Butterfield

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June 2019

Global strategy

Tariff man strikes again

As we progressed through the first four months of the year, investors became increasingly comfortable that the sharp market correction in the fourth quarter of last year was sufficient to discourage President Trump from pursuing further aggressive trade policy. The assumption that a trade deal between the US and China would be forthcoming was an important factor in the very strong start to the year for equity markets. However, the relative calm was then punctured on 5 May when President Trump announced that the 10% tariffs imposed on $200 billion of imports from China would be increasing to 25%. Furthermore, that the balance of around $325 billion in goods would also be subject to 25% tariffs "shortly". The Sunday evening tweet was accompanied with a somewhat enigmatic message that "the trade deal with China continues, but too slowly, as they attempt to renegotiate. No!"

According to Reuters, the reason for Trump's outburst and sudden escalation was that China had systematically edited the nearly 150-page draft agreement and "in each of the seven chapters of the draft trade deal, China had deleted its commitments to change laws to resolve core complaints that caused the United States to launch a trade war: Theft of US intellectual property and trade secrets; forced technology transfers; competition policy; access to financial services; and currency manipulation". This rapid deterioration in the negotiations is clearly a negative for financial markets and has led to increasing references to deglobalisation. We have written extensively about globalisation since 2016, although it isn't as simple as saying that globalisation is now going into reverse. Ultimately, globalisation is a spectrum, where the rate of change is also very important. Specifically, there is a big difference between a targeted trade dispute between the US and China, compared with the US pursuing isolationist policy versus the rest of the word.

Global strategy

Tariff man strikes again

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Unfortunately the evidence here is mixed. On the one hand, President Trump has delayed proposed auto import tariffs while negotiations continue with the European Union and Japan, but on the other hand threatened to impose 5% import tariffs on Mexico relating to the flow of Central American migrants. We know that Trump has long held views on perceived trade unfairness, with comments suggesting that tariffs should be imposed on Japan as long ago as the late 1980s. Furthermore, we know that to a large extent Trump is constrained by congress, but tariffs is one area where he is capable of wielding significant executive power.

One of the consequences of the first phase of tariffs (25% on $50bn and 10% on $200bn) has been that imports from China to the US have fallen sharply, while imports from South Korea, Taiwan and Vietnam have surged. Therefore, the big question is have we seen genuine production shifts or has it been minimal processing then onward shipment? Given the speed of the shift it is likely to be the latter; we know that low value-add manufacturing has been moving out of China for a number of years.

Overall, there is no doubt that the potential upending of global supply chains built-up over decades is a real risk for the equity market. The bond market has taken the view that a trade war would be more deflationary than inflationary, and this is probably right, even though there might be some short term inflationary impulse.

We were never in the camp that believed there would be an all-encompassing trade deal between the US and China, as this is about far more than just the trade balance. It's a difference of ideology and ultimately supremacy, of which technology is a very important factor in today's world. The extent of this recent escalation is somewhat surprising. The stock market remains the ultimate barometer for Trump and is likely to act as a deterrent, such that we get specific and targeted action rather than all out deglobalisation.

Fixed income

Failure to launch

After a period of consolidation, global government bond yields and credit spreads markets were rocked by trade tensions, which for the most part had recently faded from view. A few evening tweets suggested that not only is the threat of tariffs now the preferred method for gaining concessions, but also that no country is safe. This led to a very sharp rally in yields as market participants re-priced their expectations for global growth and longer term inflation expectations. Granted, the US has many genuine reasons to target unfair Chinese trade practices, but any action of this scope almost certainly impacts the global economy in a negative way, even if the duration is short term.

Prior to the trade uncertainties in May, we had been seeing extremely positive developments within leading economic indicators which boded well for a recovery in growth during the second half of 2019. These green shoots are now in serious jeopardy as the global economy has failed to launch – hence the rally in defensive assets. The US administration is likely to dial down the trade rhetoric, however the US Treasury market believes that the damage has been done and a recession is on its way.

