The Navigator

June 2018

Memories fade but the scars still linger

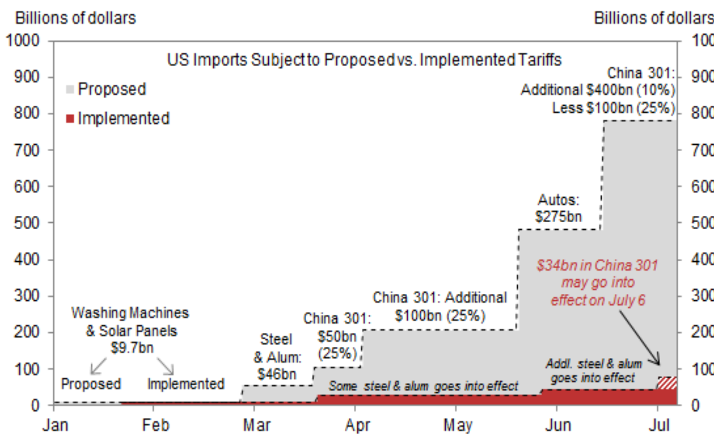
This author started his investment career months before the Baht Crisis of 1997, which quickly transmuted into the Asia Financial Crisis becoming one of the worst economic malaise seen in the last 30 years for the region. Arguably the AFC was worse than the 2008 Global Financial Crisis as more fortunes and lives were lost. Those formative investment years has left an indelible scar and foster an always alert mental radar to identify problems that lie ahead. It has also built up an arena of products knowledge and acumen to risk mitigate when such crisis comes around, and they will come around.

The price actions for most asset classes continue to trade poorly on concerns of escalating trade tensions and apparent divergences in growth trajectories across economic blocs. We will examine these two concerns in this month's issue. Trade tension against US and its other major partners have in recent 2 weeks ratchet up especially after the G7 meeting, propelling Trump to be the undisputed global #1 opprobrium. In our March Navigator, Bye, Bye, Miss American Pie, we have estimated the impact of the current form of $50bn bilateral tariffs impositions between China and US to have negligible impact to the growth of both economies. The $34bn list of products subjected to increase tariff was confirmed last week and will be imposed on the 6th July. The list of products for the remaining $16bn of the initial $50bn will be confirmed in another 6 weeks. We maintained the view that the impact remains small, in fact, the impact is smaller than the first draft of $50bn initially circulated back in April. Based on various estimates, we believe the impact to the current $50bn will shave off China GDP growth by only 0.1% to 0.2% against current GDP forecast of 6.3% in 2019 and 0.01-0.02% of GDP for US against 2019 GDP forecast of 2.4%. The impact of inflation is also negligible for both countries. In the US, the impact on inflation is smaller than initially thought as the confirmed list has a greater concentration of industrial goods versus consumer goods. Key consumer items like TV, printers and air-conditioners were omitted from the list. Impact of inflation on China is slightly more than the US potentially lifting inflation by 0.1% to 0.2% largely due to increase in prices of agricultural feedstocks.

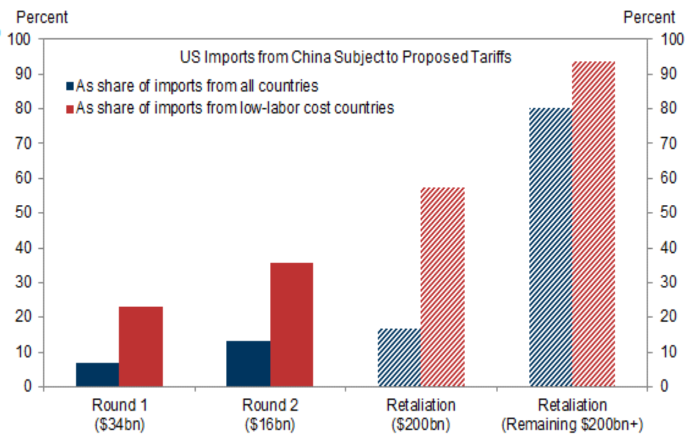
However, in another twist of madness, Trump tweeted shortly after confirming the list, he has tasked his administration to look at another $200bn of goods subjected to further 10% tariff increase. If $200bn comes to pass alongside China's corresponding response, the impact will no longer be small by the sheer size of the value involved as well as causing untold disruptions to supply chain in the short-term. It is the latter that we are most worried given the intricately connected supply chain that the world has grown accustomed to. No econometric models out there can model the impact of having to alter supply chains to suit or circumvent these tariffs. At this juncture, we have no expert nor special insights this additional tit-for-tat will materialize but for certain geo-economic risk have increased and risk

