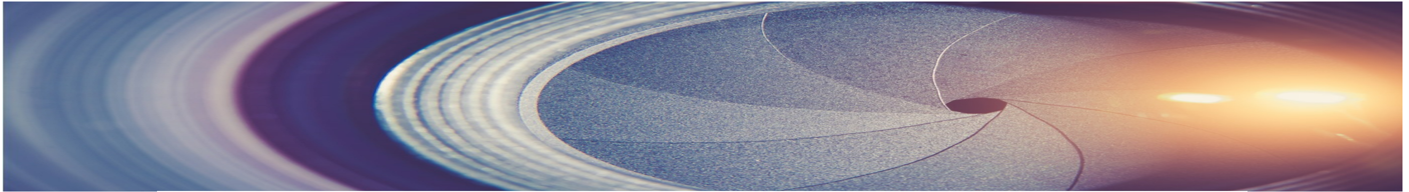

Trump, or mercantilism 3.0

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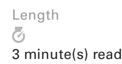
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Equity markets continued up to the end of April to steer a precarious course between two dangers – an ailing economy and wavering monetary stimulus. But starting in May, the fallout from the Trump administration's increasingly tough stance in its trade talks with China has brought home to equity investors just how fragile the existing balance is.

The question now facing financial markets is whether a new pickup in global growth will be strong enough to outweigh the US economy's waning momentum. We haven't changed our views on this issue. The current balance is fragile, and the potential for an economic upsurge is being stymied by both long-term obstacles (too much debt, limited monetary policy leeway) and short-term ones (trade hostilities).

Further down the road, the question has to do with the global consequences of the growing rivalry between China and the US. For the first time in thirty years, geopolitics could once again take precedence over world trade.

The US versus China: is there room for two mercantilist powers?

It's apparently taken financial markets a while to admit that the tensions between the United States and China stem more from strategic rivalry than from trade issues.

Those tensions can also be interpreted as an irrepressible clash between two mercantilist powers. Donald Trump's America doesn't believe in the value of free trade – it even counts itself among free trade's victims. The Trumpians show a preference for brazenly exploiting a favourable balance of power with trading partners. That policy puts the US on an inevitable collision course with China – a country criticised, and not so unfairly, for its mercantilist behaviour. Presumably the same treatment will eventually be applied to all nations running trade surpluses with the United States – beginning with Germany and Japan.

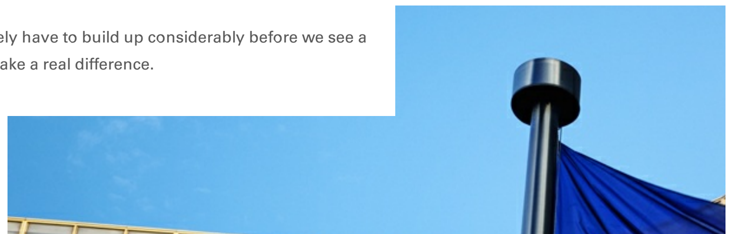
In other words, the increasing friction between the United States and its trading partners is inherent in the economic model subscribed to by the Trump administration. And as far as China is concerned, that model is coupled with geostrategic rivalry. The problem for us investors is that this turn away from the "beneficial globalisation" patterns of the past few decades not only creates short-term uncertainty, but also adds the longer-term threats that disruptions to global supply chains will depress corporate profit margins, that consumers will be saddled with higher costs and that world trade will shrink. So it would be unwise at this stage to expect equity markets to rise above their current levels – unless monetary policy shifts dramatically.

Do central banks still have their philosopher's stone at hand?

Over the past decade, investors have got hooked on the idea that a mere stroke of the magic wand by central banks will be enough to turn any bad economic or political news into good news for financial markets.

The trouble is that even though the rate-hike programme initiated two years ago has been suspended, the Fed plans to continue to pare back its balance sheet until September and the US economy has softened further. This means that while expectations of a rate cut may be keeping equity markets humming and thereby preventing the greenback from appreciating, the grim truth is that the Fed is still hewing to a hawkish line. US monetary policy will have to take a much sharper dovish turn to be able to stem the deflationary impact of mounting trade tensions on an economy already losing steam.

So pressure from financial markets will most likely have to build up considerably before we see a US monetary policy shift vigorous enough to make a real difference.



Europe between a rock and a hard place

In this complex environment, Europe is not operating from a position of strength. To start with, it looks like the reform process will be kept on hold for quite a while. Italy, France and several other member states have failed to give themselves the fiscal room to manoeuvre they will need to be able to counter the next economic slowdown. At the eurozone level as well, Emmanuel Macron's proposal to create a common budget to rekindle growth has fizzled out.

The second source of vulnerability is Europe's onlooker status in the tug-of-war between the US and China. That conflict may well prove damaging to the EU, both if the global economic outlook sours (since the pace of European GDP growth depends heavily on the state of world trade) and in the event of a US-China trade agreement, because even a shaky deal would no doubt be reached at the expense of Europe.

The EU today lacks both the economic and political cohesion and the business strength required to effectively defend its interests in a world of mounting mercantilist rivalry.

Caution and discipline

We have maintained and strengthened our prudent investment orientation over the last two months. Our equity portfolios are characterised by moderate levels of exposure and a preference for growth stocks with low cyclicality. At the same time, our fixed-income portfolios favour long maturities and carefully selected corporate bonds.

Source: Bloomberg, 31/05/2019

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