Morgan Stanley

INVESTMENT MANAGEMENT

PATH > PORTFOLIO ALLOCATION TRENDS & HIGHLIGHTS

Midgame

SOLUTIONS & MULTI-ASSET | GLOBAL BALANCED RISK CONTROL | MACRO INSIGHT | MAY 2019

AUTHOR

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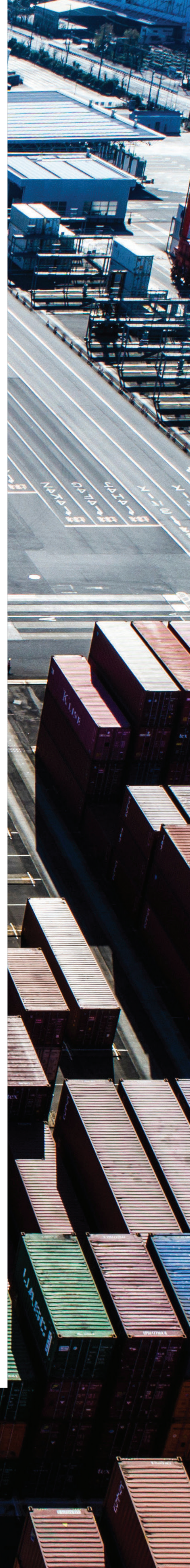
With the world economy emerging from a growth scare in the fourth quarter of 2018, we were confident that the U.S. and global economies were steadily recovering and not headed towards a recession. Our expectation was that the recovery may take a few more quarters to take hold, based on a combination of cyclical and structural trends.

That all changed on 10 May, when an increase in tariffs on Chinese imports announced by President Trump took effect, reviving the game of tariffs between China and the U.S. that has been a drag on the global economy. This did not come as a surprise to us, as the US-China trade tension is one of the key binary risks we highlighted in our previous outlook.

Despite the tensions, we believe the medium-term growth story remains intact, but given recent heightening of trade tensions this may be delayed. In fact, these trade tensions may increase the likelihood of further fiscal stimulus in China and the U.S., although this may be accompanied by volatility. Treading carefully around potential near-term volatility, investors should be keeping an eye on the midgame. We are navigating this near-term disruption by reducing risk in our portfolios on a short-term basis, with the aim of eventually moving back into equities.

"China-U.S. trade tensions have hindered world trade, resulting in the most significant decline in volumes since the 2008 crisis."



Despite tensions, global trade might have found a floor

The China-U.S. trade tensions have hindered world trade, resulting in the most significant decline in volumes since the 2008 crisis *(Display 1)* and impacting export reliant economies. World trade flows pulled back in February 2019, following a January improvement, in a move that was telegraphed by Q1 softness in new export order PMI (Purchasing Managers' Index) data.

Prior to recent tensions, new export data had indicated a significant rebound in Chinese orders and a potential bottom for orders in Europe *(Display 2)*. The trade battles of early May have the potential to again destabilise this in the short run, but we still expect trade flows to improve in the medium term.

China is important to the recovery

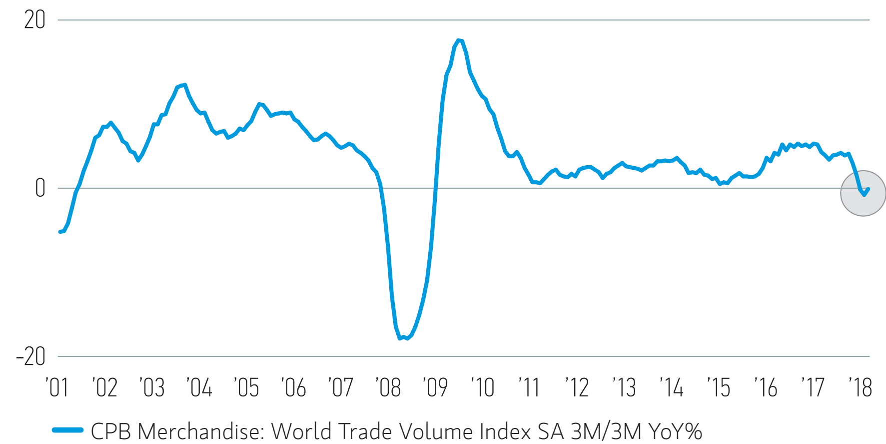
A central piece to the turnaround has been the stimulus in China. While the current stimulus is only about 1.5% of GDP on the fiscal side—a steep drop from nearly 10% in 2008—it is far more targeted.[1]

The last three Chinese stimulus cycles drove money into the property markets, which is a quick way to boost consumption. Cities like Beijing, Shanghai and Shenzhen experienced property price increases as high as 30-40% per annum.[2] This created a bubble as people sought to direct more funds into the "easy money" property markets.

