Trade War Strategies

- **Hope for trade talks sparks a rally - but the market will be skeptical it can bring tangible good news**
- **Still opportunity in the bond markets despite negative yields**
- **Saudi changes its oil minister, but the oil sector struggles to change its downward trajectory**
- **Institutional investors reduce equities**
- **UK hits a political and constitutional crisis**

Risk markets were on the rise last week on a whiff of news that trade talks between the US and China could be renewed. The US and China are understood to be restarting trade talks in early October. We have gone down this path a few times now, and the markets might be rightly sceptical that anything substantive will come of the talks. After all as people are increasingly realizing the trade war is only part of the efforts that the US is using to contain the competitive threat of China in the global economy.

Trade War Economic Pain

Chinese trade data for August showed just how brutal the impact of trade wars has been on the Chinese economy. China's exports to the US fell 16% year-on-year. Imports from the US slumped 22%. Economists expect bi-lateral trade to slow further with another raft of US tariff measures due to take effect on the 1st October and the 15th December.

The Chinese authorities seem to be on a path of providing further support for the economy in the wake of the trade war. Last Friday, China's central bank cut banks' reserve requirements for the seventh time since early 2018 to free up liquidity.

The US economy is also hurting. Last week's employment report was weaker than expected with jobs growth of 130,000 in August well below expectations. Industrial confidence is also slipping. The ISM survey for August fell by 2.1 percentage points to 49.1, now below the critical 50 level implying that the manufacturing sector is in contraction. Many of the indicators in the detail of the report are moving in the wrong direction; aggregate new orders, new export orders and employment indicators fell sharply while the measure of excess inventories rose.

Notable comments from the ISM survey respondents to the survey included…

Tariffs continue to be a strain on the supply chain and the economy overall." (Computer & Electronic Products company)

……we continue to plan for a hard Brexit and a long trade war between the US and China." (Miscellaneous Manufacturing company)

A Bond Strategy for Negative Rates

It is the fashion of the day to complain about the vast amount of bonds that offer negative yields. With a return of positive risk sentiment over the last week or so the pool has become a little bit less vast, but the issue still looms large.

It is not true to say, though, that there are not enough opportunities for income in the bond market. It is not even the case that investors have to take irresponsible risks to achieve some semblance of yield.

In the first place, some countries have deeper negative yield than others, and therefore even credit-risky bonds will be close to zero or even below. This applies to Germany, Switzerland and Japan, among others. However, in USD terms, with the US 10Y still in positive territory (around 1.5%), entirely sensible corporate bond portfolios, fully investment grade, could offer yield to maturity in the range to 3-4%.

Second, sticking to US issuers and moving a bit further down the credit curve into high yield allows for additional pick-up. **We think a blended portfolio of Investment Grade (IG) and high yield should be yielding 4.5% to 5%.** A yield in that range could be achieved without the need to take on board any form of distressed debt, odd-shaped CCC-rated bonds or the like. So, the conclusion is quite simple: for reasonable yield with acceptable risk, take a bit of credit risk, and stick to the USD.

A further strategy that can be deployed is to **look beyond developed markets for additional diversification**. US high yield has a concentration to the domestic US economy (most sectors but not all) and going for USD-issuers in selected Emerging Markets, while not necessarily bumping yield higher significantly, will add a layer of diversification.

The key caveat here is the degree of risk that the investor takes exposure to. At the end of every economic cycle, the quality of credit bonds coming to the market begins to deteriorate. This is due to the combination of slowing economic activity and investor's still-intact thirst for yield and income. The current cycle will be no different. The drop in quality will sooner or later become tangible as defaults begin to rise. It is already clear that some sectors are going to struggle or have already started to. As a simple rule of thumb, these will begin to exhibit yields in the "too-good-to-be-true" bracket: upwards of 8% is our rough guess right now for bonds that may be about to experience existential issues. Just avoid these and accept that a broadly diversified approach will deliver a more achievable target with a far less risky profile.

