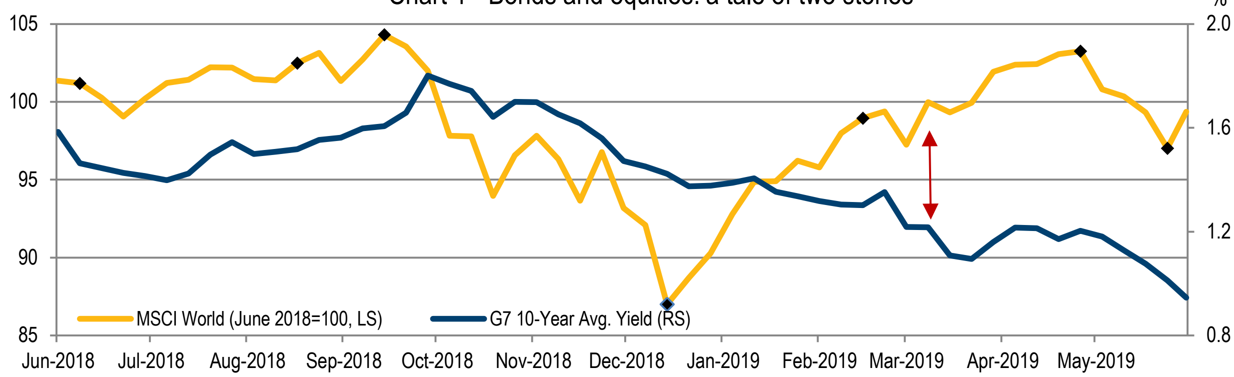
Tactical Asset Allocation (June Update) – It all comes down to one thing

Since the trade conflict between the U.S. and China emerged at the end of September 2018, equities and bonds have traded around two diverging macroeconomic scenarios. With central banks now assessing whether lower interest rates - rather than higher rates six months ago - are warranted by the end of this year, near-term developments in financial markets come down to one issue: the outcome of the U.S.-China trade negotiations which seriously deteriorated in the past few weeks. As we've argued last month we believe that the most plausible conclusion at this point is still a comprehensive trade agreement between the two rivals.

Chart 1 - Bonds and equities: a tale of two stories



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

The equity market: following the ups and downs of the trade dispute

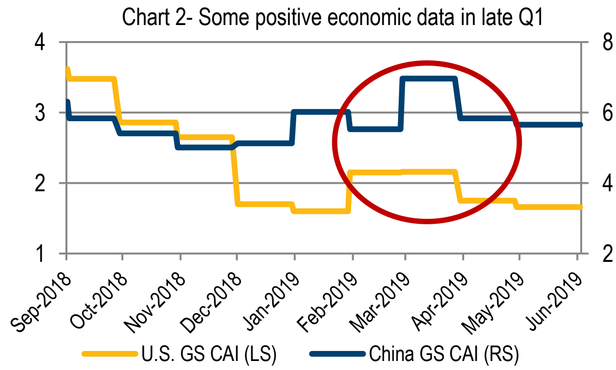
Global stock markets have generally followed the ups and downs of the trade spat between the United States and China. For instance, between September 21st, when the U.S. first imposed 10% tariffs on US$200B of Chinese imports, and December 21st, the MSCI equities *World Index* fell by 17% (chart 1). Then, when the prospects for Federal Reserve interest rate hikes in 2019 were taken off the table in early 2019 and, at the same time, the outlook of the trade negotiations between the U.S. and China improved, the index re-gained an impressive 19%. Hopes for a swift resolution of the conflict culminated on February 21st when the U.S. announced an extension of the deadline for negotiating a comprehensive trade deal with China, thereby temporarily putting additional tariffs on the back burner. But, negotiations broke down in early May when President Trump announced on Twitter that existing tariffs on Chinese imports would indeed rise to 25% on May 10th. Then, the White House also imposed an effective ban of Huawei technologies in the United States to put additional pressure on China. Equities have since fallen by 4%. Exacerbating the losses was the surprise announcement of gradual, but potential steep tariffs on all Mexican imports as a measure to force Mexico to step-up its efforts to stop migrants in what the U.S. Administration describes as an international migration crisis at the U.S.-Mexican border.[1]