Today's stimulus has been devised to prevent the bubble from bursting: It includes policies aimed at maintaining the relative tightening on the property side, while directing the fiscal stimulus to the private sector and the consumer. Given the nature of the new stimulus, we expect it to operate more slowly than in the past, but ultimately be more sustainable.

DISPLAY 1

Trade flows damaged by tariffs

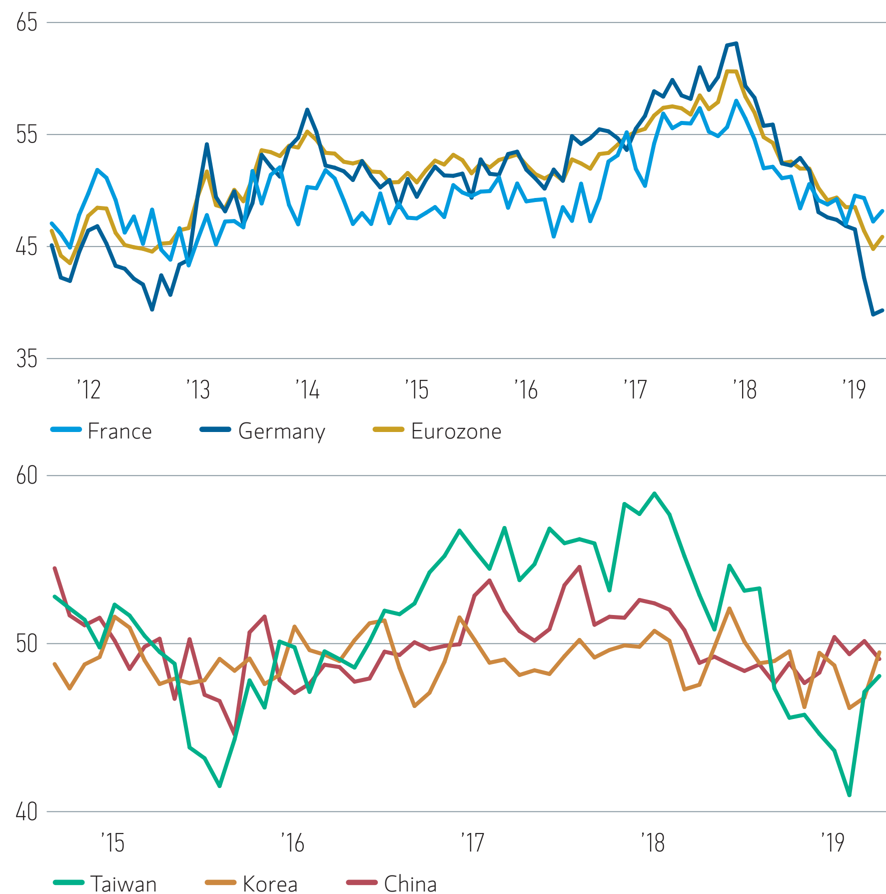


Source: CPB, Bloomberg. Data as at 10 May 2019.

DISPLAY 2

China's new export orders rebound and the eurozone may have found a floor

PMI New Export Orders



Source: Nikkei, Markit, Datastream. Data as at 10 May 2019.

[1] Increase in China's augmented deficits. Source: IMF, www.imf.org/external/pubs/ft/scr/2013/cr13211.pdf People's Republic of China: 2013 Article IV Consultants, July 2013, page 13.

[2] Bloomberg, China 1st Tier Cities Newly Built Commercial Residential Bldgs Price YoY Avg.

The Chinese consumer is far more indebted today than in the past. Over the last 10 years, debt levels have nearly doubled *(Display 3)*. Although still manageable compared to other countries' debts, the speed with which this level has risen is a concern. Also concerning is the younger generation's struggle to save: The cost of living is rising, and mortgage rates are running at about 5% to 6%, compared to 2% in the UK. It will not be easy for consumers to go on a "spending spree."

While aware of the longer-term risks of growing household debt, Chinese policymakers do not want their economy to slow any further. With tariff tensions rising again, they have already made some tentative moves to further increase the stimulus—but they seem to be keeping further increases in property prices as a last resort.

The value of U.S. public infrastructure . . .