Institutional Investors Reducing Strategic Allocations to Equities

It was interesting for us to read that the investment committee of CalSTRS, the US's second-largest pension fund is considering reducing its equity weighting to 42% from 47%. The fund's investment staff have also recommended increasing the real estate allocation to 15% from 13%. The investment team increased its recommended weighting is a basket of what are called risk-mitigating assets classes including long-duration treasuries, and strategies that specifically act as a counterweight to market sell-offs, including global micro hedge funds. The fund maintains that its asset allocation in aggregate will achieve a 7% return over the long term – only time will tell

Saudi Changes its Oil Minister as the Oil Equity Sector Approaches Junk Valuations

The recently announced change of Saudi oil minister can only signal that the kingdom is still intent on putting an upward bias on oil prices. The oil price has averaged $65 over the past two years in part due to the benefit of OPEC-plus-Russia agreement to restrain oil production. However, Saudi Arabia probably wants and needs a higher oil price. Saudi government forecasts show the country will run a deficit of around 4.2% of GDP this year. To balance the books, it needs an oil price of $85bbl. But, even discipline in OPEC or indeed further production cuts may be insufficient to stabilise prices when you consider that the United States continues to ramp up production. US output climbed to 12.5 million barrels a day last month close to 500,000 bbls a day increase year-to-date. The market expects production to rise to 13.5 m b/d by the end of the year.

OPEC members and Russia meet in Abu Dhabi this week. The market is expecting them to remain committed to their collective 1.7m b/d of production cuts. However, there is little sign that OPEC will cut production further. Also, for the moment there appears to be no discussion about removing the production cuts and allowing the oil price to fall precipitously to squeeze some of the US production out of the market.

On many measures, the global equity oil sector appears cheap. The difficulty is finding someone brave enough to buy. The oil equity sector continues to languish in the market. The sector sits at its lowest relative level in nine years, down 38% relative to the MSCI global equity total return index since 2010. However, the weakness of the oil price is only one of the problems for the sector. The increasing investor awareness of ESG factors is also weighing on the sector.

However, it begs the question just how far can the energy sector fall given the excellent dividend yields support many of the companies' shares? BP offers a dividend yield of 6.7% and a five-year historical dividend growth of 6.8%, Shell a yield of 6.6% with five-year historical dividend growth of 4.1%. Such high dividend yield compares to the 7% yield-to-worse on the Barclays High Yield Energy index a measure of the valuation of the debt of some of the lowest quality energy companies. It's also worth mentioning that BP's credit rating is A and the company's longer-dated bonds yield around 2.5%. Surely there must be value in the oil sector?

UK Endures a Political and a Potential Constitutional Crisis

After last week's political vaudeville show, there can be little doubt that the UK is enduring a major political and constitutional crisis. For the markets and business, the lack of a clear path to any sustainable solution means the risk of recession is growing by the day, and with it, the prospect of dramatic policy U-turn by the Bank of England with possible rate cut as the Chancellor's fiscal spending increases will not arrive in time. Tellingly, last week's purchasing managers indices highlighted the spread of the manufacturing malaise into other sectors of the economy. The IHS Markit services purchasing managers' index dropped to 50.6 in August from 51.4 in the previous month; the sector is considered to be the weakest seen since 2008. Also, the renewed setback in retail sales increases the possibility of a second consecutive quarterly contraction in demand.

The probability of No Deal was considered to have receded last week with the opposition legislation, about to go on the statute book. Yet, with a Trump-style of Prime Minister in place, it is sensible to be wary. There is a real risk that a No Deal trap is sprung either by Boris Johnson and his government resigning before 19th October rather than ask for an Article 50 extension or a contrived vote of no confidence leading to the same result. If, as expected, the government fails to pass a motion to trigger a general election on Monday, the poll is unlikely to occur before 31st October. So, if the Prime Minister is true to his word on this occasion and ducks asking for an extension, it will have to happen either as a result of a last-minute deal at the 17th October EU summit (a long shot) or under a new government. Here the emergence of 22 (and growing) independent Conservative members may yet prove decisive. A caretaker government, aiming at securing a soft Brexit deal and a second public vote, may yet emerge from this shambles but the price of Tory rebel support would undoubtedly be the unseating of Jeremy Corbyn as the alternative Prime Minister. Even Boris Johnson may eventually be forced down this route if all other options fail and with a contracting economy. The path ahead still sees sterling under pressure, but the loss of Boris Johnson as head of government would see buyers return in October.

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