Trump, or mercantilism 3.0

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Equity markets continued up to the end of April to steer a precarious course between two dangers – an ailing economy and wavering monetary stimulus (see our April Note, "A return to greater balance". But starting in May, the fallout from the Trump administration's increasingly tough stance in its interminable trade talks with the Chinese government has brought home to equity investors just how fragile the existing balance is.

After a few jolts over the past few weeks, stock markets have now receded to close to their end-March levels. The same can't be said of bond markets, however. They are sending out the unequivocal message that the global economy is heading in the wrong direction – and is on course for deflation.

The short-term question facing financial markets is this: does the possibility of a new pickup in global growth – supported by China's stimulus package, a favourable comparison basis after the dip in 2018, widespread dovish monetary policy and an ongoing boom in the United States – outweigh the growing evidence of waning momentum in an American economy suffering, with a lag, from the excessive monetary tightening in 2018, the natural ageing of an already long business cycle and blowback from Washington's blatantly mercantilist trade policy?

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We haven't changed our views on this issue. The balance between the two forces at work [illegible] and the potential for an economic upsurge is being stymied by both long-term obstacles (too much debt, limited monetary policy leeway) and short-term ones (trade hostilities, [illegible] the road, the inescapable question has to do with the global consequences of the growing rivalry between China and the US. For the first time in thirty years, geopolitics could once again take precedence over world trade.

The US versus China: is there room for two mercantilist powers?

It's apparently taken financial markets a while to admit that there is more to the recent tensions between the United States and China than just a spat over tariffs. They obviously reflect strategic rivalry as well. And yet *Death by China*, penned by Donald Trump's trusted advisor Peter Navarro, was published as far back as in 2011. It unmistakably bears witness to the widespread feeling in the US today that the country is heading for a Thucydides Trap (an analogy with what happened in ancient Greece when Sparta's fears over the rise of Athenian imperialism led to the Peloponnesian War).

On a less martial note, the current tensions between China and the US can also be interpreted as an irrepressible clash between two mercantilist powers (see our April 2017 Note, "Long-term investors should be wary of populism"). Donald Trump's America doesn't believe in the virtues of free trade – it even counts itself among free trade's victims. Harking back to seventeenth-century England, Holland and Colbertist France, the Trumpians show a preference for brazenly exploiting a favourable balance of power with trading partners in order to enrich their country through trade surpluses and support for domestic capital investment. That policy puts the US on an inevitable collision course with China – a country criticised, and not so unfairly, for its mercantilist behaviour. We can also assume that the same treatment will eventually be applied to all nations whose trade surpluses with the United States thwart the Trump administration's mercantilist designs – beginning with Germany and Japan.

In other words, the increasing friction between the United States and its trading partners is inherent in the economic model subscribed to by the Trump administration. And as far as China is concerned, that model is coupled with geostrategic rivalry. The intensity of that rivalry can be gauged from the fierce attack on Huawei, a firm crucial to China, by a US administration that has no qualms about practising extraterritorial overreach and seeking to commercially isolate the telecoms equipment-maker by putting it on an export blacklist.

The problem for us investors is that this turn away from the "beneficial globalisation" patterns of the past few decades not only creates short-term uncertainty, but also adds the longer-term threats that disruptions to global supply chains will depress corporate profit margins, that consumers will be saddled with higher costs and that world trade will shrink. In any event, it would be unwise at this stage to expect equity markets to rise substantially above their current levels – unless another *deus ex machina* were to appear on the monetary policy scene.

Do central banks still have their philosopher's stone at hand?

> Pressure from financial markets will most likely have to build up considerably before we see a US monetary policy shift vigorous enough to make a real difference

Over the past decade, investors have got hooked on the idea that a mere stroke of the magic wand by central banks will be enough to turn any bad economic or political news into good news for financial markets. We saw in 2018 just how dangerous their addiction to this horn of plenty is. Moreover, the market rally in the first four months of 2019 took its lead, as in the past, from the Fed's assurances that it wouldn't be attempting to break investors of that habit any time soon.

The trouble is that even though the rate-hike programme initiated two years ago has been suspended, the US economy has softened further this year, whereas the Fed plans to continue to pare back its balance sheet until September. This means that while expectations of a rate cut may be keeping equity markets humming and thereby preventing the greenback from appreciating more significantly – despite this month's stock-market selloff – the grim truth is that the Fed's current policy is supporting US economic growth in the way that a noose supports a hanged man. Monetary policy will have to take a much sharper dovish turn to be able to stem the deflationary impact of the worsening trade dispute with China on an economy already losing steam, particularly if the renminbi weakens substantially.

So pressure from financial markets will most likely have to build up considerably before we see a US monetary policy shift vigorous enough to make a real difference. Meanwhile, there isn't much leeway available to the Bank of Japan and above all to the European Central Bank. Markets will not know until next month whether the figure named to replace Mario Draghi at the head of the ECB as of October will be willing to act as flexibly and inventively as his or her predecessor if required.

