FIS GROUP

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MARKET OUTLOOK

Q4 2018: From A Trade War To A Cold War?

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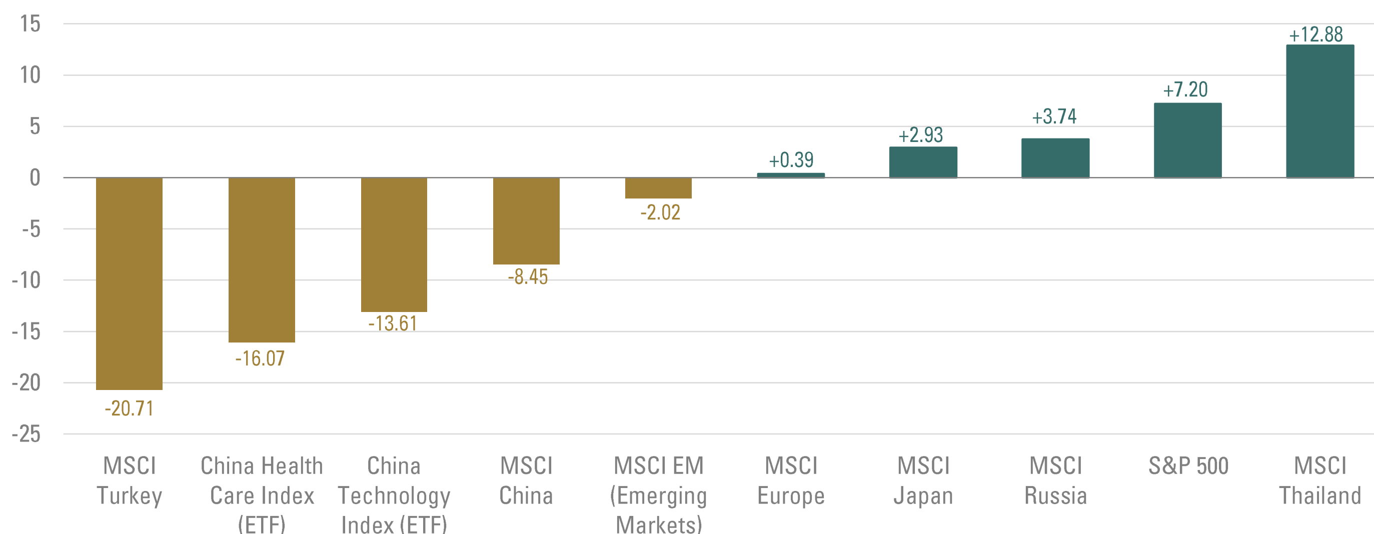
The macro environment in Q3 (and for much of 2018) has been dominated by policy divergence: whereas fiscal stimulus buoyed the U.S., Chinese growth weakened as a result of the escalation trade war combined with Beijing's attempts to constrain credit growth. This policy divergence has produced a powerful tailwind for the U.S. dollar and U.S. equities and corresponding headwinds for global equities.

In Q3, global markets were mostly flat, except in the U.S. (+7.4%) which saw a continuation of the final melt up in risk assets we forecasted last quarter. The USD continued to gain some ground globally, but not as uniformly as we saw in Q2 with the CAD and CHF rebounding against the USD modestly (+1.8% and +1.7%, respectively) in Q3 while the EUR was roughly flat (-0.5%). The best performing market among EM or DM country constituents was Thailand (+13.6%), which entered Q3 as our highest conviction max overweight position. On the downside, the worst performing major market — apart from Turkey (-20.7%) — was China (-8.4%).

Within the Chinese equity market, sentiment reversed in a hurry for the "New China" vs "Old China" theme. The previously hot performing Chinese tech stocks in particular took a tumble with Tencent (-17.7%), Alibaba(-11.2%), JD.com (-33%), and Sunny Optical (-38%) leading losses. Chinese health care (-17.9%) and consumer staples (-7.8%) also sank alongside the rest of the New China segments. Meanwhile, Old China sectors, such as other high beta and highly liquid segments of the market including China's large state owned banks, Chinese industrials, energy, and telecom stocks, were all positive during the quarter. Excluding the New China stocks, the MSCI EM index would have gained +1.9% during Q3, and Old China +1.3%, all largely in line with the non-US developed markets (EAFE), see CHART 1.

