GADD INFINUM

Market Insight

SUMMER 2018

Will the trade war take place ?

Albeit a tad softer, the growth of the world economy remains well anchored, helped by the renewed vigor of emerging countries. The United States remains the engine of global growth, and the inflationary repercussions of this dynamic are beginning to be felt. However, the tightening of the Fed's monetary policy unfolds without excess. The risk of "overkilling" inflation remains low, as is the risk of a recession in the next 12 months. Thanks to better earnings growth prospects, financial markets have returned to sound valuations and there is no sign of excess. So it's not on the side of the economy that we have to look for clouds in this clear sky for our investment policy but ... on the geopolitical side: the risk of an outright trade war is our main concern which justifies caution ahead. The rationale has it that we should experience skirmishes more than a real conflict but ... it is useful to remember that the Trojan War did take place, just like the Second World War that Jean Giraudoux was denouncing in his famous play in 1935.

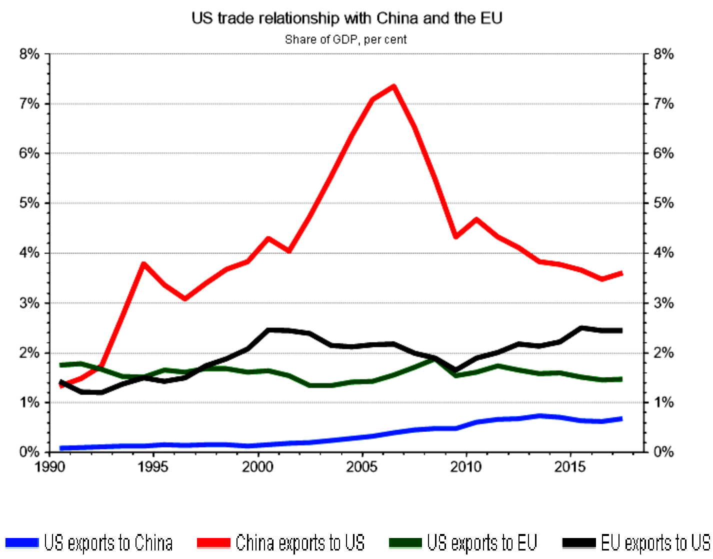
Risk taking, a case of testosterone

Attributed today to Christine Lagarde, there is a great statement which emanates actually from Ngozi Okonjo-Iweala, director of the World Bank in Nigeria. In 2009, she said: "*If Lehman Brothers had been Lehman Sisters, we would not be here today*." But it is this very Christine Lagarde who said of her talks with the former President of the Federal Reserve, Janet Yellen: "*Janet and I do not need the preamble loaded with testosterone - you mark your territory, I mark mine - which inaugurates any discussion between men. Our conversations are more direct, frank, unadorned.* " I'm not sure that a human swollen with testosterone speaks with frills, but let's move on ...

Testosterone? Let's talk about it: based on saliva samples, a study from the University of Chicago shows a clear link between testosterone levels and risk taking, whether in the management of financial investments or of his professional life. We should therefore nuance the wording of the former director of the World Bank and switch from a male / female distribution to a measure of the average rate of testosterone within the management of the late Lehman Brothers.

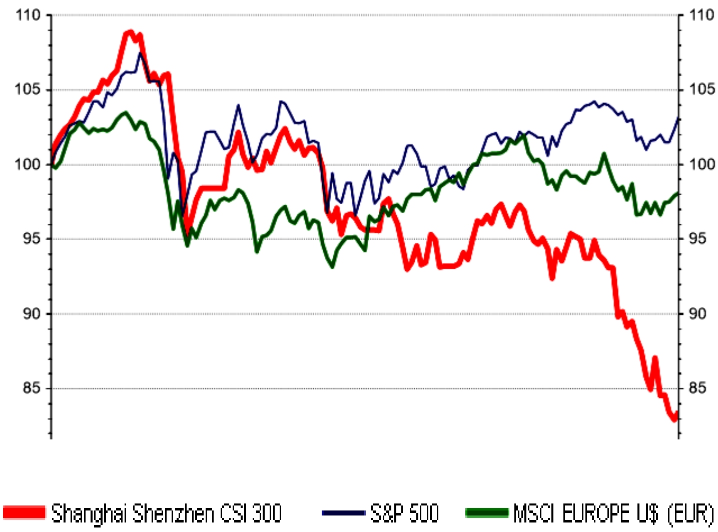
And it is by the yardstick of the link between the steroid hormone and risk taking that we must measure the danger of a trade war initiated by the current President of the United States. With him, the unthinkable becomes probable when he declares: "*Trade wars are good and easy to win*". How naive ! In a trade war, the winners are the ones who lose the least. But the whole world economy suffers. Surely, China and Europe have more to lose than the United States in a trade war. This can be seen in Chart 1, which shows that China's and Europe's share of exports to the United States is much larger than that of the United States towards the Middle Kingdom and the Old Continent.

