Monthly Newsletter Savings and Investments

Trade conflict between United States and China is turning out worse than the market assumed

May 2019

Market overview

After a strong first quarter, riskier assets continued their upturn in April. This year's rebound has been driven by accommodative central banks, the expectation of a recovery in Chinese growth, and the anticipation of a resolution to US-Chine trade negotiations. Further support for the markets came from a solid start to the Q1 corporate earnings season. However, stock markets are off to a weak start in May. The main reasons are that market performance was already very strong from January to the end of April and that the trade conflict between the United States and China is turning out worse than the market assumed. It brings some additional worrisome as at the same time world economic growth is decelerating, but we are not seeing forces that will make this slowdown unique or dramatic. Preliminary 2019 Q1 GDP figures for the US, China and the euro zone have also proved somewhat stronger than expected. On tactical horizon, we chose to slightly decrease risk tolerance towards risk assets such as equities from neutral to underweight. We see a bit weaker macro-economic data compared to April. We still expect that economic growth should stop slowing over the coming months. We still expect a trade agreement should be achieved. However, we have to acknowledge that uncertainty about both of these factors is on the rise. In line, we are closely tracking what is happening in the markets and are ready to make changes in our risk tolerance.

Stock market indexes' performance (until 30 April 2019)

Region	Index	Currency	Performance							
			2019 April	2019 YTD	12 Months	2014	2015	2016	2017	2018
USA	S&P 500	USD	3,9%	17,5%	11,2%	11,4%	-0,7%	9,5%	19,4%	-6,2%
Europe	MSCI EURO	EUR	4,8%	16,7%	-1,3%	2,3%	6,1%	1,7%	8,7%	-14,2%
Eastern Europe	MSCI EM Eastern Europe	USD	2,9%	11,5%	3,5%	-40,0%	-8,1%	33,0%	12,9%	-8,3%
Asia	MSCI EM Asia	USD	1,8%	12,9%	-7,2%	2,5%	-11,8%	3,8%	40,1%	-17,3%
Latin America	MSCI EM Latin America	USD	0,1%	7,1%	-8,0%	-14,8%	-32,9%	27,9%	20,8%	-9,3%

Major events and expectations

In focus. US-China trade conflict. Trade conflict between the United States and China is **turning out worse than the market assumed**. The optimism among investors that dominated through April and in the beginning of May was replaced by plunging prices in stock markets after President D. Trump accused China of reneging on the terms of a draft agreement and announced about **tariffs increase** from 10% to 25% on USD 200 billion worth imported Chinese goods. **China responded back** by imposing tariffs to USD 60 billion worth of imports from US from June 1st. D. Trump is also threatened 25% tariffs on a further USD 325 billion worth goods. Since recent rally in stock markets was partly driven by hopes of a US-Chinese trade agreements, **it is not so strange that markets reacted negatively to such news**. However, recently declines in stock markets slowed after D. Trump commented on the next US-Chinese round of talks that it should be very successful. **Our main scenario** that the **US and China will reach a trade agreement in near future**. On the other hand, although the **trade war in itself no longer poses a huge economic threat, it is worrisome that the dispute in escalating at a time when economic growth is already slowing and risks of coming recession is increasing.**

US. US economy continues to show strength. In the past six months, the US economy has had a slightly different role than normal during global recession worries. The slowdown has been driven by other parts of the world economy, while the US economy has only been affected to a lesser degree. After a slump around New Year, **2019 Q1 GDP growth was unexpectedly strong**, reaching an annualised rate of 3.2%. The economy is expected to expand faster than its underlying trend this year, but looking ahead, **we predict a gradual slowdown in US growth**. In the near term, we are likely to see a decline due to reversals in several factors that boosted Q1 growth. Next year fiscal policy will be largely neutral after having made positive contributions to GDP in 2018 and in 2019. The productivity, which has accelerated to a nearly 2% annual growth rate during recent year, will start slowing. Therefore, we are adjusting our **GDP growth** forecast marginally downward to **2.3% in 2019**.

We believe that **the Fed will abstain from rate hikes** and that its federal funds rate will thus remain at 2.25-2.50% at the end of 2020. As the labour market tightens, continued low inflation meanwhile provides extensive manoeuvring room for the Fed. On the other hand, in an environment where other leading central banks are sticking to their zero interest rate policies, the market is likely to continue expecting **higher probability of a rate cut than a rate hike by the Fed**. This probability will increase if US macroeconomic data deteriorates.

Europe. Macroeconomic data from Europe continues to look week. The The euro zone economy as a whole has decelerated significantly, and we have adjusted our **2019 GDP growth forecast to 1.1%**, mainly due to weaknesses in Germany and Italy. But domestic economies have meanwhile generally been resilient and **labour markets have been strong**, with both rapid job growth and continued falling unemployment. Looking ahead, **the euro zone will also benefit** from the recovery in China and other emerging market economies. Exports to Asia have gradually become more important and now account for as large a share as the US and the UK combined.

