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INVESTMENT MANAGEMENT

Sand in the Gears

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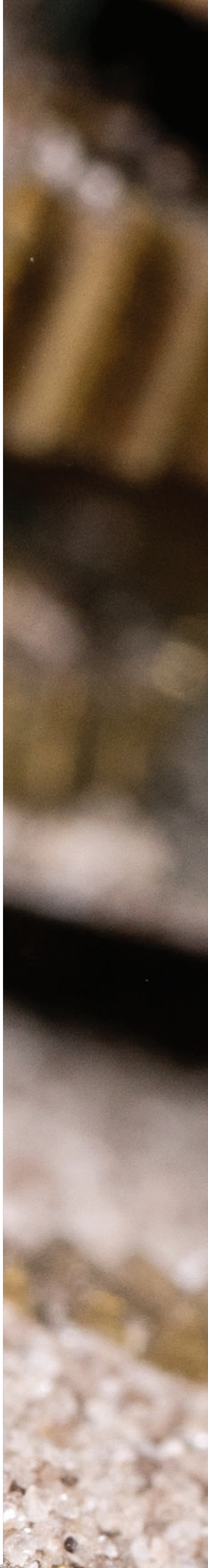
Until very recently, the U.S. and global economies were moving in a positive direction, with a significant driver of that growth being business fixed investment. Although there was some rhetoric around trade and tariffs, it seemed to be little more than an aggressive negotiating tactic. Around the middle of June, however, the trade rhetoric started shifting in tone.

At the same time, feedback from trade envoys suggested that the United States was unable to articulate how its demands could be satisfied. In our view, the shift in tone could be a sign that tensions with other countries will persist. These could add to any volatility that may arise in the lead-up to the US mid-term elections in November. This approach has put the equivalent of sand into the gears of the global economy.

Business fixed investment plays a key role in business cycle theory, because accelerations in fixed investment tend to generate greater Gross Domestic Product (GDP) growth. That in turn creates a higher demand for capital stock, which spurs more investment and more growth, becoming a self-reinforcing process. For approximately the last year and a half, business fixed investment has been in this virtuous cycle—increasing because the desired capital stock exceeded, by a significant margin, the existing capital stock.



The key aspect of this multiplier effect is that business fixed investment has to be increasing for this virtuous cycle to be maintained. And the reverse process can happen as well. Investment does not have to decrease in absolute terms—if the rate of increase slows, the demand created by that slower growth falls, which then causes the overall economy to grow less quickly, and that in turn means the desired capital stock falls. So the trend can be self-reinforcing the other way as well. And that seems to be happening now.

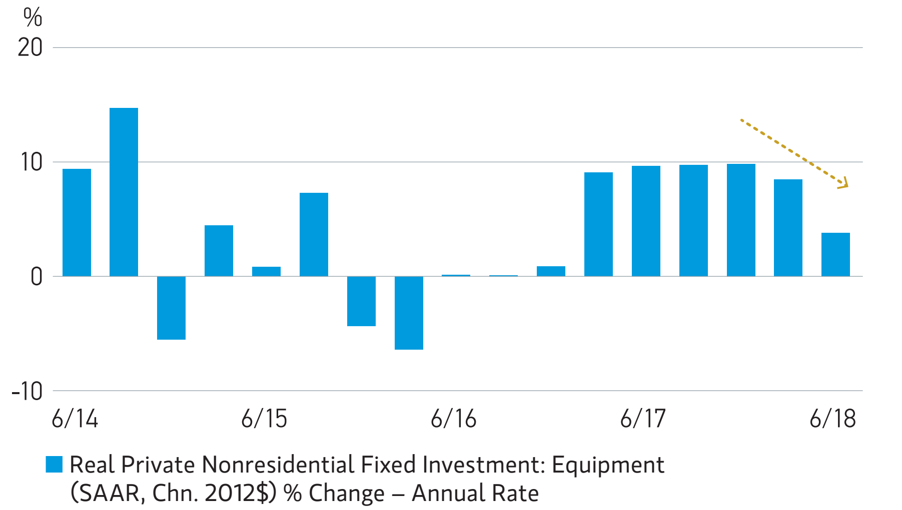
What has changed recently is the level of rhetoric on trade and tariffs. A fair amount of business fixed investment depends on global trade and supply chains, so uncertainty about tariffs potentially reducing demand or increasing the cost of inputs can cause companies to think twice about investing in capital assets. We think that this has started to play a significant role in companies' investment decisions.