Both the President and Congressional Democrats have supported fiscal stimulus through infrastructure programmes—with a $2 trillion target discussed last November. Nevertheless, during a recent meeting with the Democratic leadership, Trump made his support for infrastructure contingent on Congressional investigations into his administration and business stopping. While this is a setback it appears that backchannels for progress on legislative initiatives still remain open (for example, the disaster aid bill just passed by the Senate and is still supported by Trump). We still believe that an infrastructure spending programme remains highly popular with the public and would be likely to prevent a recession in 2020. These politically powerful drivers suggest that this initiative may be reconsidered soon. Senate Republican support would be contingent on how this initiative was funded and a gasoline tax, which has not been increased since the Clinton administration remains a good possibility even though in the end a major infrastructure bill is likely to be front-loaded and paid for initially with debt.

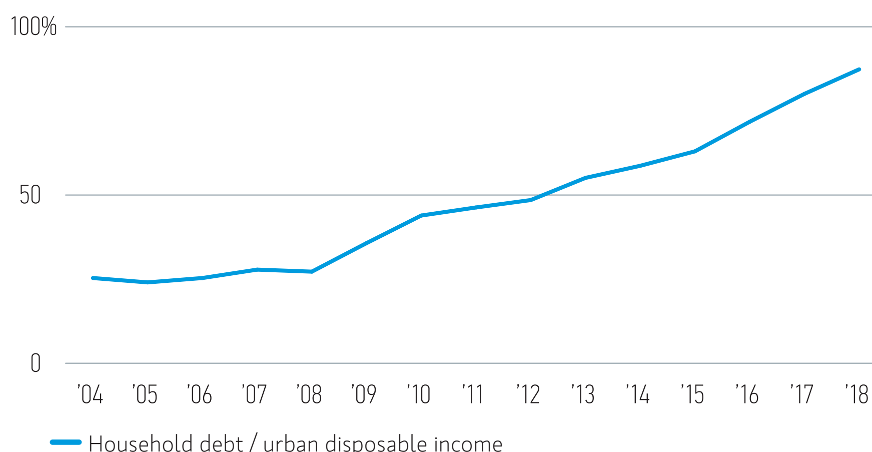
. . . and the case for an uptick in private investment

Business fixed investment is typically the most cyclical element in GDP, with a disproportionate impact on the business cycle. *Display 4* tracks how core CapEx growth recovered from the lows of 2015 and 2016, peaked in December 2017 and then stabilised somewhat before plunging in 2018. This sharp drop was likely in large part due to the trade war. Uncertainties about global supply chains forced businesses to postpone needed investment. The slight March 2019 rebound represents the biggest improvement in corporate investment in eight months.

The recent revival in tensions certainly has the potential to postpone CapEx again, but there are several trends constructive for business fixed investment to grow in the medium term. Most

DISPLAY 3

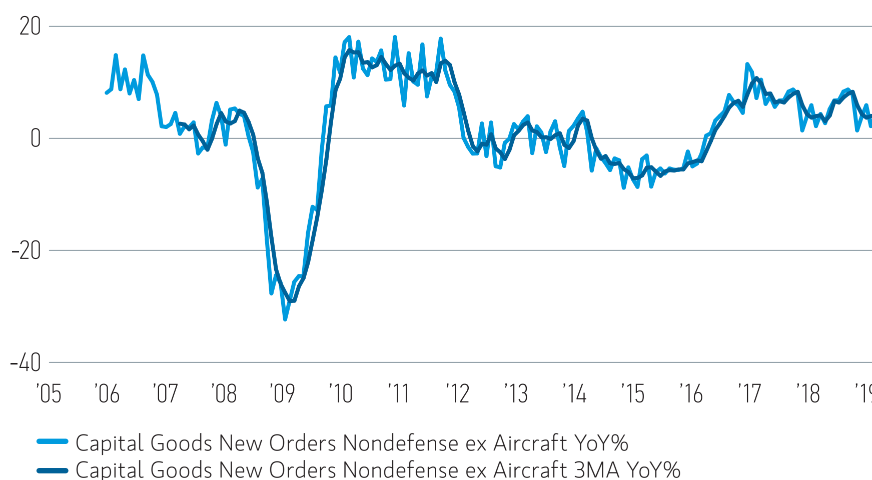
Owing more: Chinese consumer debt is rising



Source: Bloomberg, National Bureau of Statistics of China. Data as at 10 May 2019.

DISPLAY 4

U.S. business equipment orders are stable-to-improving



Source: U.S. Census Bureau, Bloomberg. Data as at 10 May 2019.

importantly, there is a significant pent-up demand—with existing capital equipment very obsolete and technological change moving at a rapid pace, businesses desperately need to upgrade their capital stock.

