Laurentian Bank Securities
ECONOMIC RESEARCH AND STRATEGY

Tactical Asset Allocation (August Update) – Trade War And Search For Yield

- The U.S.-China trade war escalated in a methodical fashion, similar to what we've seen in May. Negotiations will continue in September with low probability of improvement by then. We continue to believe that a trade deal is the most plausible outcome by year-end;
- We continue to recommend a moderate tactical underweight position in equities. Although, U.S. stocks heavily exposed to China as well as developed and emerging markets will eventually represent interesting opportunities;
- Increasing risk-aversion and falling interest rates will support defensive sectors;
- The global search for yield and negative and falling interest rates lifted corporate bonds returns since the beginning of this year. Those dynamics are unlikely to change in the near-term and we now recommend a small overweight position in corporate bonds;

Recommended Portfolio as of August 2019				
Asset Classes & Regions	Recommended Weightings (%)	Benchmark Allocation (%)	Over/Underweights (%)	Recommendation
Bonds	55.0	50.0	5.0	+
Government	34.4 (39.4)	34.4	0.0	=
Corporate	20.6 (15.6)	15.6	5.0	+
Equities	45.0	50.0	-5.0	-
Canada	18.0	20.0	-2.0	-
United States	16.0	16.0	0.0	=
Other Developed Markets	9.6	11.6	-2.0	-
Emerging Markets	1.4	2.4	-1.0	-

Note: Numbers in bracket represent previous month allocation.
Source: LBS Economic Research and Strategy.

Trade war mechanics

Last month, we recommended a tactical retreat from our prior 3-month overweight (55-45) position in equities towards a modest underweight position in stocks (45-55) versus bonds. This was based on the apprehension that fading economic momentum and the absence of meaningful progress in the U.S.-China trade war would supersede the positive effects from central bank easing on equity valuations. While economic data did not meaningfully improve, it is President Trump's surprise announcement on August 1st that the U.S. would impose a 10% tariff as of September 1st on an additional US$300B of Chinese imports not already taxed that triggered the current selloff in equity markets. On August 5th, China retaliated by letting the Chinese yuan devaluate to 7, its lowest level since 2008. It has also been reported that Chinese state-owned firms are no longer buying American farm goods. These latest spats all but annihilate the trade "truce" reached at the G-20 meeting.

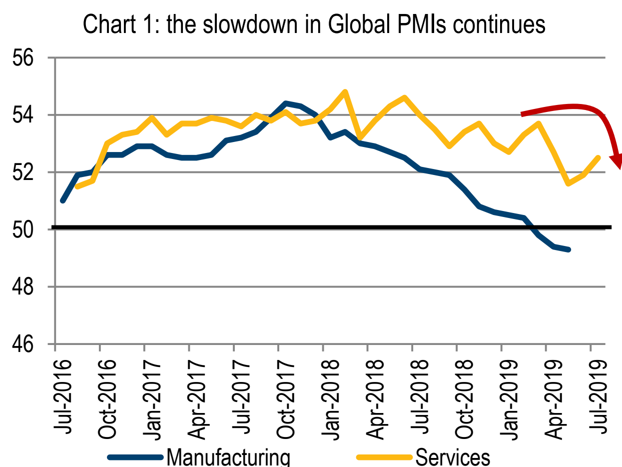
This being said, there is a **methodical** aspect to these developments that is worth mentioning as it can serve as a guide to investors:

- The events leading up to and following last week's 10% tariff announcement are similar to the May 5th 25% announcement. For instance, in a similar fashion to before the May 5th tariffs, there had been positive momentum in the ongoing negotiations due to the G-20 meetings. Then, formal talks between U.S. and Chinese officials were cut short in Shanghai last week. We believe that China was again not in a position to offer what had been reportedly agreed on in May e.g. enforceability mechanisms with regards to technology transfer, subsidies and alleged IP theft.
- Therefore, the U.S. Administration **incrementally** imposed additional tariffs to ramp up pressure on China.
- China retaliated; this time by devaluating its currency. As highlighted by Robin Brooks at the Institute of International Finance, the $/CNY would need to devaluate by 6% to completely offset the 10% tariff on US$300B imports. As of writing, the $/CNY has only been devaluated by 1.5% relative to the end of last week, meaning that the Chinese authorities are not yet willing to engage in a full blown currency war.[1]
- Formal talks between the two countries are still scheduled for September.
- Therefore, both parties seem unwilling to engage in an escalation that would completely remove any prospect for a trade deal.