appetite curtailed. Compounding the chaos, post G7 meeting, Trump threatens to impose 25% tariff on all auto imports into the US. This measure will have a significant impact to US consumption story given auto sales are a large contributor to GDP by around 3-4% of GDP and employs over 1mn people. The impact aggrieves even more to Japan as it is estimated could shave of close to 1% of Japan GDP which is currently forecast to grow only 1.0% in 2019. In Germany, auto is 10-15% of its GDP, any tariff will hurt the 3rd largest exporting country in the world. Incidentally, for the US to eradicate their $350bn deficit with China, US is asking China to buy 900 Boeing airliner which translates to 20% of China's total general aircraft, 3x more aircrafts Boeing delivered to China last year or 1.2x total aircrafts delivered by Boeing for the whole of 2017.

Bark is louder than the bite; so far



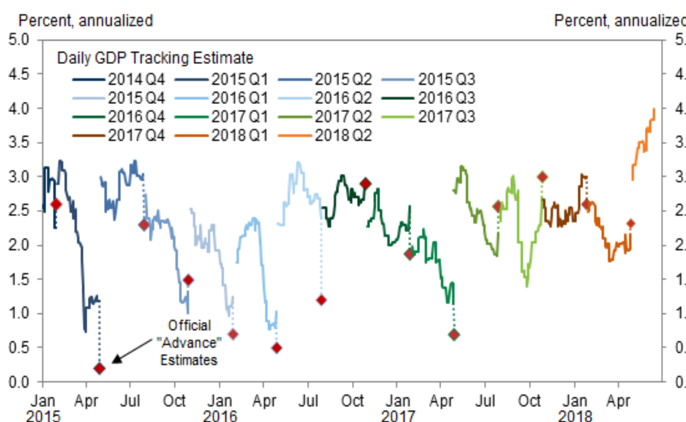
Dotard, you plan to impose tariff on 80% of your imports?



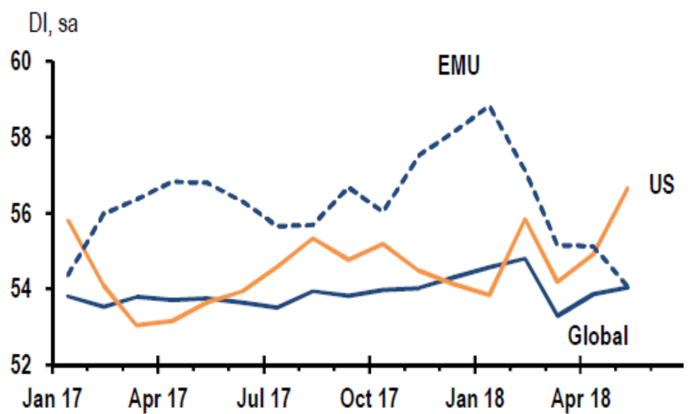
Source: GS, USTIC, USTR

One of the key tenets of our bullish view on growth when we started the year was the synchronicity of growth across many economic blocs. In recent months, incoming data is challenging this optimism. We remain sanguine about the US growth momentum over the rest of the year, barring current trade rhetoric escalating to full-scale war. We have faded first-quarter growth concerns as the underpinnings of an above-trend growth for US remains. They include medium-term dynamics of healthy employment market leading to higher wages as well as short-term boosts from their enacted tax reform and a re-accelerating manufacturing activity. GS Nowcaster is pointing to a possible GDP print of 3.7% in 2Q18 versus 1Q18 2.8%, which would be the strongest quarterly GDP print since 2015.

