capital at work
Wealth Management Foyer Group

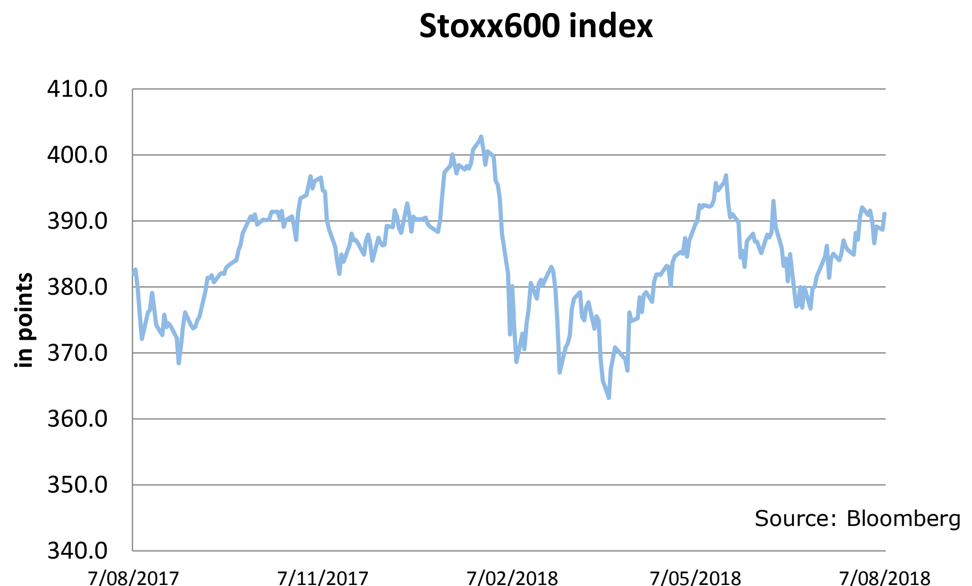
Fears for trade war shake financial markets

What impact does this have on our equity investments?

The global trade war has been dominating the news for months. Almost daily, new threats and tweets are exchanged, thereby increasing fears for escalation. These fears impact financial markets negatively and increase volatility. Nevertheless, good news on import tariffs emerged. A meeting between Donald Trump and Jean-Claude Juncker has currently led to a provisional truce between the United States and Europe and the intention to establish a new trade agreement.

In the upcoming months, meetings will be held between the United States and Europe about removing trade tariffs and other barriers on industrial products, with the exception of the automobile industry. No new tariffs may be implemented in the period these meetings are held. Even though Trump has severely threatened with tariffs on the automobiles, this industry will stay clear of new tariffs during these meetings as well. Although tariffs on steel and aluminium are not removed for the time being, both regions are looking for solutions in these industries as well. On top of that, Trump emphasized Europe's intention to import American soybeans quickly, something China had in scope as a counter measure to Trump's tariffs. Also, Europe is considering importing liquid gas from the United States. But before Europe starts these imports, infrastructure needs to be established.

Because of its sensitiveness, agriculture was not included in a potential agreement. Although an agreement is far from signed and an unpredictable Trump can pull the United States out of the deal, the financial markets reacted positively on the perspective of more free trade. It partly explains the recovery of European stocks during this summer. (Refer to the graph on the right).



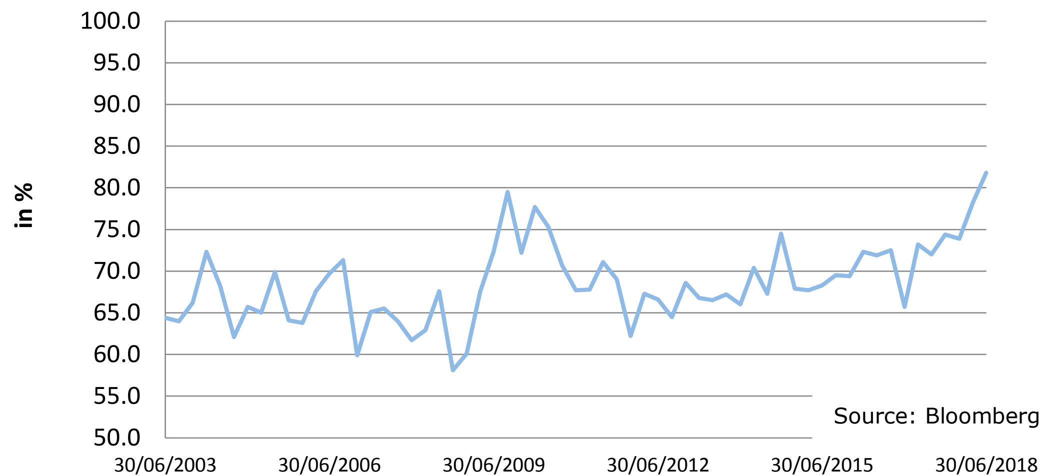
In contrast with Europe, China's trade relationship with the US has worsen. During the past few months, both the US and China have implemented more and more trade tariffs. After the US had decided to charge tariffs on 50 billion dollar in Chinese goods, additional tariffs on Chinese goods worth 200 billion dollar are being processed.

