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Illumination: Equity strategy and market outlook

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Global perspectives: Beware the incentives

- **The US vs rest of the world trade confrontation is becoming the dominant narrative.** A trade war may not make sense to many investors but does now represent a potentially serious challenge to the global trading system. We also cannot rule out at this point that negative responses in financial markets may be a prerequisite to negotiating a face-saving route out of the situation for all sides.
- **Earnings estimates show few signs of the impact of tariffs or disappointing UK and eurozone economic data.** Despite a significant slowing of economic momentum in the UK and Europe, consensus (I/B/E/S) forecasts there still call for 8-9% 2018 earnings growth on a median basis. In the US, profits forecasts have stepped up in recent months. The median US company is now expected to deliver close to 20% earnings growth in 2018.
- **Offsetting the benefits of strong US profits growth is the prospect of tighter US monetary policy and larger fiscal deficits.** US bond market investors still have to contend with rising short-term interest rates and a substantial increase in the issuance of US Treasuries to finance Trump's tax reform. Furthermore, this is happening at the same time as the US Fed attempts to reduce the size of its balance sheet. The recent trade protectionism-related flight to safety is understandable but in our view current US 10-year Treasury yields still appear too low in the context of rising US interest rates and a substantial increase in Treasury issuance.
- **Emerging market (EM) policymakers are becoming concerned with the Fed's US-focused monetary policy.** Unfortunately for EMs, with US growth boosted by a pro-cyclical fiscal stimulus and unemployment below target, we believe the Fed is likely to stay the course for now. As a result, emerging markets appear set to continue to struggle during 2018, even if earlier studies suggest a classic EM liquidity 'crisis' seems some way off.
- **There is no change to our cautious outlook.** We continue to believe developed equity markets are in a period of consolidation. Valuations are moving closer towards long-run averages by markets simply trading sideways as profits grow while monetary policy is normalised. Over the last month, downside risks have, in our view, increased as the rhetoric on trade has sharpened considerably across both the Pacific and Atlantic.

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Trade war: Beware the incentives

Will only a correction get politicians to agree a face-saving solution?

The rhetoric on trade continues to escalate. In recent days, the US administration has indicated that it will impose additional restrictions on foreign investment in US strategic industries while China's President Xi Jinping has reportedly stated in a private meeting with US chief executives that China will not turn the other cheek but will punch back. Both leaders at present appear committed to a collision course. On the face of it, the US is taking aim at China's ambition to be a significant global power in economic, political and technological terms. China, on the other hand, could be seen to be overplaying its emerging market status.

We can understand that many investors will struggle to understand the US administration's trade strategy. It is well known that the goods deficit the US carries with the rest of the world is not the whole story. Corporate tax strategies and a reliance on intellectual property (IP) or technology based information businesses mean that the raw trade numbers may seriously overstate the US trade deficit with the rest of the world.

The truth is the first casualty of a trade war

For example, US\$50bn of annual Apple sales in China do not appear as a US export, nor is the California-generated IP used to build them recorded in the trade data. After being built by a sub-contractor in a bonded zone in China, China-destined iPhones are reportedly sold to Apple's Irish subsidiary before being imported into China. To add to the confusion, each of Apple's China-assembled iPhones in fact widen the US trade deficit when imported into the "domestic" US market, despite estimates of China's value-add being only \$10 per device. Sophisticated international tax planning, endemic in new, high-growth industries therefore has the by-product of creating large distortions in the trade data.

However, in this trade war the first casualty is likely to be the truth; investors therefore need to quickly move onto the incentives for continuing hostilities. The perceived political gains for Trump are to be seen to be strong on trade and in support of the American worker. Therefore, backing down from the confrontation now established with both the EU and China without a face-saving deal is likely to be difficult. [We do however acknowledge that Trump's foreign policy has proved unpredictable elsewhere; North Korea has moved from pariah status to a potential member of the world economic community in less than a year. Furthermore, confirmation that the Congress-supervised CFIUS process for review of foreign purchasers of US assets, rather than a procedure based on an executive order, represents a pragmatic softening of the US position and a modest win for trade doves in recent days.]

