Investment Weekly

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EM could become a victim of the trade war escalation

The trade war between the US and China is back on, and it could be uglier than it was before. As the battles rage, emerging markets and commodities could be the victims for now.

Two weeks ago, the world was gearing up for the resolution of an issue that had been dogging markets for the past year. The trade war between China and the US seemed to be on the brink of resolution, with some analysts predicting a final agreement as early as last week, during a scheduled US visit of a Beijing delegation.

With a late night tweet on Sunday, however, President Donald Trump reignited animosities. Then, he stated that Beijing had until Friday to reach a trade agreement or face an increase to 25% from 10% of the tariffs currently being applied on about US$200 billion of Chinese goods. The ultimatum reportedly came as a response to a revised version of the 150-page agreement that Beijing had sent to Washington DC two Fridays ago, in which China backtracked on many of the key commitments the US had required to reach an agreement. “They broke the deal,” Mr. Trump said later at a campaign rally.

China’s reaction was swift. By Monday morning, Beijing had reduced the required reserve ratio for smaller banks again, further revving up the monetary stimulus engine. It also promised to retaliate following Washington’s move but, by today, it had yet to say how. The yuan also reacted to the news becoming the worst-performing emerging market currency last week, down 1.28% in five days. It was followed by the Chilean peso, the Colombian peso and the Indian rupee respectively.

The Chilean peso is an example of the spillover effects that the renewed trade war could have on markets. That currency is closely tied to the direction of copper prices, given that Chile is its biggest world producer. The red metal, indeed, dropped 1.38% last week, and could continue to drop if there are further signs that the trade war is worsening. Over the past decade, the health of China’s economy has been one of the main drivers of copper prices.

Meanwhile, copper often leads the way for other metals and, sure enough, the London Metals Exchange Index fell 0.98% last week. Soft commodities are not immune either, given that China is one of the biggest global consumers of food and feedstock. Soybean prices fell about 13% between April and December last year, the months when the trade war with China was raging. They fell 4.07% last week alone. The broader Bloomberg Agricultural Commodities Index fell 3.65% last week — it had dropped 12.54% last year.

The dynamics seen in the last round of the trade war could play out again this time

Lower commodity prices are only one of the ways that the Chinese reaction to the trade war could affect other emerging markets. The more important one, however, may be its impact on the value of the US dollar index.

The value of the yuan has a high correlation with the most traded emerging market currencies. In April, last year, when the US first threatened to impose the 10% tariffs on US$200 billion of goods, the yuan began to fall and by the end of October, when the Trump administration began to sound more conciliatory, it had fallen 10.25% against the US dollar. As the trade talks progressed, the currency recovered 1.89% in the year to 30th April, helping to spur a 1.44% rally in an MSCI index tied to the eight most-traded EM currencies.

If the yuan makes up for the additional tariffs on Chinese products, it means the currency, and its other EM peers, could be in for a round of significant losses. Stocks in the affected countries could follow.

A stronger dollar and weakening Chinese economy could also impact crude oil. Indeed, on Tuesday, shortly after it became clear that the trade war was back on, Brent crude dropped 1.91%. It recovered later in the week amid news that the US had dispatched an aircraft carrier to the Middle East, as tensions with Iran rose.

Still, lower emerging market currencies translate into higher petrol prices at home. That dampens demand very quickly in EM, the part of the world which is the biggest driver of demand growth in the world. For example, India's total crude imports fell 4.7% between the end of the second quarter of 2018 and 31st December, a period when the rupee depreciated and oil prices rose, according to government import data. Similar dynamics can be expected across developing nations.

The potentially weaker demand for crude, however, may not have the dampening effect on prices of last year. Unlike in the last round, OPEC nations are sticking to output curbs and the US is becoming more serious about stopping Venezuela and Iran from selling their crude internationally.

Weaker demand for oil from developing nations is being offset by OPEC discipline

Lower currency values and still high oil prices impact inflation and could stop the monetary easing wave that has swept across emerging market central banks so far this year, and which also was helping to fuel a rally in local stocks.

While it seems like there is no good news to be seen and that investors would be better off holding cash, that is not the case. At least one of the sell-offs seen last week is likely to be short-lived and may actually provide a buying opportunity.

The S&P 500 fell 2.18% last week, its worst performance since December. That move, however, may have been driven more by a technical issue than by fear of the outcome of the trade war. Just before President Trump's tweet that reignited the trade war, there was a record amount of bets that the VIX, the volatility index, would drop, and US stocks would rally further.

These short positions had to be quickly reversed as the VIX rose 24.63% last week. Unwinding a bet that volatility will drop and stocks will rise will normally be done one of two ways: either by betting stocks will drop or that volatility will rise. Both of these would have added pressure on the S&P 500, whose performance underpins the direction of the VIX.

Last week's US stocks selloff may be short-lived, more akin to the February 2018 volatility meltdown, than to Q4

That dynamic would create the kind of selloff seen last week, or in February last year. **If that is the case, the move is likely to be short-lived and therefore may be seen as a buying opportunity for both US stocks and high-yield bonds, which are highly correlated to equities.**

One of the key concerns that spurred the fourth quarter selloff is also not an issue this time around: the Federal Reserve.