US 2Q18 GDP possibly highest in the last 3 years

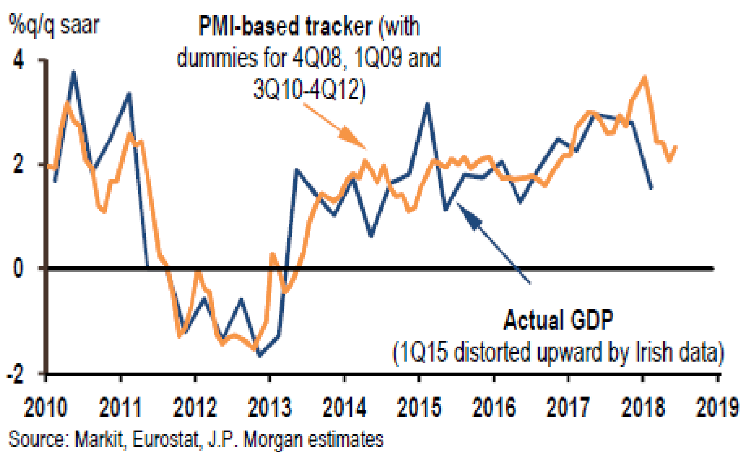


US bootstrapping rest of the world



However, the delta of growth momentum has slowed dramatically in Europe and Japan and there are genuine concerns are emanating in some part of emerging markets. The sudden drop in Europe PMI, especially for manufacturing, in the last few months have been puzzling. Perhaps trade and political tensions are hampering sentiment, or it could be a simple case of destocking in Europe given inventories were running at an unsustainable pace in the past 6 months. However, it must be emphasized PMIs for Europe remains in expansionary level with the latest reading of 55.0 for manufacturing and 54.2 for services, implying a 2.3% growth for this year. In Japan, growth remains anaemic with 1Q18 GDP at 1.0% and incoming data alludes to downside risk to full-year consensus forecast of 1.1%. An overarching concern for Japan is the specter of trade war can wipe out the entire 2019 GDP growth forecast for Japan. The impact on tariffs of its automobiles in Japan and the collateral damage from the US and China tension could wipe out another 0.4% to 0.9% for Japan.

While EU PMI has weakened, it still points to 2.3% GDP growth



Potentially deleterious impact to Japan growth

(%)

$50bn		$250bn		$450bn	
Supply chain	US & China Growth	Supply chain	US & China Growth	Supply chain	US & China Growth
-0.1	-0.2	-0.4	-0.4	-0.6	-0.7

Note: Impact of value added is partially included in the impact of growth of US and China.
Source: J.P. Morgan

Argentina and Turkey have been the focus in recent month with their currencies depreciated by 45% and 23% respectively. Credit default swaps have risen by 150bp to 400 since the start of the year for Argentina though it is still much lower than the period of EM low growth and commodities price collapsed of 2013-2015 where their CDS spread traded from 1500 to high 6000 points. It has been the similar case for Turkey with its CDS spread now at 300bps, which is at its post-GFC high. Much of these two countries malaises is traced to idiosyncratic issues and are unlikely to permeate to rest of EM. The ballast to EM growth remains with China and we are turning bullish on its growth momentum. We are expecting a pro-growth cyclical response on both monetary and fiscal policies in the coming months. These are in response to recent weakness in their economic data wrought on by their 12 months long tightening of the shadow banking activities as well as to mitigate the adverse impact of US bellicose trade actions. Following the 100bps cut in Reserve Requirement Ratio in April, we are now expecting two to three 50bps cuts till year end with one coming in weeks. Every 100bps cut in RRR releases about RMB1 trillion into the system. Though it was passed in March this year without as much fanfare as the US tax reform, China tax reform unleashed RMB800bn of income back to the consumer or approximately 0.90% of last year GDP. We believe it will also expand its fiscal