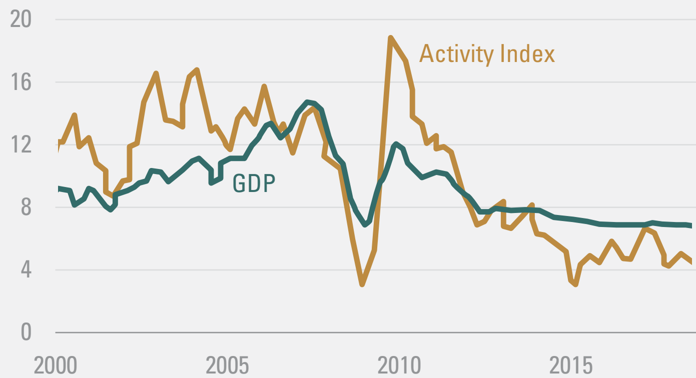
For the big liquid Chinese consumer/tech stocks, including the four leading Q3 detractors of the MSCI China mentioned above (Tencent, Alibaba, JD.com, and Sunny Optical), these price declines do not seem to have emanated from speculators or a new class of "China Bears", but largely from sales by existing investors, as short interest margins actually declined on average during this period. If price declines were led by short-sellers, one would also have expected to see more pressure on the high beta, liquid Old China equities, but these held up well. Meanwhile trading volumes were well within the recent ranges for these stocks. Together we can conclude that instead of a wholesale dumping of the New China theme, when sellers trimmed exposures to these stocks in Q3, buyers stayed on the sidelines until they could average down their cost basis. The dual concerns of a cooling Chinese economy and the trade war with the U.S. are the most likely leading contributors to this chilling of enthusiasm for the New China theme (albeit, not our own, see the MARKET OUTLOOK SUMMARY on PAGE 5). While growth is slowing, perhaps even more so than the official GDP numbers indicate (see CHART 2 on next page), the consumption growth to which the New China stocks are principally exposed, appears to continue apace as the Chinese economy restructures (see CHART 3 and CHART 4 on next page).

CHART 1 | Q3 Relative Performance of Selected Global Markets
% Change, June 29, 2018 – September 28, 2018



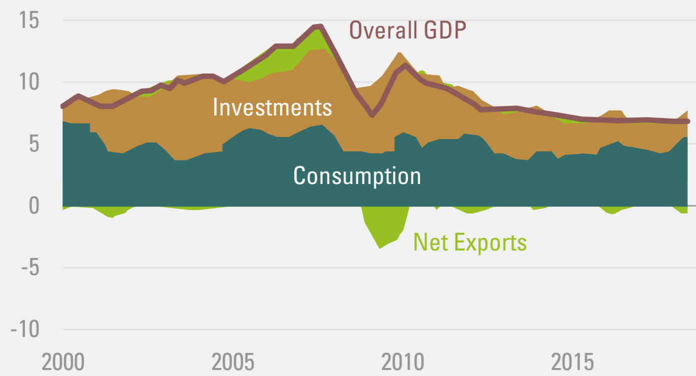
Source: FactSet

CHART 2 | China Activity Index vs GDP
Real growth rate (% y/y 3mma)



