MID YEAR OUTLOOK

BRAVE NEW WORLD

NAVIGATING TRADE-WAR RHETORIC AND THE END OF AN ELONGATED CYCLE

The overall results of a resynchronised global slowdown and low inflation can be seen in the reversal of the Federal Reserve's interest rate stance, as well as in other central banks that have paused their rate hikes. Removing one roadblock to risk assets is a positive sign, yet challenges remain. Renewed trade tensions and the actions of central banks could become a new source of market volatility.

In my 2019 outlook *A rite of passage into a multipolar world*[1], I highlighted three factors that would reshape the investment world during the course of the year:

- **A resynchronisation of global growth**
- **The ongoing US-China trade war**
- **A peak in US interest rates**

These factors have played out since the start of the year and are likely to remain significant for investors over the coming months.

While hopes of a US-China trade deal, signs of a pause in the Fed's rate hike cycle and optimism over China's stimulus measures fuelled a rally in risk assets at the start of the year, renewed trade tensions have brought the rally to an abrupt halt.

At the point of writing, risk assets have sold off

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as the impact of higher trade tariffs threatens the nascent recovery in the global economy. Even before the collapse in trade negotiations between the US and China in May, the IMF had already downgraded its forecast for global economic growth to 3.3% in April (see Fig.1) from 3.5% in January 2019, the fourth time in nine

Fig. 1: International Monetary Fund: Synchronised global slowdown[2]

Growth projections (%)	2018	2019F	2020F
World	**3.6**	**3.3**	**3.6**
Advanced economies	**2.2**	**1.8**	**1.7**
United States	2.9	2.3	1.9
Euro Area	1.8	1.3	1.5
Japan	0.8	1.0	0.5
United Kingdom	1.4	1.2	1.4
Developing economies	**4.5**	**4.4**	**4.8**
Russia	2.3	1.6	1.7
China	6.6	6.3	6.1
India	7.1	7.3	7.5
ASEAN-5	5.2	5.1	5.2
Latin America	1.0	1.4	2.4

months. About 70% of the global economy is poised to slow this year. And the trade war could shave off more than 0.6% from global GDP over two to three years[3].

The escalating tensions beg the question as to whether the green shoots (such as purchasing manager indices in China, Europe and the US hovering above the 50-point line – an indicator of expansion)[4], can survive. The second order effects – the hit to business confidence, investment and consumer spending – are also worrying.

Note that US business investment had already disappointed in 2018 despite the relatively healthy US economy. Businesses in general are reluctant to invest as they approach the tail end of the business cycle. The negative wealth effect resulting from falling financial markets would further dampen sentiment and global growth.

A REPLAY OF THE 'CLASH OF THE TITANS'?

The clash between the US and China is representative of today's multipolar world and a de-facto acknowledgement of China's economic and technological power.

Markets need to adjust to the reality of the longer-term nature of the US-China trade dispute. This rivalry will continue as China seeks to achieve economic dominance, and the US seeks to protect its current competitive edge with its political power.

Both President Trump and President Xi will likely want to agree to a resolution, but without being seen to have made too many concessions. Heading into the 2020 US Presidential election, President Trump will also need a strong US economy to quell Republican backlash in agricultural districts, thus leading to his 'Dance of Trade' against China.

For China, it needs a trade deal to help maintain its above 6% economic growth next year, so as to deliver its 10-year goal of doubling the per-capita income in both rural and urban populations by 2020 – a symbolic milestone for the country.

As 2019 marks the 70th anniversary of the People's Republic of China – an extremely important year for the country – the Beijing government is unlikely to budge an inch.

The retaliatory move by China to raise tariffs will hurt the US through higher prices although we do not believe it will hamper the Fed's ability to cut interest rates, should the US economy need it at a later stage.

In the meantime, China's cut in its Reserve Requirement Ratio (RRR) to 8% for rural commercial banks, that started from May and through to July, is a signal that China remains committed to selective easing and still has policy tools available.