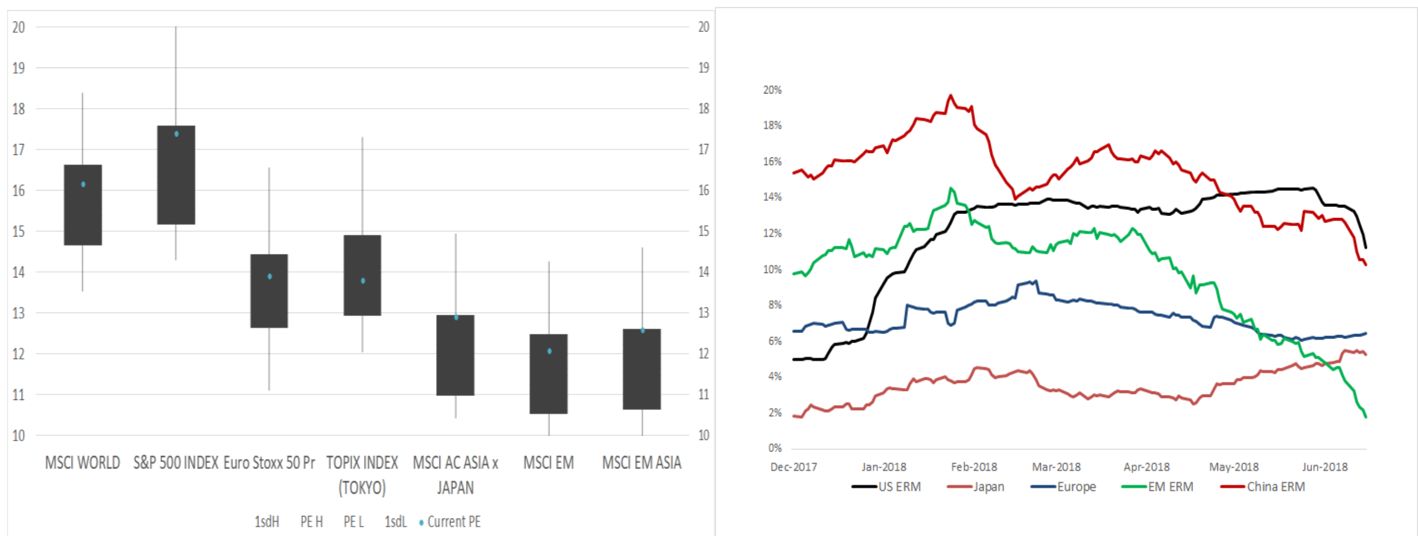
spending via targeted infrastructure and social spending and the possibility of increasing export rebate to assist its export companies.

Asset Allocation Strategy

Equities: Overweight. MSCI World Equities have given up 7% of its early year return to close flat now for the year. There have been significant performance disparities. Our overweight call in US performed the best +3%, driven by tech which is up 11.4%. Our other overweight call in EM equities have been more volatile retreating -15% for its year peak to close down -6% for the year. Most of our weights in EM equities are concentrated in China and in secular stories and they have outperformed the broader index. Europe and Japan equity markets are down -1%+ each but our exposures in both blocs have done significantly better recording mid-single digit gains. Much of our expression in Europe were concentrated in small caps and financials while our Japan small-cap positions continue its multi-year outperformance.