US could hide its strength and bide its time – but it is not a vote winner

Within 15 years, the US may be overtaken by fast-growing China as the world's largest economy. However, the US still dominates in many important areas, such as use of currency, capital markets, technology, intellectual property, international business and banking. In addition, there is no reason why these areas of specialism should not continue to grow if such activities remain competitive and inward investment is welcomed.

Rather than tariffs and restrictions on investment, the optimal strategy to maintain influence over the long term would appear to be to further amplify and firmly embed this US infrastructure – whether financial, intellectual or monetary – as widely as possible. This, however, requires a long-term perspective and has close to zero immediate electoral appeal. 'Saving' current US blue collar jobs is an easier message to communicate to voters, compared to providing an economic framework to support the prospective job market of the future. Furthermore, the beneficiaries of

tariffs are concentrated in key voter constituencies while the loss of consumer purchasing power is diffuse with, initially at least, limited voter impact.

In the eyes of China, US policy could also be viewed as misguided. The “Made in China 2025” initiative, although recently downplayed in public, aimed at moving up the value chain to secure a greater share of the global economic value-add. To take the same iPhone example, China may envy the US\$200 accruing to Apple per device compared to the paltry US\$10 accruing to Chinese assembly.

Therefore, in some respects Trump’s tariffs on China’s goods industry and restrictions on technology transfer only serve to validate the “Made in China 2025” strategy, and increase the pressure for China to move up the value chain independently of the US. Furthermore, if China cannot turn sufficient profit in older industries or high-tech assembly, it may in China’s eyes also seem counterintuitive to see a higher-cost nation such as the US incentivise investment in such unproductive areas of the global economy.

We view the escalating trade rhetoric with increasing concern. Due to its political drivers in the US, and in combination with the highly unlikely prospect of China choosing to forego its full role as the world’s largest economy, including mastery of the most challenging and sophisticated future technologies, the risks of a prolonged conflict are clear.

Fighting a trade war on two fronts carries additional risk

The US administration has also caused a significant shock in terms of the US/EU relationship. It was only recently that EU officials were rebuffed in their attempts to seek a tariff waiver for imports of basic commodities. Now, US officials are working on the national security implications of imported cars from the EU. The attraction of national security concerns is that they allow the imposition of tariffs or other measures without breaking WTO rules.

The US would certainly not be the first nation to invoke rather intriguing national security concerns to protect domestic industry from foreign competition or investment. Inward investment in China is also subject to significant restrictions. Even in developed markets, French President Macron could equally be cornered by the 2005 “Danone Law” aimed at preventing PepsiCo from launching a bid for Danone, on the basis that yoghurt manufacture was also in some way strategic. In 2008, the French government also activated a €20bn policy of taking stakes in French companies deemed of national importance to dissuade potential international bidders. With these precedents, foreign investment restrictions appear, unfortunately, less of a novelty.

For EU policymakers, after placing “gesture” tariffs on goods produced in Trump’s electoral strongholds (bourbon, jeans and motorcycles) the next step for the EU is not so obvious, as it runs a surplus with the US. We would expect a digital tariff to be high up on the agenda, not least because a digital turnover tax has been proposed by the EU commission only earlier in the year.

It must have been frustrating for the EU to have failed to grow a domestic digital economy like the US. In addition, traditional EU firms have been placed at a tax disadvantage compared to sophisticated US digital or e-commerce players. We believe US tech may represent the next level of any escalation in tensions. Reportedly, Apple executives believe prior regulatory delays in iPhone product approvals in China carried a political dimension. We note the recent market underperformance of the US tech sector, for which 60% of revenues are overseas compared to 30% for the S&P 500 overall.

Trade tariffs are a well-worn path to confrontation and a reduction in economic productivity and growth which is perhaps why there are few academic supporters and also concerns being raised by international organisations such as the IMF or BIS. It is becoming increasingly clear however that political positions in China, the US and EU are hardening. However, without a priced-in market ‘cost’ (and by implication a ‘victory’ when a compromise deal is reached), there is so far little

incentive for politicians to discuss a solution. We therefore see increased reason for running a cautious portfolio positioning as a global market decline may be a prerequisite to a resolution on trade.

