THE DRIVE YOU DEMAND

TRUMP UNCONSTRAINED

Spotlight

May 2019 | Global Investment Committee

Union Bancaire Privée

Key points

- *The Sunday night tweets from the US President not only introduced uncertainty into the ongoing US-China trade negotiations and prospects for future global growth, but should also serve as a reminder to investors of the new, more challenging risk environment facing them looking ahead.*
- *In particular, evidence is building that the previous constraints to even more confrontational policy actions by Donald Trump, especially geopolitically may now be less binding.*
- *A more reactive US Federal Reserve as highlighted at its May 1 meeting has historically translated into a rising volatility environment. Combined with a potentially unconstrained US President, proactive risk management is a priority for investors currently.*
- *As a result, we encourage investors to seek 'asymmetric' approaches to equity exposure which allow for upside participation should the cyclical improvement in the global economy continue while protecting against significant downside in the event of the realisation of geopolitical concerns as seen recently.*
- *We believe that select long-short hedge funds, convertible bonds, as well as partially capital protected strategies offer attractive, 'asymmetric' benefits for investors in an era of an increasingly unconstrained Trump.*

US-China Trade War – Risk to Global Economic Growth

Investors have rightly been focused on the outcome of the now, contentious trade negotiations between the US and China for guidance on the near-term direction of markets.

A continuation of the trade conflict between the world's largest economies poses threats to the nascent economic rebounds seen in both the United States and China.

We estimate that an increase and broadening of US tariffs on Chinese imports could reduce prospective Chinese GDP growth by as much as one percentage point in the coming year. As demonstrated in recent months, China has meaningful policy capability to mitigate these impacts in the near term (though risking aggravating long-term issues of excess leverage).

More worrisome, however, are the risks a renewed trade conflict poses to global economic growth. During the 1Q19 détente in the US-China trade conflict, world trade growth was already contracting by 1.5% year-on-year. The spillover effects to the broader world economy appear significant should the trade conflict persist.

In the US, a 1Q19 rebound in the US economy has been aided by inventory building by US manufacturers. However, this inventory building was precautionary, with producers awaiting a favourable outcome of US-China trade negotiations. Even with a trade agreement, the drawdown in these inventories seems likely to become a headwind in coming quarters.

Should the US-China trade war continue, this would serve as a shock to manufacturers' confidence leaving the already weak corporate capital spending trend – which was to serve as a counterbalance to the inventory headwind – under further pressure and serving as a drag on US economic growth forecasts in coming quarters.

More worrisome, however are the effects on major trading economies like Germany, Japan, Korea and the UK which have yet to see any meaningful rebound in activity year-to-date. Should a prolonged trade dispute restrain growth in both China and the US, the limited policy capability in Europe and Japan in particular suggests upside surprises to growth and earnings around the world are unlikely looking ahead (for more details, please see our recent publication Trump's New Tariff Threats, May 2019).

The Path to an Unconstrained US President

US threats of renewed tariffs on China are certainly concerning enough for investors. However in combination with recent developments in US policy around the world, they suggest that the US President is now operating with significantly fewer constraints on aggressive policy action than seen in the first two years of his presidency. This could indeed signal that further disruptive confrontations may lie ahead and cut right across global trade.

The first catalyst to a more unconstrained US president was the resignation of former Presidential Chief of Staff, General John Kelly in December, 2018. He was widely acknowledged to be a restraining influence on President Trump's more impulsive actions during his first two years in office.

In normal circumstances, General Kelly's resignation might have encouraged the US leader to turn his attention to confrontation and action on domestic policy agendas like immigration or healthcare. However, the electoral victory by Democrats to take control of the US House of Representatives in November, 2018 has restricted his ability to enact a domestic policy agenda. This forced President Trump to turn his attention to global matters as outlined in our spotlight, *US Congressional Elections* (November, 2018).

The second catalyst to a more unconstrained US president was the sharp rebound in US 1st quarter, 2019 economic growth and the continuing strength in the US job market. Although as highlighted earlier much of this rebound may yet prove transitory, the above 3% reading while US Treasury yields remain mired near 2.5% allows President Trump to rebut the economic pessimists; they had warned that his fiscal stimulus would result in higher interest rates and his trade war begun almost one year ago would impair US economic growth.

The third catalyst that may have unshackled President Trump and encouraged his provocative actions around the world is his domestic popularity. While the US population (and more importantly its voter base) remains especially polarised, the US President's approval rating has risen to its highest level seen during his term among Democrats, Republicans, and overall among Americans. According to Gallup, 12% of Democrats approve of him while 92% of Republicans share that view. Looking at Americans overall, he enjoys 46% support. All this is against the backdrop of the lifting of the shadow cast by the recent Mueller investigation.

