Union Bancaire Privée

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Market Review

Asian stocks sidelined amid concerns that trade tensions and rising debt costs would hinder future earnings. Washington imposed tariffs on Chinese products worth $34bn in early July, prompting Beijing to immediately respond in tit-for-tat measures. The 10/2 US Treasury yield spread continue to fall amid concerns that geopolitical tensions would weigh on investment and economic growth outlook, souring demand for risky assets. MSCI Asian Ex Japan was up +0.34% over the month.

MSCI China closed the month -3.10% lower, with utility and material sectors outperforming consumer and IT stocks. Investors were primarily concerned over high frequency macro data showing moderate deceleration in economic growth. The People Bank of China (PBOC) cut its reserve requirement ratio (RRR) for the third time this cycle to supply sufficient market liquidity, while the rate differential against US borrowing costs weakened the RMB 3% against the greenback in July. Beijing reported 2Q18 GDP of 6.7%, within the government's range. However, year to date retail sales of 9.4% and fixed asset investments of 6.7% both came in below street estimates.

MSCI India outperformed the region, gaining +6.34% as energy and financial names led positive returns. The drop in oil prices assuages import inflation expectations. June's CPI reading came in at 5.0%, above May's reading but below estimates. Analysts expect the Reserve Bank of India (RBI) to raise interest at the month-end meeting, but softer inflation pressure could allow a shallower rate cycle that eases borrowing costs. The RBI had already raised interest rates twice thus far this cycle to stem currency weakness.

Export oriented North Asian markets of Taiwan and South Korea diverged this month. Taiwan rose +3.96% on the back of information technology names. Taiwan's GDP reading for the second quarter is expected to come in at 2.98%, however, June exports of 9.4% was below expectations, perhaps serving as the first harbinger of a slowdown in smart devices. MSCI Korea dropped -1.17%, where telecommunication stocks and materials outperformed while healthcare weighed on performance. Bank of Korea left interest rates unchanged at 1.5%, while a preliminary estimate for the second quarter GDP came in at 2.9%.

ASEAN markets closed higher as MSCI Southeast Asia advanced +4.03% over the month. MSCI Thailand returned +8.23%, led by energy, financial, and material names. MSCI Malaysia and MSCI Philippines rose +5.34% and +6.93% respectively as telecommunication was the top performers. MSCI Indonesia gained +3.27% while MSCI Singapore closed +0.96% higher.

Outlook

Looking into the second half, markets can no longer ignore fiery comments emanating from the Trump administration as opening negotiation tactics, but now significant threats to unwind established supply networks. The early-year assumption that synchronized global growth would provide sufficient momentum to carry the world economy into a later stage cycle is also beginning to fade. With trade tensions diminishing confidence and lowering risk appetite, flows into USD cash and rising borrowing cost from the Federal Reserve are tightening liquidity conditions. During the July policy meeting, Fed Chairman Powell stated that the US outlook was fairly balanced and robust, supporting the central bank trajectory towards a gradual hiking interest rates.

This matters as rate differentials and market dynamics are the main drivers appreciating USD against Asian currencies and not policy counter measures to offset Washington tariffs, in our view. The RMB's 3% fall to the USD in July and 1.8% over the first half of the year reflects incremental loosening from the People's Bank of China, demonstrated by the three cuts to the reserve requirement ratio thus far in this cycle. For China, significantly weakening the currency would be counter-productive for medium and longer-term ambitions as a depreciating yuan makes holding RMB assets less desirable and negate reform efforts.

Protectionist rhetoric will remain a market overhang leading up to the US mid-term elections this November, as world leaders are unlikely to reach a deal with Trump before then. Around this time, markets will also have a better sense about the economic landscape and whether earlier public fiscal stimulus was successful in attracting private investments. The US reported a better than expected 2Q18 GDP growth of 4.1%, however most stems from tax cuts, which are expected to fade later this year. This is also possibly providing an artificial sense of security that Washington could withstand tariff retaliations, in our view.

To counter trade uncertainty, Beijing has also decided to loosen fiscal policies via tax cuts and infrastructure spending. However, the full impact of such stimulus maybe offset by overlapping measures by Ministry of Finance to curb excessive credit risk such as off-balance sheet and unregulated online peer to peer lending. The latest data showed bank lending was not making up for the gap in credit from shrinking shadow financing.

The Fund still holds the view that an initial trade shock would be economically limited, primarily due to robust domestic market within Asia's largest countries, China and India, which account for more than half of global growth. This is the case in China, as domestic consumption and demand for value added services, is a larger contributor and proliferating component to the economy. The bigger consequence portends from subsequent second and third round effects, where future uncertainty ebbs confidence and delays away future investments. These come in the form of non-tariff measures such as limiting US investments or delaying regulatory approval for US companies operating in China.

Within its holdings, the Fund is relatively defensive and balanced to minimize tracking error and risk. Markets are responding to evidence of a general slowdown, with prospects that higher debt serving costs could spill over into regional countries. However, valuations remain attractive and foreign ownership in both equity and debt are sitting at relatively depressed levels, while higher foreign exchange reserve level prevents a precipitous devaluation in the currencies. The Fund is also positioned in companies and markets that are more domestically focused and less exposed to the overseas disruption. This position will stay until after the US mid-term election, as global leaders are better positioned to respond to a more realistic political landscape.

Source: All MSCI and Economic Data from Bloomberg unless otherwise stated.