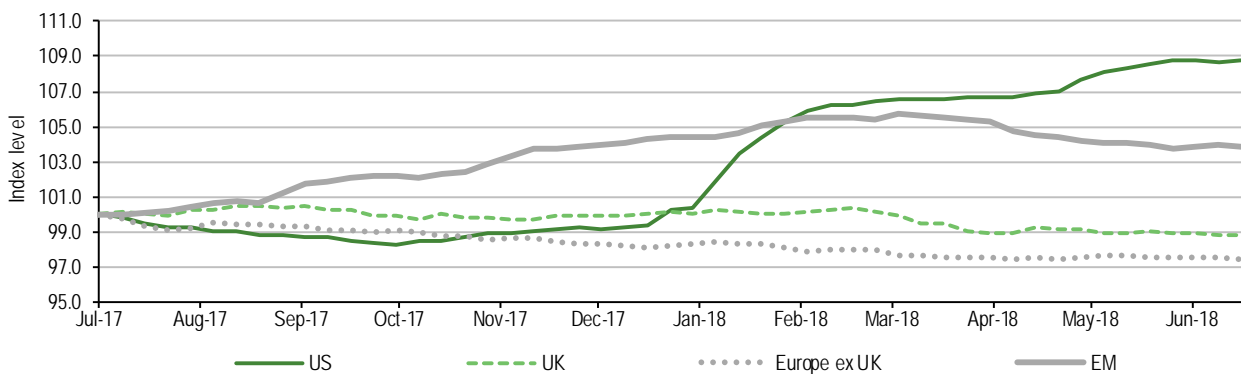
Earnings revisions: No sign of a trade war (yet)

US estimates rising again while Europe and UK remain stable

Even as tariffs dominate the headlines, the impact on the corporate sector has to date been limited to a few high profile announcements such as Daimler or Harley-Davidson who respectively have highlighted US tariffs as a reason for lowered guidance and relocation of production.

Yet despite a significant slowing of economic momentum in the UK and Europe, consensus forecasts there still call for 8-9% 2018 earnings growth on a median basis, unchanged over the last quarter. In the US, profits forecasts have stepped up again in recent months. The median US company is now expected to deliver close to 20% earnings growth in 2018 according to I/B/E/S consensus estimates. Therefore, while there remain legitimate concerns and 'headline risk' in respect of US trade policy, in our view strong profits growth offers a meaningful counterweight to the negative developments in international trade.

Exhibit 1: Unweighted consensus earnings revisions index for 2018

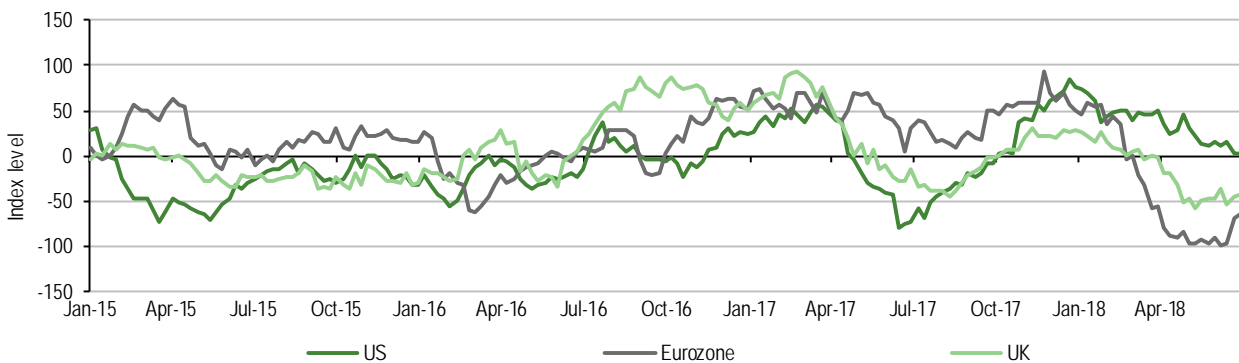


Source: Thomson Reuters I/B/E/S, Edison calculations

As Exhibit 1 shows, there is relatively little to say about European earnings forecasts. Consensus estimates have remained remarkably stable on a median basis over the last three months and have risen on a weighted-average basis (not shown), in part due to currency depreciation over the period.

