Active is: Anticipating what's ahead

At the mid-year point, dark clouds are forming in the US

by Mona Mahajan | 18/06/2019

Summary

As a companion piece to Neil Dwane's global mid-year outlook, Mona Mahajan turns a spotlight on the US, where trade tensions and politics are weighing on markets. Given the increased uncertainty about the second half of the year, investors should stay active, defensive and diversified.

Key takeaways

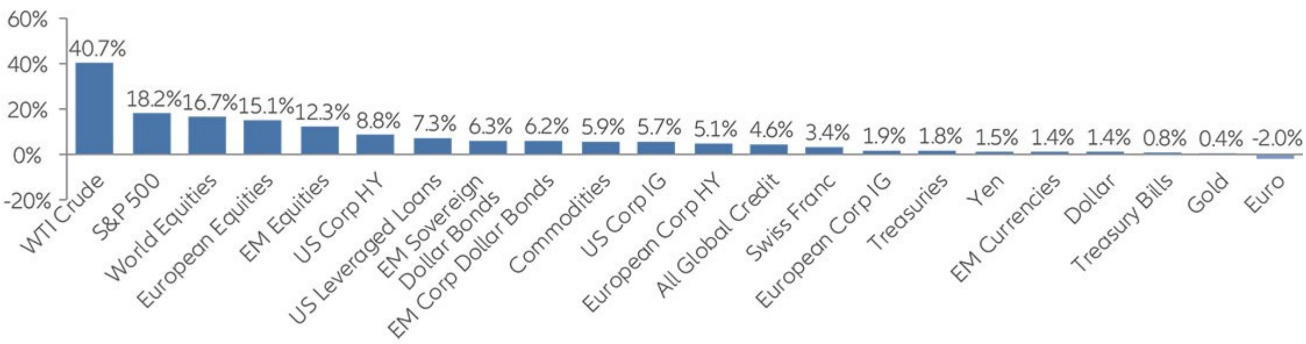
- In recent weeks, the US-China trade relationship has notably deteriorated, and US consumers are in the crosshairs; tariffs may be a long-term theme
- There are still pockets of bright spots in the US – notably a resilient US consumer, low rates and low inflation – but we see growing downside risks to economic growth
- We expect to see positive returns for the year, but we don't expect the pace of the first four months to continue
- In both equities and fixed income, we suggest moving up in quality, favouring more defensive investments with stronger balance sheets and free-cash-flow metrics

After a strong start to the year, US-China trade wars hit the markets

On the heels of a near-20% decline in the S&P 500 Index at the end of 2018, the first four months of this year were met with market optimism. Investors took the opportunity to "buy the dip" amid an improving outlook on multiple fronts – in particular, the Federal Reserve's pause in short-term rate hikes.

Many global risk assets showed strong returns in early 2019

Year-to-date total returns at the end of April



Source: FactSet. Data as at 30 April 2019.

But market performance and sentiment took a negative turn in early May, following escalating trade tensions between the US and China. President Donald Trump announced that the existing tariffs on USD 200 billion of Chinese goods would escalate from 10% to 25%, and the remaining USD 300 billion of Chinese imports not currently hit with tariffs could experience a 25% levy in the coming months.

Since this shift, the US-China trade relationship has notably deteriorated, with China indicating it is prepared for a long road ahead – and perhaps willing to start negotiations over again. A few key points are worth highlighting:

- **US consumers are in the crosshairs.** So far, consumer products have accounted for only 22% of the Chinese goods targeted by tariffs, but 60% of products targeted in the next wave of tariffs might be consumer goods. US consumers could feel an outsize impact, which may hurt confidence and potential growth.
- **China only imports USD 125 billion of US goods, so they cannot retaliate in kind.** Instead, China may utilize "non-tariff barriers" – including limiting US investments, adding additional regulatory hurdles, banning US products or brands, and ratcheting up geopolitical pressure where possible (eg, North Korea and Iran).
- **Tariffs could be a long-term theme**. Even if a trade deal is reached, the overhang of tariffs will likely remain – both as an enforcement mechanism and as part of President Trump's trade strategy. In addition, given the recent hardening of rhetoric from China, the possibility of the US and China not reaching a deal has increased, in our view.

Trade war with Mexico averted – for now

In late May, President Trump threatened tariffs on Mexico, which could have escalated up to a 25% levy on all Mexican imports if the country didn't comply with Mr Trump's demands to enhance border security. But by early June, the US and Mexico reached an agreement, avoiding a major trade dispute.

Why did Mexico react so swiftly to the threat of tariffs? Relative to its economy, the US is a dominant trading partner, accounting for nearly 80% of all Mexican exports – or about 30% of its total GDP. By comparison, the US only accounts for 19% of Chinese exports, or 4% of its GDP. Mexico clearly had a bigger incentive than China to avoid tariffs with its largest trading partner.

Although the US seems to have achieved its goals in getting Mexico to enact changes, there may be repercussions for using tariffs to address non-trade issues. Mexico is a vital trading partner for the US, and this relationship has been strained. The potential passage of the new, post-NAFTA United States-Mexico-Canada Agreement (USMCA) has also grown less certain. In addition, China may be less inclined to strike a deal if it believes the US will implement new tariffs down the road based on non-trade-related policies.

