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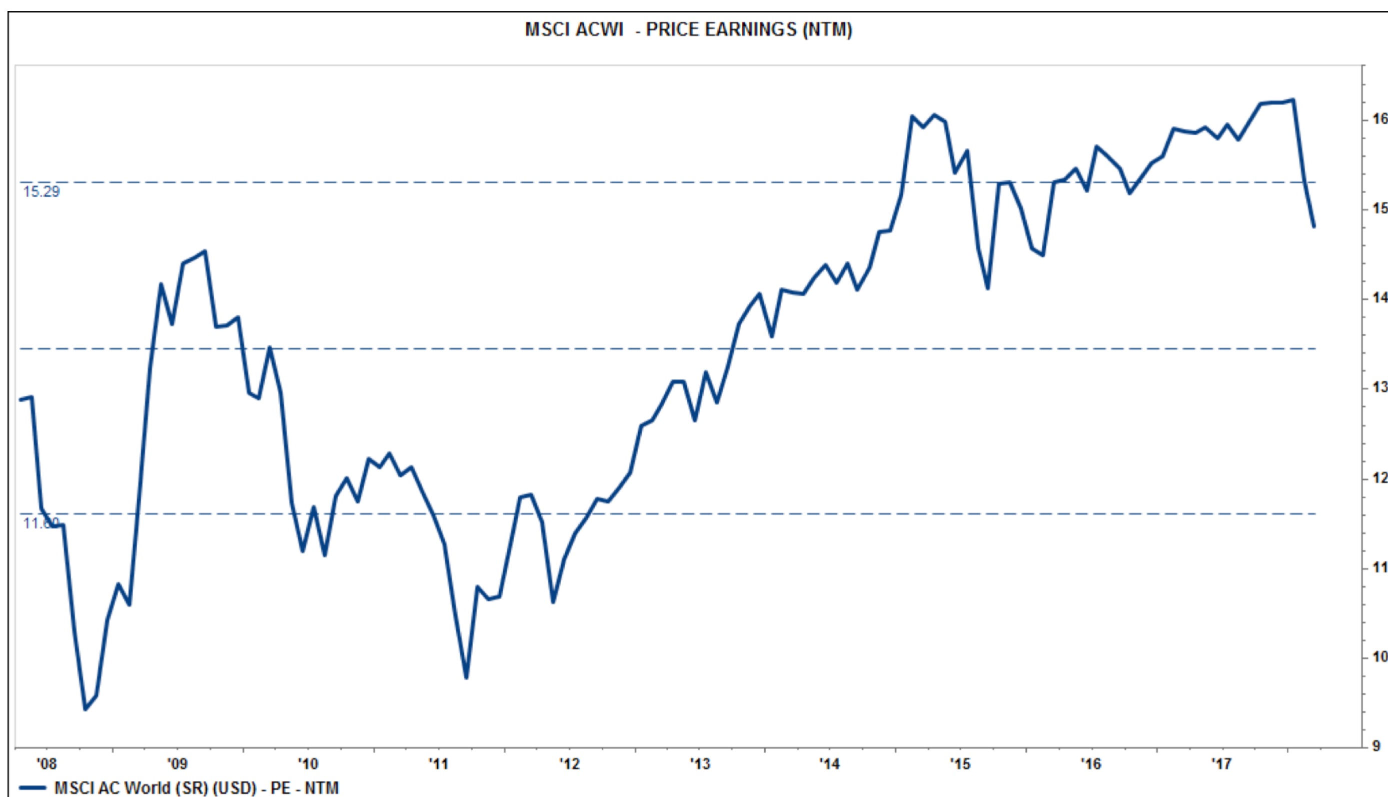
Global Growth Fund Ltd