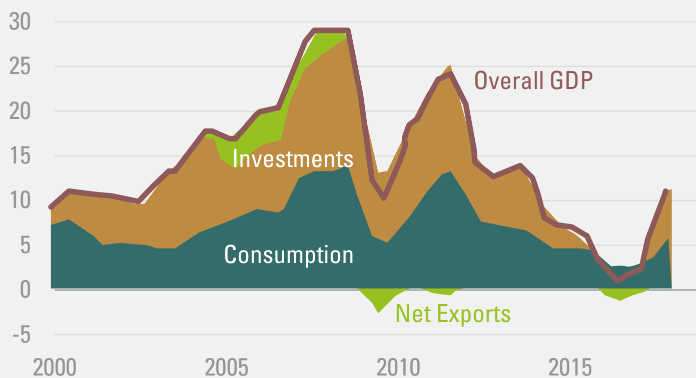
Source: EM Advisors Group

CHART 3 | China: Contribution to Real GDP Growth
% y/y 3qma



Source: EM Advisors Group

CHART 4 | China: Contribution to Nominal GDP Growth
% y/y 3qma



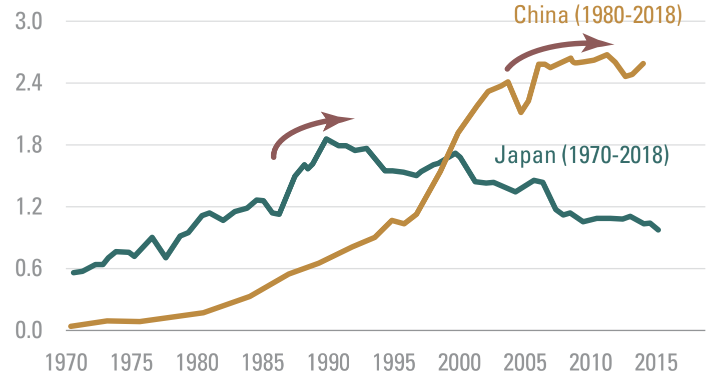
Source: EM Advisors Group

A TRADE WAR EXPANDS

Following the imposition of a second round of tariffs on Chinese goods and China's concomitant imposition of retaliatory tariffs, we are - by nearly any reasonable definition of a trade war - in the heart of one at this time. There is good reason to be concerned for even more dramatic escalation. With NAFTA renegotiation now settled, the Trump Administration is free to focus its actions and rhetoric of economic conflict even more squarely at China than before.

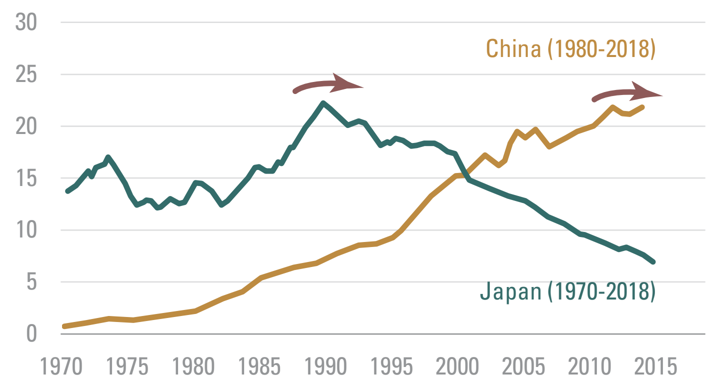
The near-term implications are for reduced trading links and cross-border investment between the U.S. and China. Indeed, as with Japan in the 1980s (see CHARTS 5-6 below and CHARTS 7-8 on next page), we have likely already witnessed the peak of 'Chimerica', in trade and investment. However, unlike the analogy with Japan, China is also now regarded by successive administrations of the U.S. Government as a

CHART 5 | U.S. Imports
As % of GDP



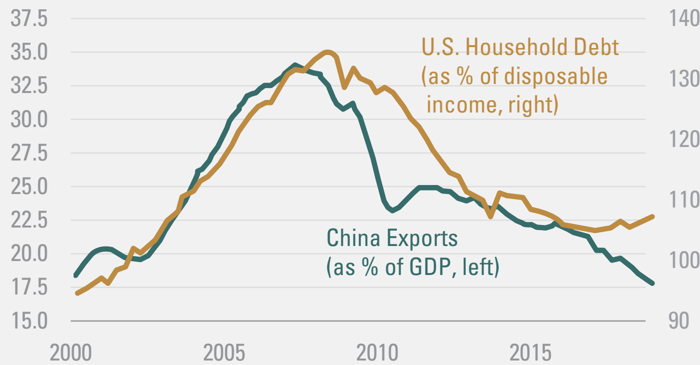
Note: All series shown smoothed. Excludes services.
Source: IMF Direction of Trade and OECD

