Trade tension and Brexit are two long-running stories for investors and on Tuesday the cracks in the ground for markets are a little wider. Some water is required to nurture risk appetite, and soon.

The latest trigger of risk aversion arrived after the Trump administration blocked a group of Chinese technology companies from buying US-made goods on the grounds of alleged human rights abuses in Xinjiang. With trade negotiations due to resume on Thursday, this latest escalation in the tech rivalry between the US and China is hardly grounds for expecting good news at the end of the week in Washington. Instead, sentiment awaits the scope of retaliation from Beijing.

Talk of a capital war is also weighing on sentiment, while technology shares are duly under pressure. That has broader equity benchmarks on the defensive, although the lows of last week (via weaker US economic data) remain intact for now. The tidings from Jay Powell this afternoon in Denver that the Federal Reserve will resume bond purchases (just don’t call it QE) only briefly alleviated selling pressure on Wall Street. A late-afternoon flare-up in trade war concerns over visa restrictions on Chinese government officials linked to Uighur detentions saw the S&P 500 close at a session low on the day.

Trade angst leaves the FTSE All World index on course for another test of its 200-day moving average, a measure of momentum that has largely held since February, when equities were enjoying their “new year” rebound. Amid the gloomy headlines, equities are holding on for a sliver of relief from the upcoming trade discussions.
In contrast, the S&P 500 remains some 2 per cent above its 200-day MA and still leads global equities by some margin in performance terms so far this year — the All World index excluding the US is only up 7 per cent in 2019, a performance that rises to 11.5 per cent, once the S&P 500 is added.

Such a divergence between the US and global equities is not seen lasting argues Oxford Economics, who say “there are reasons to believe that the US will lead the way down” starting with the prospect of declining S&P 500 earnings for the third quarter.

“The US is also where valuations are currently most stretched with the “billier” cyclically adjusted PE at almost 30x, versus just 23x for MSCI ACWI, a near record low. And it is also the epicentre of our concerns on corporate leverage given the prevalence of share buybacks in recent years.”
European equities and UK domestic shares have also been knocked by the latest Brexit developments, namely, the prospect of a deal at next week's EU summit looks dead in the water. That has weighed on the pound, versus the dollar and the euro, but currency weakness duly stemmed the selling in the UK's FTSE 100 as multinational gold miners headed the blue-chip leaderboard on Tuesday. The FTSE 100's loss of 3.7 per cent in October, now edges the FTSE 100's drop of 3.6 per cent, as Brexit drives the market conversation, rather than global and US economic weakness.

The upshot for markets of Tuesday's telephone conversation between Boris Johnson, the UK prime minister, and Angela Merkel, the German chancellor, is that Brexit will probably be delayed after the current October 31 deadline, followed by a snap general election.

More broadly, Tuesday's weaker tone for equities is limited to some degree as bond yields have also declined.

The US 10-year Treasury yield at one stage headed towards 1.5 per cent, a drop of 8 basis points from its high earlier on Tuesday. Beyond risk aversion, news that US core producer prices fell in September by the most in more than four years, was another supportive element for the rally in Treasury prices. A similar read from US consumer prices data due on Thursday, will keep the door open to further easing by the Federal Reserve at the end of the month.

Earlier on Tuesday, I sat down with Campbell Harvey, a Research Affiliates partner and a professor of finance at Duke University here in London. In the 1980s, Cam was a pioneer in looking at how a flattening yield curve foreshadowed a broader economic downturn.

With the 10-year yield back around 1.5 per cent, it remains below that of three-month bills, sustaining an inversion that has largely prevailed since late May. In the past, periods of sustained inversion have been a signal that the economy faces a recession over the coming 18 months.

What strikes Cam as being different this time (a truly dangerous term) is how the news of the current yield curve inversion has resonated far more publicly than prior bouts in 2006, 2008 and 1989. While more attention on the inverted yield curve does increase the chance that the risk of recession becomes a self-fulfilling prophecy, Cam thinks the attention today may help moderate the pain of the next downturn as businesses, consumers and investors prepare for slowing growth. One notable sign of this is how US money market funds have risen 14 per cent to $3.46tn since mid-April, and the highest level since late 2009.

Cam says the yield curve model reflects the future prospects for growth and helps improve risk management. “Why would you ignore this information,” he asks. “Once you get a warning signal, you should get more defensive.”

A defensive strategy has defined equity positioning for much of the past year, so investors are prepared for a soft landing. Whether trade friction and other shocks such as Brexit are contained is another matter as 2020 approaches.