This currency depreciation is in our view a belated reaction to the divergence in economic prospects between the US and Europe. Despite some improvement over the last week, eurozone and UK economic surprises remain firmly in negative territory, Exhibit 2. In contrast, the Atlanta Fed GDPNow model has risen to indicate a very strong 4.5% annualised growth in US GDP this quarter.

Exhibit 2: Continued weakness in Eurozone and UK economic surprise indices



Source: Thomson Reuters

For US estimates, we note a helpful second leg higher in recent weeks. The US economy is perhaps starting to deliver some of the benefits of the fiscal stimulus introduced at the turn of the year. Typically, estimates rising this strongly would be expected to result in stronger market performance than we have seen year to date. However, offsetting the positive news on profits is a US Federal Reserve which appears determined to continue on its path of normalising US monetary policy, even as volatility builds in emerging markets.

Despite this volatility, earnings estimates for emerging markets also appear to have stabilised in recent weeks after falling from the peak reached in Q118. Full year 2018 EM earnings growth is also still forecast to be over 15%, a figure which suggests that weaker EM performance may be due to investors re-positioning for a stronger dollar rather than fear of weakening corporate fundamentals.

Global implications of rising US bond yields

Tighter monetary policy and larger US fiscal deficits point to higher yields ahead – and a higher risk premium for emerging markets

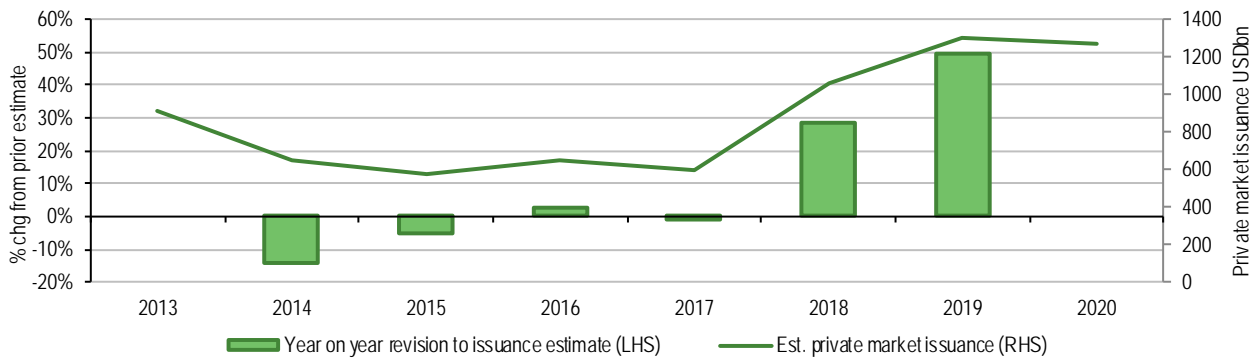
Events in Italy during early June may have highlighted a crowded short position in long-term bonds, with US 10-year yields falling by 0.25% to 2.75% during a week of political uncertainty. However, US bond market investors still have to contend with rising short-term interest rates and a substantial increase in the issuance of US Treasuries to finance Trump's tax reforms. Furthermore, this is happening at the same time as the US Fed attempts to reduce the size of its balance sheet. Current 10-year yields appear too low in the context of a continued economic expansion and emerging market policymakers are becoming concerned.

A recent opinion piece in the Financial Times by the governor of the Reserve Bank of India, Urjit Patel, suggests that the recent turmoil in dollar funding in emerging markets has arisen not because of rising interest rates but because of the combination of increased issuance of US Treasuries to finance US tax cuts and the simultaneous reduction in the Fed's balance sheet. Patel is not alone among emerging market policymakers in becoming concerned; Indonesia's recently appointed central bank governor Perry Warjiyo has also expressed similar views recently.

