DWS

Americas CIO View

EM Asia upside is worth the risk despite trade conflict

Trade tensions amid China slowdown: China likely conciliatory

Year-to-date (ytd) Emerging Markets (EM) is the worst performing region with Emerging Market Asia being down 6% and Latin America (LatAm) down 9%. We see a 60% chance that the newly announced tariffs on $200bn Chinese products take effect in September. A trade war is lose-lose for both sides. Historically, U.S. exports and imports rise or decline together. Hence, both sides should want to return to the negotiating table. But because China is at greater risk to tariffs owing to its larger U.S. exports and that tariffs could aggravate the risks of China's deliberate slowing of investment spending to defend asset values underlying loans, we think it is likely that China will reoffer a deal that could avert these tariffs.

What is the final outcome? More U.S. tariffs or less tariffs by the rest of the world?

By including the additional proposed tariffs in the existing 301 process, the additional tariffs on $200bn goods will have a relatively short time frame to be imposed if that's what the administration chooses to do. The Trump administration states that it doesn't want to raise tariffs, but wants other countries to lower theirs. The sincerity of this stance is debatable, but it would help if other countries clearly and loudly offered to lower their tariffs as soon as possible to stop new U.S. tariffs. Retaliations and threats of such empower protectionists here and elsewhere, but offers to drop tariffs by other countries could open the door to a win-win solution. We realize this isn't easily done quickly, especially by the EU, and threatens preferable multilateral dealings by introducing bilateral deals. But without quick deals or offers of such to lower tariffs, the higher-tariffs outcome is gaining chances.

Risk remains at EM Asia equities, but EM Asia offers best upside if tariff risk fades

If the 10% on $200bn Chinese goods is implemented and retaliation and further escalation occurs, downside could be 5% for EM Asia, but similar for Europe and the S&P 500 (S&P). This could be less if China quickly offers conciliatory compromises. If negotiations stop or swiftly rescind the tariffs, then EM Asia could rally near 20%, 10% for Europe and 5% for the S&P. Our 12-month targets across global equity indices include some trade risk, but a 5% cut to our June 2019 target for EM Asia and 3-5% cuts to Europe and the S&P are feasible upon further escalation. EM Asia is currently trading at 10% below our 12-month target, so limited 12-month downside

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In a nutshell

- Trade tensions amid China slowdown: China likely conciliatory
- Risk remains at EM Asia equities, but EM Asia offers best upside if tariff risk fades
- 2018E EM Asia EPS solid, NTM EPS growth of 11.5%. Still likely positive with tariffs
- S&P 500 unlikely to climb much higher without other equity markets climbing too
- 10% tariffs better than 25%, perhaps room to lower further. Watch currencies

with tariffs. We see near-term negative trade headlines to pressure global equities and change our "Next 5%+ Price Move" for the S&P from "Balanced Risk" to "Down." On a probable basis, EM Asia offers the best upside over the next 12 months and we expect global equities to appreciate over the coming year as tariffs are unlikely to cause a recession or stop S&P earnings-per-share (EPS) or EM Asia EPS growth. We cut equity allocation by 2% to 63% and raise fixed income to 32%.

2018E EM Asia EPS solid, NTM EPS growth of 11.5%. Still likely positive with tariffs

We keep a close watch on earnings trends across regions. There are some down revisions to EM Asia 2018E EPS consensus since June as trade tensions escalate. But these cuts are not due to weak revenue or margin outlook, they are more currency-related on Chinese-yuan (CNY) depreciation. S&P is the only region with upward earnings revisions ytd. Europe and EM saw their 2018E EPS cut, and Japan is flattish excluding its tax-cut benefit. Our CIO forecast for next-twelve-months (NTM) EPS growth: S&P up 12.9% year-over-year (y/y) and EM Asia up 11.5% y/y. These are the strongest regions, EM Asia would be the strongest excluding the S&P's tax-cut benefit.

S&P 500 unlikely to climb much higher without other equity markets climbing too

Another reason we think EM Asia has better upside is its even bigger valuation gap to the U.S. after its selloff on trade threats. Currently, the S&P is trading at a 10% premium to its average trailing and forward Price-to-Earnings ratios (PEs) since 2000; Europe is trading in line with its historic average; EM Asia is trading at 5% discount while offering the best corporate-profit growth among all. Low interest rates globally are supportive of higher-than-normal PEs at all regions. We think the EM Asia equity market is discounting more of the trade tension than the other regions. Our base-case view is still that even with some further trade-conflict escalation, including some auto tariffs, that U.S. and global gross domestic product (GDP) will be decent, so we remain constructive on global equity markets.

10% tariffs better than 25%, perhaps room to lower further. Watch currencies

CNY depreciation of 7% since its April peak is likely to stick and there might be a little further depreciation from here, but it's unlikely to be more than that as China would intervene. China could pursue other methods to cushion slowing exports like cutting corporate taxes and easing credit availability. Other countries in EM Asia, like India, have healthy economic growth and investment spending, which should help bolster the region's overall economy. Excluding China, other countries are 63% of equity market cap of Asia ex Japan. Chinese equities have become more growth-sector-oriented

with 40% of the Chinese equity-market cap being Tech and 56% Tech, Consumer and Health Care.

Glossary

Chinese yuan (CNY)

The **Chinese yuan (CNY)** is legal tender on the Chinese mainland and the unit of account of the currency, Renminbi (RMB).

Earnings per share (EPS)

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

Emerging markets (EM)

Emerging markets (EM) are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

European Union (EU)

The **European Union (EU)** is a political and economic union of 28 member states located primarily in Europe.

Gross domestic product (GDP)

The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Market capitalization

Market capitalization, in the context of an individual firms, is the number of shares issued multiplied by the value of the shares.

Price-to-earnings (P/E) ratio or multiple

The **price-to-earnings (P/E) ratio** compares a company's current share price to its earnings per share.

Recession

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

S&P 500

The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

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