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Equity markets hit by intensification of trade dispute

Market Comment, May 2019

As we recently explained, the combination of low volatility (anticipating a "perfect world") and expensive stock market valuations at the end of April was not a realistic reflection of the economic fundamentals. These pointed to – and continue to point to – a global economy of doubtful strength, with weaknesses particularly apparent in the emerging markets and Europe. Moreover, the markets had already factored in a rosy, tension-releasing trade deal between the US and China. Yet anyone who has read Trump's book "The Art of the Deal" can hardly have been surprised by his announcement of another ramping-up of tariffs against China, from 10% to 25%. A correction in equity markets, which in some cases were at record highs (such as the US) or had recorded significant rises since the fourth quarter of 2018 (such as the emerging markets, particularly China, but also cyclical sectors) comes as no surprise to us. We had prepared for such a scenario by scaling down our equity weighting in April, specifically our exposure to the emerging markets.

The start to the year was well above the historical average for the equity markets, with both the S&P 500 and the SMI surging to new record highs. This development was fuelled by hopes that the Fed's suspension of its tightening of monetary policy via interest rate increases would herald an end to the economic weakness that was apparent in many countries. However, the majority of leading indicators for the global economy have not changed, and continue to flag up risks to both economic and earnings growth. The latest surveys of the confidence of purchasing managers from the manufacturing sector in both China and the US have disappointed market expectations. On this side of the Atlantic, the European Commission has been forced to cut its forecast for European economic growth in 2019 even further. Indeed, GDP growth for Germany this year has been slashed from 1.1% to 0.5%, with the Commission warning of further risks to the European economy. Given this backdrop, the volatility expected by equity markets should not be languishing at what are still historically not high levels.

To compound the situation, US President Trump announced an increase in punitive tariffs against China at the start of May, namely from 10% to 25% on US imports with a value of USD 200 billion, as well as threatening to extend these tariffs to all Chinese imports. The equity markets were not prepared for this development. Indeed, they had anticipated a positive, tension-releasing outcome to the trade dispute, as is clear from the strong rise of cyclical equities generally and Chinese stocks in particular since the start of the year.

> "At our mid-April Investment Committee meeting we scaled down our weighting of emerging market equities, which are particularly sensitive to developments in the trade conflict."
>
> Gérard Piasko, Chief Investment Officer

Donald Trump's threat ratchets up the pressure on China, which has so far provided only limited stimulus to the economy while at the same time increasing the risks for the emerging markets and the global economy as a whole. Of course, it is quite possible that this recent announcement was just a form of negotiating tactic, as described by Trump in "The Art of the Deal". But if the US and China fail to reach a positive agreement to resolve their trade dispute soon and the risks of a further escalation of this conflict increase, global equity markets – and above all the emerging markets – could come under even greater pressure.

The longer these trade tensions persist, the greater the negative fallout for the markets and the economy. This is particularly true given the fact that the US economy is now particularly dependent on the so-called "wealth effect" of equity markets, given that consumer spending is the largest component of gross domestic product in the US and in the past has reacted very sensitively to equity market developments.

As an additional factor – and as mentioned in recent publications – the US equity market is now very lavishly valued. What's more, all equity regions have recorded sharp increases in valuations since the start of the year. Europe and above all the emerging markets are at least as sensitive to any renewed increase in trade tensions, as cyclical equities (i.e. stocks that are heavily dependent on the economy) and those of export-oriented companies are heavily weighted in these markets.

China has reacted to the US tariff increase of 200 billion US dollar value of goods with a tariff increase of 60 billion US dollar value of goods against the USA. In the eyes of many market participants, this increases the likelihood that US President Trump will also be able to raise tariffs on the remaining Chinese US exports of 325 billion US dollars. This is important because, of the Chinese goods affected by customs duties to date, only some 25% of the total relates to consumer goods. If the remaining Chinese exports are subject to tariffs, around 60% of them would be consumer goods, mainly technology and electronics products - hence the stronger reaction of technology stocks.

Either way, it is clear that the longer the trade conflict persists, the more the uncertainty over corporate earnings growth will be priced in by the equity markets. Where the negative economic repercussions of punitive tariffs are concerned, a distinction needs to be made between direct and indirect consequences. The direct consequence of these trade tariffs is likely to be a decline in GDP growth of around 1% for the Chinese economy and around 0.4% for the global economy. However, these direct consequences could be further exacerbated by indirect negative repercussions, such as an additional deterioration in consumer sentiment (increase in the cost of consumer goods) or business sentiment (more expensive imports and declining Chinese demand due to a weaker economy), particularly in cyclical and export-oriented sectors with significant exposure to China. We explored this issue in greater detail in our earlier market commentaries relating to the trade conflict.

Cyclical sectors of the equity market and regions with higher sensitivity to global economic developments are more risky in such an environment than the shares in which we have recently built up positions for safeguarding purposes – namely, the "Min Vol" equities (i.e. stocks that exhibit lower market volatility) and the more defensive equities with growth potential ("defensive growth plays").

Gérard Piasko

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