We believe that the latest announced tariffs will come into effect on September 1st. Threats of increasing those tariffs to 25% will be reiterated if the September talks are not constructive enough. However, we are still of the view that an agreement will be reached and tensions will de-escalate before year end. Global economic data continues to deteriorate, especially business sentiment (chart 1). Moreover, in the U.S., job creation has slowed down significantly in recent months. As a 6-month moving average, non-farm payrolls positions created monthly has never been this slow since 2012 (chart 2).[2] Granted, at 140K on average per month, job creation is still much above what is needed to keep the unemployment rate close to record-lows, below 4%. Nonetheless, growth in services jobs has also slowed. Since it is not in any party's interest to trigger a global recession, we believe that a compromise is still within reach by year-end.

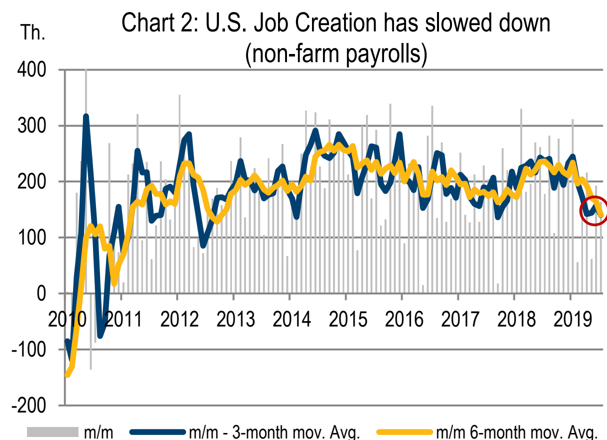
An eventual trade deal would propel U.S. stocks heavily exposed to China. Indeed, S&P 500 companies with more than 10% of their revenues generated in China have underperformed their index by 15% since the beginning of the trade war (chart 3). Similarly, we will look to upgrade our allocation to emerging markets and developed markets once a trade deal seems within reach (chart 4).

Chart 1: the slowdown in Global PMIs continues



Source: J.P. Morgan/IHS, Thomson Reuters Datastream.

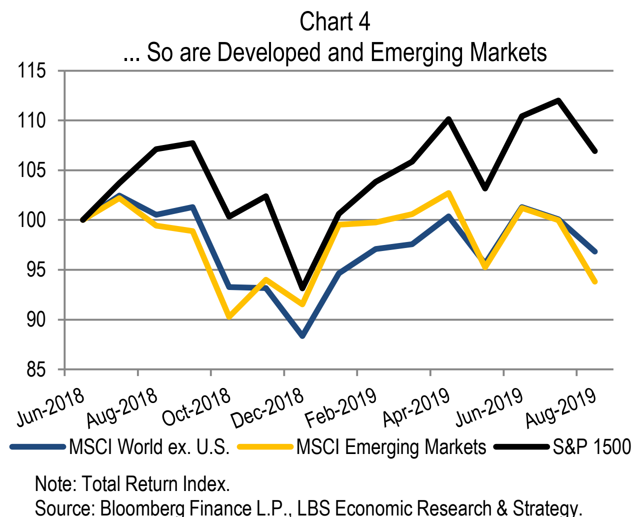
Chart 2: U.S. Job Creation has slowed down (non-farm payrolls)



Note: Truncated at 400,000.
Source: BLS/Datastream, LBS Econ. Res. and Strategy.

[1] All else equal, a 10% tariff on US$300B of Chinese imports is worth US$30B. To devalue its import by US$30B, China would need to devalue its currency by 6% (*6% x US$500B of Chinese imports = US$30B*).
[2] Granted, at 140K on average per month, job creation is still above what is needed to keep the unemployment rate close to a record-low, below 4%.

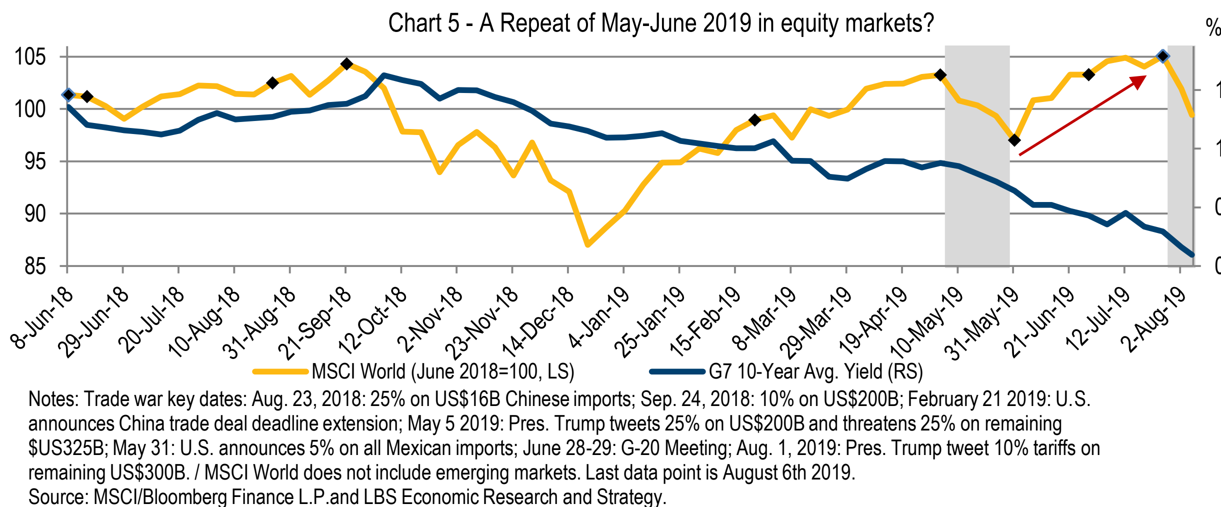
Notes: Indexed Base: June 4th 2018. Individual stocks from Goldman Sachs. Last data point is August 6, 2019. Source: Goldman Sachs, Bloomberg Finance L.P., LBS Economic Research & Strategy calculations.



