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Amundi ASSET MANAGEMENT

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Investment Talk:

G20: Market Relief, Eyes Now on Central Banks' Execution

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- **The worst case scenario of further trade escalation has been averted.** The G20 meeting last month resumed the negotiations between China and US on trade, after the tariffs increase in May on $200bn of Chinese products, and the consequent Chinese retaliation, which both put financial markets under pressure and increased downside risk to the economic outlook. The worst case scenario of an extension of tariffs on the remaining approximately $300bn of imports from China, which would have seriously damaged the global economy, has been averted in the short term. Some concessions have been made on both sides: from the US to ease the Huawei ban (US companies will be again allowed to sell their equipment to the Chinese company), and from China to step up the import of US agricultural goods.
- **A "grace" period.** The US economy has not been immune to the consequence of global trade deterioration (weak manufacturing PMI, 51.7 in June vs 56.6 at the beginning of the year, and weak investment). President Trump's will to avoid a further weakening of US economic conditions (and investors' sentiment) will allow the market to buy some time on trade disputes, before this topic comes back in focus via the harsher tones of the next US presidential electoral campaign.
- **Market relief, not a rally for risk assets.** As we expected, there was some market relief after the G20 meeting rather than a strong rally, as some progress in the trade disputes were somehow already priced in and the expectations for a full deal are still very low, especially with the tech supremacy issue increasingly taking the centre stage. The focus will be back on economic data, which continue to show some weakness, and Central Banks, where expectations for accommodative measures are high, maybe too high with some risk of disappointment.

- **Emerging Markets and European equities the relative winners of trade truce.** Although a scenario of resumed negotiations does not substantially change our overall cautious risk assessment, we believe that both EM assets and European equities could benefit in relative terms from the post G20 relief.

"US-China trade truce at the G20 meeting may give temporary relief, but does not represent a game changer".

Do you see the Japan G20 meeting as pivotal in the trade negotiations process?
It is not pivotal, but it is undeniably a short-term relief. The outcome of the G20 is a little more favourable than expected. On the one hand, because negotiations will resume without a new deadline that could have crystallised tensions again in the near future, while on the other hand, because it shows that Donald Trump is ultimately pragmatic. The deterioration of surveys in the US indicates that the economic outlook may deteriorate further if the pressure on the consumer intensifies (via a loss of purchasing power). The consumer is the last line of defence. Trump seems to be taking the risks associated with his protectionist strategy more into account, which was not obvious before the G20 meeting. The suspension of the export ban on Huawei (a rather unexpected measure) relieves pressure on value chains in the technology sector. In exchange for a more accommodating attitude, Trump has obtained from China to increase its imports of agricultural products from the US (still no details about that). At the end of the day, we must not conclude that the tensions between the two countries have disappeared. The truce is clearly fragile.

What could be the next steps in the negotiation process? Do you expect the tone of the disputes to soften?
At first glance, the outcome of the G20 is encouraging. Trump bought time. In substance, the truce reached does not change much. The most complex issues (intellectual property rights, technology transfers) were not addressed at the G20. The confrontation between the US and China will therefore return to the forefront sooner or later. It should not be forgotten that the US is entering a pre-election period. The opposition to China goes far beyond the Republicans. Whatever his successor in the White House next year, the opposition between the two countries on strategic issues could worsen their relations in the coming years. It is therefore important not to misunderstand the context. The prevalent protectionism will not disappear from the radar screens. The likelihood of a global trade agreement is very low. And in the end, there is still a great risk that Donald Trump will impose a tariff increase on an additional $300bn of imports from China, even if not immediately, and at a lower rate (more likely 10% than 25%). Tariff uncertainty is long-lasting, which is clearly not good news for investment and trade.

"Our expectation is of a long-lasting uncertainty regarding the global trade agreement as most complex issues as still waiting to be addressed".

Politics and central banks: how is the relationship changing, in a phase in which central banks are called to provide further liquidity in the market?
In the short term, central banks (CBs) will monitor the impact of this truce on the business climate, particularly in industry. Indeed, the PMI indices in the manufacturing sector have deteriorated sharply worldwide since the start of the year, to such an extent that the trade war was considered a major risk by CBs. The longer the pressure on industry lasts, the more likely it is that global demand will weaken, with a knock-on contagion to services.
Actually, the shift in CBs communication since the beginning of the year is largely explained by the increase in this risk. In the short term, the truce should encourage a "wait and see" attitude. In the context of low inflation, we know that CBs are ready to react if the economic outlook deteriorates. But there is no urgency for them to act in the short term. That said, tariffs are not the only cause for concern. Low inflation at an advanced stage of the cycle, weakening investment in many countries, and rising global debts are also of concern to the CBs in advanced economies (AEs). Their key rates will we believe remain low for a long time.