1. China and Europe have more to lose from a trade war than the United States



To be sure, Equity markets have not mistaken. Since President Trump's war rhetoric has strengthened, Chinese and European stock markets have fallen, while the flagship index of the US stock market has remained stable.

2. Stock indexes show the losers of the trade war

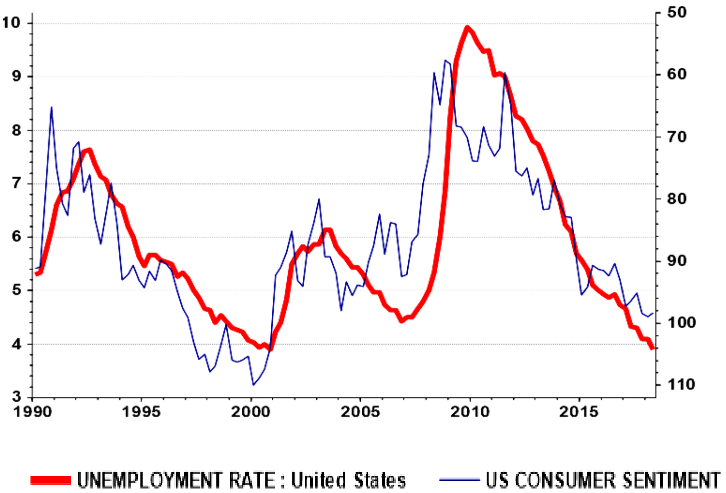


The overheating of the US economy, Trump's best ally

The relatively good performance of the US stock market since the beginning of the year should not lull us into illusions: it would be illusory to believe that the US economy would not suffer from a trade war. Actually, some large US companies have already begun to reduce their investment plans: this is revealed in the minutes of the meeting of the Fed on June 12th and 13th. Admittedly, the time to launch a trade war is well chosen by President Trump: the US economy is experiencing an unprecedented boom which is close to overheating, as evidenced by the tensions on wages and prices. It is probably no coincidence that the White House has chosen the date of Friday, July 7 to signify the passage to action and the introduction of tarriffs on USD 34 billion worth of Chinese imports. That day, the U.S department of Labor released a figure of job creation above expectations and an unemployment rate of 4%, well below its non-inflationary threshold of 4.7%.

This buoyant job market is fueling consumer confidence, which is nearing the peak of another boom in the US economy, that of the late 1990s. Chart 3 shows this strong link between the unemployment rate (in red and on the left scale) and consumer confidence (in blue and on a reversed scale on the right). The latter is also the best barometer I use to assess the danger of recession. We are far from it today but ... we must remain vigilant, as both an outright trade war together with the tightening of the Fed's monetary policy should both slow the economy.