Note: Total Return Index.
Source: Bloomberg Finance L.P., LBS Economic Research & Strategy.

No repeat of the May-June movement: stay moderately underweight equities

Following the early-May tariff announcement, developed market equities fell by 6%. Then, mostly on the back of Federal Reserve and ECB monetary easing expectations, they rallied significantly in June and reached fresh record-highs in July (chart 5). As of August 6th, developed markets equities had fallen over 5% relative to the end of July. Only this time, most *plausible* interest cuts from the Federal Reserve in 2019 (more than 60 bps) has already been reflected in financial markets. This makes it more unlikely that central banks easing will lift equities in the weeks to come. Moreover, we do not expect any meaningful improvement in economic data as long as uncertainty remains that high. Therefore, we continue to recommend a **moderate underweight allocation to equities versus bonds** as we see limited upside in the near-term (45/55, see table). Also from a tactical perspective, we continue to **moderately underweight Canadian equities**. Short-term indicators such as the strength of the U.S. dollar, a relative under-performance of globally oriented versus domestic stocks as well as the S&P TSX versus the S&P 500 are pointing towards a light under-performance in Canadian equities.



Notes: Trade war key dates: Aug. 23, 2018: 25% on US$16B Chinese imports; Sep. 24, 2018: 10% on US$200B; February 21 2019: U.S. announces China trade deal deadline extension; May 5 2019: Pres. Trump tweets 25% on US$200B and threatens 25% on remaining $US325B; May 31: U.S. announces 5% on all Mexican imports; June 28-29: G-20 Meeting; Aug. 1, 2019: Pres. Trump tweet 10% tariffs on remaining US$300B. / MSCI World does not include emerging markets. Last data point is August 6th 2019.
Source: MSCI/Bloomberg Finance L.P.and LBS Economic Research and Strategy.

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Finally, consistent with our previous strategy, we continue to overweight defensive sectors (**utilities** and **consumer staples in the U.S. and Canada, telecommunication services in Canada and health care in the U.S.**). In Canada, those two sectors over-performed the broader index in July and are expected to continue to do so amidst current market conditions (see table). Moreover, as explained below, sustained search for yield globally and thus falling interest rates will support defensive sectors. We also keep our overweight positions in **information technology** in Canada, which returned a 47% price return year-to-date; by far the best performing sector in 2019. Canadian IT companies should continue to benefit from a healthy U.S. consumer in the near-term.

July 2019 Month-Over-Month Return	Canada (S&P TSX)	U.S. (S&P 500)
Consumer Discretionary	3.5	1.0
Information Technology	**3.2**	3.3
Materials	2.3	-0.4
Real Estate	2.1	1.7
Industrials	1.8	0.7
Utilities	**1.8**	**-0.3**
Consumer Staples	**1.6**	**2.5**
Financials	1.1	2.4
Index	0.3	1.4
Telecommunications Services	**-1.1**	**3.4**
Energy	-3.9	-1.8
Health Care	-13.3	**-1.6**

Notes: Total Return Index. Bolded figures represent recommended sectors in July.
Source: Bloomberg Finance L.P. and LBS Economic Research and Strategy.