We remain overweight in Equities at this late stage of a cycle. World Equities EPS are still forecast to grow by 15% this year and 9% next year. US and China are expected to post the strongest 2 years EPS growth among major markets up +14% and 19% respectively. Valuations are not expensive and are trading within their 10-year band while earnings revision momentum remains positive except in Latam and EMEA. We retain our preference for the US and underweight Europe and Japan. Within EM, we continue to avoid outside of Asia partly because of complicated domestic nuances and the team's lack of informed opportunities. With our views that China's growth is inflecting, we have half of our EM Equities exposure in China-related names. We are exploring several key thematic in Asia including healthcare and AI. We also see growing case for shareholder activism managers in Asia.

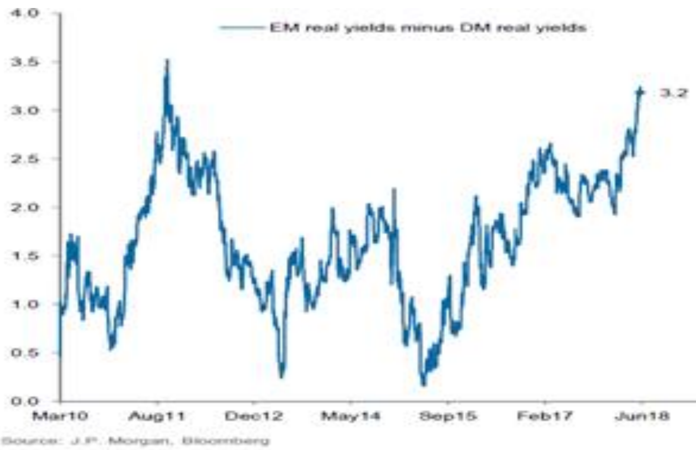
Equities valuations are not expensive; within 10 years band | **Earnings revision momentum still +ve except LATAM,EMEA**



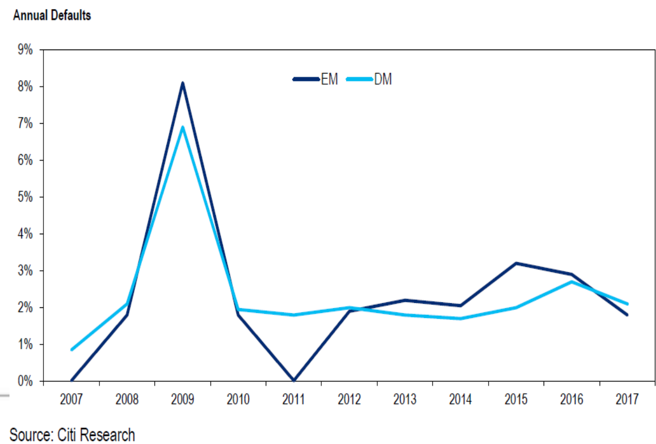
Source: Bloomberg

Fixed Income: Underweight. Our Fixed Income portfolio has been the main detractor of performance as the bond prices have to recalibrated quickly to the rapid increase in US rates. But as we mentioned in last month edition, Thucydides Trap, we believe the biggest move for US rates for 2018 is already done. we have been reducing our underweight in Fixed Income as the market is already pricing in-line with Fed's dots into 1H19. With the US ten-year at 2.90% currently, market is only 10-20bps within our year-end fair value. We continue to favour financials bonds especially AT1 and CoCo debt given their yield have increased by 100-150bps in the last 3months and are now yielding close to 6%. We strongly believe that their capital levels can withstand material slowdown in the global economy, which isn't our base case scenario anyway. While EM debt has been one of the worst sub-classes of bond, we retain our constructive view of EM debt as we believe growth in EM will be bootstrapped by the US and China. Furthermore, the spread between EM and DM yield have widened close to its ten-year high while corporate default remains low.