Since 2014, business fixed investment in equipment *(Display 1)* shows a mixed record until 2017, when the economy started growing quickly enough to hit capacity constraints and companies realised they needed to invest in order to produce the level of goods and services that customers demanded. This was followed by a consistent rise from 2017 until last quarter. We believe the noticeable slowdown in the growth rate this past quarter is tied specifically to uncertainty around tariffs and the business climate.

US regional Fed surveys[1] of Capital Expenditure (CapEx) intentions in the United States also indicate a significant decrease of planned investment, indicating that U.S. growth might well be decelerating. But this is not just a U.S. problem. The first half of 2018 bought with it a sharp deceleration in growth indicators in a number of key economies *(Display 2)*. Japan suffered negative GDP growth in Q1 2018, business sentiment in the eurozone fell to levels below those reached in 2016 and Chinese data highlighted an ongoing slowdown in activity.

DISPLAY 1

Business investment in equipment: A noticeable slowdown



Source: U.S. Bureau of Economic Analysis, Haver. 27 July 2018. Seasonally Adjusted Annual Rate (SAAR) in billions of Chained 2012 Dollars (real dollars adjusted for inflation for comparison purposes).

DISPLAY 2

Decelerating growth expectations in Europe

Source: ZEW, Bloomberg, 31 July 2018.

[1] Including the US Empire State, Philadelphia Fed and Richmond Fed surveys.

More than one source of sand

While the tariffs are important with respect to the business cycle, so are the Fed's rate hikes. Residential fixed investment has detracted from GDP over the past two quarters. Housing starts[2]—a key leading indicator of economic strength—pulled back sharply in June, down 12.3% relative to May 2018 *(Display 3)*. This drop is likely due to the fact that interest rates are now rising.

The combination of tariffs and tightening interest rates are creating an inflection point, where the recent strong growth rate with low inflation may be shifting to a slower growth rate, with higher inflation.

Past peak confidence?

Consumer sentiment is driven in part by the unemployment rate, which has been low, but it also has a strong inverse correlation to the savings rate *(Display 4)*. When people are feeling better about things, they save less. And, in fact, the most recent numbers show an increase in the savings rate, which suggests that on a forward-looking basis either consumer confidence is falling or disposable income is being squeezed by the rising oil price.

Oil prices have almost doubled since a year ago, with Brent crude going from around $44 towards the end of June 2017 to $80 at the end of May 2018, while gasoline prices have also increased. And tariffs can directly raise prices on consumer goods, especially at the lower end of the scale where goods tend to be produced in China.

Manufacturer surveys: Tariffs and truck driver shortages

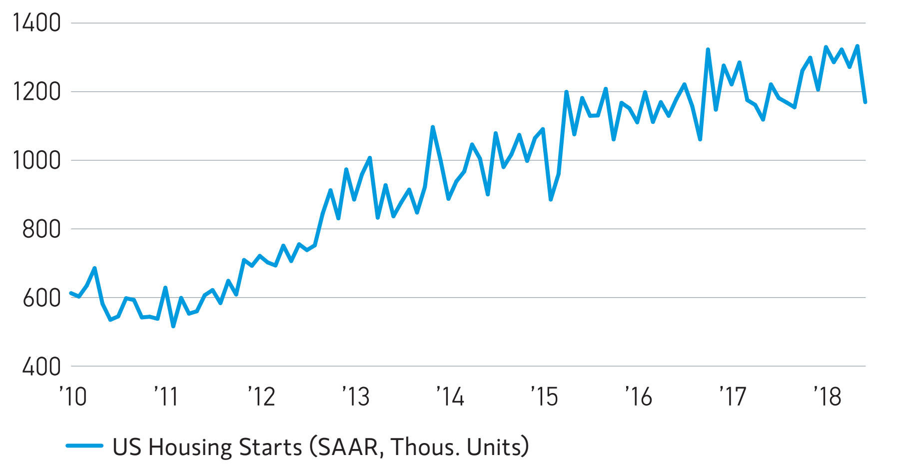
In recent surveys,[3] manufacturers have echoed these concerns. They see tariffs causing supply disruptions and higher input prices, and describe labour shortages as constraints to growth. In particular, they cite a shortage of truck drivers. These sorts of shortages would have been ameliorated in the past by importing labour from abroad, but that is not feasible under current immigration policies.

Timing: Front-loaded

Both the tariff disputes and immigration constraints seem to be driven by President Trump's desire to appeal to his voter base. As the pressure on the president increases, we could see more political initiatives that continue to weaken the economic picture.