This rally in bond yields has been sharp and fast with the whole US Treasury curve shifting downwards, leaving two year rates at 1.92% (down -34bps) and ten year rates at 2.13% (down -37bps). This was partly driven by lower inflation expectations, with ten year inflation break evens -21bps lower, but also a much lower growth outlook and term premium. For US short term rates, the market is now pricing in a 95% probability of one 25bps cut in interest rates during 2019, up from 67% last month. This dovish tilt comes after the Federal Reserve has already given the market a good dose of dovish medicine earlier in the year. Risk assets have remained stable due to the prospect of monetary policy bailing out a reckless US administration. Make no mistake, policy makers are being forced down this route and most members would prefer an extended period on hold rather than encourage speculative behavior in risk assets.

Fixed income

Failure to launch

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With very short dated interest rates now higher than longer term maturities, investors are not rewarded for taking term risk given that three base rate cuts over the next year are now fully priced in by markets. Long dated bonds are therefore only attractive as a recession hedge, although considering recent market movements, a case can be made that this trade may have passed. As we referenced last month, due to central banks globally manipulating their bond markets, there are few assets that will act as an effective hedge for when the next recession does come, which explains the demand for US Treasuries. Therefore, a further weakening in economic data could spur additional haven flows in the short term.

This fragile backdrop has led us to tighten up our underweight duration positioning slightly by adding some duration exposure. Investor positioning in US Treasuries remains stretched, leaving the market prone to bouts of extreme volatility if the trade situation shows any signs of a positive outcome, so we remain very cautious.

As we have communicated since February, we have been reducing credit risk across portfolios and still believe this is the correct course of action given the negative news flow and signs of weak global growth. However, the recent rise in credit spreads has opened up some pockets of value and we have been selectively adding back some exposure where the risk/reward outlook is favourable. We see relative value in shorter dated financial maturities, which carry a higher spread than other sectors. They look set to be the main beneficiaries from a steeper yield curve as either short term borrowing costs are lowered and/or the flight to quality premium in longer dated US Treasuries unwinds. In addition, with monetary policy adding stimulus to the US housing market, we have been adding exposure to high quality agency mortgage backed securities. These allow us to capture a spread over US Treasuries, but with much lower volatility and higher liquidity than corporate bonds.

Equities

Equity rally stalls

The rebound in equity markets stalled in May as investors were reintroduced to issues surrounding global trade. The MSCI World had touched all time high levels in late April, but investors turned jittery in May, sending the index down -5.8%. The MSCI World, despite May, has returned +9.7% in 2019, a strong recovery from the fourth quarter 2018 correction. China appears to have responded to US sanctions on Huawei, a Chinese technology corporation, with threats of curtailing sales of rare earth metals. Rare earth metals are used in the production of many products ranging from electric vehicle batteries, to pharmaceutical drugs used to treat certain cancers, so there is a wide reaching impact of any decision from the Chinese.

The first quarter earnings season wound down as the trade talk heated up in May. S&P 500 earnings growth was mildly positive for the quarter, a much better result than consensus expectations. Continuing a several year trend, US companies sourcing the most revenue outside US borders have seen their earnings estimates cut the most, with those companies most exposed to China bearing the brunt. Looking forward, there appears to be a small chance of an earnings recession in the second and third quarters, however the base case is for positive readings. Earnings estimates are showing negative year over year growth estimates in the second quarter, and only mildly positive growth in the third quarter. Typically, earnings recessions coincide with falling markets in the short term, but rising markets within 12 months of the event.

