The background of the top section is a dark image featuring several wooden blocks stacked in a precarious, toppling arrangement. The Morgan Stanley logo is in the top left corner.

Morgan Stanley

INVESTMENT MANAGEMENT

## Q2 2018 Update: A change in direction

SOLUTIONS & MULTI-ASSET | GLOBAL BALANCED RISK CONTROL TEAM | MARKET PULSE | 19 July 2018

Until recently, our base case for 2018 had been that the global economy would see a continuation of the growth momentum enjoyed in 2017. We attributed the deceleration in growth observed outside the US in the first quarter of this year (most notably in Europe) to one-off factors such as “a harsher winter” and have been anticipating a pick-up in activity. However, thus far this bounce has failed to materialise. Instead we have seen a further deceleration in European activity and a softening of indicators in emerging markets and China. What has become clear is that President Trump’s combative rhetoric on trade has weighed on sentiment and growth. However, even without an outright trade war, the global economy has suffered some collateral damage.

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### The politics behind the trade war

Until early June, we had interpreted President Trump’s threats to impose tariffs as merely a negotiation tactic. However, with the loss of momentum in constructive discussions between China and the US, and growing confusion around the exact nature of Trump’s demands, we no longer expect the US President to back down on tariff threats. So far the US has imposed steel and aluminium tariffs on imports from the EU, Canada and Mexico, and an initial tranche of tariffs on \$34bn worth of Chinese goods, with the intention to impose additional tariffs worth \$16bn and a threat of a further \$200bn to be charged on Chinese goods. In response, Europe, Mexico, Canada and China have imposed retaliatory tariffs against the US. The next move is likely to be one targeted at Europe following Trump’s threat of a 20% tariff on EU car imports. Indeed much of Trump’s commentary on his recent trip to Europe in July (i.e. his disapproval of Germany’s imports of Russian gas and his criticism of inadequate European budgets on

NATO defence spending) suggest to us that Trump may be laying the groundwork for tariffs against the EU.

In our opinion, President Trump's behaviour is likely being driven by the US mid-term elections scheduled for the beginning of November 2018. The President's 'tough negotiation' strategy and protectionist rhetoric may be designed to appeal to his voter base.

There is evidence that this strategy is working. A poll from the *Washington Post* shows the Democrats' lead is narrowing. A so-called "generic ballot", where voters are asked which party they plan to vote for in the coming election, showed that President Trump's approval ratings have strengthened. In January, the Democrats led Republicans in a generic matchup by 12%, but by April that lead was just 4%. As of July though the Democrats recovered some ground, leading by 8%<sup>1</sup>. Even if the President's base approves today, Trump is facing headwinds on a number of fronts. Consequently there is still a possibility that the Republicans could lose their joint majority in the House and the Senate, subsequently hampering President Trump's ability to gain approval for additional reforms.

Republicans and Democrats are now united in expressing their concerns over potential economic damage resulting from trade tensions, and are backing a measure to give Congress a greater say on trade policies.

Immigration policy is another area where the US President currently has few supporters in Washington. Recent reports (from the Pew Research Center) indicate that Americans think Democrats could do a better job dealing with immigration and more than half of Americans disapprove of how Trump has handled immigration issues so far, according to an early July 2018 Quinnipiac poll.

President Trump is likely attempting to strengthen his position amongst his base ahead of the event which has the potential to have the greatest negative impact on his standing in the polls - the outcome of the Mueller investigation. We expect Special Counsel Robert Mueller to make his move in the coming months and most likely in September. The rationale for this timing is that if an announcement were to be made any later, it could be viewed as an attempt to influence the outcome of the mid-term elections.

### **The effect of tariffs and US dollar strength on global growth**

Significantly, of the \$505bn<sup>2</sup> Chinese exports to the US in 2017, only about 60% was value added in China. The remaining \$250bn<sup>3</sup> was the value of inputs imported to China that went into producing the goods, which were eventually exported to the US. This means that only half of any tariff-related reduction in Chinese exports should impact the Chinese economy – the other half will impact the economies of the countries globally that supply China. This implies that about half of the impact of US-imposed tariffs will be directly transmitted to the rest of the global economy – primarily (but not only) Asian countries which

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<sup>1</sup> Source: [https://www.realclearpolitics.com/epolls/other/2018\\_generic\\_congressional\\_vote-6185.html](https://www.realclearpolitics.com/epolls/other/2018_generic_congressional_vote-6185.html)

<sup>2</sup> Source: US Census Bureau. <https://www.census.gov/foreign-trade/balance/c5700.html>