Fig. 2: US-China trade scenarios for the second half of 2019 and the resulting impacts on global equities[5]

Context	Scenario	Likelihood	Impact
De-escalation	• Quick resolution, trade agreement by early Jul after Xi meet Trump in G20 Japan.	Less likely	Positive
No further escalation	• No quick resolution, 25% tariff imposed on USD 200 bn of exports. • Trump and Xi agree to continue negotiations without further escalation after G20.	More likely	Slight negative
Temporary escalation	• No agreement at G20, US imposes 25% tariffs on remaining USD 300 bn of goods • Eventually agreement/truce gets reached in 4Q on weakened global economy.	Likely	Negative
Extended escalation	• No agreement, US imposes 25% tariffs on remaining USD 300 bn of goods. • China retaliates with non-tariff measures: export restrictions and currency devaluation.	Likely	Negative

Fig. 3: Dovish shifts of major developed-market central banks[6]

Major central banks	Dovish shift	Rate-setting
Federal Reserve	Projected rate path shifted lower	Unchanged
European Central Bank	TLTROs extended	Unchanged
Bank of England	N/A	One hike
Bank of Japan	Lower rate guidance extended to spring 2020	Unchanged
Swiss National Bank	Chairman Thomas Jordan: the SNB could cut rates further	Unchanged
Reserve Bank of Australia	Hiking bias removed	Two cuts
Reserve Bank of New Zealand	Cut the official cash rate by 25 bps to 1.5%	One more cut
Bank of Canada	Hiking bias removed	Unchanged
Norges Bank (Norway)	N/A	Two cuts
Riksbank (Sweden)	Projected rate path shifted lower	Unchanged

With global growth at stake, it is hoped that President Trump and President Xi would come to an eventual resolution, although the June deadline appears ambitious. See Fig. 2.

A comprehensive solution would require a shared vision of how commerce works and a commitment to enforcement.

This will be challenging (but not impossible) given opposing visions, intensifying rivalries and mutual suspicion.

With 'peripheral' topics such as Iran or North Korea also potentially at play, it is more likely that the current imposed tariffs will remain. That said, the additional tariffs on the rest of China's exports to the US (around USD 300bn) tend to stay untouched, in our opinion.

With markets disliking uncertainty, risk assets are likely to remain under pressure until we achieve greater clarity.

A MORE ACCOMMODATIVE BACKDROP

There is a significant difference between the current backdrop and 2018. The Fed is on a pause and unlikely to hike further for the rest of the year. In fact, the futures market is pricing in a 25 basis points (bps) cut in 2019 and another 25 bps cut in 2020. With the Fed on hold, global central banks have all shifted to a more dovish stance. See Fig. 3.

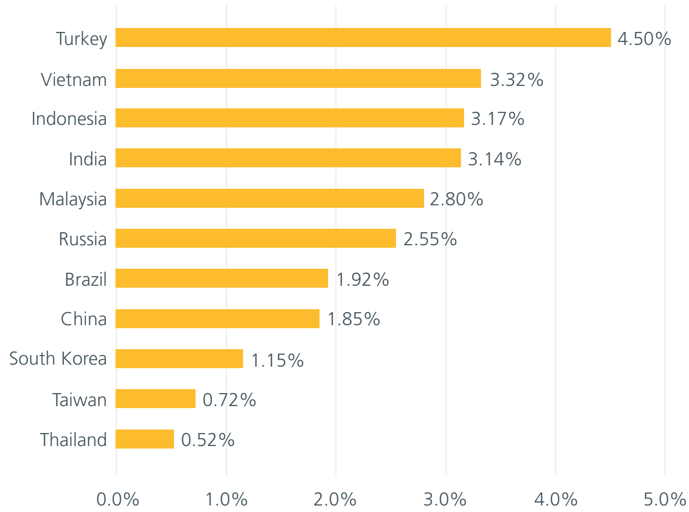
The Bank of Japan (BOJ), Bank of Canada and the European Central Bank (ECB), for example, have kept interest rates unchanged at their last meetings. The Reserve Bank of New Zealand even cut the official cash rate (OCR) by 25 bps to a record low of 1.5% in May.

Taking their cue from these major central banks, emerging market central banks have made 12 interest rate cuts between February and April this year[7].