3. In the United States, the fall in the unemployment rate is fueling consumer confidence



Central Banks manage the risk of recession

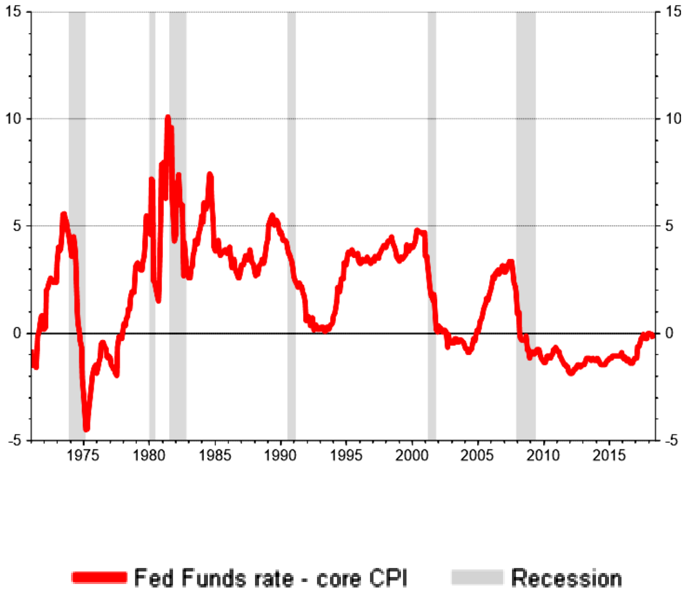
Central bank errors, both in the United States and in the Eurozone, are a major fear for investors for the next 12 months, after the danger of a trade war. This is why many observers scrutinize the yield curve in the United States: its flattening does not bode well, if we remember that almost all recessions were preceded by a inversion of the curve, in the form of short-term rates exceeding 10-year bond yields.

True, the risk of overkilling inflation exists as the impact of a tightening of monetary policy on growth and prices occurs with a time lag of about 18 months, and this lapse of time varies according to the state of the economy. All over the world, central banks have learned how to manage risk and want to avoid the shortfall of ammunition as much as possible when the next recession comes.

In the United States, the risk of overkill appears to be limited at present, if we judge the level of the key interest rates expressed in real terms. This is a good measure of the Fed's degree of effective restraint as it quantifies a form of "premium" that the Central Bank puts above core inflation.

Chart 4 shows this well: as long as real rates do not reach a minimum threshold of 3%, the danger of recession (indicated here by the gray vertical bars) seems limited. Whenever the US has experienced a recession in the past, real rates were at least 4%, which allowed the Fed to sharply lower rates as soon as the recession became a reality. Assuming that inflation could rise to 3 - 3.5% (against 2.2% currently), it would be necessary for the Fed Funds rate to reach 7% for the US economy to be in danger of recession. We are very far from it.

4. Fed policy : no risk of overkill for now

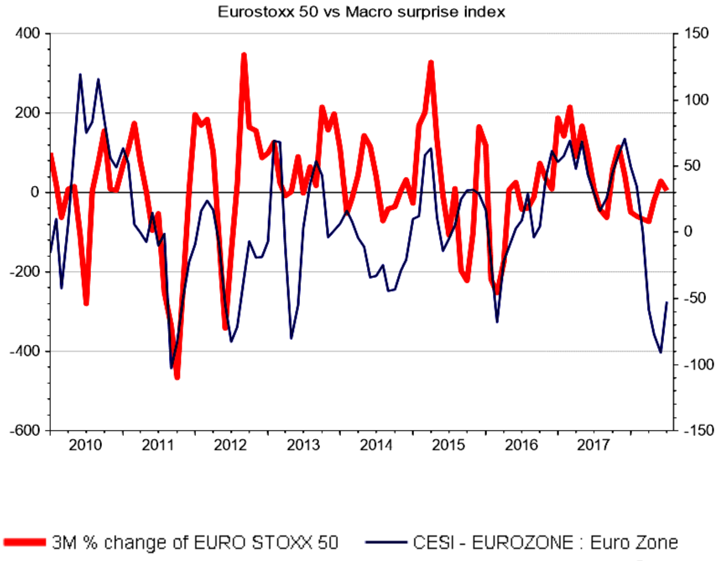


Slower growth outside the United States

Although growth remains satisfactory in the Eurozone, it still falls short of expectations, as shown in Chart 5. On the right scale of the chart, the blue curve shows the historical evolution of the "Surprise index" in the Eurozone, expressed as the average difference between the published economic figures and the expectations of economists. The disappointments are perfectly visible, and do not bode well for the stock market, in red on the chart. It must be said that growth expectations have run very high since last summer, under the effect of a resolutely accommodating monetary policy of the ECB and the election of President Macron full of promises.