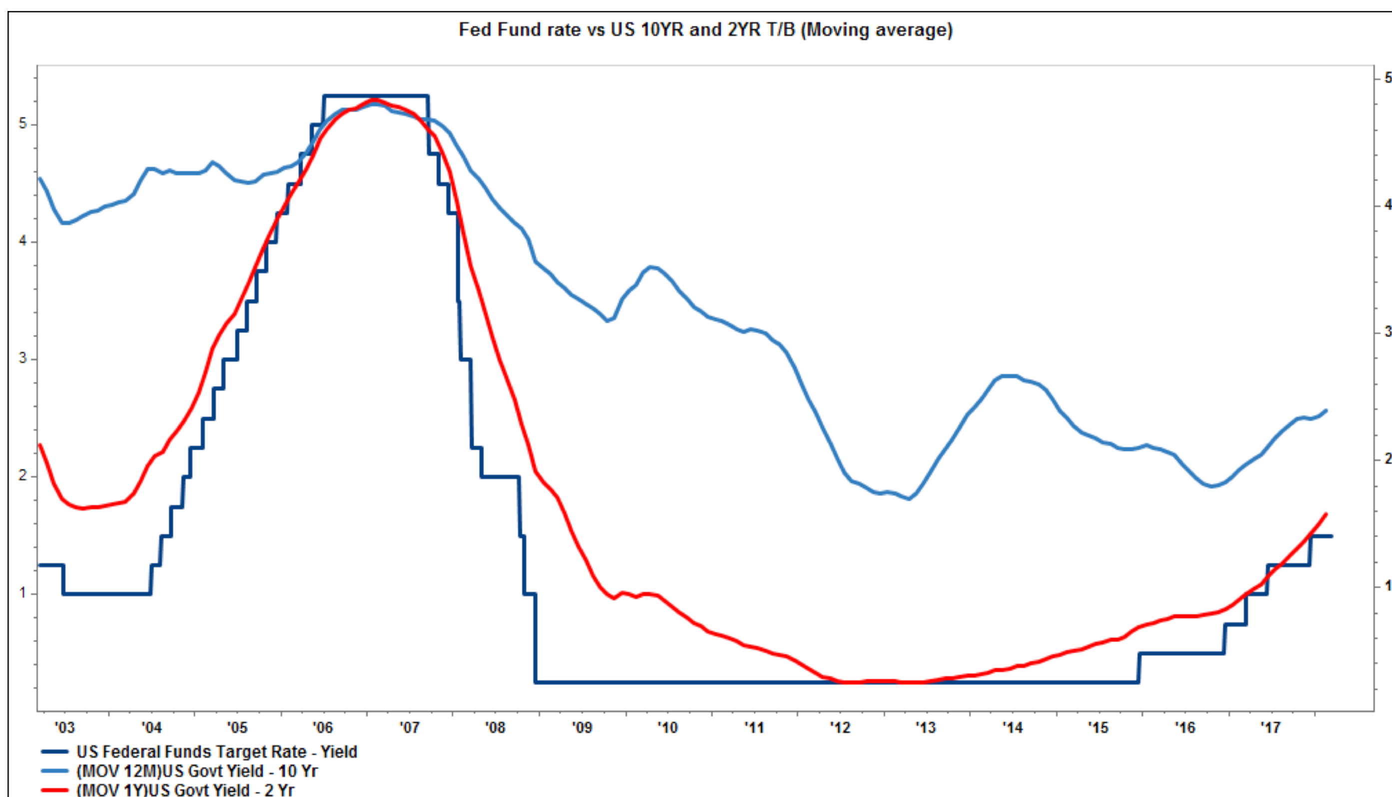
Global trade wars stoke volatility, but investors in diversified portfolios can ride through the storm

After a strong start to the year, investors had to be content with negative returns at the end of the first quarter as a combination of elevated valuations, rising interest rates and renewed fears of a full-blown trade war weighed heavily.

After a prolonged period of relatively low volatility and positive returns in equity markets, investors had to moderate their return expectations as the reality of higher global inflation, accompanied by higher interest rates and reduced liquidity, became key challenges. Elevated equity valuations, which provided little room for error, adjusted to a more uncertain environment.



