Investment Weekly

For inquiries related to this article, please contact:

Alain.Marckus@bankfab.com
Christofer.Langner@bankfab.com

3 May, 2020

Revival of trade war amid Covid-19 recession could sap rally

♦ Stock market sell-off on Friday leaves US indices down for the week.

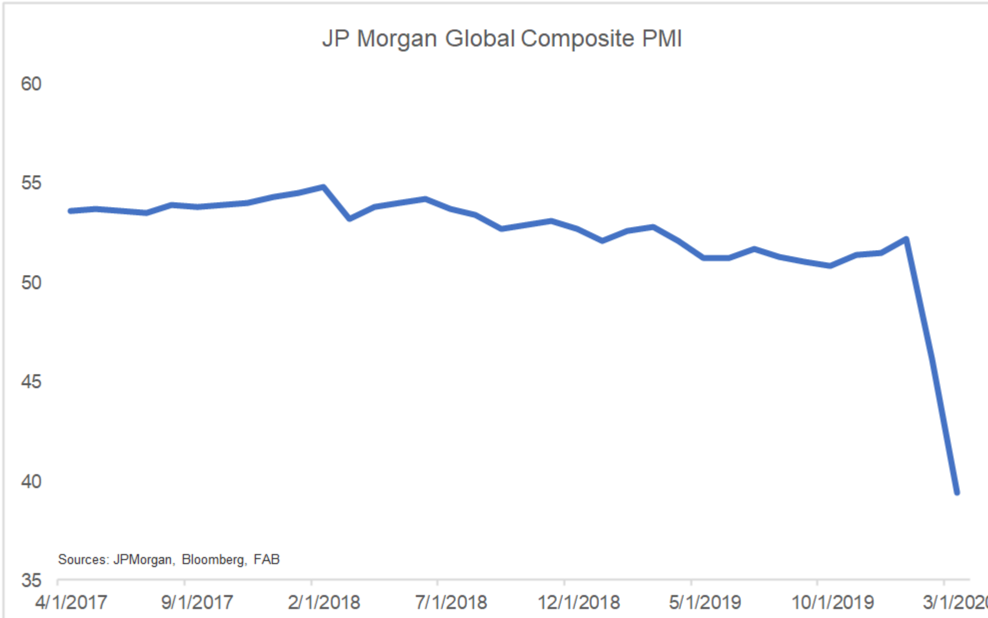
♦ Investors must assess the impact of a revival of the trade war against China amid a recessionary environment.

♦ Record unemployment in the US may explain President Donald Trump's renewed negativity towards China.

♦ Factory output and employment in the US fell at the fastest pace in several decades in April.

♦ Investors are likely to also consider the potential impact of a Democratic president as Senator Joe Biden starts to take the lead in polls in key states.

♦ FAB AAC remains underweight equities and overweight gold amid continued market uncertainty.



It was all going so well that a spanner had to be thrown into the works. On Friday, President Donald Trump turned his attention to China again as more signs of the depth of the US recession due to the Covid-19 lockdown emerged. The President suggested he may revisit tariffs, while some of his closest aides said that China should be "held accountable" for the global pandemic.

The prospect of a revival of the trade war while the world is still grappling with the fallout from closing the biggest economies added renewed uncertainty to markets. The S&P 500 fell 2.8% on Friday, erasing gains from earlier in the week and finishing the five-day trading negative, the first down-week in three. The index already had some negative sentiment associated with it as it approached a technical resistance just below the 3,000 level, having rallied 30.2% between 23 March (its recent low) and 30 April.

It is still unclear whether Friday's sell-off will be the start of a new leg down, but there is reason to believe that risk asset prices could see downward momentum. It stems from the uncertainty about what President Trump might do, and the impact of such actions on an already frail world after two-thirds of the global economy stopped in an attempt to slow the spread of the virus. Investors always need some time to price in uncertainty.

Unfortunately, there is also reason to believe that President Trump's anti-China rhetoric could be intensified. With the US November presidential elections looming closer, President Trump seems to be defaulting to the strategy that helped him win in 2016: bashing China. That message helped him carry three traditionally Democratic states in the so-called 'rust-belt': Michigan, Pennsylvania, and Wisconsin which won him the election. Retaining them will be key for President Trump to remain in the White House. They have also been among the worst-hit by the lockdown-generated recession, as factory employment has dropped sharply.

The global PMI survey, a measure of activity, has fallen to a record low in April

About one in five of the people in the workforce in Michigan and Pennsylvania have filed for welfare benefits in the past five weeks, according to state data. While the states had seen some of the fastest job creation in decades during the first two years of President Trump's mandate, most of those jobs were erased in the past month. It is no wonder, therefore, that these two states are already leaning toward the Democratic presumptive nominee Joe Biden for the November election, according to the latest polls. More clarity on just how many jobs were lost will come on Friday, when the Department of Labor releases its nonfarm payrolls report. It is likely to be very bad, and could trigger more ranting in the White House.