DISPLAY 3

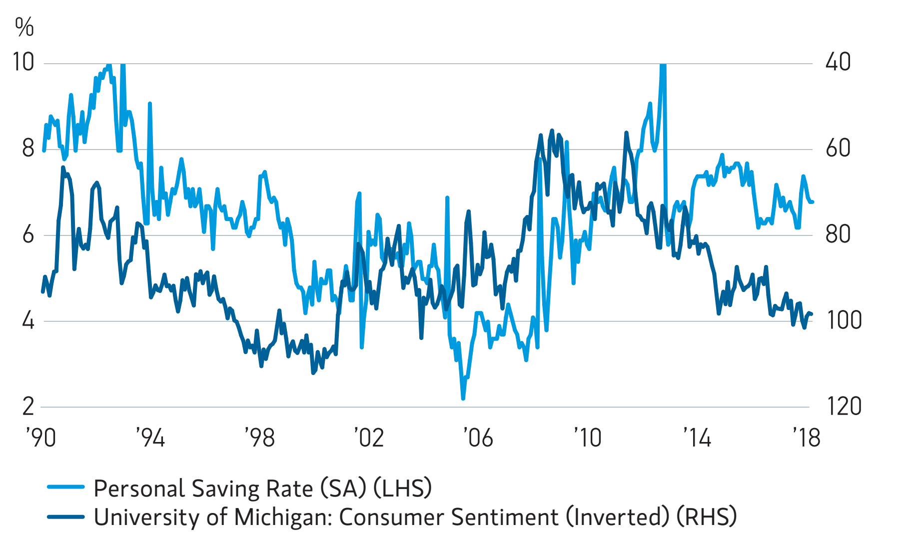
Housing starts pulled back in June



Source: Census Bureau, Haver, 18 July 2018.

DISPLAY 4

When people feel better, they save less



Source: Bureau of Economic Analysis, University of Michigan, Haver, 31 July 2018.

[2] New Private Residential Construction Projects started per month as reported by the Census Bureau.

[3] Fed Beige Book, 18 July 2018 and the June ISM manufacturing survey.

Two political events on the horizon are generating a lot of the sand that is currently being thrown into the gears, and they are both coming up soon. One is the Mueller investigation into Russian interference in the 2016 U.S. presidential elections, the results of which are likely to unfold within the next couple of months. The U.S. midterm election itself is the other key event. Once the election is over, policies could moderate and become more economically driven as opposed to politically driven. But this also suggests that there could be a significant amount of volatility between now and the election, possibly front-loaded if Mueller wants to avoid a surprise right before the midterm elections that could be interpreted as deliberately influencing their outcome.

Inflation is picking up

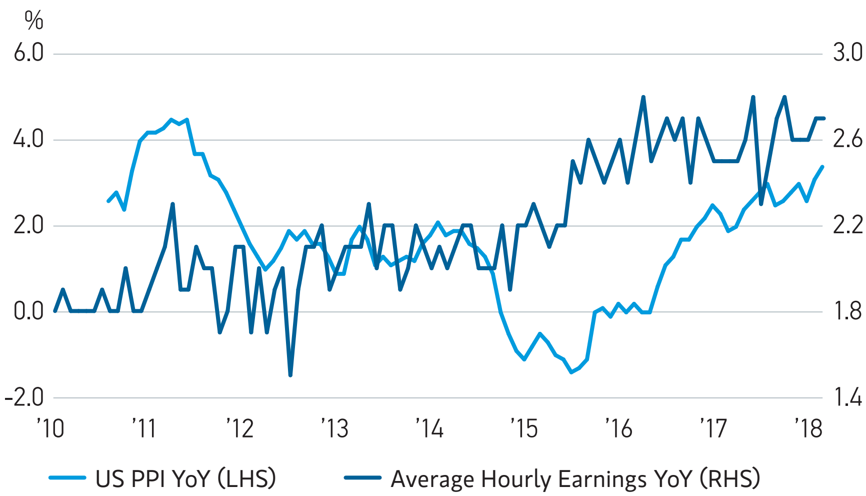
Besides the tariffs, which are inflationary and create significant distortions in pricing and market efficiency, the rally in oil prices has contributed materially to an increase in headline inflation. Producer prices have also been trending up, along with labour costs. In Europe, 41% of small businesses say they face "important difficulties" in hiring,[4] a figure which is up 10 points from a year ago and is at the highest level since 2002. But in our opinion the economy most at risk is the U.S. *(Display 5)*, partly because the rest of the world already experienced a weak first half of 2018—so the inflection point is potentially sharper in the U.S.

Investment implications

Given the strong economic growth in the United States, a great deal of money has shifted into U.S. equities, and particularly into the tech sector's most recognised names. As a result, we have started to see exuberance and very high expectations for earnings even as the outlook for the United States has become less favourable. Having previously risen sharply, trends in earnings revisions are now turning down in the United States.

