

MARKET INSIGHTS IN THE FINANCIAL TIMES

Brace for collision between lower growth and weaker central bank firepower

31/07/2018 | DIDIER SAINT-GEORGES



Investors are worried Donald Trump's protectionist crusade will set off an economic crisis or at the very least a sharp slowdown in China.

Over the past month, international investors have shunned emerging-market bonds and currencies, including the Chinese renminbi. Despite the stimulus Beijing announced last week, the Chinese stock market remains down about 13 per cent this year.

So are there grounds for viewing Trump as a kind of modern-day Achilles, driven into a confrontation with his adversary that won't end until the latter is defeated? No offence to the president, but he doesn't quite have the stuff that Homeric heroes are made of.

True, Trump's entourage includes advisers like Peter Navarro for trade and John Bolton for national security who postulate that China is a strategic or an even existential threat to the US.

If the current clash over trade proves to be just the opening salvo in a major assault on the Made in China 2025 strategy underpinning president Xi Jinping's vision for China then we are in for a long confrontation.

The Chinese president is not about to give up his ambition to move his country to the top of the industrial value chain, above all in technology. However, if Trump is following the playbook one would expect from a real-estate wheeler and dealer, the anxiety that he is a doctrinaire ideologue on China and trade eases.

Yes, his political future will depend initially on the midterm Congressional elections in November, when the Republican Party will have to battle to hold onto their Congressional majority. Trump is keenly aware of the political payoff he can get from the US trade deficit issue, much like Matteo Salvini does with migration in Italy.

But he surely also understands that appealing to some of the general public on the question of trade will encounter resistance from US businesses. Indeed, once a large enough number of US companies have stepped forward as collateral victims, Trump will conclude that he'd better start applying his famous "art of the deal" to his trading partners if he wants his party to make a decent showing at the polls in November.

In the event, Beijing would have little trouble offering an agreement he could hold up as a trophy – provided, that is, that the terms negotiated don't run counter to China's long-range ambitions. But such a deal is unlikely to happen overnight and with almost four months until the midterm elections, expect the current market jitters to continue in coming weeks despite the US and Europe last week agreeing a ceasefire in their trade war.

Panic in markets is certainly unwarranted. The short-term spike in volatility we have seen is down to the posturing and one-upmanship typical of negotiations carried out in the public eye, particularly by a showman who revels in that role.

The real risk to investors from Trump's policy is more subtle.

The detrimental effect of uncertainty on the confidence of businesses – especially those with global supply chains - risks throwing into reverse a cyclical upswing that is already losing momentum.

The danger is amplified because central banks are running out of ammunition and governments from the US to Europe have precious little room left for fiscal expansion.

It is a serious problem that potentially lies just a few months down the road. For equity investors, it demands a clear distinction between tactical and strategic positions.

Tactically, as politics will be unavoidable during the summer, equity exposure should be modest but include bullish positions in the options market. The implied volatility in derivatives instruments is still low, allowing for the purchase of call options at a reasonable price on large equity indices, including those in emerging markets.

This trade would allow investors to catch a spike higher in equities in the event of a trade truce between China and the US is announced.

However, the strategic challenge for investors is to construct portfolios prepared for the inconvenient collision that looms between a global economic slowdown and central banks with far less ammunition in their arsenals. The key idea is to run a long-short strategy that favours those companies generating earnings growth and that have strong balance sheets. They are typically found in the tech and pharmaceutical sectors, primarily in the US, China and India.

By contrast, cyclical stocks with large financial leverage should be shunned, particularly in Europe and Japan, which will suffer disproportionately when the collision occurs.

Trade tensions may provide opportunities but is more likely to reveal investor complacency over a US economic cycle nearing its end just as central banks retreat.

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