A Democratic victory in November is another element of uncertainty that markets are likely to start grappling with, along with the heightened rhetoric against China. While Senator Joe Biden has not indicated clearly whether he would roll back corporate tax cuts enacted by President Trump, he has used language suggesting he could do so (such as calling large corporations “greedy”). Much of the market rally during President Trump’s tenure can probably be traced back to his tax reduction policies, and any sign that these might be reversed is likely to have a major impact on risk asset prices.

Such a reassessment comes at a time when valuations were already relatively stretched for many asset classes. Take stocks, for instance. The S&P 500 was trading at 17.3 times its expected earnings in 2021 (investors seem to have completely written-off 2020), the highest level by that forward-looking metric since 2002. That still implied that earnings would grow 27.1% in 2021, after dropping only 12.4% this year, with both forecasts probably sounding optimistic.

Those levels, naturally, were taking into account some relatively good news that came to the fore in the past few weeks, as well as unprecedented stimulus — just the European Union, Japan and the US have committed to a combined US$10 trillion of fiscal and monetary easing.

In addition, Gilead Sciences, a US pharmaceutical company, announced last week that it was aware of positive data emerging from a study being conducted by the National Institute of Allergy and Infectious Disease on the efficacy its drug, Remdesivir, in the treatment of Covid-19. Yesterday, Bloomberg reported that the drug had been cleared for emergency use by the US Food and Drug Administration.

A potential treatment would remove the risk that the world goes into lockdown again if there is a second round of infections after the current social distancing measures are lifted. Being sure that life will go back to normal (and stay like that) is key for investors. Hence, stocks were rallying on the prospects of a more limited probability of another lockdown and of nearly unlimited stimulus to restart the world economy.

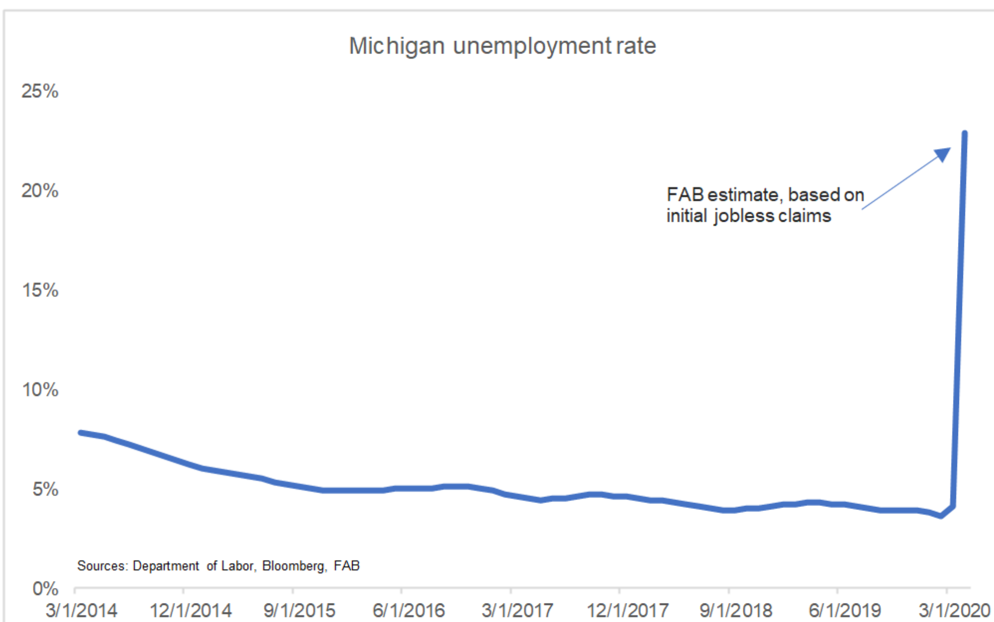
Throwing a new trade war into the mix is the last thing that investors need, and that could easily derail the rally. Eventually, the result of the US election and the outcome of the trade war will be fully reflected in the pricing of high-yield bonds and stocks, but until that time investors who are still overweight risk may have to brace for a rough ride.

This will also be the case for investors in oil-related assets, including those in the MENA region. Crude prices recovered last week after a record sell-off the week before, which was partly the result of technical issues related to the lack of storage. West Texas Intermediate crude rallied 16.8%, while Brent was up 23.3% in the week as investors weighed the reduction in investment from several oil majors (which translates into lower future supply), as well as the official start of an output cut agreement by the OPEC group.

