The Tariff Man Strikes Again

In our last edition, Show Me The Money, we urged caution as valuations no longer provide any buffer to any negative surprise shocks. Furthermore, economic growth remains tenuous with the service industries and employment remaining robust, but the manufacturing industries are in a technical recession. We downgraded Equities to Neutral. Kept Fixed Income as Neutral preferring to add government bonds as a hedge but have taken some profit on high yield debt. We also recommended raising Cash to level higher than normal and has advised to put on hedges in the form of long JPY/USD, volatility products and in Gold as a safe haven. What has prevented us to be outright bearish is that global positionings in several risk assets are relatively light though we have caveated our view that the US and China will reach a trade deal in coming months.

However, the calm that has prevailed in the last five months have been derailed. In a series of tweets, President Trump has threatened to increase the tariff on the current $200bn Chinese imports from 10% to 25% and threatened to impose the tariff on the remaining $300bn of goods from China. We are in no position to render any view if this will come through but will instead focus on the impact it would have on global growth. According to Citi economists**, the increase from 10% to 25% tariff on current $200bn imports will shave off global growth by 0.31% which China and Eurozone growth, given its trade dependency, will be reduced by 0.83% and 0.27% respectively. The impacts are material to global growth as it will shave of -10% of 2020 forecast, -14% for China, -19% for Europe but the US has the least impact at -5%.** The $200bn imports are mostly intermediate goods used in manufacturing sectors of the US, followed by capital equipment while the consumer has the least impact of three broad categories of goods. However, should Trump proceed to enact tariffs for the remaining $325bn, the impact on growth globally will be even more meaningful even for the US. The main detrimental transmission impact for the US will come in the form of higher inflation as the remaining goods are concentrated in consumer products. US Core inflation could rise by as much as 0.37%ppt point to 2.37%, a 20% lift to consensus inflation forecast for 2020. At 2.37% core inflation, the Fed will have a difficult balancing act of maintaining growth while adhering its dual mandate of keeping inflation below 2%.

Rising tariffs have biggest impact on China and EU

Chinese goods	Tariff	China	US	Eurozone	Global
$50bn	25%	-0.21	-0.03	-0.07	-0.08
$200bn	10%	-0.33	-0.04	-0.11	-0.12
$200bn	25%	-0.83	-0.10	-0.27	-0.31
$325bn	10%	-0.54	-0.07	-0.17	-0.20
$325bn	25%	-1.35	-0.17	-0.43	-0.51

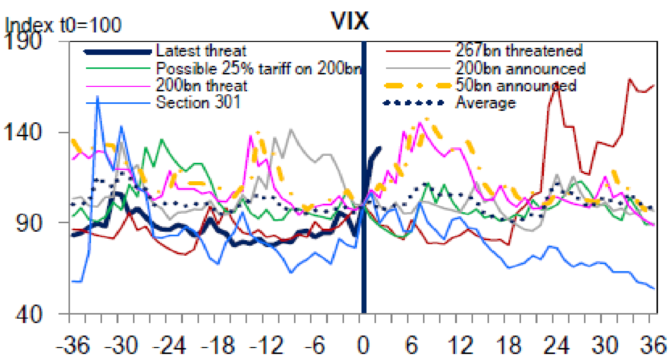
See: Global Economics View - How Would China's Slowdown Affect the Global Expansion? Source: Citi Research

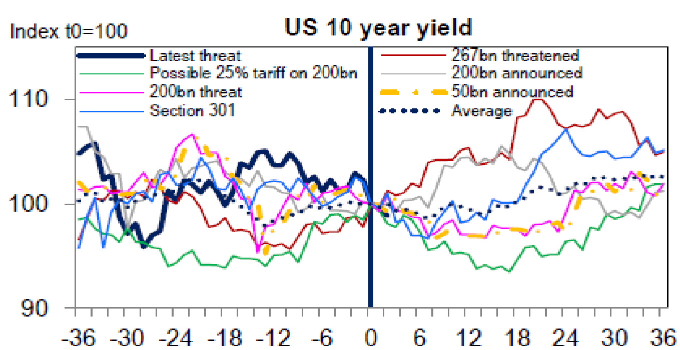
But the passthrough to US inflation is major concern