EM vs DM Yield most attractive since 2010



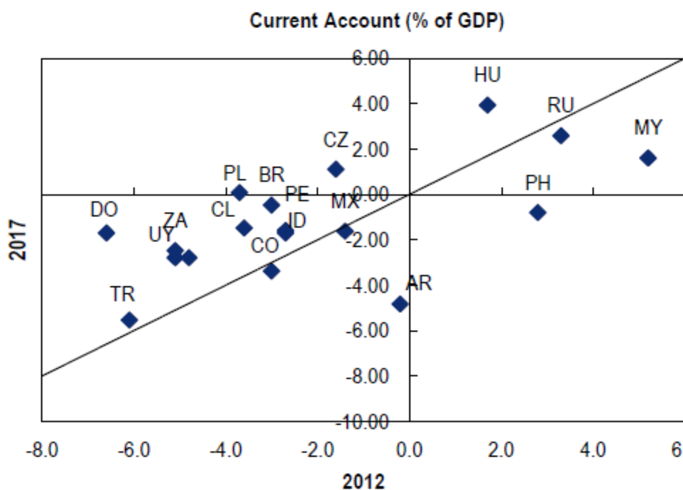
Corporate defaults remains low



Source: Citi Research

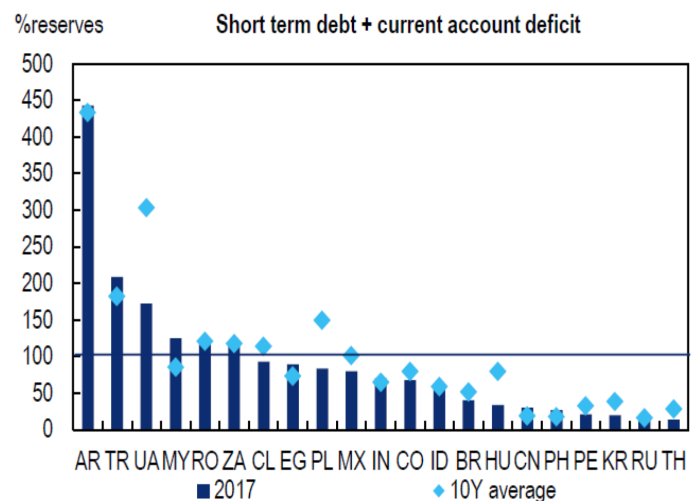
Our analysis of EM vulnerability shows that Argentina and Turkey are the clear standouts to risk of capital flight due to its debt level and current account deficits. Only Argentina, Turkey and Philippines have seen their current account deficit from 2012 till last year thought Philippines deficit is small. Argentina and Turkey are also the large outliers with insufficient foreign reserves to cover its short-term debt and current account deficit.

Turkey, Arg and Phi CA worsen since 2012



Source: Bloomberg, Citi Research

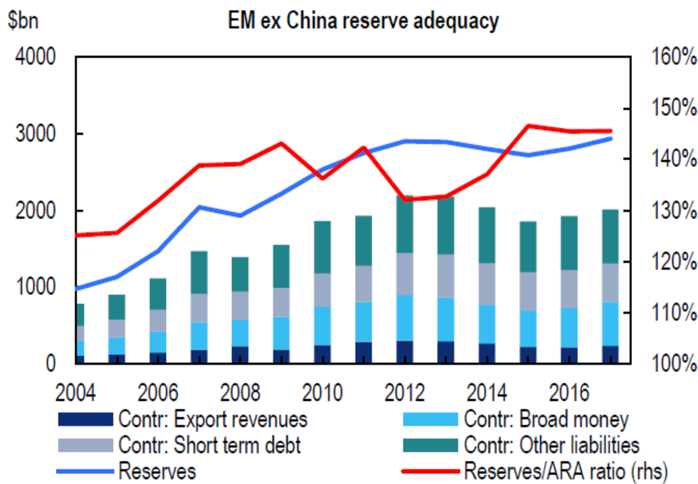
Arg, Turkey, UAE and MY have weak reserve cover