Global growth is strong and expectations are that 2018/2019 will generate above average economic growth as higher wages and an uptick in investment spending provide support to economic activity. Lower taxes and fiscal expansion in the US will also provide and underpin for growth at least in the immediate future. It is therefore understandable that central banks have become more comfortable to signal that less monetary support is required as the economic cycle becomes more sustainable. But herein lies the risk. Interest rates have been kept artificially low for so long, and have been a key driver behind the improvement in global growth and investment market returns. In time, higher interest rates are set to reveal some of the unintended consequences from a prolonged period of risk taking and ultra-accommodative monetary policy.



Equity investors have therefore adjusted to the reality of higher interest rates and high dividend yielding sectors (predominantly defensive companies) such as telco's, staples and real estate have felt the brunt of the underperformance this year. Share prices of information technology companies with unique secular growth opportunities have continued their outperformance over the rest of the market, but are also susceptible to selling pressure, as the recent fallout from the Facebook data saga has illustrated.

The tension between higher interest rates and market valuations will persist as monetary policy becomes less supportive of growth. Higher interest rates are initially perceived to have very little effect on an expanding economy, but once the rate reaches a certain inflection point and beyond, investors start to discount the increased risk of the next economic downturn and equity markets react negatively.

But it wasn't just the threat of higher interest rates that unnerved global investors. Investment markets reacted negatively to Donald Trump's announced plans to introduce new trade tariffs on imports of steel and aluminium. The argument was that the levies were necessary for national security (a permissible reason under WTO rules) and that there would be a fair process. Officials from China and Europe immediately responded and threatened retaliation. The Europeans hinted at introducing countermeasures, such as import tariffs on US jeans, motorcycles and bourbon should Trump go ahead with his plans. Some countries and regions were exempted, either permanently or temporarily, from the tariffs.

It's a long time since the world had to deal with such an onco-ordinated and unilateral approach. Markets are thus concerned that the capriciousness of the implementation and the responses will have uncontrollable outcomes. It wasn't just US trading partners that expressed dissatisfaction - senior Republicans such as Paul Ryan, the House Speaker, warned about the unintended consequences of enforcing such tariffs and viewed it as a tax on US manufacturers and consumers. Gary Cohn, a trusted economic advisor to the administration, announced his resignation shortly after Trump's announcement.

Part of the focus was on protecting US intellectual property and the metal industry from "unfair" trade practices in China. The plans announced, which later also included tariffs on products such as robots, technology and pharmaceuticals, were deemed necessary to address the $375bn trade deficit with China. Trump also planned to introduce restrictions of Chinese foreign investment on "strategic" sectors in the US. So far, the Chinese reaction has been measured and more precisely targeted.