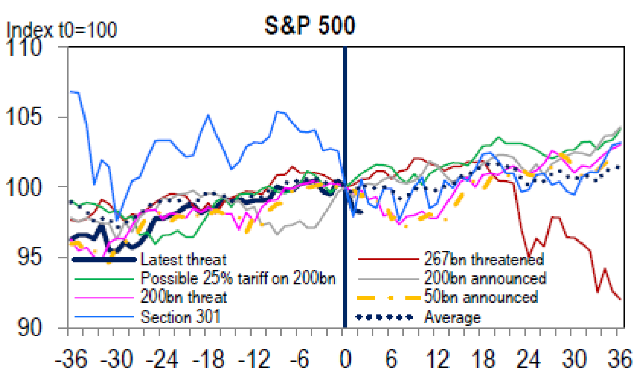
Pass-through	60%		100%	
	Headline	Core	Headline	Core
$50bn @25%	0.007	0.006	0.012	0.009
$200bn @10%	0.03	0.03	0.05	0.04
$200bn @25%	0.07	0.07	0.11	0.11
$325bn @10%	0.05	0.10	0.15	0.17
$325bn @25%	0.22	0.24	0.37	0.41

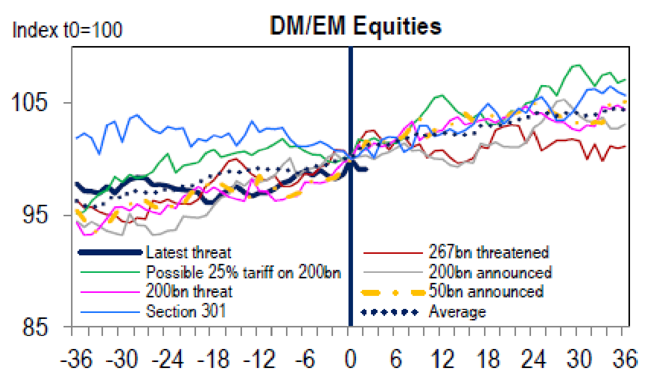
See: Global Economics View - Why More Tariffs on China Could Lead to Accelerating Inflation?
Source: Citi Research

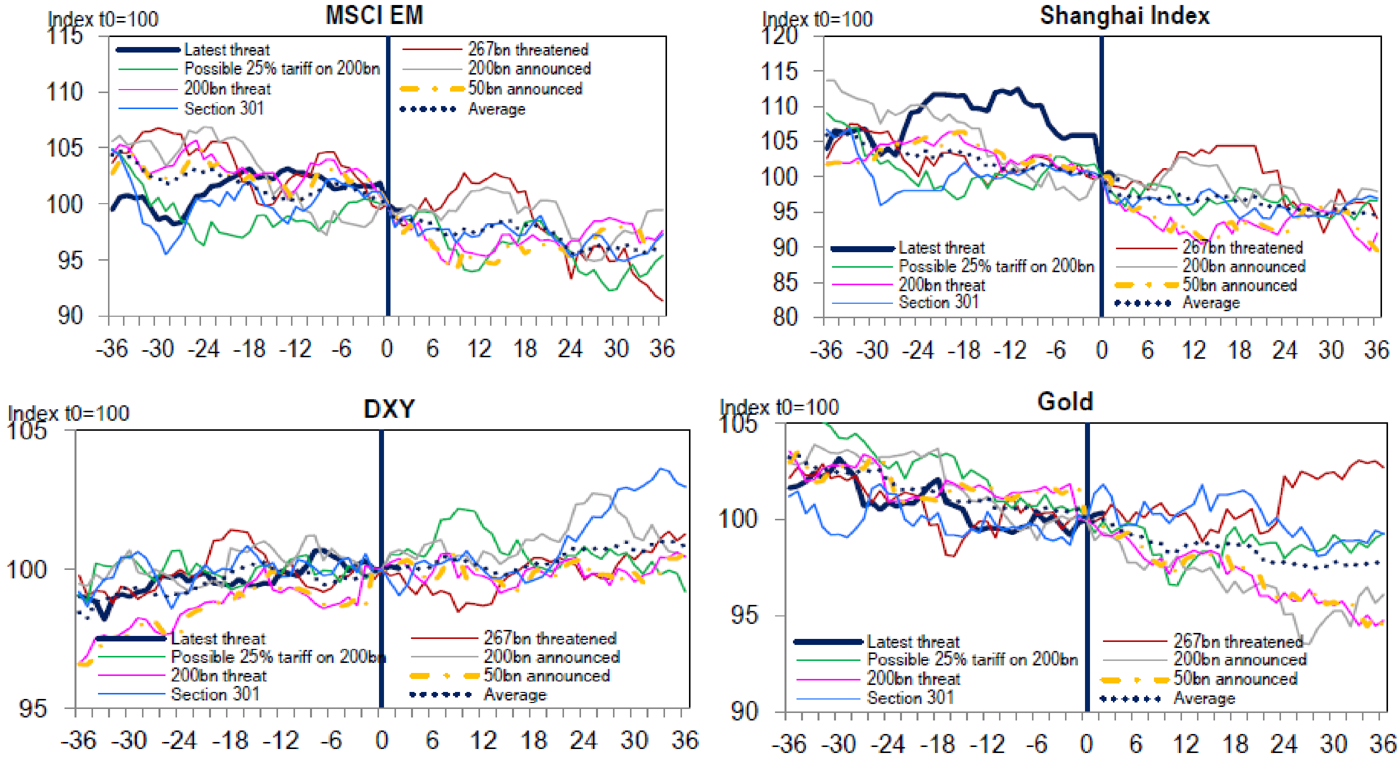
The impact to asset prices will be adversely impacted as the market has baked in an amicable resolution in the past months. We analysed the market reactions in previous announcements of tariffs. Volatility as measured by VIX Index, rose on average by 15% and can spike as high as 70% within the first 36 days. It is less obvious for US10 Treasury yield which fell in the first few days before rising for the remaining period due to the Fed continuing to articulate a hawkish stance. S&P declined was modest except for one episode where it fell close to 10% which occurred during the 4Q18 meltdown. As expected, given the economic impact is far greater for EM than DM economies, DM equities outperformed EM equities throughout this period by as much as 5%. MSCI EM Equities index and Shanghai Index fell close to -5 to -7% each. The US$ index had a modest gain of less than 2% with Chinese Yuan bearing the biggest brunt of it (-3%), followed by EUR (-1%) while the JPY strengthen modestly. Gold surprisingly does not provide any use as a hedge falling by -3%.