Source: IMF, Citi Research

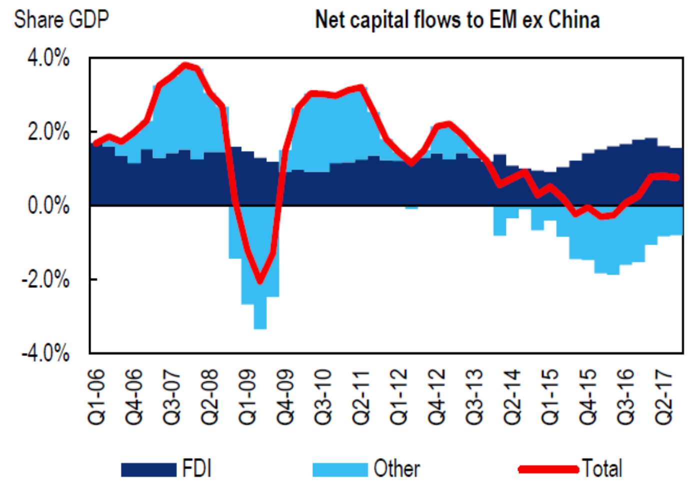
Unless the world descends into an omnishambles of multi-lateral trade retaliation, we believe contagion risk from Argentina and Turkey will not spread to rest of EM. There are several critical points to substantiate our views. The grouping itself, safe for Argentina, Turkey, UEA and Malaysia, reserve coverage is above 140%. The constitution of capital flows into EM has altered substantially which is now supported more by stickier foreign direct investment rather than flighty capital flows.

Strongest foreign reserve coverage in EM



Source: Citi Research

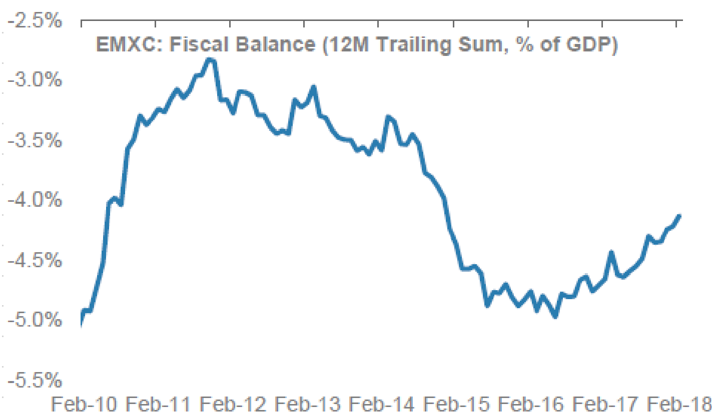
Sticker money, FDI, forms larger part of flows



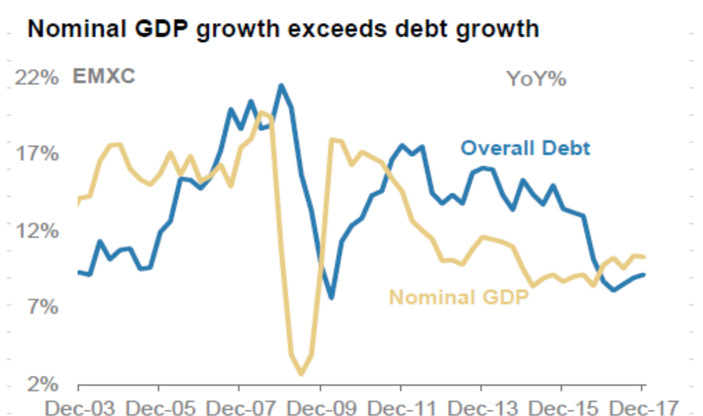
Source: Haver Analytics, Citi Research

While EM is still running fiscal deficits, the gap has been narrowing. In the last 2 years, real GDP is growing faster than debt increases. We believe this growth trend should continue as commodity prices recover while collaborative rising middle-class in EM alters the growth drivers over a longer term.

