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Goldilocks or Game of Thrones?

The past few months have seen something of a "Goldilocks" period for stock markets. The global economy has generally been doing fine and perhaps better than some investors had expected. However, it is not running so hot as to make central banks want to put up interest rates.

That combination of steady economic growth and loose monetary policy has been very good for stocks and allowed them to recover from the sell-off towards the end of 2018.

There were several things worrying investors at that time. Up until recently, each one of those issues had improved:

- Fed rate increases – now on hold
- Brexit – now delayed
- Chinese slowdown – now accelerating
- US / China trade war – ceasefire as talks are under way

It is the last point which is now worrying investors again. The fragile peace has been shattered, and trade hostilities have been renewed.

As is often the case with President Trump, the venue for this new attack was on Twitter. On 5 May, he tweeted that the Chinese had tried to back down on commitments made during negotiations. As a result, the US was to increase tariffs on selected Chinese goods and services from 10% to 25%.

Markets did not like this one bit and immediately sold off around the world. Interestingly, it was not just Asian markets but also US stocks which fell.

It is worth remembering that a tariff is paid on imports of Chinese goods to America, which means that it is the importer that pays it. The higher cost of those goods will either be born by the American company doing the importing or passed on to American consumers through higher prices.

In theory, US consumers could just switch to buying goods from other countries. Preferably, if you're Donald Trump, they should buy American goods. Of course, that's only going to happen if there's an American manufacturer of the product that can make it as cheaply as a Chinese manufacturer in the first place.

The Chinese have (predictably) retaliated, imposing their own tariffs on a further $60 billion of US goods. Most of the media focus is on exports from China to the US, but of course trade goes both ways. For example, China was, until recently, one of the biggest buyers of soybeans, a principal product of the Mid-West States which (coincidentally?) largely support Trump. Demand for US soybeans slumped last year when the trade war first reared its head, as the Chinese switched to purchases from South America and elsewhere.

A commitment from China to begin purchasing US soybeans again has been one key area of recent talks.

As we've noted previously, these are the two biggest economies in the world, so their trading relationship matters. Most people believe that some sort of trade deal will eventually be reached given the potential impact on both economies.

However, it seems likely that this is only the start of clashes between the two countries which may well continue for many years to come.

Game of Thrones

Chart one shows how the global economy has changed over time, starting at the year one AD!

For the first 1,500 years or so, India and China accounted for a large proportion of the world's GDP by virtue of their large land masses and populations. That changed as the European powers began their global conquests and, for a time, the British empire was the global leader.

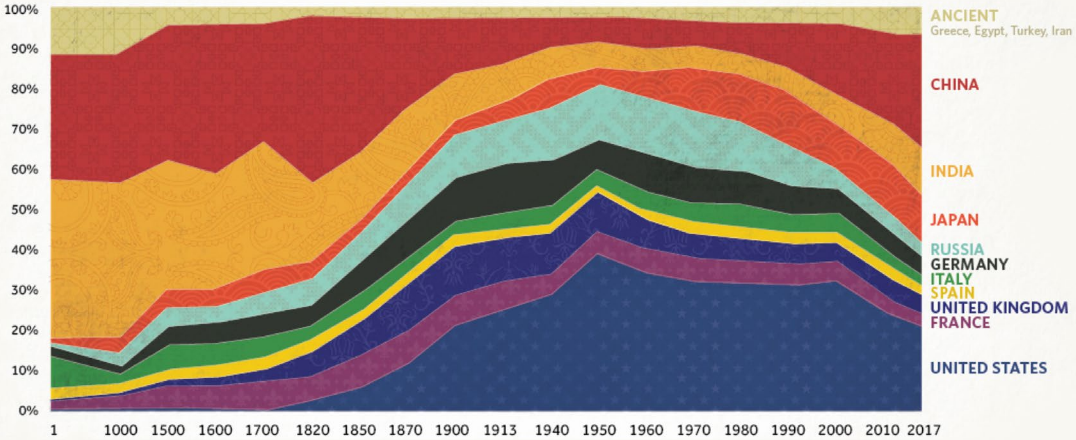
The USA has been the world's largest economy since 1871, nearly a century and a half. That's a long time for a country to be the world's top superpower.