The threat resulted in lower Chinese stock indexes, which in turn led to a devaluation of the Renminbi. American multinationals importing large amounts of raw materials and components from China are affected as well. In the end, this will be harmful for American consumers, as it is expected that these multinationals will levy these imports on their customers. In addition, American exporters are affected as well, due to retaliating trade tariffs set by the Chinese. An example of one such tariff is the Chinese tariff on soybeans, which brings American farmers in difficulties.

As a consequence, major consensus to stand up to China is arising in the United States. Trump administration's goal is to force China to end unfair trade practices, open up its market and allow real competition to enter. Moreover, the threat of China surpassing the US economically and technologically is strengthen this policy.

The general expectation is that Trump will force China to the negotiation table by acting hard, in order to secure a better trade deal for both countries. In our view, this scenario is very likely to happen.

Somewhat overshadowed by all the protectionist news are the quarterly reports which companies have released worldwide.



The general conclusion on these quarterly reports is that despite increased markets expectations, most companies were able to beat expectations again. The strong global economy keeps supporting sales- and revenue growth of companies. In the graph on the right, the percentage companies which were able to beat average estimated earnings per share on Bloomberg are shown. Although some companies have not released their quarterly reports yet, this percentage is the highest level of all time, reaching levels above 80%. The financial health of companies is in top shape, partly thanks to a better than expected effect of the decrease in American corporate taxes. Nevertheless, it's important to note that this indicator says something about the past, not the future. Therefore, vigilance is advisable.

What does this mean for our fixed income investments?

The European Central Bank has announced the end of the Quantitive Easing program. In the last quarter of this year, monthly purchases will be halved to 15 billion euro. At the end of the year, monthly repurchase plans should be terminated.

Then, attention is drawn to the first interest rate hikes by the ECB.

However, these are not expected until late second half of 2019, or early 2020. This expectation is based on the ECB's promise to keep interest rates low for a while. Timing of the interest rate hikes depend in the first place on inflation developments. If we take a look at the break-even inflations, which is the best spot indicator of future inflation, we can notice it stays well below the ECB target of 2%. Moreover, economic growth expectations are downwardly adjusted for both this year and the next.

The FED has raised interest rates in the US for the seventh time already. The tax reforms have sustainably boosted business climate and consumer confidence. Nevertheless, the markets react sceptical, with a very flat yield curve as a consequence.

At its current level of 3%, US Treasuries are attractive for multiple reasons. First of all, the American economy is in excellent condition, shown by its most recent 4% economic growth rate. In addition, US Treasuries offer safety, especially when compared with:

- Emerging markets, which face difficult times due to their high debt levels in dollars (Turkey is an example)
- China's decelerating growth
- Declining prices of raw materials
- Some heavily indebted European countries which show little economic growth, like Italy.

The arguments mentioned above may lead to a stop on interest rate hikes of the FED. Some even claim that the reduction of their balance sheet is in jeopardy.

The past few months, we have increased our position in US Treasuries. Even taking currency risk into account, it's difficult to imagine better returns than in US Treasuries for the coming years. Together with German Bunds, promising a 10-year yield of only 0.3%, US Treasuries will be the last survivor in a world drowning in debt.

In addition, corporate bonds have been increasingly interesting this year, thanks to an increase of credit spreads.

In general, corporate bonds comprise 45% of our fixed income asset allocation, the other 55% are held in government bonds. From all bonds, 25% is invested in inflation-linked government bonds. As the name suggests, these bonds are automatically protected against higher inflation. Less than 10% is invested in government bonds of emerging markets, mostly in India, Mexico and China. Within our corporate bonds, the majority consists of investment grade bonds, supplemented with opportunities in high yield bonds.

This all leads to the current key figures, offering an underlying running yield of over 2.6% at a weighted average duration of just above 4.4 years. This is realized by a well-diversified and balanced portfolio.

Conclusion

The first part of the right answer to the zero yields, like we have been experiencing for years now in Europe, is to put your capital at work. The second part of the right answer is to put your capital at work by diversifying your portfolio, within the agreed upon risk profile. This means diversification for both the bonds- and equity part of your portfolio. As mentioned in this newsflash, we see a lot of opportunities caused by volatility and strong corporate results from companies in which we are invested.

At every evaluation, we conclude that our portfolios are excellently positioned, not only to profit from the decent world economy today, but also when it takes a turn for the worse. Whether problems appear in Italy or Turkey, whether tensions between the United States and China intensify, we note that in difficult times our diversified portfolio pays off. Tensions in the Euro zone (Italy) have in general a positive effect on our portfolios, because a depreciating euro is positive for our dollar-oriented portfolio. In addition, we do not possess any Italian government bonds. When the fear for slowing economic growth due to a possible trade war strengthens, we note that investors flee to the safe heaven, US Treasuries and German Bunds. These two are our biggest positions in our bond portfolio.

Via outspoken choices, we try to put your capital at work and protect you from risks we deem important.

Yours sincerely,

The Executive Committee of CapitalatWork Foyer Group

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