Improving fiscal balance



Real growth increasing, debt growth slowing

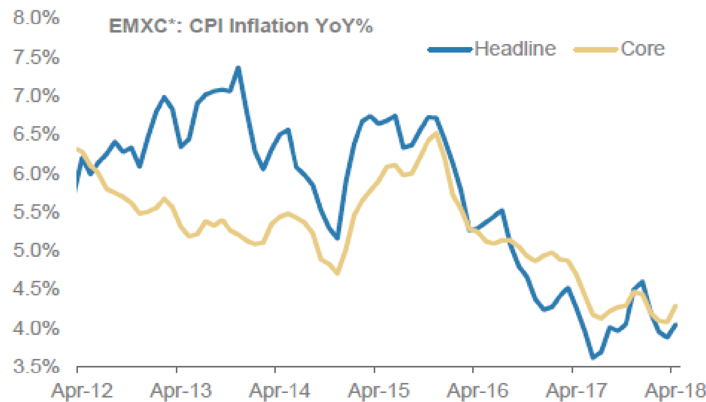


Source: Morgan Stanley

Finally, as inflation has abated while real rates differentials are largely positive in EM, theircentral banks have a significant powerful lever to slow down capital outflow; ie by raising rates. That is exactly what has happened in the past months

with India, Indonesia, Brazil alongside Argentina and Turkey have all raised rates to stem flows. Nonetheless, barring a sharp growth slowdown or another more than 10% move in USD, EM rates will rise modestly with throughout the year. It is worth highlighting the sensitivity of USD strength on EM rates. Based on JPM analysis, the GDP-weighted EM rates have hiked by 50bps since start of the year, another 10% strength in the USD will move EM rates by another 25bps rise in EM with the impact to high-yielders countries rising by a larger extent of 40bps.

Benign inflation and +ve real rates allow EM CBs to raise rates to curb capital outflows

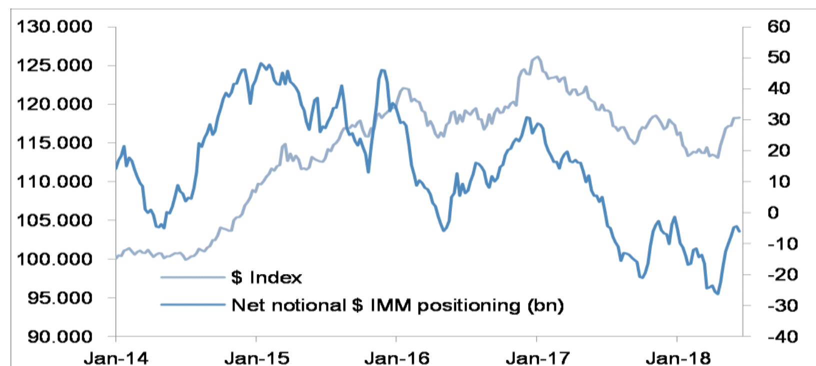


Source: Morgan Stanley

Commodities: Overweight. We have downgraded our view on oil last month and since then oil has retraced $6bpl from the high, Nonetheless, we believe the oil price will range between $70-80 till 1H19 when the US shale gas distribution bottleneck is resolved. Our preference to express this sanguine oil view throughout the last 12 months were to invest in high dividend paying oil majors and service providers whose earnings are about to turnaround. We remain positive in our view on copper and are exploring other basic materials like steel, coking coal and lithium.

FX: Neutral. While we have never been that prescient in calling currencies, but we think the short-term move up in USD is largely done. Significant shorts in the US have already been unwound as of latest data and short-term technical suggest dollar appears to hit a resistance.

US$ shorts have been stopped out, short-term DXY resistance



Alternatives Investments: No change with preferences for long/short credit manager and total return FI manager.

Cash: Cash level remains 5 to 15% providing enough dry powder. Adopted significant downside put protection opportunistically.

Featured Picture/Quote:

Space Force.

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