DISPLAY 5

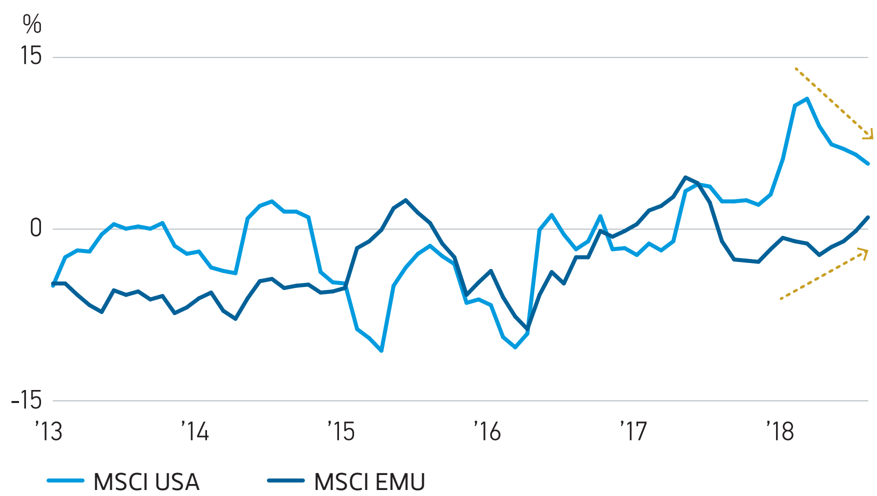
U.S. economy at risk as input prices rise



Source: Bloomberg. NSA indicates non-seasonally adjusted.

DISPLAY 6

Earnings revisions: Rising in Europe, falling in the US



Source: Datastream, IBES.

Europe, in contrast, is seeing revisions turn higher, likely supported by the weakness of the euro in 2018 *(Display 6)*. Furthermore, once the elevated EPS expectations for 2018 drop out, the gap between U.S. and eurozone EPS growth expectations virtually disappears. Earnings expectations for 2019 in both the U.S. and eurozone stand at 10%.

Although bullishness in U.S. assets—equities and the US dollar—and

[4] https://www.lesechos.fr/economie-france/social/0302020039303-les-difficultes-de-recrutement-des-pme-a-des-sommets-2193990.php

bearishness towards European assets continues, the combination of lower hurdles for earnings, rising earnings expectations and a relatively weak euro all favour European equities over the United States *(Display 6)*. Once a reversal takes place, it could be sharp, given how crowded these trades look. Owing to high hedging costs, recent flows have likely been unhedged, so investors may take a hit on both the underlying markets and the FX.

As a result, we could see a broader market sell-off, at least in the short term as investors become disenchanted and try to reposition. Such periods are typically accompanied by significant volatility. If and when the rebound occurs, however, we would expect it to be more concentrated in Europe.

We are also positioned for a rotation out of growth into value. If we see a loss of momentum in the high PE growth sector, then we might finally see a rotation into value, which has been oversold in relative terms. Financials, for example, have underperformed since the start of the year, but have started to pick up over the past month, and we expect that to continue.

We are positive on the banking and energy sectors. Having gone through the financial crisis, the banking system as a whole—especially in the United States—has been reinforced, well capitalised and underleveraged relative to historical circumstances. And in energy, high oil prices are clearly translating into higher earnings expectations.

China: More fragile than normal

The other major engine of the world economy has been China, and it is also slowing. China's objective of improving the quality of its economic growth, reducing leverage and eliminating inefficient producers has slowed its pace of growth. This means the tariffs have come at a sensitive moment for the Chinese economy.

Asia ex-China: Knock-on effect

The tariff penalty on Asia could be significant. The value-added of Chinese exports to the United States is around 60%, which means the remaining 40% is imported into China in order to produce the goods for the U.S. This knock-on effect of 40% from tariffs imposed on China will hurt the countries that supply China, which are largely in Asia.

Latin America: Shifting demand

Although emerging markets are typically considered high-beta players, Latin American EM are probably less affected by the tariffs—and could even benefit—because of the shift in demand. For example, the tariffs have shifted Chinese purchases of soy beans from the United States to Brazil. Secondly, high oil prices, while they hurt the consumer, benefit LatAm oil exporters. They help insulate those countries, although certain segments will suffer from rising prices.

An uphill climb

The U.S. has been acting as a locomotive, pulling the rest of the world out of a weak economic environment into a stronger one. With the tariffs and trade disputes, this engine has been spiked as though with sand. Higher interest rates have created an inevitable uphill climb, and when combined with the tariffs the gears are unable to turn efficiently. As a result, the whole global locomotive may be slipping a bit. It is still moving forward, but it is slipping.

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