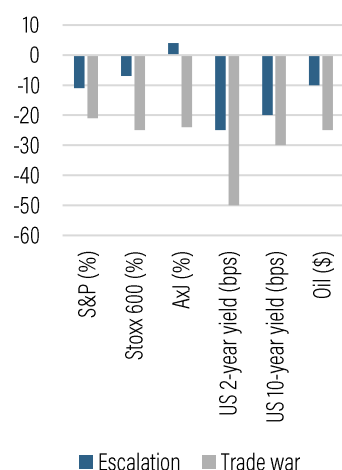




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There is no shortage of trade and geo-political risks waiting in the wings to scuttle the global outlook

Impact of further escalation on financial markets



Source: UBS

Trade wars and other risks

How will they affect markets?

There is no shortage of trade and geo-political risks waiting in the wings to scuttle the global macro outlook. Indeed, over the past month, since we moved tactically overweight US equities and further underweight global fixed income, risk markets have still managed to edge higher, despite a plethora of potential trade and geo-political hot spots.

This month we go 'around the grounds' to provide an update on the latest developments for some of these key risks. This includes, most prominently, the recently escalated US-China trade dispute, and other US trade negotiations, such as the North American Free Trade Agreement (NAFTA) and European Union (EU) auto tariffs. We also discuss the latest in the Brexit negotiations, and the troubles of UK Prime Minister (PM) Theresa May's government, as well as recent political uncertainties in Italy and Germany. Denuclearisation of the Korean peninsula also remains another potential flashpoint.

While event risk collectively remains elevated, it has not overtly challenged risk markets' ability to grind modestly higher over the past month. Since our move overweight at the start of July, US equities have gained almost 3%, while EU equities (where we maintained our overweight) have risen almost 4%. In contrast, while modest, global bond yields have generally reasserted their upward drift, rising around 10 basis points (bps) in July, with US 10-year Treasuries once again on the cusp of breaching 3%.

US-China trade dispute—is further escalation unavoidable?

Most estimates suggest the impact of the 25% tariffs on USD 50 billion of trade between the US and China—introduced on 6 July—to be inconsequential, at just 0.1 percentage points off each country's growth over the coming year. However, as UBS has noted, the decision by the US to implement tariffs on an additional USD 200 billion of Chinese imports under its investigation into intellectual property "marks a material escalation of trade tensions". The US further threatened tariffs to cover all China's imports.

This dispute is presently the largest concern facing markets. But while narrow, the path to some de-escalation does exist. Much depends on US public hearings on the proposed tariffs, slated for 20-23 August, as well as China's response to them. Markets are speculating, rightly or wrongly, that China's retaliation will be less than proportional (in part due to its more limited imports from the US, at around USD 150 billion). This increases the possibility of 'de-escalating negotiations' before this next larger round of tariffs is implemented, most likely by the end of September.

Recent UBS analysis suggests further escalation of the dispute—including full retaliation by China—could stymie the currently robust global growth cycle, including as much as 1 percentage point off growth for the US and 0.5 percentage points for China. Société Générale estimate the drag for China could be larger at "close to 1%". Of course, China is expected to ease policy further to offset some of the negative trade impact. UBS suggests a marked further escalation, with a full China retaliation, could lead to US and European equity markets correcting by more than 10%. US yields could also rally, with 10-year Treasury yields dropping back to the mid-2s (see chart opposite).

We continue to expect that the US and China will choose negotiation and de-escalation of their trade dispute

These events are clearly of concern for the global outlook. The World Trade Organisation recently noted that the "marked increase in new trade restrictive measures among G20 economies should be of real concern to the international community." As BTIG also opines, "the trade issue extends well beyond Beijing, reinforced by President Trump's pointed reminders to Europe about the immediate need to redress their own imbalances with the US". Here, a truce between the EU and the US formed late in July, with both countries agreeing to hold off from new tariffs and negotiate lower barriers.

We continue to expect that the US and China will also choose negotiation and de-escalation, given the substantial economic harm a full trade war could cause. This should allow risk markets to continue to grind higher and enable US inflation and US Federal Reserve (Fed) policy to reassert its influence on market outcomes. But risks from this hotspot will continue to ebb and flow, and confidence it will remain contained is low.

NAFTA—can arguments with close neighbours be resolved?

The Trump administration has also threatened to tear-up the NAFTA. Even if Trump intends to maintain some form of trade deal with Canada and Mexico, he has the option to trigger a six-month withdrawal period as a negotiating tactic. Like the US-China trade dispute, either of these developments could jolt equity markets lower.

According to BCA, Congress will push hard to save the agreement "because it is important for so many US companies, especially those with supply chains that criss-cross the borders with Canada and Mexico". As the November mid-terms approach, there is a risk the president will be willing to take risks with equity markets to increase his popularity.

Brexit—can PM May successfully negotiate the Brexit?

Negotiations between the UK Government and the EU on the terms of the UK's 'Brexit' remain unresolved ahead of the March 2019 deadline for the UK's departure. Complicating the process is the inability of PM May to form an agreement within her own government on the terms of that exit, in turn threatening her leadership. Further complicating matters, in late July, EU's chief Brexit negotiator Michel Barnier also rejected May's current proposal.

In early July, PM May won backing for her plan that, according to CBA, involves remaining "closely aligned in terms of trade" with tariff-free access for 96% of goods (not services), but also requires the UK to be bound by EU rules and regulations. This 'soft' Brexit has not been well received by prominent Eurosceptics, with the resignation of three senior members of the May government further heightening the risk of a 'no-confidence' vote.

