Commentators prematurely assume a trade war

The bell-weather S&P 500 index fell 5.95% last week in a marked 'risk-off' reaction to concerns about the possibility of a trade war after President Trump's recent tariff announcements, as well as a further high-profile departure at the White House - with all this being fanned by data security issues at Facebook, which hit the social networking space. The first appearance of Jerome Powell at his inaugural after-FOMC policy briefing as the new US Federal Reserve Chairman - following the fully-discounted 25 basis point increase in the Fed funds rate - almost became just other items on the list of the week's events, with the conclusion that markets generally took the Fed statement and 'dots' to be only slightly net-hawkish relative to the December meeting. Having initially threatened not to avert a possible US government shutdown, President Trump signed a $1.3 trillion spending bill passed by Congress, but did so rather grumpily (saying "never again"), seemingly on the basis that there wouldn't be sufficient money to build his Mexican wall. Overall, the MSCI All Country World Index closed down 4.42%, while the Bloomberg Barclays Global-Aggregate bond index closed 0.61% to the good. In European equities, the STOXX Europe 600 index closed 3.15% lower over the week. Japan's TOPIX index closed 4.13% lower, and China's CSI 300 index was down 3.73%. Gold in dollars registered the 'risk-off' stance elsewhere (rising by just over $33/oz - or 2.51%), to $1,347.33/oz, as well as some weakness in the dollar, which closed 0.88% lower on its index (DXY: 89.436). The yen was notably strong, with the dollar 1.20% lower against it over the week, at ¥104.74. The euro rose by a restrained 0.51% vs. the dollar, to $1.2353, maybe held back by the March Eurozone IHS/Markit Composite PMI being below expectations, at 55.3, vs. 57.1 in February and a consensus estimate of 56.8 (so expansion is still quite good, although not as good as it was). In commodities, Brent crude was strong, up 6.40% over the week, at $70.45/barrel, mainly as the perceived Middle Eastern risk premium inflated further with the replacement of H.R. McMaster by the hard-liner, John Bolton, as US Security Advisor. **Gold in euros, arguably a better representation of overall hedge demand for the yellow metal, rose by just under 2%, although without breaching medium-term downtrend lines.**

"We are not concerned about a trade war"

Trump's steel and aluminium tariffs of a few weeks ago now look like a negotiating ploy, given the exemptions granted so far. The US will grant the EU and some other countries a temporary exemption from its steel and aluminium tariffs, based on criteria that are not yet public. As well as the EU, those exempt include Argentina, Australia, Brazil, and South Korea. In a new development last week, President Trump signed a memo effecting 25% tariffs on $60 billion of imports from China, supposedly to reflect a payback for China stealing US companies' intellectual property (IP) over the years, and said, "This is the first of many" trade actions. Following that, China made it clear it would retaliate, saying it intends to impose tariffs on about $3 billion-worth of US exports to China, with the expectation that these will be finely-targeted to hit Trump politically where it hurts the most. We understand that China will hit certain products in the technology sector - and of course China could always target US agricultural produce, a large proportion of which is exported to China (such as soya beans). A statement from China's commerce ministry said, "China does not hope to be in a trade war, but is not afraid of engaging in one", adding, "China hopes the US will pull back from the brink, make prudent decisions, and avoid dragging bilateral trade relations to a dangerous place". After the imposition of tariffs on Chinese imports, US consumers could face higher prices, while US businesses will have to accommodate new arrangements and prices in its own product chains. To us, this smacks of political posturing to keep the average Trump voter on-side ahead of November's upcoming mid-term elections ('America First'), with the possibility of being able to say that such threats resulted in trade deficit control. Treasury Secretary Mnuchin will have already calibrated the 'pinch points' - how far can these actions be pushed without hurting US GDP growth prospects? Over the past five years almost a fifth of total US imports are from China. Irrespective of arguments about IP (and/or 'dumping'), what about the possibility that the Chinese are in reality rather good at exporting – especially to the US? So far the Chinese response appears one of calmness, while there is no comparison between the $60 billion of targeted US import value and the $3 billion Chinese response on the one hand - and the $375 billion trade deficit that the US suffers with China on the other. Also in Mr Mnuchin's mind is likely to be the fact that the Chinese are the largest holders of US government debt. **This is not to say that China would dump those bonds, of course, however this needs to be seen as part of the big picture; China always takes the long view, and can afford to do so.**

"Jerome Powell as FOMC Chairman equals continuity"