Patel states bluntly his opinion, as the head of one of the world's leading emerging market central banks, that unless the US Fed responds to this increased US Treasury issuance by adjusting its plans to shrink its balance sheet, a crisis in EM dollar funding markets is inevitable. He also highlights the recent reversal of capital flows, with foreign capital now fleeing emerging markets at the rate of US\$5bn per week. In his view, the Fed should change course on its balance sheet reduction programme which was in any case designed before Trump's tax cuts became a reality.

Unsurprisingly for a senior central banker, his views are confirmed by the substantial upward revision to expected US Treasury issuance over the last 12 months as a result of US tax reform, Exhibit 3. Compared to expectations a year ago, an additional US\$260bn of US Treasuries will have to be absorbed by private markets in 2018 and US\$430bn in 2019. The US fiscal deficit is forecast to remain close to 4% of US GDP from now until 2022, rather than 2.5% over this period only a year ago. The additional funding requirements are therefore substantial and will place upward pressure on long-term US interest rates.

Exhibit 3: Significant upward revision to US funding requirements in 2018

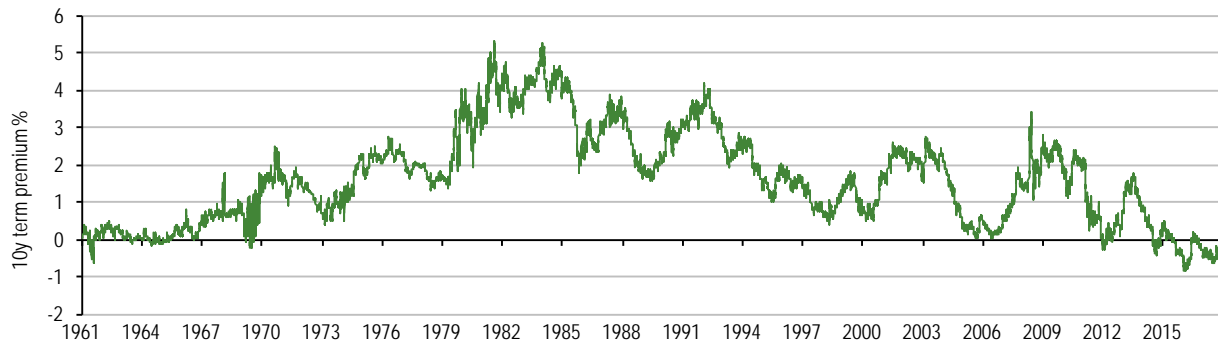


Source: Treasury Borrowing Advisory Committee (TBAC) presentation

In some respects, this easing of US fiscal policy is exactly what the US Fed hoped for - only much earlier in the cycle. Earlier this decade, there was ample slack in the economy and below target inflation which would have created the conditions for policy rates to remain low even as borrowing expanded. However at this juncture, the Fed's room for manoeuvre is more limited with unemployment at 3.8%, below its long-run estimate of 4.3-4.7% and inflation already close to target.

There is also a significant amount of Fed credibility invested in its current policy of gradually normalising US monetary policy, both in respect of interest rates and the size of the Fed's balance sheet. In terms of the Fed's balance sheet, Fed Chair Powell stated in November 2017 that the balance sheet would decline by US\$1.5-2trn over the next three to four years, and at a rate of US\$50bn per month by late 2018. This compares to a peak level of quantitative easing of US\$85bn per month earlier this decade. However, following the implementation of December's US tax reform, this quantitative tightening will occur during the same period that the US will be running a 4% fiscal deficit.

In terms of figures, while there is necessarily significant uncertainty, academic estimates suggest that each incremental 1% increase in the US fiscal deficit corresponds to a 0.25% increase in US bond yields. Following the 2% increase in the forecast fiscal deficit over the last 12 months, this indicates upward pressure in the region of 0.5%. The impact of the Fed's quantitative tightening is also difficult to estimate with precision, not least because it is unprecedented. However, term premium estimates published by the Federal Reserve Bank of New York indicate that 10-year yields may have fallen by as much as 100bp due to the impact of quantitative tightening, Exhibit 4.