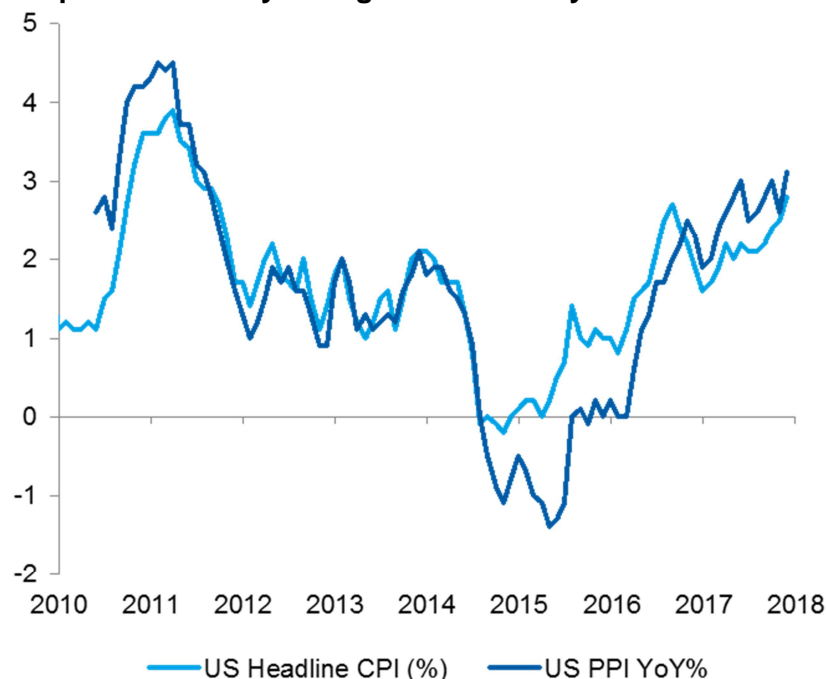
<sup>3</sup> This estimate is based on OECD data, which shows that the domestic value added (DVA) in gross exports from China was 70% in 2014. However, the paper Domestic Value Added in Chinese Exports from 2011, published by Hiau Looi Kee and Heiwai Tang of the World Bank and Tufts University suggests that DVA in gross exports to the US is 60% (the findings and results of the paper do not represent the views of the World Bank, its Executive Directors, or the countries they represent).

supply China with the inputs used to produce their exports. Indirect transmissions to the global economy could be larger, but are less easy to estimate.

Any gains that the US may receive from a trade war with China are potentially smaller than appearances may suggest. It is likely that most of the value added from US exports to China (\$129.9bn in 2017) is created in the US, implying that the impact of tariffs will be largely felt by the US economy. In contrast, as mentioned above, only about half of the tariff impact should directly affect the Chinese economy. Therefore, the relative direct exposures of the US economy versus the Chinese economy to tariffs are roughly \$129.9bn versus \$250bn respectively.

The US economy is fundamentally in very good shape. Consumption has been robust amidst historically low unemployment, while capital expenditure has been rising owing to the need to invest in new technology and the falling stocks of available labour. The US tax bill and expansionary fiscal policy have also contributed to the strong momentum in the economy. At the same time, while inflation remains subdued, relative to history it is rising. US Producer Price Inflation (PPI) increased by 3.4% YoY in June (the largest increase since November 2011), while CPI stands at 2.9%, the highest level since February 2012. However, given the potential for the trade war to eventually slow economic growth in the US and add to existing inflationary pressures, we may be approaching an inflection point - growth may start to decelerate just as inflation is finally climbing.

#### US prices at a 6.5 year high and are likely to climb further amidst tariffs and rising oil prices



Source: Bloomberg. Data as of 2 July 2018.

In addition to this, the US dollar has continued to strengthen over the course of 2018 and an escalation in the trade war will likely push it higher in the near term. The US dollar is the primary global funding currency and thus strength in the currency translates into tighter financial conditions. Most exposed to this

tightening in financial conditions are emerging markets, which have faced the sharpest depreciations in their currencies year-to-date and also increased their US dollar-denominated borrowing by 10% in 2017<sup>4</sup>.

## Looking ahead

As we move into the second half of 2018, the key risk to growth is that the combination of a trade war (or simply ongoing uncertainty in relation to trade) and the declining availability of credit and rising funding costs, could result in an abrupt deceleration in the rebound in capital investment that we have witnessed since 2016. In the absence of rising investment and the associated productivity growth, capacity constraints could start to become a real concern. The short-term risk to assets is a further escalation in the trade war – in our view the focus of Trump's trade war is shifting to Europe and we expect that an announcement of tariffs (most likely on cars and car parts) is imminent. Moreover, a further \$200bn of tariffs could also be imposed on China. Such an escalation in the trade war would likely serve to increase inflation and undermine global growth.

