Trade war US-China?

Which impact on our equity policy?

Investors looked forward to the G20 meeting last month in Buenos Aires, Argentina. The focus was not on the G20 summit itself but on the duel that took place between President Trump and Chinese President Xi Jingping. The main focus was on the trade relations between those two countries. As trade war threat between the two regions was the most important explanation for the nervous markets, investors' hope for an agreement reached a high level.

The outcome of the meeting was therefore rather positive, whereby a temporary truce of 90 days was announced. As a sign of good will, some mutual promises were made. Among other things, the US agreed not to increase the import tariffs from 10% to 25% on 200 billion $ of Chinese products starting January 1st. In return, China will purchase a substantial amount of agricultural, energy, industrial and similar products from the US to reduce the trade imbalance between the two countries. Both countries also promised to start negotiations immediately concerning structural changes in relation to the protection of intellectual property, technology and cyber-attacks. Both sides spoke of a constructive meeting aimed to achieve a sustainable agreement. The Chinese trade minister has recently revealed that the ultimate goal is to eliminate all trade tariffs between the two countries.

After an initial positive reaction of the financial markets, the fear quickly resurfaced, whereby shares were eagerly sold. Investors are sceptical that a trade agreement will be found in this short time span of 90 days. The situation intensified after Canada arrested the CFO of Huawei at the request of the US for violating US sanctions against Iran. The sharp and legitimate reaction in China further increased pressure to find an agreement. The Chinese manufacturer of network equipment for the telecom sector was already on the radar of several countries, including the US, out of fear for the security of the network, cyber-attacks or spying from China. With the emerging deployment of 5G networks worldwide, some countries have even announced the eventuality of a ban on Huawei equipment.

Despite the recent events, we continue to believe in an agreement between the two countries, whereby partial agreements can be reached in different sectors. The negotiations are ongoing and the importance of a meeting point for both China and the US and to a more global extent the world economy remains at a high level. We are therefore inclined to believe that common sense will ultimately prevail.

The end of increasing interest rates in the US?

On the health of the American economy, the chairman of the FED, Jerome Powell, repeated last week that the economic outlook for 2019 will remain strong and decided therefore to bring a new rate hike in December. Meanwhile, Powell stated that the interest rates were now close to a neutral level, a completely different message than last month when he affirmed there remained a long way to reach neutrality. With the inflation rate remaining under control, The US economy does not seem to be overheating.

Decreasing oil prices

A remarkable movement of the recent months was the significant drop in oil prices. In the last weeks, prices have declined more than 30% and are now below levels experienced at the start of the year. Decreasing oil prices are often linked to a decreasing demand and thus a slowing economy, what usually contributes to uncertainty in the financial markets. This does not appear to be the case today since the demand for oil has not weakened. We therefore believe the reason for declining prices are rather linked to an increased supply. While oil extraction in the US is booming, Trump has incentivised Saudi Arabia, among others, to increase oil production and keep prices low, using the killing of Khashoggi as a mean of pressure. The US also authorized certain countries to import oil from Iran. A low oil price can be good news for some regions, i.e. the importers like most of western Europe, and for large oil consuming entities. However, an agreement to reduce the production of OPEC could be compromising.

European sentiment remains negative

Meanwhile, the general atmosphere in Europe is mitigated. The outcome of the Brexit deal, the Italian budget and the "gilet jaunes" movement in France are at the heart of this sentiment. With Merkel rein coming to an end and next year's European elections, the future of Europe remains uncertain, which is also reflected in the valuation of European indices. In the eyes of US investors, Europe seems therefore "uninvestable".

Cheaper valuations

It has become clear that the sharp price correction of the recent months have provided cheaper valuations of equities. European markets are currently trading at a price earnings ratio of approximately 12.3 times profits for next year (forward PE), which is considerably lower than the long-term average of approximately 14.4x. The S&P500 index quotes at 15x the average profit forecast of 2019, below the thirty-year average of 16x. This situation is of high interest to us since we do not expect any economic recession before 2019. Profit growth will inevitably slow down, but we do not forecast any sharp decline in corporate earnings.

However, the valuation of the stock market cannot be decoupled from the risk-free interest rates. Reversing the price/earnings ratio results in what is called "earnings yield", or "profit return". This ratio is currently 8% in Europe and almost 7% in the United States. When subtracting their respective risk free rates, Europe's 10-year rate for the German government bonds at 0.3% and the US 10 year treasury yield at 2.9%, the risk premium can be found. This risk premium is currently very high in Europe (8% - 0.3% = 7.7%) and still interesting in the United States (7% - 2.9% = 4.1%). Both indicate the advantage of equity investments. They also exhibit that the evolution of the risk-free interest rate is very important. This matter is analysed in further details in the next paragraph.

And what about our bond policy?

The reaction of the bond market has not been anything unexpected during a turbulent equity market as their interest rates have fallen. The nominal interest rate in Germany fell from 0.4% to 0.25%. The 10yr US Treasury fell more sharply from about 3.2% to 2.9%. As a result, our investments in government bonds have done very well in recent weeks.

In the meantime, credit spreads have increased significantly, in accordance with the nervousness felt in the equity market.

The Euro Investment Grade credit spreads increased from 0,6% to 0,8% over the past two months, while the Euro High Yield spreads increased to 0,5%.

The European Central Bank is in the last month of quantitative easing (buying companies' debt), which is expected to come to an end by year-end of 2019. A question that is now materializing is on the identity of the next purchaser of Italian sovereign debt. Based on funding and credit conditions, the ECB may choose to extend the "Targeted Longer-Term Refinancing Operations" funding to banks and therefore let the Italian banks breathe a little longer.

Since September, we have been implementing a substitution of the more risky credit positions in both the Corporate Bonds fund and the High Yield fund into US Treasuries. We consequently have increased our sovereign exposure of fixed income securities from 45% to above 60%. The two main components are US Treasuries for 26% and German Bunds for 12%.

Our conclusions :

1/ The "wall of worry" (Brexit, Italy, trade war, etc) is gaining the upper hand and has negatively affected the sentiment of many investors. Sharp decline in equity markets lowering the valuation of the stock market that can now be considered as relatively inexpensive.

2/ The speeches of the different central banks show that the interest rate hikes should stop in the US and are not expected in the EU.

The combination of those factors strengthens our conviction that the medium-term perspectives for the next 5 to 10 years in order to achieve a good return are favourable. In addition, we are convinced that the majority of this return will have to be achieved by investing in strong companies, exhibiting healthy balance sheets, and sustainable cash flows.

Do not hesitate to contact us if you have any questions.

Kind Regards,

The Management of CapitalatWork Foyer Group

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