The unemployment rate in Michigan, a battleground state, is likely to hit a record this week

Crude oil prices could weaken once again this week, as investors start to consider what impact a new trade war and a political reversal in the US could have on oil prices. Perhaps a preview of that was being seen in the Saudi Tadawul index on Sunday, as it dropped as much as 7% at one point. The fall, however, also reflected the sovereign’s rating move into negative by Moody’s, as well as sober comments from the Saudi Finance Minister, who said the country will have to take “painful” measures to deal with low oil prices and slower global growth.

In conclusion, for various reasons the immediate outlook for risk asset prices may deteriorate. At times like these it is worth focusing on increasing the overall quality of investment portfolios, potentially preparing them for pending opportunities to make judicious selected purchases in the months to come.



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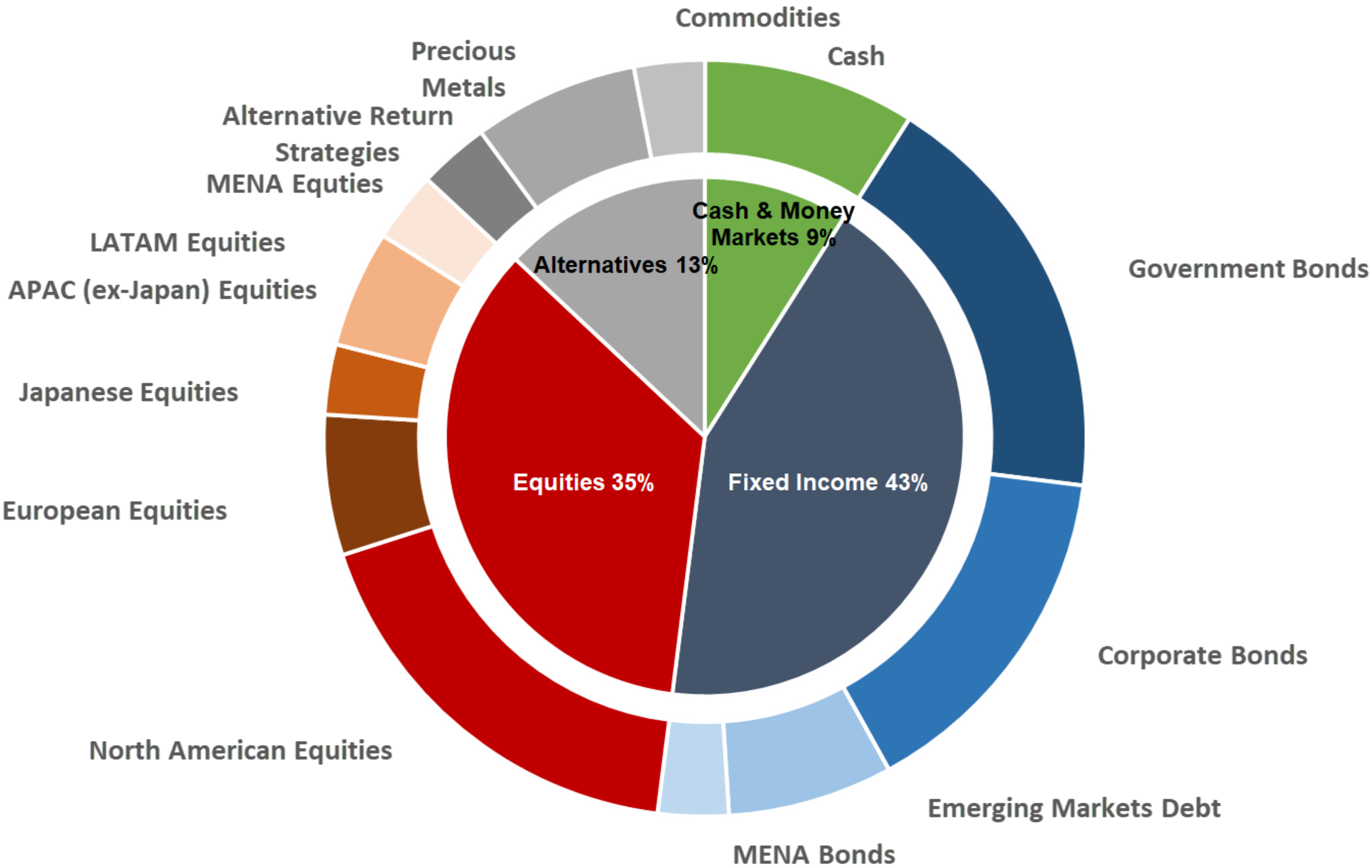
Current Tactical Asset Allocation



Asset Class	Positioning	Detail
Cash	Overweight	After taking profits on some equity positions.
Fixed Income	Overweight	Keeping slightly overweight focused on EM dollar debt and corporate investment grade bonds
Equities	Underweight	After taking profits on part of the US and European equity exposures
Alternatives	Underweight	However, overweight on precious metals specifically

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