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Investment Update – August 2018

Overview

The world economy remains strong and the near-term outlook is fairly bright, despite the recent escalation in trade tensions. Global growth is robust as major economies continue in mature phases of an extended economic expansion.

Global Overview and Trade Tensions

Trade wars continue to dominate the global economic narrative. The US have implemented new tariffs and officials have threatened to escalate these further. US trading partners, including China, the EU, and Canada, have retaliated with their own protectionist measures.

Tensions could rise further as Mr Trump is likely to remain stubborn over concerns that some of the US bilateral trade relations are not always reciprocal and are 'unfair'. In particular Mr Trump points to some of the restrictive non-tariff measures to services trade imposed by the Chinese government. There have been some signs of de-escalation of the protectionist rhetoric. Recently the EU and US agreed to new negotiations aimed at defusing rising transatlantic trade tensions and to work together towards eliminating all tariffs, trade barriers and subsidies related to non-auto industrial goods. They also said they would work together to reform the World Trade Organization and reduce trading costs and regulatory barriers across the Atlantic. This potential ceasefire puts further tariffs, including Mr Trump's threatened 20 per cent levy on auto imports, on hold while talks proceed.

With respect to the US and China dispute, the US has formally published a list of $200bn of targeted imports from China to be subject to an additional 10% tariff. A public consultation period will commence from now until end of August. The impact of the US tariffs on Chinese imports remain small for now. Some commentators suggest the direct hit on China GDP from tariffs should be small, even including a worst-case scenario around the new $200bn list. This is likely to rise in 2019 if no settlement is reached before year end. The new announcement creates a clear risk of some further weakness in the yuan exchange rate. However, much will depend on both how the USD trades and how the Chinese government chooses to manage the yuan.

Understanding the potential risks from escalating trade tensions is tricky because there are few historical precedents and the costs would depend on the nature of the conflict. Global supply chains have been designed under the assumption of relatively free trade. Escalating trade tensions could weigh on global growth and push inflation up. This is against an otherwise positive macro outlook, with the US and Europe economies continuing to expand and their central banks responding to a more positive macroeconomic backdrop. So far however, despite the intensifying rhetoric and worrying media headlines, risk assets (i.e. shares) have remained relatively resilient recently. US equities are a few percentage points off their all-time highs and volatility remains low. Emerging markets have been somewhat more pressured, but this is largely from the impact of tighter Fed policy and an appreciating US dollar. Foreign exchange markets are the key asset class where trade tensions are being felt, and the tail risk of a currency war has emerged.

The latest IMF review warned that the tariffs on imports threatened by both Mr Trump and his trading partners could lower the annual growth rate of the global economy. The IMF still expects the world economy to grow at a healthy clip this year and next but warns the 'risks to the outlook are mounting'.

The US

The unemployment rate of 4% is near an 18-year low and the US economy has added jobs every month over the past 93 months, which is the longest consecutive stretch on record. The tax cuts and additional spending are estimated to contribute nearly 2% of GDP per annum into the US economy for the next two years. This fiscal stimulus could trigger a rise in US inflation, from stronger wages growth, over the next year or two which could be problematic for the Federal Reserve and complicate its efforts to engineer a 'soft landing' with rising rates. On the other hand, however, if economic growth were to slow substantially for some reason the Fed may be forced to reverse these interest rate rises.

Recently Jerome Powell, the chairman of the *Federal Reserve*, testified to lawmakers about the health of the American economy. Solid growth and stable inflation should, he said, allow the Fed to raise interest rates gradually. His comments helped to support a strengthening US *dollar.*

The UK

The UK seems to have made some progress towards a soft Brexit but expect no clarity on a final outcome until later this year as significant uncertainties remain.

The UK's Monetary Policy Committee (MCP) is unlikely to wait too much longer before raising interest rates. Although the beneficial effects on exports of the pound's fall may be fading, it is too soon to conclude that the sterling boost to growth is over. And with sustained rises in real wages now in prospect, GDP could rise over 2018 and 2019, allowing the MPC to raise interest rates at a faster pace than markets expect.

The EU

The *European Union* and *Japan* recently signed the world's largest bilateral trade pact. The Economic Partnership Agreement is the result of five years of negotiation. The Japanese will gradually lower their tariffs on European wine, meat and cheese, and the EU will drive down levies on imports of cars and vehicle parts from Japan. This will be welcome news for markets concerned with the direction of global international trade policy.

In Italy, ongoing political tensions are a reminder that there are no grounds for complacency on the Italian outlook. Media reports of internal conflict within Italy's Government have led some investors to question the longevity of the government in its current form. In particular, recent news raised questions about the possible resignation of the Finance Minister, Giovanni Tria. The risk is reflected in higher Italian bond yields and ultimately some the political risk relates back to the stability of the euro and dampens investor sentiment more generally.

The European Central Bank (ECB) is set to reduce asset purchases fully by December and with the Fed shrinking its balance sheet too, "global" QE is on course to end in Q4 this year. However, market participants are sceptical that the euro-zone hits the 2% target inflation on a sustained basis any time soon and the divergence in monetary policy between the Fed (continuing to tighten and hike interest rates) and the ECB (maintaining low and accommodative interest rates) could grow wider.

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Emerging markets

The growing threat of a US-China trade war is the key risk to the outlook for both emerging market currencies and equities. Even if trade tensions don't worsen GDP growth in Emerging Asia has peaked and is likely to ease over the coming year.

Emerging Europe growth is likely to slow over the medium term. The sharpest slowdown will come in Turkey, where the recent sell-off in the lira and dramatic tightening of financial conditions will push inflation higher and hit their economy hard.

Australia

A combination of tightening credit conditions and easing house prices will be a key concern for the Australian economy. The rise in headline inflation to be within the Reserve Bank of Australia's (RBA) 2-3% target range for only the first time in 15 months was due to a jump in petrol prices. There is not much price pressure elsewhere and, with underlying inflation having fallen back below 2.0%, the RBA is unlikely to raise interest rates soon.

New Zealand

At home the rebound in CPI inflation in the second quarter, from 1.1% to 1.5% (Reserve Bank of New Zealand (RBNZ) figures), is encouraging, but with growth potentially slowing, inflation is unlikely to be strong enough to warrant interest rate hikes anytime soon.

Similar to Australia, a large contributor to inflation come from a price rise in petrol. But the more recent fall in the oil price suggests petrol prices are unlikely to rise further. Overall prices were also held back by unusually large falls in vehicle and subscriber TV prices. A weaker housing market is also likely to hold back inflation.

It's possible that underlying inflation will climb a bit further as the effects of the recent weakening in the dollar and rise in the minimum wage are felt. However, with potentially slowing growth, it's unlikely that underlying inflation will challenge the upper limit of the RBNZ's 1-3% target and be problematic for the RBNZ, who argue the next move could be equally to cut or hike the OCR. Public sector wage negotiations will potentially feed through to generalised inflation although the extent of the wage increase at this stage is uncertain.

Summary

The global economy is strong. The Fed is increasing interest rates and global trade disputes are the key risk to global growth. Investment returns have been strong for a considerable period, and we continue to recommend that a balanced approach to investment be maintained.