Investment Update – October 2018

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Global Markets Overview

Global GDP growth potentially peaked in Q2 but should remain reasonably strong over the rest of the year. The Federal Open Market Committee (FOMC) shrugged off trade concerns and boosted the target range for interest rates another quarter percentage point to 2% to 2.25%, the eighth increase of the current cycle, while teeing up a further increase in December. Next year, however, we expect the US economy may cool as monetary tightening starts to bite and the fiscal stimulus delivered by the Trump administration to the US economy wears off. With China's economy also losing steam, this will slow the pace of global growth. Against this backdrop, equity markets are likely to experience some volatility and we expect returns both in the US and more widely to be more moderate than recent years.

Trade Update

The White House recently implemented 10% tariffs on an additional $200bn of imports from China. These new tariffs on half of all Chinese exports to the US have triggered counter-tariffs by the Chinese government on $60bn worth of US exports. The tariff rate could well increase to 25% on most of these goods, though a lower rate might be proposed on consumer goods.

Although the risks are more concentrated in the US-China relationship, this does not mean other areas are without risk. NAFTA negotiations have finally been resolved with the announcement of a tripartite agreement, although details at this stage are scant. Beyond NAFTA, across-the-board auto tariffs remain a threat and the US-China trade conflict is still heating up. In any case, protectionism is such a key part of Trump's political brand that it is likely here to stay.

Overall, protectionist rhetoric and policies are likely to continue having more of an impact on certain sectors and markets. Prices of commodities such as steel and soybeans, as well as the Mexican peso and shares in auto firms, have all been rocked by trade news recently. That is likely to continue. However, even if the trade conflicts escalate and become more far reaching, the aggregate global macroeconomic impact is likely to remain small. The biggest impact is likely to be on bilateral US-China trade, but that accounts for only 3% of world trade. It's difficult to estimate the impact of a global trade war because there are no good precedents and the costs depend on the exact scenario. It would require measures on a much bigger scale than anything proposed so far to have a major macroeconomic effect. Best guess is that even if all countries were to impose 25% tariffs on all external trade, the hit to world GDP would be 2-3% and there would be some reduction in potential growth. This is mostly due to unwinding global supply chains which would affect smaller, open economies most. We are a long way from such a severe trade conflict so in practice the fallout from Trump's trade war should be much smaller.

The US

Economic growth appears to have picked up in the current quarter, largely reflecting a bounce-back in household spending. Business investment continues to grow strongly and the overall outlook for growth remains favourable. Several factors support this assessment: Fiscal policy is boosting the economy, ongoing job gains are raising incomes and confidence, foreign economies continue to expand, and overall financial conditions remain accommodative.

These observations are consistent with FOMC recently raising the funds rate target range 2% -2.25%, as widely expected. Changes to the post-meeting statement were minimal with the removal of the description of the policy stance as "accommodative". Fuelled by fiscal stimulus, GDP growth should remain strong over the rest of the year, allowing the Fed to continue raising interest rates. But with signs that tighter monetary policy is starting to weigh on rate-sensitive spending and the fiscal boost set to fade, growth may start to slow next year.

China

The main headwind to the Chinese economy over the coming quarters will come from the ongoing slowdown in credit growth. Policymakers have shifted their focus from deleveraging to supporting growth and we think they will loosen policy more forcefully over the months ahead. Meanwhile, the renminbi's recent depreciation will offset much of the impact of the tariffs proposed so far. But a further escalation of the trade conflict with the US would clearly be a concern.

The EU

Despite the economic slowdown this year the outlook for the euro-zone remains optimistic. That said, underlying inflation pressures remain subdued and it is likely the ECB Bank will leave interest rates unchanged another year. Trade tensions with the US, and the worries about public debt sustainability in Italy, remain downside risks to the outlook.

UK

Markets generally expect that the UK will strike a Brexit deal with the EU at the eleventh hour, securing a status-quo transition period lasting until the end of 2020. If inflation continues to ease, the UK economy would continue to expand into next year, allowing the Monetary Policy Committee to press on with normalising monetary policy. But the possibility of the Brexit negotiations breaking down or a change in UK government present significant downside risks to this forecast.

Emerging Asia

The escalation of the US-China trade war is the key risk to the outlook for this region. Even if tensions do not worsen, GDP growth in Emerging Asia has peaked and is likely to ease over the coming year. Central banks in Indonesia, Pakistan, Thailand and the Philippines are likely to raise interest rates further before the end of the year. Other central banks in the region will be in little rush to follow.

Emerging Europe

The financial turmoil in Turkey is likely to push the economy into a recession in the next few quarters while inflation continues to rise. In contrast, we expect the recovery in Russia to strengthen. While we no longer expect interest rate cuts in Russia this year, further policy loosening is still on the cards over a 12 to18 month horizon.

Australia

The main risk to economic growth in Australia is further escalation in global trade tensions suggesting that the Australian dollar could fall further. Release of the minutes of the RBA's September meeting noted that "members observed that there were significant tensions around global trade policy and that this represented a material risk to the outlook".

Bloomberg published details of the modelling conducted by the RBA on the implications of the trade war. In its 'limited tariff scenario', which is closest to the current situation, the RBA concluded that the effects on Australian GDP "are negligible". However, in the worse 'retaliatory scenario', where the US imposes 20% tariffs on all imports from all countries and all countries except Australia do the same to all imports from the US, the Australian economy would be 3.5% smaller than otherwise by 2022.

The upcoming proposals in the Royal Commission's interim report on the financial sector may shed some light on how credit conditions will influence the Australian economy and will be important to watch.

New Zealand

The RBNZ kept the official cash rate (OCR) unchanged at 1.75% at the September meeting as widely expected. The attending statement contained few major changes, with the RBNZ maintaining its firmly neutral guidance and the language that "the direction of our next OCR move could be up or down". While acknowledging that Q2 GDP had been stronger than expected, the RBNZ nevertheless noted "downside risks to the growth outlook remain". In turn, while the possibility of a rate cut in the near term appears to have diminished, it is likely to still be some time before the RBNZ becomes more confident about the sustainability of the expansion and increases interest rates. If the OCR stays lower for longer than consensus and the market expect, the New Zealand dollar could weaken further.

According to the ANZ Business Outlook Survey, business confidence in New Zealand rebounded in September, while firms' own activity outlook also recovered a touch. In the context of a solid Q2 GDP results, the survey outcome was encouraging - although both headline measures remaining at relatively low levels.

Summary

The global growth remains strong as major developed economies continue in mature stages of their economic cycle. While the threat of a much larger escalation of protectionism remains, the tariffs imposed so far are too small to have major macroeconomic consequences. Meanwhile, the troubles in some emerging economies are likely to continue as the Fed and ECB gradually introduce tightening policies.

Investment returns have been strong for a considerable period and we continue to recommend that a balanced approach to investment be maintained.