Our outlook for growth and leading economic indicators

- If trade tensions escalate into a full-blown trade war, we see a downside to US and global real GDP growth. According to Bloomberg, an escalating trade war could shave 0.7 percentage points off of US GDP and 0.9 percentage points from China's GDP, lowering global growth by 0.6 percentage points over the next two years.
- Given the trajectory of decelerating growth in the US, there is a growing risk that a trade shock could tip the economy into a downturn.
- While there are still pockets of bright spots in the US – notably a resilient US consumer supported by relatively low rates and low inflation – we see growing downside risks to economic growth, particularly if tariffs hurt consumer-goods pricing.
- Globally, we've seen substantial drops in key indicators such as purchasing managers index (PMI) data, which show economic trends in manufacturing. Together with declines in OECD leading indicators, this suggests potential softness in the global economy.

Our view on the second half is getting murkier

While the markets began the year with growing optimism for a second-half recovery, tensions between the US, China and Mexico have created concern – as has the decelerating momentum in leading economic indicators such as PMIs.

In the US, we think earnings expectations remain relatively elevated for the second half of the year, particularly in the fourth quarter. Consensus estimates call for a 7% year-over-year growth in S&P earnings. But if the US dollar continues to strengthen, US exporters could feel more pressure – a de-facto additional tariff as US companies try to sell their goods and services abroad.

With the growth outlook now deteriorating, markets have priced in two or three Fed rate cuts by year-end. In our view, the possibility of a rate cut has grown more likely to become reality given the potential for slowing economic fundamentals. However, we think the Fed will continue to be patient and data-dependent, and it won't act unless data or expectations have meaningfully changed.

Overall, while we expect to see positive returns for the year, we don't expect the pace of the first four months to continue. Geopolitical shifts could also increase volatility.

A mixed outlook for the remainder of 2019

Indicator	2017	2018	2019 expectation
US equities (S&P 500)	+19%	-6.2%	High single-digit to low double-digit
US rates (10-year yield %)	2.41 (2.04 - 2.63 range)	2.68 (2.41 - 3.24 range)	2.25 - 2.75
US real GDP growth	2.2%	2.9%	2.4% (lower in full trade war)
US inflation (core PCE)	1.6%	2.0%	2.0% - 2.2%

Fed rate hikes	3 hikes	4 hikes	0 hikes (data dependent, rate cut probability higher)
Volatility	All-time lows	Increases in spurts	Increases in spurts

Source: Allianz Global Investors. Data as at May 2019.

Strategies for positioning portfolios

Given the increased uncertainty in the second half of this year, we advise investors to stay active, defensive and diversified.

- In both equities and fixed income, we suggest moving up in quality, favouring more defensive investments with stronger balance sheets and free-cash-flow metrics.
- In equities, consider a "barbell" approach: on one end could be tech firms specialising in mobile payments, cloud computing and cyber-security; on the other, defensive sectors such as health care, staples and defence/military positions.
- In terms of regions, we remain neutral on China, but favour parts of Asia that may benefit from supply chain disruptions (Thailand and Vietnam) or that recently completed positive election cycles (India and Indonesia). We are cautious on Europe, which has seen deteriorating growth and is more exposed to global trade declines.
- In fixed income, we are neutral on duration and favour higher-quality US investment-grade and high-yield issues. Parts of the securitised fixed-income segment could complement corporate bonds. We also see pockets of value in areas like European and Asian high yield.
- Additional alpha potential may be found in investments focused on ESG (environmental, social and governance) issues, infrastructure debt/equity strategies and absolute-return strategies. These asset classes could benefit as we head into the second half of 2019 and position for a maturing economic cycle.

Further reading

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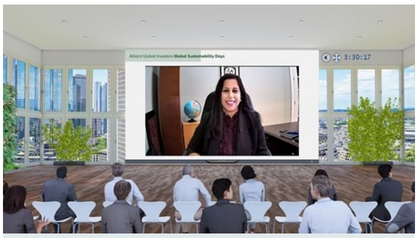

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Mona is the US investment strategist and a director with Allianz Global Investors, which she joined in 2017. As a member of the Global Economics and Strategy team, she is responsible for providing US retail and institutional clients with differentiated investment thought leadership.

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Do US-China trade tensions signal an end to globalisation?

by Neil Dwane | 25/06/2019

Summary

It looks increasingly unlikely that the US and China will reach an amicable agreement to end their ongoing trade conflict. If tensions between the two countries continue to escalate, we could witness the end of a decades-long period of globalisation – with several major implications for investors.

Key takeaways

- It seems there are good reasons for the leaders of both the US and China to avoid backing down in their ongoing trade dispute

- Higher US tariffs on imports may drive up inflation, which might compel the Fed to hike rates, boosting the US dollar but hitting US growth expectations and emerging-market assets
- The use of the dollar as an economic weapon may see the currency strengthen in the short term; this could undermine its appeal as the world's reserve currency over a longer horizon
- China might retaliate with a "don't buy America" policy, hitting US corporate profits for decades to come, and by denying US companies access to critical China-based supply chains
- Countries around the globe are likely to come under pressure to choose sides in the dispute, resulting in an increasingly polarised world

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