While there remains a strong incentive for both the UK and the EU to conclude a comprehensive agreement, the situation is likely to remain fluid and potentially destabilising for the UK economy and markets. Although the likelihood of a no confidence vote succeeding is quite low—given a lack of UK government consensus around a 'hard' Brexit—the focus ahead is likely to turn to renewed negotiations between the UK and the EU. Bank of England (BoE) Governor Carney has warned that "leaving the EU with no deal in place would have a major impact on the [UK] economy". According to UBS, the prospects for an orderly UK Brexit have "dimmed over recent weeks".

EU integration risks—will the recent calm persist?

Sceptics on the longevity of the 'European project' have been surprised by the extent of recent moves toward further EU integration. These have come in the wake of June's Franco-German Meseberg statement and late-June's Eurogroup and Euro Summit. Not only has the EU managed a deal on migration, but EU leaders have agreed to move forward gradually on a Banking Union (including a deposit insurance scheme), as well as first steps toward a European area budget (albeit largely symbolic).

According to Société Générale, "crucial details still need to be agreed", and the path to fiscal union will push questions of political union to the forefront. Despite the calm, there remains potential for heightened uncertainty to remerge ahead of EU parliamentary elections in May 2019.

UK PM May's inability to form an agreement within her own parliament on the terms of Brexit has been threatening her leadership

Earlier volatility has recently eased in Italy...

...but the new government needs to submit its draft budget in October and it is unlikely to meet the EU fiscal rules

Concerning for markets has been the weakening of Angela Merkel's position in Germany...

... she is seen as a source of political stability in Europe and a prominent advocate for Europe on the international stage

The very recent increase in uncertainty and risks to the growth outlook reinforce the importance of ensuring an appropriate strategic allocation to government bonds

Italy—will fiscal largesse reignite volatility?

Uncertainty and volatility rose sharply in Italy in May following the long-awaited forming of a government post the March 2018 election. The new M5S-Lega coalition (both of which are populist political parties) was seen to have policies around reducing migration and increased fiscal largesse that would be inconsistent with European institutions. However, the new government's decision to initially forego some of its most expensive policies and refute claims of plans to manage an EU 'break-out' calmed markets.

There is a significant likelihood of a return to volatility in Italy later this year or in 2019, most likely via a renewed sharp rise in Italian bond yields. According to UBS, "the fiscal plans of the new Italian government are ... potentially very expensive, at an estimated 4½% to 7% of GDP. These would need to be scaled back significantly to avoid derailing the debt path". European fiscal rules require Italy to submit a draft budget for 2019 by mid-October this year. However, market discipline may well be the key source of fiscal control, reflected in renewed volatility in EU bond yields.

Germany—could a Merkel departure heighten uncertainty?

Germany's Chancellor Angela Merkel has recently come under significant pressure from her own Christian Democratic Union and coalition partner, the Christian Socialists, for welcoming more than 1 million immigrants in 2015. Early in July, Merkel was able to strike an agreement (involving the screening and potential return of immigrants), narrowly avoiding the dispute bringing down her own government.

Concerning for markets has been the weakening of Merkel's position in Germany, where she has been in power since 2005. Merkel is seen as a source of political stability in Europe and a prominent advocate on the international stage. But reflecting unrest over migrants, Merkel's position has been further undermined by recent poor regional electoral results.

According to Société Générale, a "deeper migration reform could be reached before the May 2019 European elections...weakening support for EU sceptic parties". However, Merkel's coalition government remains fragile and the potential for instability to permeate markets remains.

North Korea—all quiet on the peninsula?

As BCA recently noted, "not every move by the Trump administration is increasing geopolitical volatility". After the mid-June meeting between Trump and North Korea's Kim Jong-un—culminating in a two-page press release—diplomacy appears on track and the risk of war on the peninsula is fading.

North Korea's missile tests have ceased, US political prisoners have been released and North Korea has committed to 'complete denuclearisation'. The US has given North Korea security guarantees, committed to discontinue military drills with South Korea, albeit the US has not yet eased economic sanctions. There appears little near term that is likely to re-antagonise this situation with negotiations expected to continue in the background.

In summary, asset allocation remains key

The recent escalation of the US-China trade dispute remains the most pressing near-term concern for markets. In contrast, a calm has developed regarding the Korean Peninsula and risks of European break-up centred on the lack of progress regarding integration. Beyond the US-China trade dispute, as we have highlighted, several trade and geo-political hotspots retain the potential to flare up and heighten volatility in markets.

Unanticipated risk-off events, such as the current escalation in the US-China trade dispute, remind us to remain vigilant in ensuring our strategic asset allocation is appropriate. As we noted in last month's *Core Offerings*, the economic and asset cycle is maturing, reflecting our current tactical overweight to cash and liquidity and our recent decision to increase our allocation to alternative assets.

The risk of an unexpected weakening in global trade and production is also embodied in our recent decision to remain neutral on emerging markets, further underweight domestic equities, a key beneficiary of positive global risk sentiment, while increase our exposure to unhedged offshore equity markets, such as the US.

It could also lead us to reconsider our current modest underweight to high-grade government bonds.

The very recent increase in uncertainty and risks to the growth outlook reinforces the importance of ensuring an appropriate strategic allocation to fixed income assets, particularly government bonds (as opposed to hybrids and corporate credit). Such defensive assets—along with alternative assets—can provide some protection for total returns should a further escalation of the trade war ensue.

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