Americas CIO View

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Maximum pressure equals maximum risk

United States has put maximum pressure on China in this trade war

Trade-war crossfire has intensified. Trump announced a new tariff of 10% on the remaining $300 billion imports from China, which we believe will become effective on September 1. China allowed the Chinese yuan (CNY) to devalue above 7.0, and the U.S. Treasury declared China a currency manipulator. The United States is putting maximum pressure on China to reach a deal. However, we think this tactic will not succeed, at least in the near term, and tariffs could go to 25% on all imports from China and remain for a long time. We believe that more pain needs to be felt on both sides for this to be de-escalated, which will take time. Cross-asset volatility is likely to remain heightened for the weeks to come.

Renminbi depreciation beyond 7.0 is a bad sign in many ways

If deliberate devaluations of currency occur, this would turn the trade war into a currency war. A weaker CNY will make oil more expensive to China, which will weaken its demand and perhaps cause China to turn more fully to Iranian supply. If capital-flight fears return in China, it could depreciate CNY more than the People's Bank of China (PBoC) can contain. China's economy can probably handle the impact from tariffs and a volatile CNY and still deliver 5.5%-6.0% gross-domestic-product (GDP) growth, but economies elsewhere with large exports to China could be tipped into a recession. The trade war has caused slower trade, weaker investment spending and slower manufacturing activities globally. And now introducing tariffs on consumer goods will rattle U.S. consumers.

More Fed cuts are priced in, but will it be the antidote for the slowdown?

The market is pricing in a 100% probability for a September U.S. Federal-Reserve (Fed) cut, up from 40% after the July Federal Open Market Committee (FOMC). Also four rate cuts are now expected by 2020 end, up from three. But is "easier" monetary policy enough to offset a likely S&P 500 profit recession and a darkening global economic outlook? The 10-year vs. 3-month yield gap is -30 basis points (bps). We have argued repetitively that a slightly inverted yield curve (up to ~50bp) is not a strong signal for recession but a market indication that the Fed is at or slightly above its neutral rate. But if the inversion gets close to -100bps, then we believe it becomes a strong recession signal. Global purchasing manager indexes (PMIs) are weak and most regions are below 50. Further deterioration will mean more of a slowdown is likely underway. Second quarter bottom-up earnings per share (EPS) in the United States and emerging markets (EM) are flat on a year-over-year basis, and all other regions are down. The world is almost in a profit recession already. Accommodative monetary policy is helpful, but

In a nutshell

- United States has put maximum pressure on China in this trade war
- Renminbi depreciation beyond 7.0 is a bad sign in many ways
- More Fed cuts are priced in, but will it be the antidote for the slowdown?
- Are low interest rates good for S&P 500 P/E? Not necessarily
- Risk of 10% correction high, sector tilts are helpful to weather the pullback

it takes time to work through the system, and we expect it to be better for the economy than for corporate profits.

Are low interest rates good for S&P 500 P/E? Not necessarily

The U.S. 10-year Treasury yield dropped to 1.6% and the yield on 10-year Treasury-Inflation Protected Securities (TIPS) is 0.0%. Very low interest rates have been supportive of higher price-to-earnings (P/E) multiples than history at the S&P 500, but can they push P/Es higher? Secularly lower interest rates are good for equity multiples, but cyclically lower interest rates are not. Cyclical-economic and corporate-profit downturns are usually accompanied by simultaneous lower interest rates and equity multiples. In this cycle there are two instances when interest rates have been as low as today: 2012 and 2015-16. In 2012, the S&P 500 P/E was compressed to 12x amid double-dip recession fears. And during 2015-16, the S&P 500 fell into a profit recession caused by the oil price collapse and dollar surge. The S&P 500 P/E was compressed from its high of 18x to a low of 16x. In our view, today's low interest rates reflect both secular and cyclical forces, but the recent moves are more cyclical. The Fed suggested that the July rate cut was a course-correction adjustment, not the start of a long easing cycle.

Risk of 10% correction high, sector tilts are helpful to weather the pullback

This significant trade-conflict escalation hurts profits at trade-sensitive industries, pressures oil prices and poses upside dollar risk. These very low interest rates threaten Bank net-interest margins. We cut our 2019 estimate for the S&P 500 EPS from $165 to $163, flat year-on-year; and our 2020 estimate for EPS from $175 to $173, 6% year-on-year. The average S&P 500 trailing P/E this cycle (since 2010) is 16.7x. We think this could be a reasonable P/E support level. We expect the S&P 500 to soon fall to about 2750, i.e. 17x our 2019 EPS estimate, or 10% selloff from the peak of 3025. However, if recession fears flare up and the 10-year yield sinks below 1.5%, then S&P 500 P/E can compress to about 15x or lower, i.e. 2450 or 20% selloff from the peak is possible. Several other major risks are also on the horizon: a more likely no-deal Brexit, worsening conflict in Hong Kong, possible U.S. tariffs on Europe, and upcoming Japan consumption-tax-rate hike. We continue to believe that the risk of a near-term S&P 500 correction is high. Our sector S&P 500 tilts are positioned for this pullback. We are overweight Health Care, Communications, Utilities and Real Estate, and we are cautious on all other sectors.

Glossary

Accommodative

The aim of an **accommodative** monetary policy is to support the economy by means of monetary expansion.

Basis point

One **basis point** equals 1/100 of a percentage point.

Chinese yuan (CNY)

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

Correction

A **correction** is a decline in stock market prices.

Devaluation

Devaluation is the forced reduction of the value of a currency against other currencies.

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Earnings per share (EPS)

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Emerging markets (EM)

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

Federal Open Market Committee (FOMC)

The **Federal Open Market Committee (FOMC)** is the committee that oversees the open-market operations (purchases and sales of securities that are intended to steer interest rates and market liquidity) of the U.S. Federal Reserve.

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.

Inflation-indexed securities

Inflation-indexed securities are securities whose coupon payments are tied to a inflation rate.

Monetary policy

Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

PBoC

People's bank of China (PBoC) is the central bank of China.

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.

Purchasing Managers Index (PMI)

The **Purchasing Managers Index (PMI)** is an indicator of the economic health of the manufacturing sector in a specific country or region.

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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Treasuries

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

U.S. dollar (USD)

The **U.S. dollar (USD)** is the official currency of the United States and its overseas territories.

U.S. Federal Reserve (Fed)

The **U.S. Federal Reserve**, often referred to as "**the Fed**", is the central bank of the United States.

Volatility

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

Yield

Yield is the income return on an investment referring to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

Yield-curve inversion

A **yield-curve inversion** is when the yields on bonds with shorter duration are higher than the yields on bonds that have a longer duration.

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