

Investment Update – June 2019 Politics and Trade

Trade war trenches

The abrupt increase in US tariffs on imports from China threatens the nascent recovery in global industrial production that appeared to be underway. Tariffs and tariff fears have a large impact on high frequency data such as trade, industrial production, business investment and many highly correlated financial asset prices. Roughly half of China's exports to the United States face 25% tariffs.

A trade deal might still occur before July, ending or at least reducing the tariffs. President Trump has an incentive to make a deal because not doing so risks the strong growth and solid equity market performance that will help his prospects in next year's election. President Xi has an incentive to make a deal because China faces a shock, with business failures and rising unemployment, if no deal is reached. However, President Trump has solid bipartisan political support for his tough China stance. Getting China to change its norms and business practices and increasing the level of reciprocal treatment foreign firms can expect would be a major strategic victory for Trump, giving him a powerful message partly vindicating a generally disruptive and scattered approach to policymaking. It will take pressure to force the US to capitulate, and so equity market performance, labour market data, and the US Central Bank (the Fed) decisions are all important variables that will affect the negotiators' next moves.

On the southern border, Donald Trump abruptly announced that Washington would impose levies on all Mexican goods unless it took more forceful action to contain migration to the US. The levies, initially set at 5 per cent, are due to kick in on June 10, touching off a scramble to reach a deal before then.

Donald Trump predicted that tariffs on Mexican imports would take effect as planned next week, dashing hopes that an agreement could be reached on migration in the coming days despite growing criticism from some Republicans about his latest trade move. The possibility of escalating tariffs on trade in North America has clouded economic prospects for both countries and has also rattled global markets.

Interest rates go lower

Short term interest rates continue to go lower as central banks set accommodative monetary policy (forecasting rate cuts) to support economies in a slower growth environment. The Reserve Bank of Australia most recently cut the rate by 0.25 percentage points to 1.25 per cent, a new record low, in an effort to boost employment, wage growth and hit its inflation target. Jay Powell, chairman of the Fed, signalled the central bank stood ready to cut interest rates, saying it would "act as appropriate to sustain the expansion" amid the economic impact of escalating trade wars.

The Fed is very attuned to the risks to the outlook and if they crystallised it could be a reason for more accommodative monetary policy.

Long term rates also trend lower as investors look to long term bonds in a 'flight to safety' to shelter from uncertainty about the global economy. The yield on the benchmark 10- year Treasury fell to a 20-month low as escalating trade tensions between the US and China and elevated concerns over a slowing global economy continued to drive interest in safe government bonds. The yield on the 10-year note, which moves inversely to price, fell to 2.10 per cent, the lowest level since September 2017. The trade issue with China is having a pronounced effect on global growth.

Brexit Inertia

Theresa May has abandoned attempts to make progress on Brexit before she steps down as prime minister, leaving her successor little time to break the political deadlock at Westminster before the country's scheduled exit date on 31st October (coinciding with Halloween, some noticed).

Mrs May's Brexit deal has been rejected three times by MPs, and key cabinet members last month rejected her plan to try to secure parliamentary approval at the fourth time of asking by offering a vote on a Brexit referendum. She then announced she would end her three-year premiership. Boris Johnson is currently frontrunner in the crowded contest for the succession to Theresa May. His brazen 'No deal' Brexit plan is compelling for euro sceptics, but the outcome fails to clarify the future trade relationship between UK and Europe except to apply World Trade Organisation trade rules.

We have previously discussed the impasse of Brexit as the UK continues to remain stranded between leave and remain, creating uncertainty for business and markets. Conditions for businesses in the UK's services sector worsened in the three months to May, according to a survey by the CBI employers' group, in the latest indication of how the extended uncertainty over Brexit is weighing on companies. Optimism about trading conditions weakened in both the business and professional services sector and the consumer services sector, according to a survey by the CBI employers' group.

So far there appears to be no clear route that releases the UK from the present limbo. The nation is divided and parliament paralysed. Inertia appears to be the prevailing force.

