level at the end of the first quarter were near the 2.85% level. If 10 year yields push past 3%, you will likely see increased incentive for investors to shift more into fixed return assets rather than keep money sitting in high dividend yield stocks.

1) Don't totally abandon the equity markets-

Corporate profits have not been disappointing in 2017 and into the first quarter of 2018. There is still a chance that we will end 2018 with higher equity indices than when the year began. However, expect higher volatility in the equity markets in 2018.

Information technology remains a sector that enjoys structural upside. The themes of artificial intelligence and cloud computing remain compelling. Healthcare, particularly in China, will become an increasingly attractive sector for investment. Figures show that there will be 340 million Chinese aged 60 or older by 2030 (a 300% increase since 1990). Healthcare spending per capita and as a percentage of GDP (6%) in China remains low compared to many developed countries and will certainly be increased in the coming decade as part of China's "Healthy China 2030" campaign .

2) Seek opportunities to invest in senior credit note instruments-

They may be a better investment than an ordinary bonds. Why? Senior loan notes normally roll over every 3 months and, if the US Fed continues to raise short term rates, these instruments will rollover at higher rates for investors.

Another attractive feature of senior loan notes is that they often have a lien on company assets and in rare cases of default they retain a much stronger recovery rate (80%) versus normal bonds (30%).

As bond yields begin to edge higher, beware that bond prices are inversely related to yields. Stay with short term durations in the bond markets (3 to 5 year maturities) and take note of opportunities with floating rate notes.

3) Be selective in choosing alternative investments-

Gold- This precious metal has traditionally performed well in times of global geo-political chaos, high inflation, and has relatively low correlation with equity markets. Holding some gold in a portfolio is a good insurance against sudden chaos in the equity markets. However, over investing too large of one's portfolio asset allocation into gold is called "speculation," not investing!

However, gold prices become vulnerable in the face of rising interest rates. The U.S. Fed under new Fed Chairman Jerome Powell raised short term rates by 0.25% on March 21 and one can expect a slightly more hawkish posture from the new leadership compared to outgoing Chairperson Janet Yellen. Banks are now quoting monthly time deposit rates in the 1.70% range. There is a wide consensus of banks predicting at least two more Fed rate increases in 2018. Gold pays no interest;. Rising time deposit rates incentivize investors to place more cash into short term deposits rather than gold. Don't go overboard investing in gold!

Hedge Funds-

The past decade have not been kind to many hedge funds. According to Banque Julius Baer, hedge funds have only achieved an average annual return of 2% since 2009, vastly underperforming compared to the 17% average annual return of the S & P 500. Hedge Funds as an asset class come in so many forms. It is not fair to write-off the entire class of funds. There are still many outstanding hedge fund managers in the industry. However, be discerning in one's selection of such type fund as the sector has lost its luster.

Footnotes:

- i) This edition's cover page features a photo of US Senator Reed Smoot (R-Utah) and Willis Hawley (R- Oregon 1st) who were the architects of the controversial Smoot-Hawley Bill in 1930. Both politicians would be out of US Congress by 1933 as well as then President Herbert Hoover who was swept from power two years later when Franklin Roosevelt was elected in 1932.
- ii) The Theory of Original Sin allegory is taken from the Augustine Christian doctrine that asserted that "man is born a sinner" and in life will have a tendency to disobey. Pundits often cite this theory as a way of saying in the secular world that "we all have our faults and nobody and no nation is perfect."
- iii) Hedge Fund Return statistics for last 10 years is based on the Hedge Fund Research Group (HFRX), the leading daily and monthly hedge fund performance benchmark, shows an aggregate dismal 24% return (or average 2% p.a.) for the past decade.



About the author:

Bruce VonCannon is a native of North Carolina USA and currently a Managing Director with Vanheel Management Ltd., a Hong Kong SFC and U.S. licensed independent asset management firm founded in 2002. His career spanning 27 years in international banking and wealth management has included assignments in New York, Taiwan, Hong Kong, Singapore and Geneva. He is a frequent speaker at financial seminars, universities, and business forums and author of “A Guidebook for Today’s Asian Investor” (2017) published by Palgrave Macmillan.