Meanwhile, climate change-related disruptions will tend to accelerate the rate of capital investment as the economy transitions towards things like electric vehicles and solar energy. And any fiscal stimulus programme based on infrastructure spending would also boost capital expenditures (CapEx).

Stimulus prospects in Europe

As populist movements continue to gather support—as demonstrated in the recent EU Parliamentary elections—the pressure on European governments to increase spending grows. A stimulus agenda appears to be gaining with it. The Eurozone's four largest economies now appearing likely to implement expansionary fiscal measures in 2019. This expectation is supported by the latest data from the European Commission, which anticipate some degree of stimulus from Germany, France, Italy and Spain *(Display 5)*.

The outlook for automobiles

The traditional bounce in auto production may not be as pronounced as during previous cycles. In fact, the disruptive transition from internal combustion engine to electrical vehicles may weaken the effect of industry growth in the short term. Many auto manufacturers are planning to shift to electric vehicles, a change that could be quite constructive for longer-term capital investment. Employment, though, could suffer because the production of electric vehicles requires far less labour. Automakers may close down facilities before they open new ones, so to the extent this occurs, it could take time to see the potential boost to net investment.

We expect a recovery, but not in the traditional V-shape

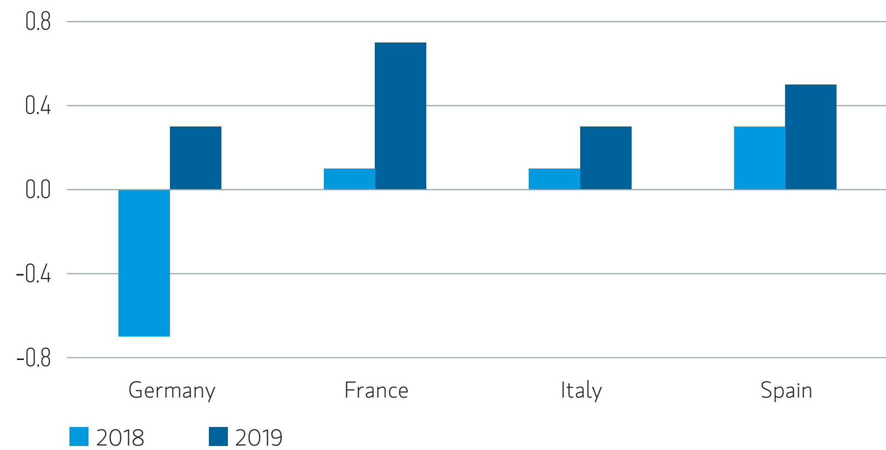
While stimulus from China helped create a V-shaped recovery in 2015-2016, their current stimulus is both smaller and designed to benefit just China, with less constructive spillover to the rest of the world.

Global inventories are also generally too high, likely due to stockpiling in anticipation of Brexit disruptions and the trade war *(Display 6)*. This excessive inventory cycle will have to be worked off. For example, the semiconductor downturn has not bottomed, with high chip inventory levels still weakening spending.

DISPLAY 5

For Eurozone's four largest economies, stimulus looks likely

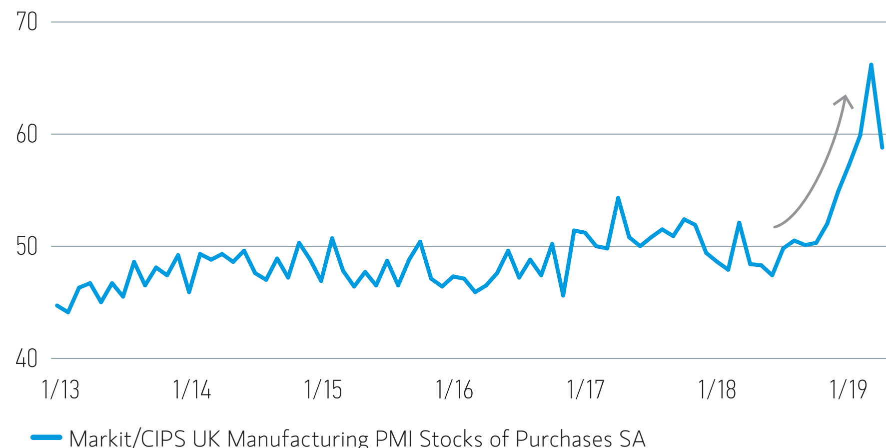
Change in cyclically-adjusted primary balance (+ is fiscal boost)



Source: European Commission, MSIM. Data from European Economic Forecast (Spring 2019) released on 7 May 2019. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

DISPLAY 6

UK manufacturing inventories show evidence of stockpiling



Source: Markit/CIPS, Bloomberg. Data as at 10 May 2019.