Equities

Equity rally stalls
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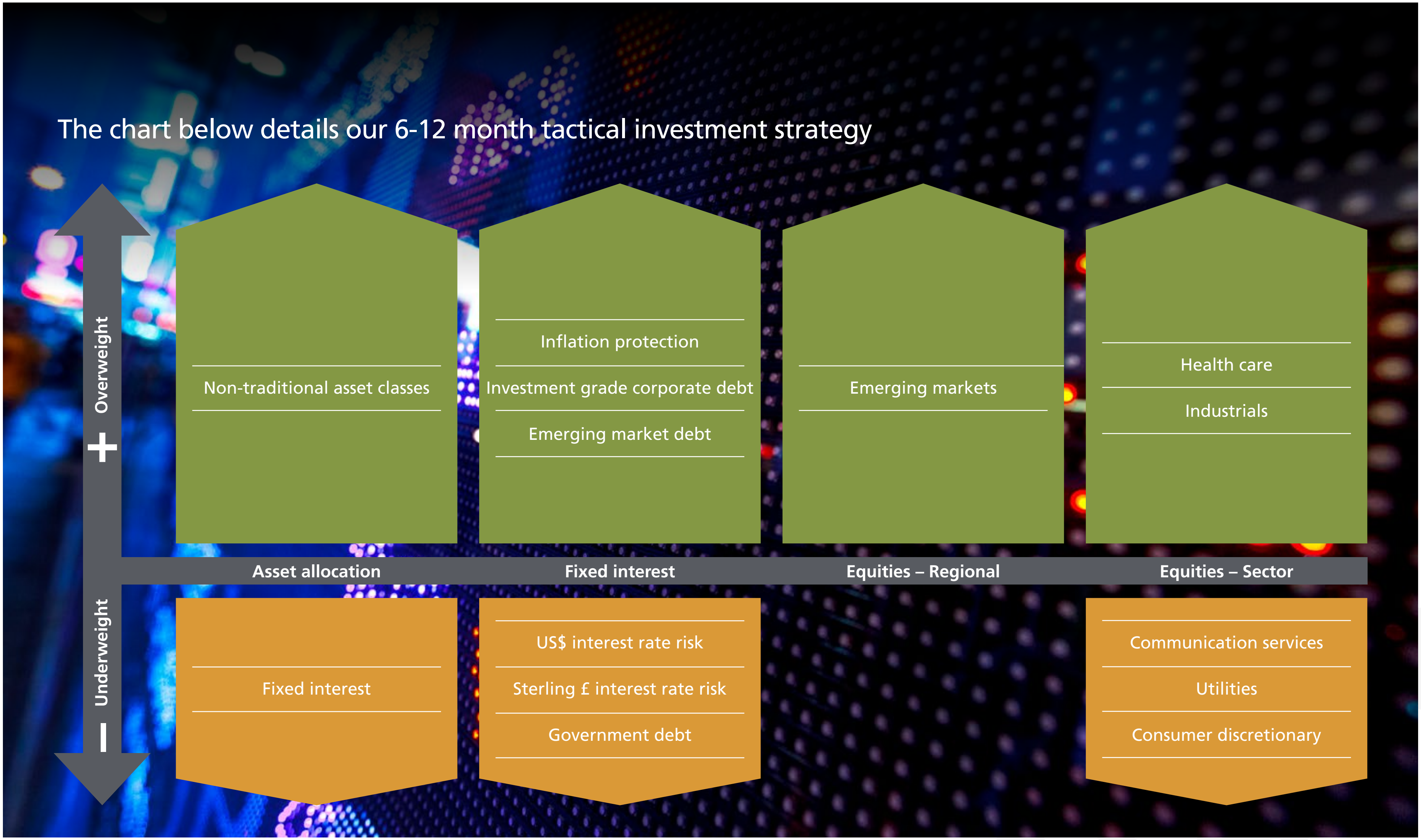
At a sector level, the strongest performers in May had a defensive and interest rate sensitive flavour. Real estate, utilities, and health care all outperformed their peers. Technology was the worst performing sector, falling -8.4%, pulled lower by the semiconductor sub-sector – a market increasingly caught in the trade war cross fire. We continue to focus on software companies within technology – as there is less of an impact of global trade and political risk on this cohort of companies. Unsurprisingly, given the S&P 500's reliance on the technology sector, US equities underperformed the MSCI World, falling -6.3%, while Europe fell -5.5%, and Japan fell -4.0% for the month.

Global equities have formed a trading range over the past 17 months, coinciding with the beginning of global trade tensions. There are other factors clearly at play, but it is impossible to ignore the impact of the trade war – global earnings are falling and the multiples that investors are willing to pay per dollar of earnings have fallen as global risk has risen.

Global asset allocation



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