However, the dragons are coming, and if respective growth levels continue as they are, China is likely to take the throne, perhaps in the next decade.

Whilst this change of leadership could happen peacefully and amicably, the US is unlikely to give up their supremacy without a fight. The trade war is merely a symptom of Trump's battle to keep America first.

The Chinese are now global leaders in electric cars, solar energy and mobile technology amongst other areas. No longer are they simply making cheap copies of western goods and "borrowing" the intellectual

Chart one: Historic shares of GDP



Source: Visual Capitalist

property. According to the World Intellectual Property Organisation, Chinese companies and individuals were responsible for 40% of all patent applications in 2017.

Most recently, Trump has used his executive powers to bar US companies from using foreign telecoms believed to pose national security risks. In particular, this seems to be targeted at Huawei.

Huawei is the largest telecom equipment manufacturer in the world and the second largest manufacturer of smartphones. Whilst there are legitimate security concerns, this move could also be viewed as trying to curtail Chinese supremacy in this area of technology.

China's emergence as a superpower to rival America is not just economic. Under president Xi, military spending has surged, and Beijing has taken a more assertive stance on their claims to the South China Sea. The US have responded by sending their own warships to patrol the area.

For the past two decades, the relationship between the US and China has been mutually beneficial. The US would buy goods from China, and the Chinese government would buy US government bonds. China currently holds around $1.12 trillion of these US treasuries, but recently has been selling these down. One repercussion of the trade war is that China may accelerate this selling, which could raise the cost of borrowing for the US government.

The point is that the current so-called trade war, may well be merely season one of this particular Game of Thrones. And (spoiler alert) those who've been watching the TV series know that the side with the dragons tends to win in battle!

The current spat may well end in a deal which allows both Trump and Xi to save face and claim victory. If so, then markets should rebound, but bouts of tension are likely to be a recurring theme over the next few years that investors will have to learn to live with.

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General economic overview

The global economy continues to post modest levels of growth. Whilst this is slower than a year or so ago, it remains positive and there seems little likelihood of a global downturn in the near future. In fact, first quarter growth in the UK, US and China was ahead of most expectations.

Despite this, it seems unlikely that central banks on either side of the Atlantic will increase interest rates this year. Uncertainty remains, not least from Brexit and the trade war.

Equity markets

Most stock markets are still cheaper than they were 18 months ago, although not as cheap as they were at the beginning of the year. The UK, China and Japan look best value in our view, whilst the US is back close to its peak and trades on a high multiple of earnings. We are cautiously optimistic about stock markets but think it's important to be selective.

Fixed interest

With interest rates apparently on hold, it has been a good environment for bonds. In addition, with economic growth continuing, companies are doing okay and so default rates on corporate bonds remain low. This environment looks set to continue, however yields are low by historical standard so returns are also likely to be low.

Commercial property

Commercial property has been hard hit by Brexit related uncertainty with very few transactions taking place as investors wait to see what happens. Retail properties have been hard hit by a downturn in this area, which is partially driven by the shift to online purchases. Despite this, by being selective we expect low but positive returns.

Cash

With interest rates remaining at record lows, returns on cash will remain below average for the foreseeable future.

Balanced asset allocation

For a typical balanced portfolio, we are underweight fixed interest and property, and slightly underweight traditional equity. This is balanced by additional holdings in defined returns and alternative equity, giving an overall risk/return profile roughly in line with our long-term average position.

These represent Equilibrium's collective views. The value of your investments can fall as well as rise and is not guaranteed. Investors may not get back the amount originally invested. We usually recommend holding at least some funds in all asset classes at all times and adjusting weightings to reflect the above views. These are not personal recommendations, so please do not take action without speaking to your adviser.