Nevertheless, what is usually missing from a sustainable recovery is growth in CapEx. Today, we see strong potential for CapEx growth, though it may be postponed by trade tensions. Moreover, we see several self-reinforcing countercyclical elements that may help even in the face of the trade war. The more intense the tariff tensions become, the more likely it becomes that the Chinese will increase their stimulus and the U.S. will pass a significant infrastructure plan. And companies are more prepared now for shifted supply chains than they were when the trade war was initiated.

Ignore (mostly) the trade noise

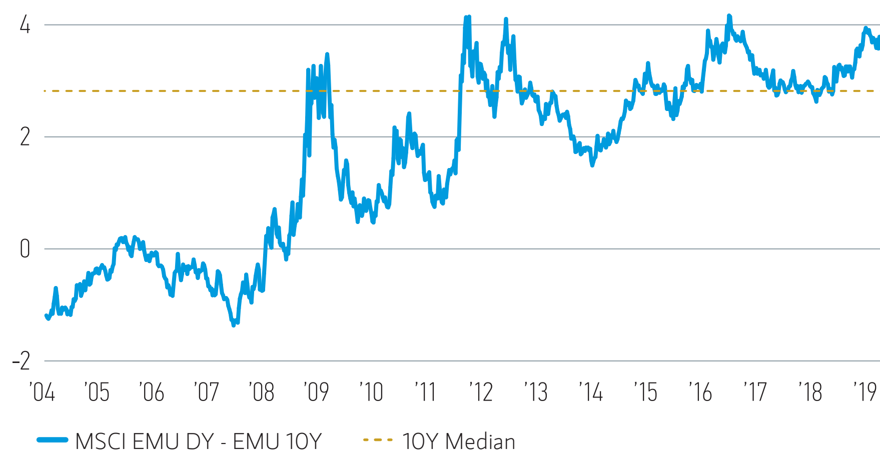
The medium-term outlook is positive. While trade issues do suggest near-term caution, fiscal stimulus in China, potential U.S. infrastructure spending and the pent-up demand for capital expenditure are all powerful positives that are ready to help the markets as soon as the trade dispute is resolved.

A resolution would also help with European fixed investment, which is closely tied to trade. Eurozone equity valuations look attractive based on the average yield premium versus bonds *(Display 7)*. Also, the European Central Bank (ECB) is turning much friendlier towards the banking system than it was in the past. We also expect more consolidation in European banks. One area where we are cautious is the U.S. technology sector, where valuations again appear to be overshooting earnings.

DISPLAY 7

Eurozone equity dividends are offering a healthy premium over bond yields

Dividend yield minus bond yield (equity risk premium)



Source: IBES. Data as at 10 May 2019. **Past performance is no guarantee of future results. The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment.** See disclosure section for index definitions.

On bonds, our longer-term outlook is positive for the economy, so negative for bonds. But tariff tensions can make bonds, on a temporary basis, look more attractive.

The growth story remains intact

As highlighted in one of our recent commentaries, the revival of U.S.-China trade tensions is one of the binary risks that could complicate our generally positive view on a global recovery. And while these unpredictable lightning strikes emanating from the White House have a disruptive near-term impact, we nonetheless remain positive on the medium-term growth story—the midgame.

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The **CPB Merchandise World Trade Volume Index** measures the volume of trade across borders between the world's major regions. The **CIPS/Markit UK Manufacturing Purchasing Managers' Index (PMI)** is a composite index based on five of the individual indexes with the following weights: New Orders - 0.3, Output - 0.25, Employment. The **CPB World Trade Monitor** shows that the volume of world trade decreased 1.7% in February, having increased 2.1% in January (initial estimate 2.3%). The **MSCI EMU (European Economic and Monetary Union) Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of countries within EMU. The indexes are unmanaged and do not include any expenses, fees or sales charges. It is not possible to invest directly in an index. Any index referred to herein is the intellectual property (including registered trademarks) of the applicable licensor. Any product based on an index is in no way sponsored, endorsed, sold or promoted by the applicable licensor and it shall not have any liability with respect thereto.

Business fixed investment means investment in the machines, tools and equipment that businessmen buy for use in further production of goods and services. The stock of these machines or plant equipment etc. represents fixed capital. **Capital expenditure or capital expense (CapEx)** is the money a company spends to buy, maintain, or improve its fixed assets, such as buildings, vehicles, equipment, or land

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