Europe between a rock and a hard place

In this complex environment, Europe is not operating from a position of strength. Not only can the ECB provide little in the way of monetary support, a handicap which would lead to a crippling appreciation of the euro in the event of a "currency war" between China and the US; the European Union also suffers from a number of vulnerabilities. The latest EU parliamentary elections are hardly to blame. True, several mainstream parties took a shellacking, notably in France and the United Kingdom. But the results at the polls show continued strong attachment to the EU – the relative aggregate weight of europhobic parties has changed little compared with 2014 – and the growing community of those advocating more energetic stimulus policies suggest we will see greater consensus than before on that front.

The trouble lies elsewhere. To start with, it looks like the reform process will be kept on hold for quite a while. Italy, France and several other member states have failed to give themselves the fiscal room to manoeuvre they will need to be able to counter the next economic slowdown. At the eurozone level as well, Emmanuel Macron's proposal to create a common budget to rekindle growth has clearly fizzled out. The second source of vulnerability is Europe's onlooker status in the tug of war between the US and China. That conflict may well prove damaging to the EU, both if the global economic outlook sours (since the pace of European GDP growth depends heavily on the state of world trade) and in the event of a US-China trade agreement, because even a shaky deal would no doubt be reached at the expense of Europe. The Tokyo Lab's bout the economic and political cohesion and the business strength required to effectively defend its interests in a world of hunting mercantilist rivals. One wonders whether the EU's German auto industry can avoid becoming the first sacrificial victim of this particular vulnerability.

The times thus call for a cautious, disciplined attitude towards equity markets – despite the remorse shown by financial analysts as they gradually move away from the extreme pessimism they evinced at the start of the year when they slashed their corporate earnings forecasts for 2019. We have accordingly maintained and strengthened our prudent investment orientation over the last two months. Our equity portfolios are characterised by moderate levels of exposure and a preference for growth stocks with low cyclicality. At the same time, our fixed-income portfolios favour long maturities and carefully selected corporate bonds.

Source: Bloomberg, 31/05/2019

Investment strategy

Equities

Equity markets have retreated from their early-year rally, as increasingly belligerent trade-war rhetoric and dwindling hopes for a swift rate cut by the Fed have re-ignited investor fears. In response, we gradually dialled back our equity risk over the past two months. After stock prices rose impressively, we moved in late April to lower our tactical exposure to the more cyclical market segments. We maintained that approach in May with new hedges on the tech sector, where semiconductors and a number of other segments show significant volatility at a time of escalating trade tensions.

Stock-picking is our primary performance driver, as it has been since the start of the year. We have kept our core equity portfolio focused on names that can do well in a global economic climate marked by persistently low growth. Our international scope enables us to hunt down such names in the United States, Europe and China, whether in healthcare, tech or specific consumer-goods segments like luxury goods. Thus, we added US jeweller Tiffany, whose revamped management and design team should revitalize the company's strategy.

Fixed income

Moves by the Fed and the ECB since the beginning of the year have encouraged fixed-income investors to buy government paper from the leading developed countries. That backdrop, combined with fears over slowing global growth, has led us to maintain a high modified duration via eurozone sovereigns (from Belgium, France, Italy and Greece) and US Treasuries. In addition to diversifying geographically, we have spread our holdings over several maturities, depending on the issuing country. The rationale behind that choice is that the United States and the rest of the world are experiencing differing monetary cycles.

In Europe, where GDP is once again growing below potential, the 5-year forward inflation index has slid from 1.6% to 1.3% in three months' time. This makes the ECB's claims to be able to fulfil its price stability mandate seem even less credible than before. The region also suffers from structural weaknesses. Monetary policy normalisation has been put on hold in the eurozone, strengthening the case for investment strategies geared to a flattening yield curve and lower spreads on investment-grade paper.

Our allocation to emerging markets in turn reflects an idiosyncratic approach favouring countries like Chile and Turkey. Meanwhile, an already lengthy credit cycle and considerable risk premia compression since the start of the year have convinced us to maintain a cautious risk profile in corporate bonds. We have accordingly selected our holdings carefully, with names like Altice, which was supported by continued fundamental stabilisation and reiteration from management that deleveraging is a key strategic priority.

Currencies

Further balance-sheet trimming by the Fed up to September, combined with an interest-rate differential that works to the advantage of the US currency and political uncertainty in Europe around Brexit and the EU parliamentary elections, has tended to keep the greenback high. But even in the current risk-averse climate, the dollar hasn't become much of a safe-haven currency. Investors now seem to expect the Federal Reserve to take a dovish turn in order to counter the first signs of waning GDP growth and the mounting US trade and fiscal deficits.

In the absence of a clear direction for major currencies, we therefore intend to keep our currency risk low by remaining overweight the euro and taking only limited exposure to the US dollar and the yen. How well emerging-market currencies fare will be further conditioned in part by how the dollar is doing, but a number of them, notably India's, already offer a few opportunities.

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