We are also anticipating the outcome of the Mueller investigation, which should be released ahead of the mid-term election and could be a challenge for the President. Assuming President Trump is not negatively impacted by anything coming from the Mueller investigation, there is a possibility that as we approach the mid-term elections, Trump-related volatility declines, which in turn could finally result in a sustained equity rally. However, this is with the caveat that Trump does not meaningfully dampen sentiment and growth via an escalation in the trade war.

## Fund positioning

In light of the above, throughout June we gradually decreased our overall equity exposure temporarily. In particular, we decreased our exposure to Chinese equities and to Asian countries, which are most exposed to Chinese imports. Key activity indicators in China including retail sales and industrial output continue to trend lower as the trade war risk undermines China's rebalancing efforts.

On the fixed income side, we have marginally increased the duration of our funds and positioned ourselves in asset classes which could benefit from an increase in inflation (e.g. US TIPS and Euro inflation-linked bonds). We have also maintained our underweight position in emerging markets debt.

With specific reference to our mutual funds range, we have provided below the asset allocations of each of our four Luxembourg SICAV Funds, as of 17 July 2018:

	VOLATILITY TARGET P.A. <sup>1</sup>	EQUITY %	FIXED INCOME %	COMMODITIES %	CASH %
MS INV F Global Balanced Risk Control Fund	4% – 10%	23.7	56.5	1.5	18.3
MS INV F Global Balanced Income Fund	4% – 10%	23.9	48.2	1.5	26.4
MS INV F Global Balanced Fund	4% – 10%	25.5	52.4	1.5	20.6
MS INV F Global Balanced Defensive Fund	2% – 6%	9.0	68.0	1.0	21.9

Source: Global Balanced Risk Control team, Morgan Stanley Investment Management.

Allocations are subject to change on a daily basis and without notice. For information only and not a recommendation to buy or sell specific investment strategy.

MS INV F standards for Morgan Stanley Investment Funds.

1. Volatility targets are indicative ranges. There is no assurance that these targets will be attained.

<sup>4</sup> Source: BIS.

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There is no assurance that the Strategy will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Accordingly, you can lose money investing in this portfolio. Please be aware that this strategy may be subject to certain additional risks. There is the risk that the Adviser's **asset allocation methodology and assumptions** regarding the Underlying Portfolios may be incorrect in light of actual market conditions and the Portfolio may not achieve its investment objective. Share prices also tend to be volatile and there is a significant possibility of loss. The portfolio's investments in **commodity-linked notes** involve substantial risks, including risk of loss of a significant portion of their principal value. In addition to commodity risk, they may be subject to additional special risks, such as risk of loss of interest and principal, lack of secondary market and risk of greater volatility, that do not affect traditional equity and debt securities. **Currency fluctuations** could erase investment gains or add to investment losses. **Fixed-income securities** are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall. **Equity and foreign securities** are generally more volatile than fixed income securities and are subject to currency, political, economic and market risks. Equity values fluctuate in response to activities specific to a company. Stocks of **small-capitalization companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing in **emerging market** countries are greater than risks associated with investments in foreign developed markets. **Exchange traded funds (ETFs)** shares have many of the same risks as direct investments in common stocks or bonds and their market value will fluctuate as the value of the underlying index does. By investing in exchange traded funds ETFs and other **Investment Funds**, the portfolio absorbs both its own expenses and those of the ETFs and Investment Funds it invests in. Supply and demand for ETFs and Investment Funds may not be correlated to that of the underlying securities. **Derivative instruments** can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the portfolio's performance. A **currency forward** is a hedging tool that does not involve any upfront payment. The use of **leverage** may increase volatility in the Portfolio. **Diversification** does not protect you against a loss in a particular market; however, it allows you to spread that risk across various asset classes.



## DEFINITIONS

**Consumer Price Index (CPI)** measures changes in the price level of a market basket of consumer goods and services purchased by households.

**US Producer Price Index (PPI)** measures the average change over time in the selling prices received by domestic producers for their output. The prices included are from the first commercial transaction for many products and some services.

**U.S. Treasury Inflation-Protected Securities (TIPS)** are the inflation-indexed bonds issued by the U.S. Treasury.

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