The search for yield continues to drive bond returns

Since the beginning of 2019, the average G-7 bond yield has fallen by 80 basis points on the heels of a fading economic momentum and trade tensions (chart 5). Interestingly, despite the heightened uncertainty, Canadian corporate bonds returned 7.3%, over-performing government bonds which returned 5.8%. Those were certainly aided by the fact that both investment grade and high yield spreads to risk-free bonds did not persistently widen, shrugging off weaker economic data as well as three quarters of estimated negative corporate earnings-per-share.[3] Falling risk-free global bond yields, record-level equity prices and the increasing volume of negative-yielding bonds created an environment in which the search for yield has driven large inflows towards relatively riskier corporate bonds as well as more illiquid municipal bonds, supporting strong returns (chart 6). Reports have also shown growing international interest for Canadian municipal bonds. We believe that this search for yields will continue in the near-future and therefore put a slight overweight position in corporate bonds in August.

[3] Year-over-Year, 2019Q1 to 2019Q3. Source: Factset Earnings Hindsight.

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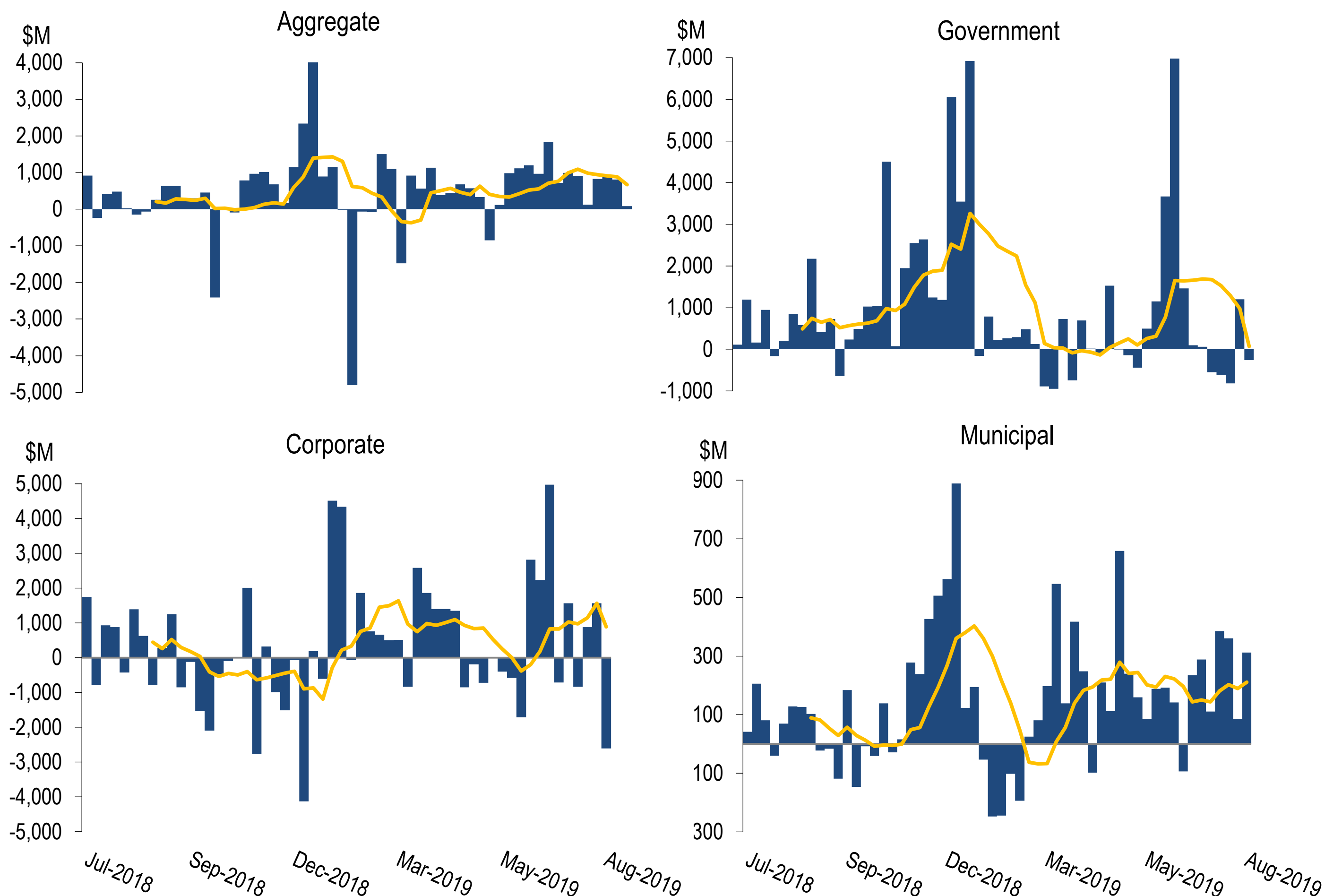
Chart 6: Weekly Fixed Income ETF Flows



Note: Yellow line denotes 8-week moving average.
Source: Bloomberg Fixed-Income ETF Tracker, LBS Economic Research & Strategy.

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