Quarterly Commentary as at 31 March 2018

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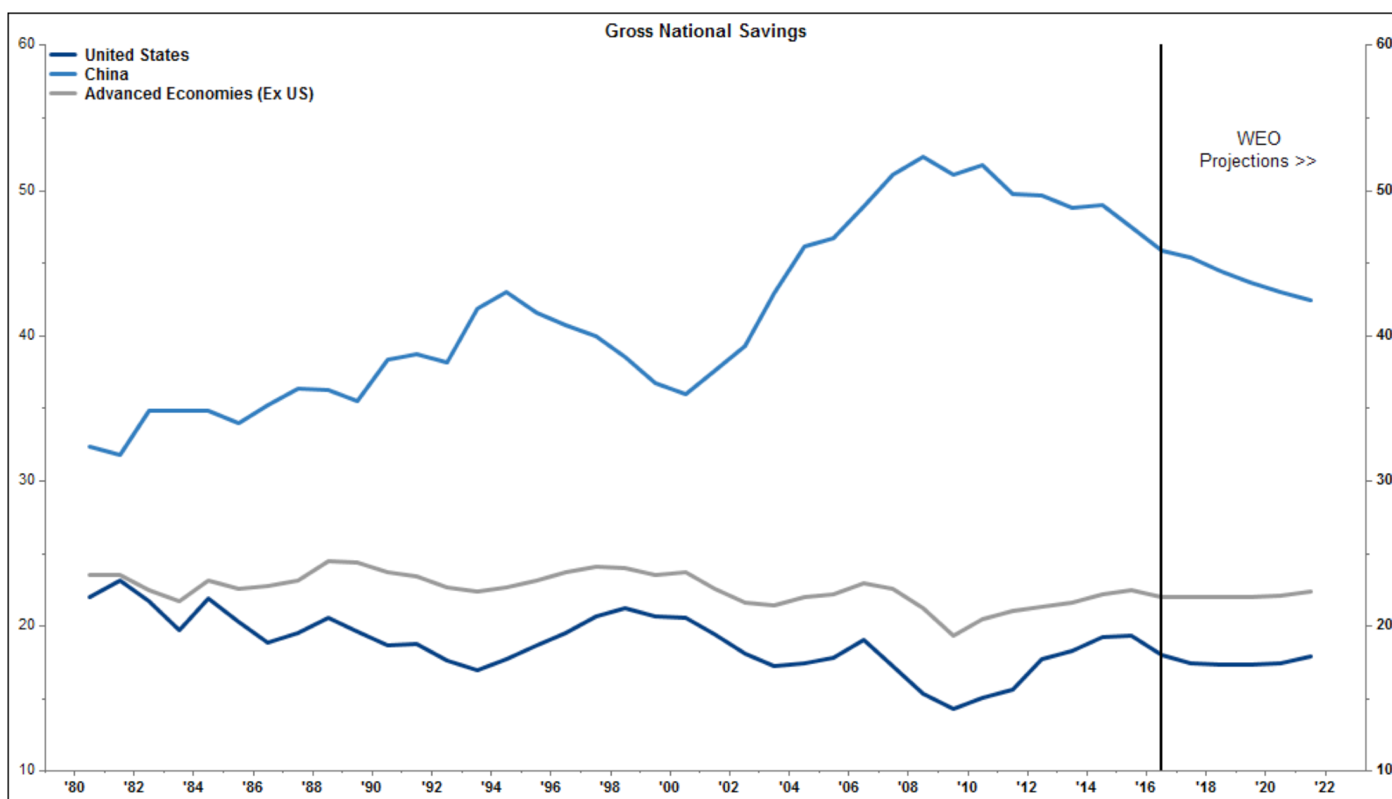
Differences in trade barriers between the US and its trading partners are only part of the reason for significant trade imbalances. Import tariffs in China have been coming down, but are still higher than US import tariffs overall. Non-tariff trade barriers for US imports into the EU are generally higher than for EU imports to the US, across a wide variety of industries. But the US trade deficit is structural, and is a function of the US's low savings rate (and high levels of consumption), in stark contrast with the historically high savings and investment rate in China. This is a situation which is unlikely to change anytime soon.



In the end, common sense ought to prevail: the US has a material interest in China's success. The income generated by companies such as Apple and General Motors in China is very substantial. Revenues of US companies operating in China were estimated at $223bn in 2015. General Motors manufactures and sells more vehicles in China than it does in the US. A retaliation by the Chinese authorities against US subsidiaries doing business in China could clearly have detrimental consequences to the long-term growth prospects for these companies.

But the threat for investment markets is that long-term trade relations between the US and its most important trading partners are bungled to such an extent that large-scale economic damage is done. At the worst, capricious sanctions are instituted against specific companies.

If global trade has resulted in more choice for consumers at lower prices and improved quality, the opposite can be expected from increased protectionism. Although the protected domestic industries would initially benefit from this development, the rest of the supply chain won't as they become less competitive globally, which will ultimately result in large layoffs, reduced incomes and a contraction in economic activity.

Furthermore, history suggests we should expect reduced productivity from the protected domestic industries over time as they become less incentivized to invest in new technologies and innovation.

"Trade wars are good and easy to win" asserted Mr Trump via Twitter. They are neither.

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Conclusion

Economic fundamentals remain positive and the outlook for earnings growth above trend, but some of the growth vectors such as interest rates and global trade have changed direction. Valuations have corrected somewhat, but the margin of safety at current levels remains relatively unattractive.

Investors should position themselves for lower and more volatile returns than what they have been accustomed to over the past few years. The fund is well positioned for the current environment and will participate in investment opportunities as they unveil themselves.

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