Growing Signs of an Unconstrained President Trump

Previously, we had worked within a framework that suggested that President Trump's concern about economic growth and the US equity markets, both viewed as critical to his re-election prospects in 2020, presented the most significant constraints on the US President.

However, 2019 has now presented two clear signs that these constraints are no longer as restrictive. Trump has grown in confidence (potentially due to the above developments) and US economic performance and equity markets are not quite such a critical priority for the US executive branch.

Investors will recall that in May, 2018, the United States withdrew from the Iran Nuclear deal (Joint Comprehensive Plan of Action). By October, 2018, countries purchasing crude oil from Iran had to cease buying or risk US sanctions. However, with Brent crude oil prices reaching US$70-80/barrel and US growth starting to slow in 2H18, the US issued temporary waivers to crude oil purchases. The intention with this was to prevent high oil prices from putting pressure on the US economy.

In marked contrast today, with crude oil prices once again hitting US$70-80/barrel in early-2019, rather than extending the waivers granted in late-April, the US instead indicated it would allow them to expire exposing purchasers of Iranian crude oil to American sanctions.

With US growth rebounding from its slowing pace of 2H18 combined with the fact that the largest importer of Iranian crude is China, it appears that an unconstrained President Trump has taken the opportunity to focus on other American strategic objectives. This reveals a shift away from his previous approach of being more mindful of the potential economic and election related impacts of his actions.

More recently, President Trump's tweets threatening new and expanded tariffs on China imports have rattled markets.

Just like the situation with Iran, this represents a step back from what had been a more conciliatory tone in December, 2018 when markets and US economic growth weighed more heavily on investors (and perhaps, pro-Trump voters). Indeed, just a few weeks ago, the President indicated flexibility on a key strategic plank to US negotiating priorities – applying greater enforcement mechanisms against intellectual property theft - in pursuit of a final deal.

While recent press reports suggest that China may have backtracked on commitments they had previously agreed, the threatened expansion of goods subject to US tariffs combined with a short "take it or leave it" timeline suggests a much more confrontational tone that risks a broader breakdown in talks.

China has already limited purchases of American goods sourced from Republican leaning states. Undoubtedly, Chinese policymakers will increase such pressure should trade talks break down. In spite of recognising this threat, given Trump's rising domestic popularity and the perceived limited impact of this tactic in the 2018 mid-term elections, it appears clear that the US President is less constrained by this potential targeting of some of his core political support.

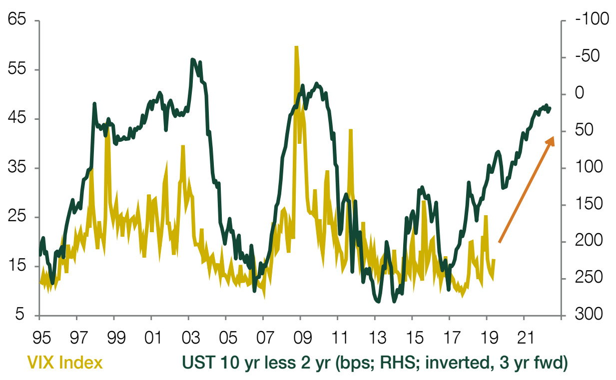
Seek 'asymmetric' exposure to manage risk proactively

With signs growing that the global economy increasingly faces an unconstrained US president, the crystallisation of a new risk environment for investors appears complete.

Indeed, with other potential bilateral flashpoints, including EU trade, Iran, North Korea and Venezuela, a more confrontational stance across any of these axes poses an elevated risk beyond the US-China trade conflict for global investors in the months ahead.

Complicating the risk environment still further is the shift by the US Federal Reserve to a more reactive rather than proactive policy environment. Historically, such a position following a period of central bank interest rate rises has translated into a spell of rising volatility – not only periodic, but a longer cycle rise in volatility (chart).

A Rising Volatility Regime Lies Ahead



Sources: Bank of America Merrill Lynch , Bloomberg Financial L.P., and UBP

With a combination of these two threats, proactive risk management becomes a live priority for investors. In particular, we encourage investors to seek 'asymmetric' approaches in constructing their equity exposure. We prefer select long/short hedge funds, convertible bonds as well as capital protected exposure (where available) as alternatives to directional equity exposure. In the USD fixed income space, duration presents a valuable risk management tool to help cushion portfolios as equity volatility rises.

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