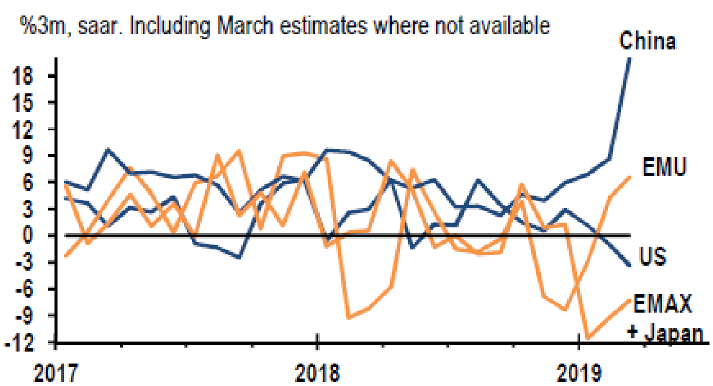




Source: Citi Research

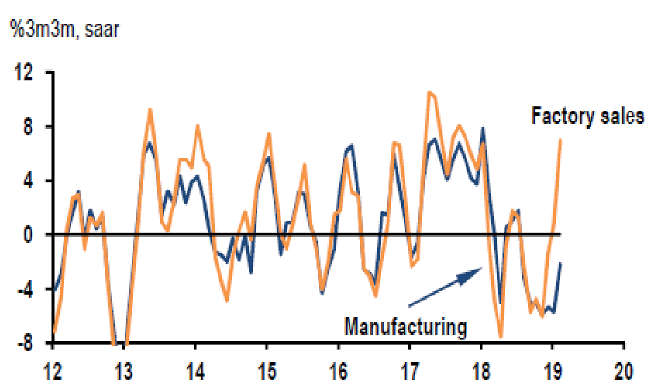
Moving away from the uncertainty that we cannot predict, **we are seeing some greeshoots in the manufacturing sector and 1Q19 earnings scorecards have been better than expected**. Global industry output has been anemic in the last 2 quarters at only 1% ar growth but we are seeing signs that the manufacturing growth is set to rebound in 2Q19 3Q19. The improvements are coming from the normalization of China's supply chain in response to US-China already enacted tariffs as well from its relatively successful fiscal pump-priming that included a barrage of front-loaded infrastuture spending and cuts in various taxes. We also expect handphone shipments to rebound in the next few quarters due to new product launches which should aid tech supply chains in Asia. Several transitory factors appear to have weighed on Europe in the last 3 quarters such as Germany's auto demand and inventory issues, pharmaceuticals decline due to transportation bottleneck, the yellow vest protest in France and Italy's political stalemate. However, Europe's output has already rebounded since the start of the year even without much participation from Germany; which we think will normalize ahead.

