Falco Private Office Limited
City Pavilion, 27 Bush Lane, London EC4R 0AA
Tel: 0203 946 7356

Now for the Policy Response

- **Policy makers finally respond to the collapse of asset markets**
- **Fed Chairman signals an adjustment to thinking**
- **Equities enjoy a rebound but US government bond yields unmoved**
- **Markets hoping for, but nor discounting an end to trade wars**
- **European policy makers unmoved despite weak economic data and fall in markets**
- **Chinese authorities chip in with a loosening of monetary policy**

So, the collapse in financial markets finally got to them. The policymakers had to respond to the damage in financial asset markets eventually. Fed Chairman Powell was the first major policy maker to blink. In his speech last Friday, he held out an olive branch to the financial markets by saying "with muted inflation readings that we've seen coming in, we will be patient as we watch to see how the economy evolves". In a further break with comments after the last Fed meeting, he made mention that the Fed could adjust its tapering of quantitative easing. The Fed blinked, and the markets rallied.

Meanwhile, the markets can't be confident of any substantial response from the US government. President Trump is hunkered down in his bunker waiting to build more Mexican wall while Capitol Hill is locked down due to a lack of a budget.

Hope for a further recovery in the markets will rely on this week's renewed trade talks between China and the United States in Beijing. One would have hoped that the fall in the financial markets would have brought more pressure on both sides for a deal to be struck. However, the markets shouldn't expect any immediate resolution. The talks are being held between more junior members of the negotiating teams. It is more likely that a likely meeting in Davos between Donald Trump and Xi Jinping would bring a more substantive outcome.

China has recently made some conciliatory moves by drafting new rules that would limit technology transfers. They have also promised to buy more US products and improve access to foreign companies. One hopes that the US leaves behind its triumphal rhetoric that invariably characterises China as the biggest danger to the global economy. There must be face-saving for both sides of the argument for a genuinely substantive and long-lasting agreement to be achieved.

The knee-jerk reaction in markets on Powell's speech was for the assets that have fallen most to rebound by the most. Hence, we wouldn't read too much into last Friday's recovery. It was telling, however, that the US government bond market was mostly unmoved with the US 10-year government bond yield at 2.67%. While Mr Powell's words of comfort helped risk assets, they only reinforced from the bond markets perspective the view that interest rates are close to peaking at a substantially lower yield than ever before. For equities, this implies that valuations will be challenged by lower long-term growth than previously envisaged.

Mr Powell also perhaps more meaningfully adjusted the language on the use of quantitative easing suggesting that the Fed might change the pace and scale of any reduction in QE dependent on market circumstances. Only a few weeks ago Mr Powell had said that QE reduction would go ahead as planned. Such flip-flopping on policymaking doesn't do anything to reduce the volatility of markets and undermines the credibility of Fed policymaking.

European asset markets have been poor performers over the past year, and that looks likely to continue given the weak economic data. The European economy remains under pressure. Even more than the US, the region needs some help given that both industrial confidence and inflation appears to be ebbing away. Eurozone inflation for December was well below expectations (1.8%) at just 1.6% compared to 1.9% in November.

We believe it unlikely that the eurozone policymakers will deliver anything material in support of markets at this juncture. The ECB does not appear minded to pulling back from, in essence, freezing its QE programme and leaving interest rates unchanged at near zero. Equally the eurozone governments don't seem minded to spending their way out of a mini-crisis in the financial markets. After all, Italy was reined in by the eurozone governments when they targeted a relatively modest expansion of government spending.

Despite the ongoing poor data from the eurozone the euro didn't manage to make any meaningful progress against the dollar in the past week. The euro has lost 6% against the dollar over the past three months. The dollar trade-weighted has largely maintained its firmness against other currencies and does show signs of any remarkable weakness for the moment.

The dollar's performance led to some profit taking in gold although it appears to be short-lived. From a peak of $1298, profit-taking took it down to $1280. However, in early trading this week the metal is on the rise again suggesting that retail demand, in particular, is persistent. For technical analysts, $1300 remains a critical level. Should the price break through $1300 to the upside we would see a fair amount of follow-through momentum buying.

China is one further potential source of policy stimulus. Although the authorities have tended to have a real mixture of policy to deal with their domestic challenges it appears that policy is set to be more accommodating as we move through 2019. Income tax changes will be stimulatory, and last week the central bank relaxed lending to the small and medium-sized enterprises. The latest changes should add around $130 billion of liquidity into the market.

If someone can take a two to five-year view, it's probably right to be considering an investment in Chinese assets. A 12-month return of -26% from the Shanghai index looks at the very least 'interesting'.

Gary Dugan – *Investment Committee Member*
Bill O'Neill – *Non-Executive Director & Investment Committee Chairman*
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