With real central bank rates remaining reasonably high in emerging markets (see Fig. 4) these central banks have room to cut rates.

Fig. 4: Real interest rates in emerging markets[8]

Benchmark interest rates minus inflation (%)



The accommodative stance by developed and emerging market central banks will lend some support to the global economy and global bond markets.

NEW CHIEFS, NEW VOLATILITY? NEW TOOL BOX

The important role played by central banks also implies that the upcoming changes at the helm in selected central banks may be a new source of volatility for the markets, a consideration that is not yet on investors' radar.

In the Eurozone, Mario Draghi will step down as ECB president in October 2019. Under his eight-year tenure, the ECB embarked on a quantitative easing (QE) bond-buying programme, as well as targeted longer-term refinancing operations (TLTROs). Such accommodative measures have provided ample liquidity support for troubled banks[9], especially those in debtor countries.

This support cannot last forever. Draghi's successor will surely inherit a plan to gradually unwind these measures. While many are trying to anticipate when the ECB will start raising rates, it is important to realise that in a slower global growth environment, the ECB may find it difficult to implement.

Over in the UK, the search for the next governor of the Bank of England (BoE) is underway. The incumbent Mark Carney will leave office in January 2020. The new governor must be able to maintain global confidence in UK financial markets, not to mention finding the firepower to handle any financial shocks that may stem from a 'no deal' Brexit.

Besides the rise of economic nationalism and populism in their countries, the new chiefs will face a similar dilemma on the monetary front.

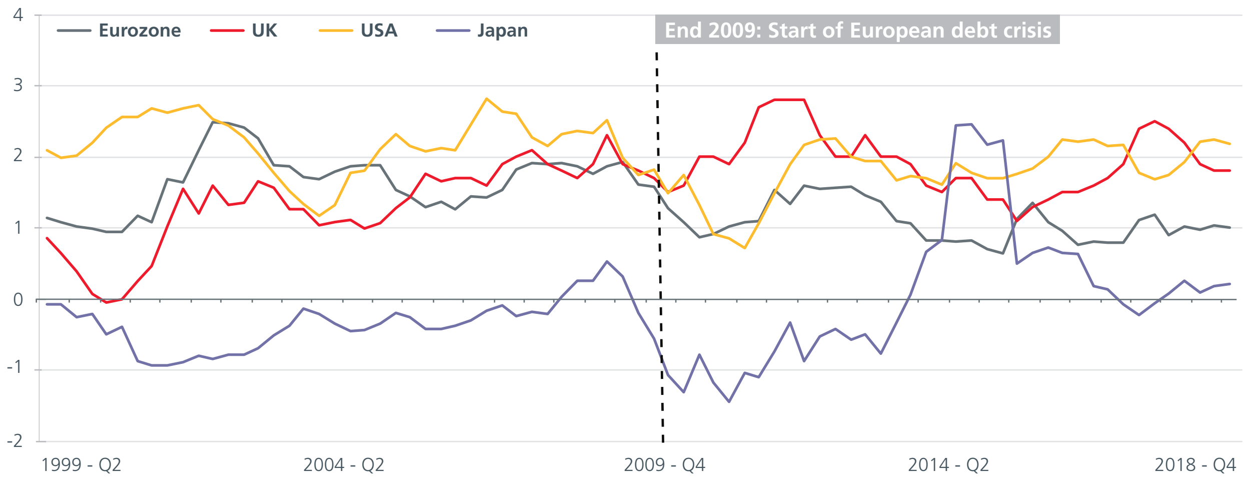
Despite persistently low inflation (see Fig. 5), the central banks' 'tool box' in Europe and Japan is smaller than it was in 2008, now having less room to manoeuvre with rate cuts to stimulate growth and inflation. Given these challenges, governments may place greater focus on fiscal and banking reforms instead.

Meanwhile, central bank independence globally is coming under greater scrutiny and financial markets will be unnerved if policy makers are seen to succumb to political pressures. Some of President Trump's Fed nominations, for example, are seen as his desire to create a more compliant Fed board.

The Reserve Bank of India is also under pressure from the Indian government to ease up on lending restrictions, so that small and medium enterprises can obtain loans more easily.