Greater focus on US-EU trade talks. Our main scenario is that the US will announce higher tariffs on imported cars in this month but will grant a temporary waiver to the European Union. This will enable the US to pressure the EU in trade talks. But the elections to the European Parliament (EP) late this month may complicate such trade talks when a new Parliament and a new European Commission take office, with nationalist forces gaining increased political influence. The impact of the elections are also likely to be visible on other issues, such as intensified EU and euro zone cooperation, fiscal policy coordination and putting together a long-term EU budget.

Emerging markets. The **growth rate in emerging market** (EM) economies **looks set to be a bit slower this year than in 2018**. Most of the deceleration has probably occurred already. **We expect the stabilisation** in trade flows and industrial production that was discernible in March and April to signal a more positive trend in the second half of the year. The **Chinese** authorities are now stimulating domestic demand with a package of tax cuts, infrastructure investment and measures designed to support bank credit growth. This important factor **should stabilise EM growth**. Although the acceleration will be very modest in 2020, EM countries **will remain an important global growth engine**, with stable annual GDP growth of 4.5-5%.

Globally. We have adjusted our **global growth outlook for 2019 slightly lower** and now foresee **global GDP growth of 3.3% this year**, compared to our earlier forecast of 3.5%. But we are sticking to our forecast of **3.5% in 2020**. This represents a pace that is still somewhat above the long-term trend. We predict that **unemployment in advanced economies will fall a bit further** from the current 5.0%, which is the lowest since 1980. **Inflation has again surprised on the downside**. Trends towards accelerating pay increases have faded to some extent, helping improve the outlook for continued stable economic growth.

Our global growth scenario, combined with 2019 Q1 corporate reports that were better than earlier downward-adjusted earnings expectations, suggests that **stock markets may provide positive returns in the coming year**, but that the **journey ahead will likely be volatile**. In 2018, global equity investors chose more defensive behavior, which turned to overweigh liquidity in their portfolios. That situation will persist, although the most recent upturn has been driven partly by some increased risk exposure in portfolios.

To **summarize**, on tactical horizon, we chose to **slightly decrease risk tolerance** towards risk assets such as equities from neutral to underweight. Recently increased tension regarding **trade wars is not the main reason for that**. We see a bit **weaker macroeconomic data** compared to April. But more than seeing it as weaker we are actually more concerned about the fact that it does not accelerate. We see that currently macroeconomic data is not getting above the bar that equity markets have set. This is the **primary reason why we reduce risk tolerance** for now. We **still expect** that **economic growth should bottom over the coming months**. We **still expect a trade agreement should be achieved**, using the same argumentation as the rest of the world that the rational course of action is to get it done. However, we have to acknowledge that **uncertainty about both of these two factors is on the rise**. Although we can discuss how large the economic impact of the trade war is it will undoubtedly have an effect on tactical leading indicators. Both as the uncertainty leads to postponement in investments and as tariffs lead to higher input costs, higher prices and higher inflation. If the trade deal does not get signed (we expect it to be signed) then the case for a rebound in macro falls further.

Glossary

Terms used	Explanation
Fiscal policy	Fiscal policy relates to government spending and tax collection. Fiscal policy refers to the use of the government budget to influence economic activity. For example, when economic growth is slowing down, the government can step in and increase its spending to stimulate demand and economic growth. Or it can lower taxes to increase disposable income for people and businesses.
Gross Domestic Product (GDP)	The monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.
Investment grade bonds, high yield bonds	Investment grade bonds – bonds (sovereign or corporate) with credit ratings that indicate a relatively low risk of default. High yield bonds – bonds (sovereign or corporate) with credit ratings that indicate a relatively higher risk of default than investment grade bonds. Because of the higher risk of default, these bonds pay a higher yield than investment grade bonds. Two main credit rating agencies Standard & Poor's (S&P) and Moody's, use different designations consisting of upper- and lower-case letters 'A' and 'B' to identify a bond's credit quality rating. S&P designations of 'AAA' and 'AA' (high credit quality) and 'A' and 'BBB' (medium credit quality) are considered investment grade. Credit ratings for bonds below these designations ('BB', 'B', 'CCC', etc.) are considered low credit quality, and are commonly referred to as high yield or "junk bonds".

Monetary policy	Monetary policy is the process by which the monetary authority (usually the central bank) of a country controls the supply of money (the size and rate of growth of the money supply), for the purpose of promoting economic growth and stability. For example, if the money supply grows too fast, the rate of inflation will increase and the economy will “overheat”. If the growth of the money supply is slowed too much, then economic growth may also slow. The main tools to control money supply include open market operations (buying or selling assets), changing interest rates and changing reserve requirements for commercial banks.
Purchasing managers’ indexes (PMIs)	An indicator of the economic health of the manufacturing sector. The PMI indexes are based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. A PMI of more than 50 represents expansion of the manufacturing sector, compared to the previous month. A reading under 50 represents a contraction, while a reading at 50 indicates no change.
Yield	The income return on an investment. This refers to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment’s cost, its current market value or its face value.