Manufacturing output rebounding in China and Europe



Source: J.P. Morgan

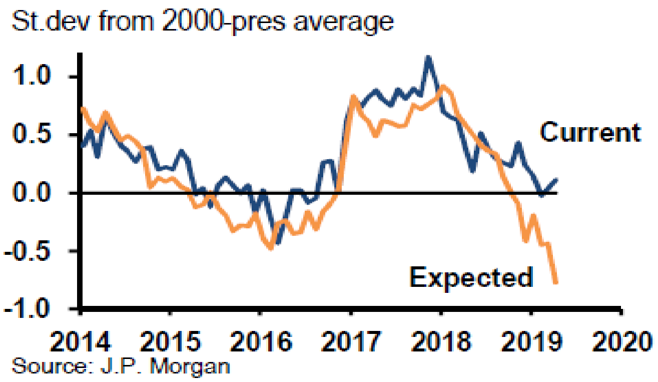
Germany factory sales > output; inventory work down



Source: J.P. Morgan

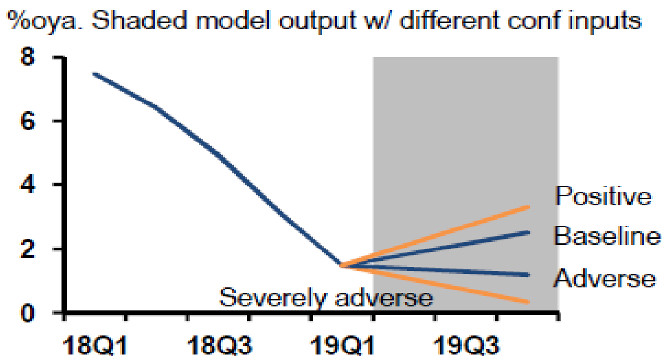
For a sustained rebound in industrial production, we need policy easing to continue, financial conditions to remain accommodative and geopolitical risk to fade. We believe the first two factors should prevail, but the latter remains a wild card as demonstrated by last week event. Geopolitical risk has a particularly pernicious impact on sentiment. Surveys on sentiment started to deteriorate sharply after last Sep when Trump threatened to impose tariffs on all imports from China. Corporates responded by delaying their investments with the capex proxy sliding from 8% growth in 1Q18 to just 1-2% in the last few months. We have in many past editions commented on the importance of a capex led growth on EM economies, financial markets and even re-rating of valuation multiples.

DM manufacturing sentiment surveys sliding further



Source: J.P. Morgan

Capex investment grinding to a halt



Source: J.P. Morgan (*Global excl China for data reasons)

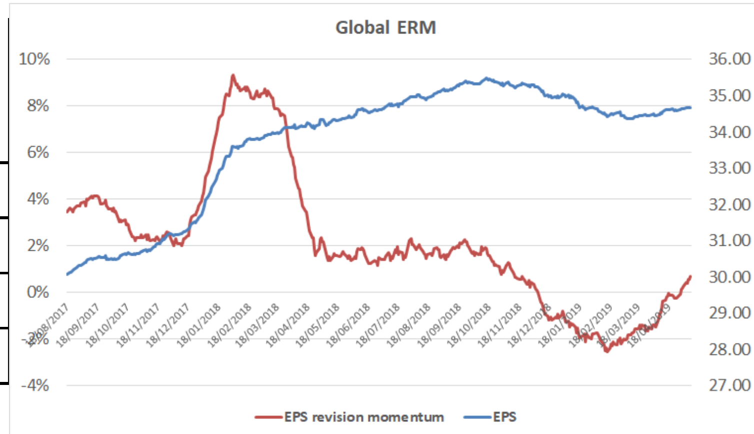
1Q19 earnings season has been better than expected in the US and Europe but poorer in Japan and Asia ex-Japan. In the US, 90% of the companies have reported with 73% of the companies reporting better than expected earnings; better than last quarter's 66%. EPS growth in 1Q19 was a positive 3% yoy in contrast to th expectation of negative -4% growth a month ago. 75% of companies in Europe have reported of which 55% are exceeding expectations which is also above its historical median. EPS came in a +3% surprise lifting growth to 2% yoy for the quarter. However, Japan scorecard has so far been poor with 42% of companies have already reported and only 34% reporting positive surprise while 49% results were worse than expected. EPS growth is tracking +5% yoy but is a -8% miss so far. Not surprising, domestic Japan is performing better than its export contingent. Over in Asia ex-Japan, 47% have reported with only 37% beating and 43% missing forecasts. Profit declined by -12% yoy skewed largely by Korean tech and materials across the region. However, according to Goldman Sachs, the forward guidance during earnings call in Asia ex-Japan has improved. **While overall, EPS revision momentum (ERM) has improved and are now tracking positive revision upwards. Nonetheless, acutely aware seniment and demand can alter quickly if US-China trade re-negotiation remains protracted and elusive or turns for the worse, analysts and companies will be quick to revise down their estimates.** By regions, the US and Europe are experiencing the best and positive revision momentum but we are watching carefully China's ERM as it has started to trend lower to close to negative after improving for 7 months. Japan downward revision appears to have stablised but it has yet to record positive revision and given dour 1Q19 earnings so far and its sensitivity to global trade, it will be hard-pressed to expect its ERM to turn positive in the coming months.