Fig. 5: Core inflation remains low in the Eurozone and the UK[10]

Annual change (%) in consumer price index, excluding energy and food



OPPORTUNITIES IN ASIAN ASSETS

On balance, with the Fed's current policy, as well as the current escalation in US-China trade tensions, opportunities in Asian assets are arising.

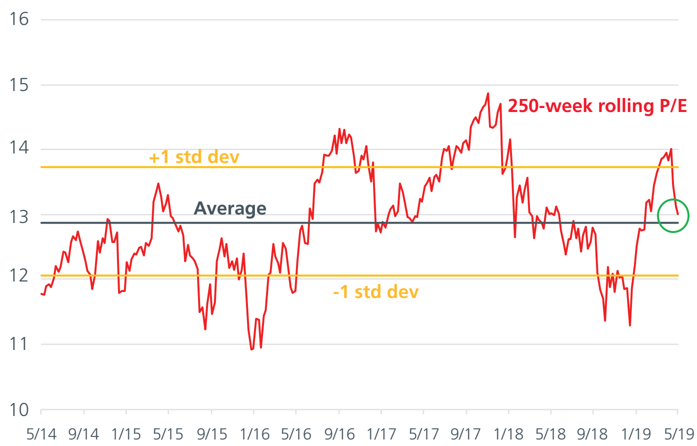
The recent market volatility is a reminder to investors to always have downside protection in their portfolios in order to reduce risk. Either through diversification by adopting multi asset strategies, or by including bonds and bond proxies to formulate low volatility strategies.

The sudden unpredictability of US-China trade tensions has made investment strategy difficult, yet it has also provided tactical opportunities. For example, Asian local currency bonds with longer durations are more likely to benefit from potential rate cuts as many Asian countries – including China, South Korea and India – have room to ease monetary policies.

Simultaneously, valuations of Asian equities remain attractive, with their price-to-earnings ratio trading close to its historical average (see Fig. 6). We continue to see opportunities in companies, with attractive valuations and good long-term fundamentals.

Fig. 6: MSCI Asia ex Japan's price-to-earnings (P/E) ratios[11]

Best estimate price-to-earnings (X) for MSCI AC Asia ex Japan



Sources: [1]A rite of passage into a multipolar world: https://www.eastspring.com/insights/2019-market-outlook-a-rite-of-passage-into-a-multipolar-world. [2]International Monetary Fund (IMF): World Economic Outlook "Growth Slowdown, Precarious Recovery", April 2019. [3]OECD (2019), OECD Economic Outlook, Volume 2019 Issue 1, May 2019. https://www.oecd-ilibrary.org/sites/b2e897b0-en/index.html?itemId=/content/publication/b2e897b0-en. [4]Markit Eurozone Composite PMI, China Caixin Manufacturing PMI, and US Manufacturing Purchasing Managers Index, May 2019. [5]Eastspring Investments, Quarterly Investment Insights, 28 May 2019. [6]Citi Research and Bloomberg, 2 May 2019. Eastspring, updated on 23 May 2019. [7]Thomson Reuters Datastream, as at 30 April 2019. [8]Bloomberg, real benchmark interest rates, citing government agencies and central bank data, as at 8 May 2019. Real rates are calculated using the year-over-year change in the headline figure for consumer prices. For the US, the real rate is calculated by subtracting the year-over-year change in consumer prices from the Upper Bound of the Federal Funds Target Rate (0.25%). [9]European Central Bank: What is TLTRO-II. https://www.ecb.europa.eu/explainers/tell-me/html/tltro.en.html. [10]OECD (2019), Inflation (CPI) (indicator). doi: 10.1787/eee82e6e-en (Accessed on 04 May 2019). [11]Bloomberg, as at 24 May 2019. The MSCI AC Asia ex Japan Index captures large and mid-cap representation across two of three Developed Markets (DM) countries (excluding Japan) and 9 Emerging Markets (EM) countries in Asia. With 957 constituents, the index covers approximately 85% of the free float adjusted market capitalization in each country. Past performance is not necessarily indicative of the future or likely performance.

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