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The US economy remains strong, but tail risks are rising

Mona Mahajan | 29/08/2018

Summary

Tax reform has given the US economy a second wind and widened its divergence from the global economy, which has faltered amid fears of trade wars and emerging-market uncertainty. Sector rotation in US equities could make tech and consumer discretionary attractive; energy and industrials may also benefit.

Key takeaways

- The Fed will continue on its normalisation path as we move later in the cycle, but we don't foresee a recession in the next 12-18 months
- Tail risks are emerging – including trade wars and geopolitical uncertainty – but US equities could still outperform global peers, albeit with higher volatility and some sector rotation
- It's too early to move completely away from the tech sector, which has still delivered strong year-to-date returns; in the overall markets, we believe mid to high single-digit returns are still feasible this year
- Investment opportunities could also be found in energy and industrials, short-duration fixed income, Asia and alternatives

We started the year on quite an optimistic note for the US. There were two primary sources of growth: fiscal stimulus from tax reform and the global synchronized growth story. However, global growth has faltered as tail risks emerge – most notably the threat of a trade war and emerging-market uncertainty.

As we have gone through the first two quarters of the year, we can now observe a few things:

- The US economy continues to be robust, in large part driven by 2017 tax reform.
- The global synchronized growth story has slowed somewhat. We saw this first with volatility in Europe, exacerbated by the political and economic crisis in Italy; then with the impact of rising US interest rates and stronger dollar on the emerging markets; and finally in Asia, from the escalating tussle over tariffs.
- Tail risks have emerged that are clouding the outlook, most notably the threat of a trade war and uncertainty in the emerging markets.

Meanwhile, we expect the Fed to continue its normalization path with two more rate hikes this year and reductions in its balance sheet, eventually bringing the economy into a more mature phase of the current business cycle.

Strong US GDP numbers

Digging deeper into the US economy, we observed quite a strong US GDP print. The second-quarter report came out at 4.1% – slightly below the consensus expectation of 4.2% but with a strong showing across most segments.

- This was a highly anticipated report, and speculation of a GDP figure above 4.0% was largely priced into the market.
- Nonetheless, as Exhibit 1 shows, the second quarter was impressive on several fronts, including a personal consumption growth of 4.0%, business investment of 7.3% and export growth of 9.3%.
- We believe that much of the personal and business spending was driven by the tax-reform stimulus earlier this year, which means it may slow as we continue into the next 12 months. The rise in exports was also supported by an acceleration of exports ahead of tariffs this quarter. These items, combined with a rising dollar for much of the last six months, may be headwinds to future growth. Keep in mind that GDP for 2018 overall will likely be close to 2.9% – and 2.5% for 2019 – likely making this a peak year for economic growth.

Exhibit 1. GDP by Expenditure (%q/q ann.)

	Personal consumption expenditure	Business investment	Residential investment	Government expenditure	Change in private inventories ($bn)	Exports	Imports	GDP (%q/q ann)	GDP (%y/y ann)
Q3 17	2.2	3.4	-0.5	-1.0	64.4	3.5	2.8	2.8	2.3
Q4 17	3.9	4.8	11.1	2.4	16.1	6.6	11.8	2.3	2.5
Q1 18	0.5	11.5	-3.4	1.5	30.3	3.6	3.0	2.2	2.6
Q2 18	4.0	7.3	-1.1	2.1	-27.9	9.3	0.5	4.1	2.8

Source: Thomson Reuters

Trade progress is a mixed bag

On the trade front, we continue to feel a sense of "two steps forward, one step back":

- President Donald Trump made some progress on the trade front with Jean-Claude Juncker, president of the European Commission. While President Trump's meeting with Mr Junker was light on details, it did mark some progress in trade discussions: Mr Trump has agreed not to pursue auto tariffs against the European Union for now, and the EU has agreed to enhance its trade in areas like soybeans and liquid natural gas.
- However, this positivity quickly dissipated when President Trump announced that not only he would like to move forward with USD 200bn in additional tariffs but also move the rate on these tariffs from 10% to 25%.
- Keep in mind that China's financial markets have experienced quite a bit of pain since tariff talks have escalated. Chinese equities are down about 18% year to date and the renminbi has devalued about 8%. In the US, the S&P is up about 5% year to date and the US dollar is up about 7% against the renminbi since February.
- Most recently, the US and Mexico announced a new bilateral trade pact that rewrites portions of the current NAFTA arrangement. We have yet to see if a similar agreement will be struck with Canada as well.