The bond market: consistently pessimistic

Over the same eight months, contrarily to equities, movements observed in the bond market have not supported the idea that a positive resolution of the U.S.-China trade negotiations was the most realistic outcome. At the beginning of October, long-term bond yields in the G7 started to fall from a decade-high average of approximately 1.8% to almost 0.95% today; a rally of roughly 85 basis points. In spite of some positive news regarding U.S. and Chinese economic growth in late 2019Q1 as well as a temporary positive trade outlook earlier this year, the downward trend in bond yields resumed (chart 2).

To be clear, this current bond rally is tied to two intertwined issues. First, the idea that central banks have tightened monetary policy too fast last year and may need to reverse course. Second, bond markets are pricing a negative economic outlook due to the global trade war. Indeed, fears of a recession either in late 2019 or early 2020 have been reflected in rapid and significant yield curve flattening, if not outright inversion between various maturities. Recession fears have been exacerbated earlier this week with the publication of the weakest U.S. IHS Markit manufacturing PMI since September 2009. The index barely stayed in expansion territory at 50.5, down from 52.6 in April.

Second, the weakest component of the J.P. Morgan Global Manufacturing PMI (currently at 49.8) is the new exports component. It has been trending below 50 and the overall index for some time. This suggests that international trade conditions are the most significant impediments to growth, as of yet.



Source: Goldman Sachs current activity indicator/Bloomberg Finance L.P., LBS Econ. Res. and Strategy.

In fact, domestic economies are still growing. In China, the fiscal stimulus, measured by a 23% y/y rise in total social financing (total credit to the private sector) coincides with the third consecutive improvement in manufacturing conditions in May (above 50, chart 3). In the U.S., consumer confidence is more than 5% above the low-level reached in January 2019, prompted by continuous strong employment gains. In Canada, evidence suggests that the economy accelerated at the end of the first quarter after a temporary slowdown partly driven by the fall in energy prices in the second half of 2018.

This perhaps pointed equity investors towards an optimistic picture. But, it was drawn without factoring in the tariffs on Chinese imports which were recently increased to 25% (from 10%) as well as the threat of tariffs that could reach 25% on all imports Mexican imports in October (starting from 5% on June 10th). To be sure, if the trade war continues to intensify such a positive outlook does not have a chance to hold for very long. Last Wednesday, the World Bank revised downward its global growth forecast, again.

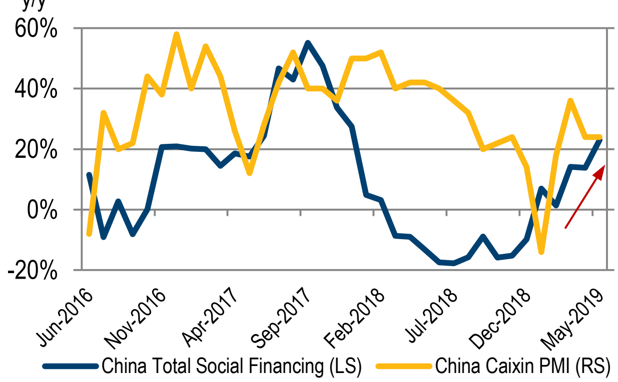
A trade deal is still the most plausible outcome: overweighting equities

In light of recent market turmoil, our tactical asset allocation model recommends a neutral stance towards equities versus bonds. However, our model is not designed to capture the outcomes of trade

[1] 5% tariffs on all Mexican imports will become effective on June 10. Those tariffs will rise to 10%, 15%, 20% and 25% on the first day of July, August, September and October if the White House deems that the crisis has not been alleviated.

negotiations. We believe that despite very contentious issues in the U.S.-China trade negotiations, an imminent agreement is likely.