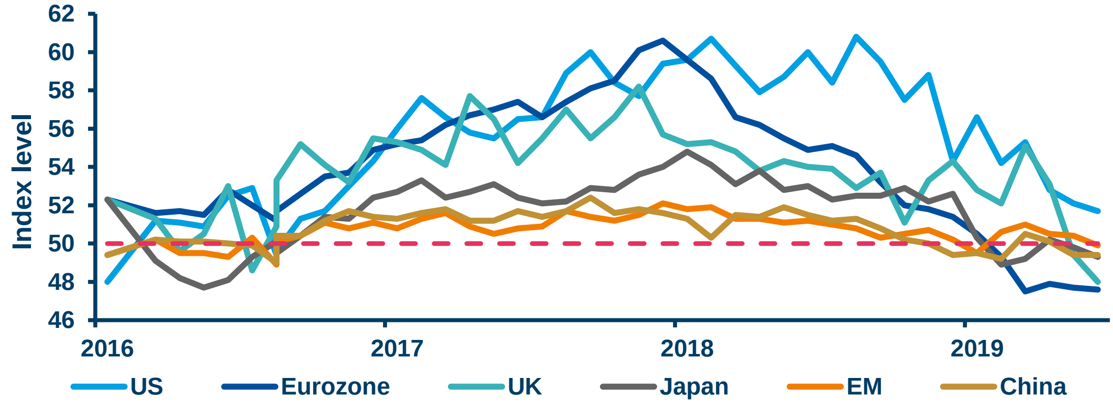
How does the evolving trade relationship between China and US affect your central case scenario for the global economy?
The US/China rivalry is a specific element of risk and uncertainty. Nevertheless, the truce illustrates that the US needs China and vice versa. Value chains are still highly integrated. It is

"Our view is that the global economic slowdown will remain moderate this year as long as the US-China relations remain stable".

not in the US interest to suddenly see consumer prices rise due to tariff barriers (products imported from China are obviously not manufactured in the US).

If US-China relations were to worsen, it would put more pressure on global trade and darken the global economic outlook. This can cost Europe, the US, and China a few tenths of a point of growth. However, it is unlikely to cause a recession as long as the pressure on trade remains moderate. Keep in mind that global growth is mainly driven by domestic demand, and that consumption still benefits from tight job markets in the major AEs. In addition, global monetary and financial conditions are very accommodative. In addition, the impact of stabilisation policies (i.e. contra-cyclical fiscal and monetary policies) should not be underestimated. Against this backdrop, we maintain our view that the global economic slowdown will remain moderate this year (we expect world growth at 3.3% growth in 2019, and slightly higher in 2020).

Manufacturing PMI, a reason for concern



Source: Amundi analysis on Bloomberg data, as of 1 July 2019. 50 is the threshold between contraction (<50) and expansion (>50).

What are, in your view, the implications for financial markets?

"There are no fundamental reasons for a rally in risk assets, from current levels".

As was largely expected, there was some market relief after the US-China trade truce from the G20 meeting, but not a rally, as some progress in the trade dispute was already somehow priced in and the expectations for a full deal are still very low, especially with the tech supremacy issue taking the centre stage.

We also caution that the rally in risky assets that resulted after the G20 summit in November 2018, which also involved an agreement between China and the US, was very short-lived as concerns around global growth quickly dominated. The costs of trade disputes escalation had been priced by the markets, and is already reflected in the economies' weakness, eventually forging a more dovish stance in monetary policies' rhetoric.

In June, the manufacturing activity further decelerated across the board: China, the US, and Europe continued to show weak data readings, with the level falling below the threshold alert of 50 in most cases.

Moreover, several other series of economic data are expected to be released in the coming days, and this should pave the way for Central Bank path. Significant actions have been priced in by the markets, and some risks of disappointments are possible. If we look at the price action, we see that the ultra-accommodative tones of Central Banks in June have already brought equity indices back to yearly highs, and there are still significant uncertainties that could prevent markets further extending gains. In particular, the earnings season that is set to start in few weeks will signal how much the slowdown and trade war have hit the balance sheets.

Based on our analysis, the US Purchasing Manager Index in the 50-53 range had been consistent with earnings per share (EPS) growth in the 12-month forward of about 3%, which is well below of consensus expectations. EPS forecasts stand today at double-digit and are likely to be downwards revised with the July update. The acceleration in the expectations for

4Q19 and 1H20 is unlike to materialise, and we see the risk that markets are still overly complacent and too dependent on Central Banks.

US PMI and S&P500 Earnings per Share Growth (12-Month Forward)

Source: Amundi Research, as of 30 June 2019. PMI and EPS yoy with data sample Jan 1948 - May 2019.

"EM assets and European equities could benefit from easing trade tensions. The FX market may offer relatively good opportunities in this phase".

As such, we remain cautious on the overall risk assessments. There are no fundamental reasons to see a strong increase in risk taking without a material improvement in economic conditions, and this is hard to see at this stage. In relative terms, EM assets and European equities could be the main beneficiaries of a temporary easing of trade tensions. The currency market could also offer some opportunities, in this phase. As many other asset classes, FX has already been discounting some more constructive outcome. Even if the messages were mixed, FX markets seem to have bought the "I think we have a very good chance of doing something with China", rhetoric. This explains the good performance of CAD, AUD and NZD to date. The rally is likely to continue owing to the outcome of the G20.

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