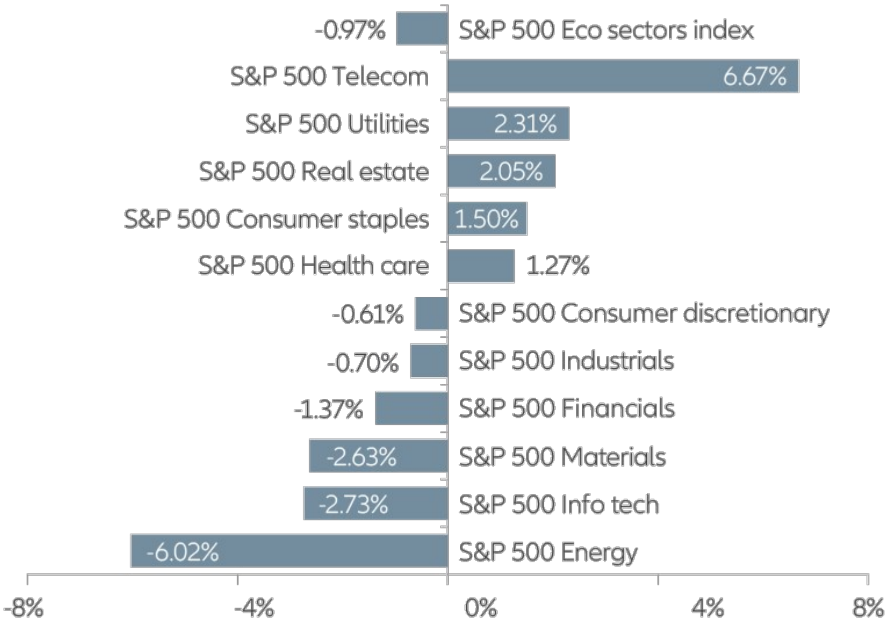
Is tech-sector softness the start of a rotation?

In late July, reports of Facebook's earnings wreaked havoc on the technology sector, as the company reduced its growth outlook and raised its expense guidance. While some of this weakness is company-specific – Facebook has been battling privacy concerns and regulation – some of this downdraft was driven by elevated market expectations. This theme of elevated expectations has carried over to many of the FANG names (Facebook, Amazon, Netflix, Google) and, more broadly, to other technology leaders.

While it is too early to call a complete rotation out of tech, we find it reasonable for this sector to take a breather and for investors to take some profits here. Sectors that have emerged as leaders include telecom, staples and health care. Of course, it's important to keep in mind that while recent performance in tech has clearly lagged (it's down almost 3%), this sector may be undergoing a secular shift driven by areas like automation and robotics, which could make it less cyclical than it has been historically. The tech sector is also a clear winner on a year-to-date basis (up 15%). See Exhibits 2 and 3 for more details.

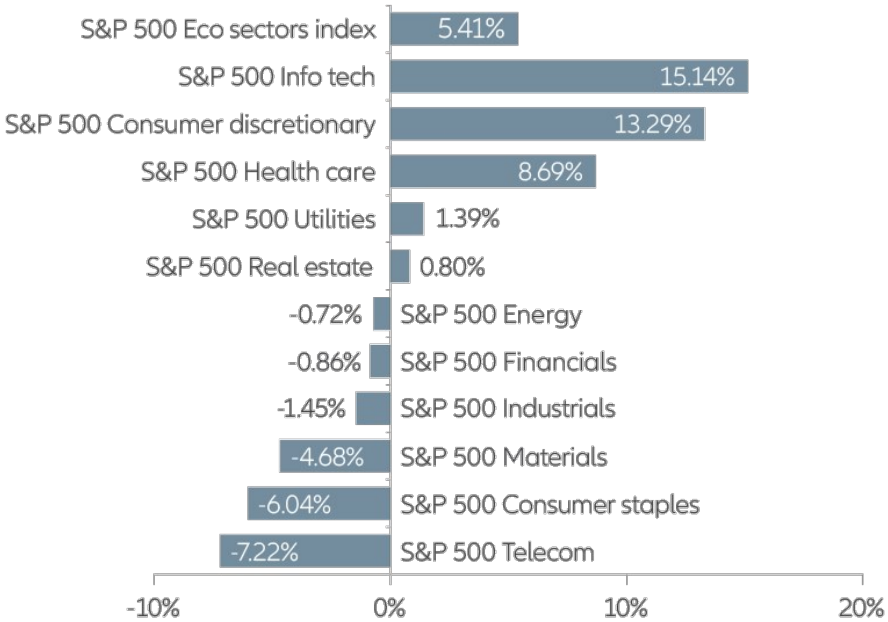
Exhibit 2: Recent sector returns show the rotation...