Australia's election surprise

Even by the admission of the prime minister, Scott Morrison, it was a "miracle". His centre-right Liberal Party was expected to lose the federal election on May 18th. Instead, it has been returned to power with more MPs than it had before. The result blindsided Australians, because pundits (and a clairvoyant crocodile) had predicted victory for the main opposition party, Labour, which had led the coalition in the polls since soon after the previous federal election, in 2016. The Liberals have been consumed by infighting between centrist and conservative wings, leading to the toppling of two sitting Liberal prime ministers by their own MPs.

In the end, the election was won in Queensland, a state full of marginal electoral seats. Global warming is exacerbating its frequent floods and droughts and has devastated big parts of the Great Barrier Reef, which stretches along its coast. But the state's economy is dependent on exploiting natural resources, notably coal, and many of its voters are wary of environmental regulation and supportive of employment.

Market sentiment is becoming more optimistic on the outlook for the Australian economy following the Coalition's win. In comparison to the Australian Labour Party, the Coalition's policies are less aggressive and more business friendly, with proposed income tax cuts and policy support for first-home buyers. It is clear the Australian Treasury, banking regulator and central bank are coming together to deliver a boost to domestic demand, housing and employment.

These measures will at the very least help eliminate the downside risks to domestic demand and are likely to stimulate economic growth. The increase in household disposable incomes, better access to credit and lower interest costs should see more local cash flow into the equity market, while the Coalition's business friendly policies should help ensure more international portfolio flows.

New Zealand's Budget, Business Confidence and Financial Stability

New Zealand's 2019 Budget reiterated that NZ's fiscal position remains healthy overall. The government adopted a "well-being" approach to the budget because it argued that a fixation on economic expansion says little about how the benefits of that growth are being shared and fails to tackle urgent social issues.

With a stronger starting point for the FY2019 surplus (ahead of the Half-year Economic and Fiscal Update estimate), Prime Minister Ardern announced significant spending on tackling mental health issues, child poverty and family violence. But a slowing global economy and sluggish domestic demand means the government will borrow more and run smaller surpluses to deliver its policies. However, the smaller surplus forecasts over the next four years (totalling NZ\$14.3bn) and the strong net debt position (20.4% of GDP in FY2020), still point to a strong public finance position overall. Taken together, the Budget is unlikely to significantly alter New Zealand's economic outlook over the next couple of years, and unlikely to have near-term implications for monetary policy. Growth in New Zealand is likely to continue to be supported by accommodative financial conditions (including the Reserve Bank May rate cut) and moderate fiscal spending, and expect inflation to gradually track higher, with rates likely to be reduced.

The ANZ Business Outlook Survey of NZ business confidence rose moderately in May, while firms' own activity outlook edged slightly higher. In context, both readings remain at weak levels and well below their long-run averages.

The outlook for residential construction and commercial construction both fell, with the former falling to the lowest level since the GFC. While part of this may be attributable to a gradual shift of residential construction towards the public sector and away from the private sector, its ongoing weakness continues to bear close watching - especially given the lack of a rebound following the government's announcement to drop its plans for the capital gains tax in mid-April.

The Reserve Bank's semi-annual Financial Stability Report noted that New Zealand's financial system remains "resilient to current risks", although "risks to the financial system remain elevated and are largely unchanged in the past six months". The Reserve Bank left its LVR restrictions unchanged following the easing in late 2018, although it expects to ease these further "if household lending risks continue to fall gradually". On bank capital requirements the Reserve Bank offered little new guidance on the review process and expects to release the responses to the submissions by the end of November 2019.

Summary

Uncertainty about trade and populist policies continues to weigh on market sentiment. We remain moderately cautious as, on the one hand, a period of heightened uncertainty present risks to the downside, and on the other, central banks continue to demonstrate a willingness to set accommodative monetary policy to support slowing economies. A balanced diversified investment approach remains appropriate

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