Turning to the Fed from last week: In last week's statement (and via the 'dots') the FOMC maintained their forecast for two further rate increases this year, although they now expect one more rate rise in 2019 than they indicated last December (making a total of three for that year). The US labour market remains strong, the economy continues to expand, and inflation appears to be moving toward the FOMC's 2% goal, the latter helped by earlier declines dropping out of the year-on-year calculation. Growth in household spending and business investment appear to have moderated early this year, although the fundamentals underpinning demand remain solid and the economic outlook had strengthened in recent months. Fiscal policy has become more stimulative, ongoing job gains are boosting incomes and confidence, and foreign growth is firm. The median projection for the growth of real GDP this year is now 2.7% (up from 2.5%), 2.4% for 2019 (up from 2.1%), and 2% for 2020 (unchanged). The median projection for the unemployment rate stands at 3.8% for the fourth quarter of this year (down from 3.9%), is now 3.6% for the end of 2019 (markedly down from 3.9%), and is 3.6% for the end of 2020 (down from 4.0%) - and at 3.6% is almost a percentage point below its expected longer-run normal rate. Core PCE inflation is expected to be 1.9% at the end of this year (unchanged from the December forecast), and 2.1% at the end of 2019 and 2020 (both up from 2.0%). So compared with the projections made in December, real GDP growth is looking stronger, expected unemployment is lower, and inflation is slightly higher. The statement said that participants' projections of the appropriate path for the fed funds rate 'reflect our gradual approach': the median projection for the fed funds rate is 2.1% at the end of this year, 2.9% at the end of 2019, and 3.4% at the end of 2020 (at which it would be modestly above its estimated longer-run level trend). **Current market expectations for the Fed funds rate two years from now are 2.51% i.e. perhaps two hikes behind the 'dot plot'.**

"Inflation in the US should edge up, but should not take off"

Continuing with the Fed discussion, the statement said the program for reducing their balance sheet (which began in October), is proceeding smoothly, and barring a very significant and unexpected weakening in the outlook, they did not intend to alter it. Turning to the Q&A, we thought the key points were as follows: Chair Powell said "…there's no sense in the data that we're on the cusp of an acceleration of inflation. We have seen moderate increases in wages and price inflation, and we seem to be seeing more of that". Asked about any discussion of tariffs, confirming various members had mentioned this, the Chairman summarized their views: "…there's no thought, I think, that changes in trade policy should have any effect on the current outlook". He confirmed, though, that "…trade policy has become a concern going forward for that group (business leaders)". The Chairman reiterated the point that productivity has been very weak since the financial crisis, although, "…in the tax bill there are incentives…that allows expensing of investments (that should) encourage additional investment (and) productivity. In theory, an individual tax bill that lowers tax rates should encourage more labor force participation". He added that, "...the current view of the Committee is that financial stability vulnerabilities are moderate…", and that "…participants believe there will be meaningful increases in demand from the new fiscal policies for at least the next, let's say, three years…". Touching on the Phillips Curve, he said, "...wages should in theory represent inflation plus productivity increases… productivity's been very low…(and) inflation's been low…so low wage increases make sense". **On yield curve inversion, he said: "…it's true that yield curves have tended to predict recessions,** *however* **(our italics), "…if you look back over many cycles, a lot of that was just situations in which inflation was allowed to get out of control, and the Fed had to tighten, and that put the economy into a recession. That's really not the situation we're in now…I don't think that recession probabilities are particularly high at the moment, any higher than they normally are".**

"Buy quality genuine IT stocks beaten-down by the social networking debacle"

INVESTMENT SUMMARY: (1) We don't see a trade war, either globally, or between the US and China; Mnuchin says they are looking for a trade agreement; (2) We view last week's Fed messages as only slightly more hawkish; improving and moderate growth expectations are good, and (3) …especially when inflation expectations remain in a low range; last week's rate hike was (a) fully expected, and (b) prudent; (4) The 10-year US Treasury yield closed three basis points lower over the week (at 2.8135%); that tactical bond bet is still on; (5) Large price falls in social networking stocks last week unfairly dragged down some excellent 'genuine' technology stocks; (6) Greater regulation of social networking companies runs the risk of P/E multiple contraction across the sub-sector; (7) For investors, last week's Brexit transition deal time-frame 'achievement' misses the point - a transition to what, exactly? and (8) **The Asset Allocation Committee met last week and reiterated its bullish stance on global equities, despite short-term volatility.**

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