Since 25 July 2018 (Tech: 2nd lowest performer)



Source: Bloomberg, as of 15 August 2018. The above chart is illustrative in nature and should not be considered a recommendation to purchase or sell any financial instrument. Past performance is no guarantee of future results.

Exhibit 3: ... on YTD sector winners
YTD performance (Tech/Discretionary: best performers)



Source: Bloomberg, as of 15 August 2018. The above chart is illustrative in nature and should not be considered a recommendation to purchase or sell any financial instrument. Past performance is no guarantee of future results.

Overall, while tail risks are emerging, we continue to feel that late-cycle US equity markets can continue to perform well versus global peers, albeit with higher volatility and some sector rotation. Typically, we don't see bear market corrections over more than 20% unless we are in a recessionary environment or entering a recession – neither of which we see happening in the US over the next 12-18 months. So while we may not get the high double-digit returns we saw last year, we still believe mid to high single-digit returns are feasible this year.

Five to watch

Looking ahead, these five ideas could help power portfolios:

1. Buying opportunities in "winners from disruption"
Within equities, we have started to see the growth/small-cap trade falter just a bit. While we continue to like the long-term theme of "winners from disruption," and we believe fundamentals in sectors such as technology and consumer discretionary have not altered materially, it remains uncertain whether this is shorter-term profit-taking or a broader sector rotation. As a result, we remain cautious in the near-term but believe we may ultimately see some favourable buying opportunities as the long-term secular technology theme plays out.

2. Energy and industrials are looking stronger
We also are looking for leadership beyond the technology and consumer discretionary sectors

as we enter the second half of 2018. We are becoming more favourable on energy, given the positive supply/demand fundamentals and recent pullback in the sector. Energy stocks have lagged actual oil performance, which could provide an opportunity. Industrials may also re-emerge as the global defence-spending theme gains traction and, perhaps, as infrastructure spending re-emerges as a focus.

3. Keep duration short in fixed income
Within fixed income, we continue to favour shorter-duration strategies. As we do not see a rise in defaults on the horizon, higher-yielding fixed-income securities continue to remain attractive. We also continue to favour convertibles, which have potential equity upside as well.

4. International investors: look to Asia
We remain selective in international exposure. With softness in Europe and some rollover in the emerging markets, we continue to look towards Asia as a potential source of growth. While it is likely too early to build substantial conviction given trade tail risks, we could see an opportunity in China for long-term investors if the trade war overhang dissipates. Valuations in China appear reasonable and growth should remain robust thanks to the country's continued focus on "China 2025" and "One Belt, One Road" strategic economic and foreign policy initiatives.

5. Alternatives look attractive
As we move further along the US economic cycle, we believe investors should gradually increase allocation to alternative strategies, such as absolute return and infrastructure debt and equity, which are generally uncorrelated to equity markets over time.

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Ms. Mahajan is the US investment strategist and a director with Allianz Global Investors, which she joined in 2017. As a member of the Global Economics and Strategy team, she is responsible for providing US retail and institutional clients with differentiated investment thought leadership. Ms. Mahajan is also a key spokesperson, communicating – both internally and externally – the firm's high-conviction investment ideas and views from the Global Policy Council. Ms. Mahajan was previously a fixed-income portfolio manager, a structured-finance product specialist and a global market strategist at MetLife. Prior to this, she was an emerging-market strategist at Mirae Asset Global Investments; she also worked at hedge fund companies Para Advisors and Ziff Brothers Investments. Ms. Mahajan has a B.S. in economics from The Wharton School, The University of Pennsylvania; a B.A.Sc. in computer sciences from the University of Pennsylvania; and an M.B.A. from Harvard Business School.

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