Regional 1Q19 earnings scorecard

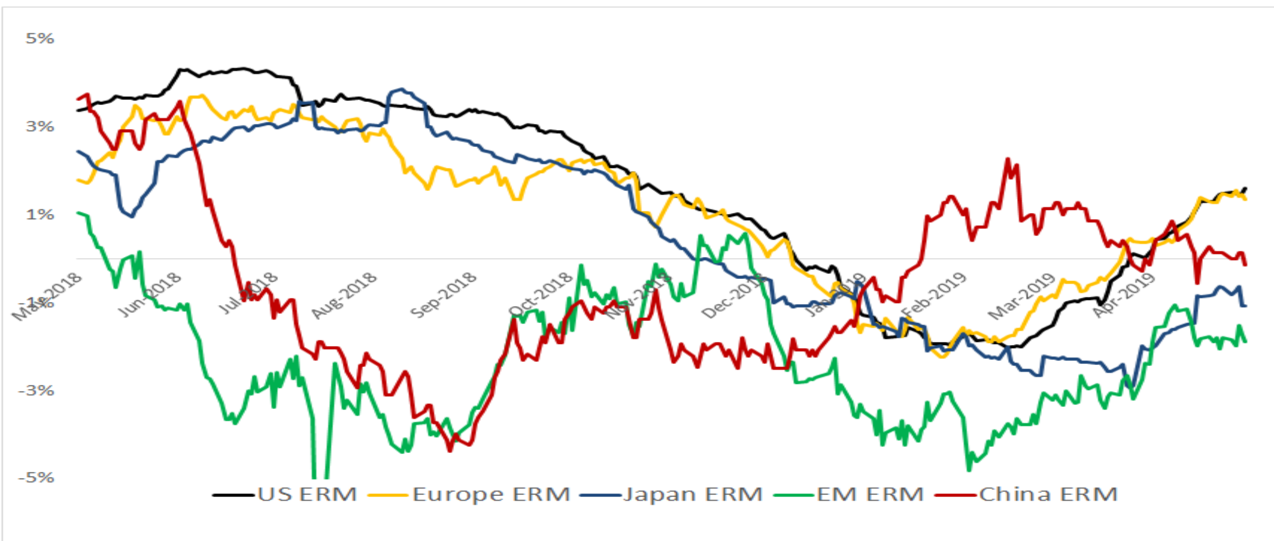
	% companies reported	% companies exceed	EPS Growth 1Q19	EPS Surprise
US	90%	73%	3%	7%
Europe	75%	55%	2%	3%
Japan	42%	34%	5%	-8%
Asia ex-Japan	47%	37%	-12%	-2%

Source: JPM, GS

MSCI World revision momentum have turned +ve



ERM +ve for US and Europe but trending lower for China and still -ve for Japan



Source: Bloomberg

Asset Allocation Strategy

Equities (Downgrade to Underweight from Neutral): We have de-risked the Equity portfolio significantly even before this recent umbrage with our equities exposure now an underweight with large hedge in the form of put options and volatility product. We are underweight EM equities now, momentarily underweight in the US as well and market weight in Japan and Europe. It is too early to re-engage risk and if we do, it will likely be in the US, Europe, and China in order of preference. The sector tilt is also less aggressive with defensive accounting for 20% of the portfolio, 22% are in small-cap managers that are generally more domestically focused while the secular tech ideas form the largest expression of growth.

Fixed Income: Neutral and we continue to add Government Bonds in developed markets and selectively quasi-sovereign debt in emerging markets to deploy our excess cash as well as act as a hedge to our equity portfolio if macro data continues to worsen. The portfolio remains highly skewed towards investment grade credits as we have reduced EM credits in the past few months.

FX: USD may get a safe haven bid as the tension between US-China escalates. We have long Yen/USD as a portfolio hedge

Commodities: Neutral with Gold as a safe haven hedge.

Alternative Investments: We are exploring a non-correlated events manager and will update further.

Cash: We intend to hold larger than normal cash level.

Featured Picture/Quote:

We are Liverpool, this means more

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