US stock markets were mostly resilient throughout last year, reaching a record at the end of the third quarter despite the fact that the trade war with China had been going on since April. What changed on 26th September and may have created the downward spiral in the fourth quarter was the Fed's position. After it ended its September meeting, the rate-setting committee of the US central bank signaled that they expected three more rate hikes before the end of 2019, an unexpectedly hawkish position. That surprise triggered all kinds of technical moves, forcing carry-trades to be unwound, shorts on US Treasuries and increased bets on volatility.

Now, however, the Fed made it clear in its last meeting that there are no plans to move interest rates this year. Last week's April US inflation numbers also missed estimates, reinforcing the notion that consumers prices are under control even as unemployment hits the lowest in half a century. It would take a couple of quarters of high inflation for the Fed to get hawkish.

In fact, part of the reason why the US President may feel emboldened to take his time in negotiations with China is the resilience of the US economy, which was still growing at a 3.2% pace in the first quarter, despite the negative impacts of the government shutdown and the equity selloff in the fourth quarter.

Hence, bets on the US stock markets are likely to continue unabated once the VIX positions have been cleared. To be sure, not all sectors will fare evenly. Stocks that are more heavily exposed to emerging markets or commodities are likely to continue to lag the rest of the market.

The materials sector is the perfect example. The S&P 500 subindex for the industry is down 6.5% in the past year, even after having rallied 8.88% this year to date. It, however, dropped about 11% between mid-April and the end of October, the period when the trade war was most intense last year. Semiconductor stocks are also likely to suffer given their reliance on China for their supply chain.

Investors are likely to focus on stocks that benefit from a strong US domestic economy

Two industries are likely to come into focus, given their sensitivity to the US domestic economy and to interest rates: utilities and real estate. Both, however, have enjoyed very strong performance year-to-date and may correct before they start to be seen as attractive again. The S&P 500 Utilities subindex has gained 9.28% so far this year, while the real-estate subindex is up 16.11%. Property-related stocks are trading around 42.4x expected earnings, a high number and more than the 37.8x average of the past five years, according to Bloomberg. Utilities, meanwhile, are currently valued at 18.7x future profits, also higher than the 17.2x five-year average.

In any event, investors are likely to sit on the sidelines until they start to see some clarity about the direction of the markets, and that is unlikely to come this week.

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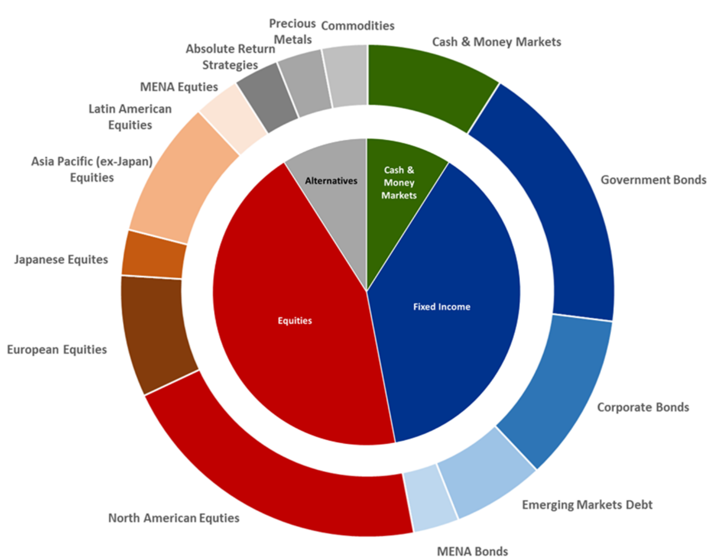
FAB Investment Management Global DPM			Gross Performance		
Strategy	Inception date	AUM	Year to Date	1 Year	Since Inception
Fixed Income	October 2013	US$41.5 million	2.70%	3.80%	2.22%
Conservative	October 2013	US$193.3 million	5.95%	5.73%	3.94%
Balanced	October 2013	US$119.9 million	10.08%	7.61%	5.75%
Growth	October 2013	US$10.7 million	14.38%	8.86%	7.64%
Equity	October 2013	US$1.7 million	17.21%	9.61%	9.20%
	Performance is for our model portfolios and is not a composite of the performance of actual client mandates.				

FAB Investment Management DPM			Net Performance		
Strategy	Inception date	AUM	Year to Date	1 Year	Since Inception
UAE Growth	December 2007	US$3.8 million	23.53%	16.67%	3.31%
GCC Growth	October 2015	US$206.8 million	16.59%	18.94%	12.12%
MENA Growth	July 2014	US$288.9 million	15.36%	12.37%	0.84%
Shariah GCC Growth	March 2016	US$15.9 million	14.56%	13.68%	6.89%
Shariah GCC Income	March 2016	US$37.2 million	15.94%	13.99%	8.12%
Global Growth	October 2018	US$184.7 million	18.16%	n/a	7.40%
Global Income	October 2018	US$3.9 million	16.35%	n/a	11.80%
MENA Fixed Income	September 2017	US$471 million	3.66%	5.44%	2.99%
Sukuk	June 2013	US$319 million	3.11%	4.69%	3.47%
EM Hard Currency	December 2016	US$189 million	3.71%	1.30%	2.12%

Current Tactical Asset Allocation



	Positioning	Detail
Cash	Overweight	In Cash & Money Markets
Fixed Income	Slightly Underweight	In Corporates
Equities	Overweight	In Asia
Alternatives	Underweight	In Hedge Funds

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