The good news of this subdued growth in the Euro zone is that the European Central Bank will not put both feet on the brake and risk a recession. It is likely to implement the downsizing of its asset-purchase program by the end of this year, and will wait until the end of next summer before considering a real tightening of monetary conditions, in the form of interest rate hikes. But by then, the ECB will undoubtedly have the opportunity to review its plans, especially if the trade war becomes real and fully fledged.

5. Disappointment of growth in the Euro zone



Elsewhere in the world, growth is also at a crossroads. Growth was negative in Japan in the first quarter, following a strengthening of the Yen which penalized exports. The recession should be avoided, judging by good prospects in the labor market that also fuel consumer confidence in this part of the world.

If three quarters of the 3.5% of global growth expected in 2019 should emanate from emerging countries, the big unknown is China. Growth there remains solid but shows a slowdown that could intensify if the trade war initiated by the United States at the beginning of July was to become general, with the inevitable retaliatory measures orchestrated by the Chinese authorities.

On the equity markets side, valuations have become reasonable again, which is further reinforcing the pause in bond yield pressures. All in all, caution in our investment policy is essentially warranted by the threats posed by a generalized trade war on growth prospects.

Michel Girardin, ***Senior Economic Advisor***

Source : Thomson Reuters Datastream

Money-market and fixed-income

The global economy continued to fare well in the second quarter but in a less synchronized manner. While the pace of growth slowed in the euro zone and in Japan, the US economy continued to expand at a robust pace that could reach an annualized 3% in 2018. As expected, the ECB decided to extend its monetary support policy by prolonging QE until the end of 2018 and keeping its key rates at their current levels until at least summer 2019. Meanwhile, the Fed took on a more hawkish line in raising its Fed Funds target rate for the seventh time by 25bp and in projecting two more rate hikes for 2018. Spreads widened on short-term rates while fixed income yields receded : the 10-year US government bond yield pulled back to around 2.80% after rising as high as 3.10%, and the 10-year Bund yield fell from 0.64% to 0.30%. In our balanced allocation we continue to increase our investment grade weighting (15%) by taking advantage of positive yields on euro-denominated government and corporate bonds. We plan to reduce our overweighting (13%) of high-yield bonds as soon as spreads narrow again. The portfolio's average duration was lowered to about 3.5 years.

Equities

Despite the steep upward revision (+22%) in US corporate earnings forecasts in the first half of 2018, the S&P 500 has gained just 3% on the year to date, which is a natural reversion to the mean after its exceptional outing in 2017. Political uncertainties in Europe, the economic slowdown in Japan, and the weakness of some emerging economies are stoking risk aversion, exacerbated by fears of the trade war that Donald Trump has declared on the rest of the planet. Although this protectionist scenario is not our baseline assumption, we have decided to temporarily hedge a portion of the equity portfolio, tactically reducing the equity portion of our balanced allocation to about 39%. We continue to overweight Europe and Japan and to underweight the USA. Asia-Pacific makes up 73% of our emerging market allocation, mainly in China, India and Korea. Technology, consumer cyclicals, financial services, healthcare and industry are the main sectors represented.

Currencies

The US dollar rallied by 7% to almost 1.15 vs. the euro on the steady widening of spreads between the USA and the euro zone and the Italian political crisis. We reiterate our target of closing our tactical long USD/EUR position under this level. We have hedged our other currency exposures except for our tactical Chinese (CNY) position.

Alternative

We are gradually reorganizing our alternative allocation (15% of the balanced allocation) through a portfolio consisting of strategies such as Global Macro, Systematic Trading, Equity Market Neutral, Merger Arbitrage, and Long Volatility. The goal is to select strategies that are not correlated with one another and to set up a portfolio that itself is decorrelated as much as possible from risky assets such as equities. The ultimate objective is to generate an annual return close to Euribor + 4% with controlled overall risk.

Outlook

The trade war has not yet triggered panic on the markets, but companies likely to suffer from the crisis, such as major US multinational exporting companies, have begun to see their share prices take a hit. Protectionist fears are beginning to send investors into the safe havens of the US dollar and government bond, with negative impacts on emerging markets and corporate and high yield spreads. Risk aversion is back, at least until the US elections in November. Although the global growth picture, driven by a booming US economy, is still favorable for the coming months, we prefer taking on a more cautious stance during the summer months.

Armand du Pontavice, *CIO*

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