Chart 3 - Chinese fiscal stimulus has come to fruition



Source: Markit, PBOC /Thomson Reuters, LBS Econ. Res. and Strategy.

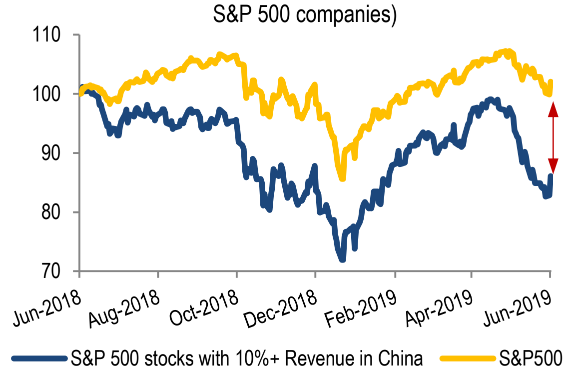
The G-20 meeting in Japan on June 28th-29th is indeed providing an excellent opportunity for the U.S. and China to reach a compromise on many trade issues, agree to lift tariffs and postpone until later the resolution of more sensitive issues.

1. China has already offered to significantly reduce its US$419B bilateral goods deficit by as much as US$200B by importing more U.S. products would a deal be reached.

2. Section 301 tariffs related to China's alleged technology transfer, intellectual property and innovation are more complicated to settle since it involves China's internal laws, rules and regulations. So far, American efforts to force China to amend its own legislation and offer guarantees of compliance have not succeeded. Yet, since it is in both countries' interests to compromise, we believe that the U.S. will agree to temporarily lift existing import tariffs in exchange of China's "commitment" to quickly implement legislative reforms. A deadline would be set to keep pressure on China but to also give it the opportunity to make those changes independently while mitigating their economic impacts and managing their political fallouts. Beyond this deadline, the U.S. would commit to re-impose tariffs and punitive sanctions if China failed to comply.

If a trade agreement is reached shortly following the G-20 summit in June, equities should rally. As we expect the meeting between Xi and Trump to be announced ahead of the G-20 Summit, equities could gradually regain their footing as we approach the Summit. In particular, equities currently exposed to the Chinese market should over-perform the overall market. Since the end of April, S&P 500 companies with 10% or more of their sales in China have seen their share price fall by 11%. They have underperformed the broad index by 6 ppts. In large part because we expect a tentative trade agreement to be reached by the end of June, we continue to recommend a moderate 55% equity position (neutral 50%) with an overweight mostly in cyclical sectors.

Chart 4: Large potential upside for China-exposed S&P 500 companies)



Notes: Indexed Base: June 4th 2018. Individual stocks list from Goldman Sachs.
Source: Goldman Sachs, Bloomberg Finance L.P., LBS Econ. Res. & Strategy.

Out of the six most U.S. heavily exposed sectors to China, we favour four**: information technology**, **industrials**, **consumer staples** and **consumer discretionary**. In Canada, we prefer **utilities** to consumer discretionary. In both countries, we continue to recommend **telecommunication services** which have performed well in the last month; beating their respective benchmark.

Similarly, despite some moderate tensions in the corporate bond market and a widening in high yield corporate bond spreads, we continue to hold a 30/70 neutral stance towards corporate and governmental bonds.

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Recommended Portfolio as of June 2019				
Asset Classes & Regions	Recommended Weightings (%)	Benchmark Allocation (%)	Over/Underweights (%)	Recommendation
Bonds	45.0	50.0	-5.0	-
Government	32.0	34.4	-2.4	-
Corporate	13.0	15.6	-2.6	-
Equities	55.0	50.0	5.0	+
Canada	20.0	20.0	0.0	=
United States	19.5	16.0	3.5	+
Other Developed Markets	11.6	11.6	0.0	=
Emerging Markets	3.9	2.4	1.5	+

Source: LBS Economic Research and Strategy.