Exhibit 4: Term premium compression due to QE may be reversed with quantitative tightening


Source: Federal Reserve Bank of NY

Therefore, we would be inclined to put the impact of a deliberately gradual US quantitative tightening at not more than 0.5% over the next 18 months. Finally, there is the steady recovery of inflation expectations close to 2% and rising estimates of the neutral rate of interest, which Fed policymakers currently estimate at 0.8% (real). Adding these factors together suggests US bond yields should be moving closer to 4%, rather than 2.9% currently.

In respect of Patel's view that the Fed should change course on its balance sheet reduction to avoid an inevitable emerging market crisis, this would be a significant shift in the Fed's position, given its often-repeated intention to reduce the balance sheet "gradually and predictably". In addition it has also been stated that the primary Fed tool for responding to changes in the outlook is interest rate policy.

Fed policymakers will be aware of research which suggests a linkage between the flow of US dollar credit and US monetary policy. This link is not as straightforward as it may appear at first sight. When US policy rates are rising during an expansion, growth in credit provided to emerging markets is positively correlated with rising US rates, as banks search for yield. It is only when the stance of monetary policy shifts – from accommodative to restrictive – that the risk of a flight to safety out of emerging markets markedly increases. At the present time, the US Fed views interest rates as being in a process of normalisation and that they remain accommodative; therefore, at least some data do not support the view that an emerging market crisis is imminent, even if it may remain a risk for a later date.

Despite the concerns from emerging market policymakers, while the US Fed may not be on a pre-set course in respect of reducing its balance sheet, to change course would require a meaningful international dislocation in our view, justifying a switch in focus to international financial conditions rather than US domestic factors. In any case, we believe the Fed considers the primary tool for managing near-term shifts in the outlook is interest rate policy. In respect of current conditions, the spread between 2-year and 10-year rates is already uncomfortably narrow and any widening through higher long-term rates may even be welcomed in the short term.

Bank of International Settlements (BIS) data suggest that there is US\$10trn of offshore US dollar-denominated debt with approximately 30% of this allocated to emerging markets. BIS estimates also highlight derivative transactions which imply a similar additional amount of synthetic dollar liabilities. The link between US policy rates and the potentially volatile behaviour of US financial institutions in allocating credit offshore at various points of the cycle is therefore important.

For dollar-reliant emerging markets, the economic risks associated with using short-term interest rates to deter capital outflows also has many unfortunate precedents. However, at least the nature of these problems are now well understood as a result.

These gentle shots across the bows of the Fed's balance sheet reduction policy, even in the context of a strong US economy, highlight that political and economic risk may be brewing in respect of global financial conditions. Should US economic growth remain strong, US rates are likely to continue to rise. A switch to risk-averse lending behaviour by international financial institutions – if Fed policy ultimately becomes restrictive – could again lead to a repatriation of capital out of emerging markets. While current interest rates are still some way from that point, it may be a real factor in 2019. Recent emerging market volatility and the underperformance of the largest global banks in recent weeks suggests investors are starting to price this in.

Conclusion

The politics of trade are now being felt in the day-to-day movements in global markets and the US administration appears to be determined to stay on a collision course with China. Positions are hardening across the world and a market decline may be a prerequisite for resolution. While Trump may be backing away from more extreme forms of investment restrictions in recent days, this is just a further example of the policy volatility which is unhelpful for investors.

Against this challenging political backdrop, 2018 forecast profits growth has to date remained robust and 2018 profits forecasts are even rising again in the US. Notwithstanding the risks from trade, we still view the highest probability scenario for global equities as a benign de-rating, where markets trade sideways as profits grow. During this period, and absent negative political shocks, there are fundamental reasons in respect of US Treasury issuance and the Fed's quantitative tightening to expect higher US bond yields than currently prevail.

There is no change to our cautious outlook, although we are dismayed by global trade developments in recent weeks and the risk of a sharper decline – but quickly followed by a face-saving resolution on trade – has in our view risen. In a subdued equity market, investors should remain focused on company- or event-specific ideas to drive portfolio returns.

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