CHART 6 | U.S. Imports
As % of Total Imports



Note: All series shown smoothed. Excludes services.
Source: IMF Direction of Trade and OECD

CHART 7 | U.S. -China Symbiosis is Dead



Source: BCA Research

CHART 8 | China Imports* from Developed Countries
Excluding U.S., As of imports from all developed countries

Excludes services. Source: IMF Direction of Trade

strategic rival, which imposes an additional degree of uncertainty as the trade war deepens and potentially expands into a new cold war.

The U.S.' perspective is that China's recent slowdown is evidence that it is winning the trade war. From China's perspective, the U.S. will be hamstrung by its extreme level of political divisions and dysfunction, and massive level of government and corporation debt. Therefore, each side sees the other's hands as weak – which further lessens the probability of compromise.

President Xi cannot be viewed as kowtowing to the U.S.; but on the trade front, because China imports much less from the U.S. than the U.S. does from China, it cannot match the U.S. tit-for-tat on tariffs. Consequently, the trade war has, from China's perspective, underscored the need to complete independent trade deals with other countries (see CHART 8 above and CHART 9 on next page) and further internationalize the RMB. The oil futures market which was established this March in Shanghai is an important example whereby China is creating markets in which key commodities are purchased in RMB – not dollars. In just 7 months, that market is already 14% of the global oil futures market.

It also seems clear to us that the two sides are bracing for conflict and are now seeking to mold public opinion more actively. In a speech on October 4, U.S. Vice President Mike Pence laid out a comprehensive case that China is a geopolitical rival seeking to undermine the United States and specifically the Trump Administration. Meanwhile, official Chinese Communist Party rhetoric increasingly characterizes the U.S. as an enemy whose real intention is to "contain" China's rise [NB: which we believe is accurate] and has recently called for Chinese "self-reliance" in the face of U.S. sanctions.

The risk of such public posturing is that it threatens to escalate any minor incident into an international crisis and already tensions are high. The most recent and high profile such incident occurred on September 30. The USS Decatur, an American destroyer nearly collided with a Chinese destroyer in the South China Sea. Reports indicate that the Chinese destroyer had approached to a mere 45 yards of the Decatur's bow, before the American warship maneuvered to prevent a collision. While this was not an unprecedented incident in and of itself, it came very close to a collision that could easily have resulted in a shipwreck and military fatalities, a full-blown U.S.-China crisis, and a global sell-off in financial markets. Following the incident, China canceled a high-level annual security meeting planned for mid-October, while other recent news included accelerated military equipment sales to Taiwan and B-52 bomber flyovers in the East and South China Seas.

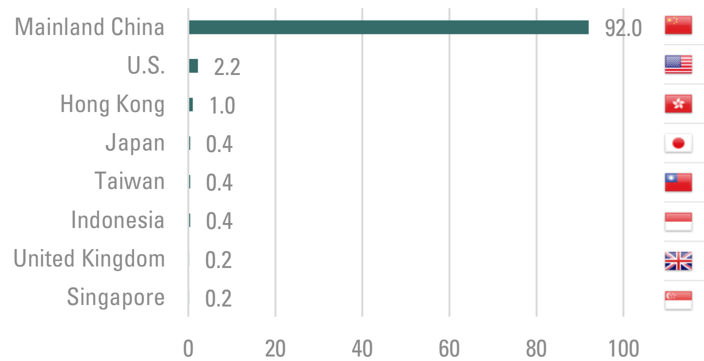
We expect the tensions to persist, such incidents to become more frequent and for this strategic rivalry to continue to spillover into other economic and non-economic arenas. These are likely to include limits on visas for Chinese tech workers and students, more frequent and harsher sanctions on Chinese companies for cyber-espionage, and of course more and harsher tariffs on Chinese exports and limitations on cross-border investment.

Economically, the biggest losers will be those companies with the heaviest cross-border exposure. These firms will see their business models stressed as both countries continue to make business more difficult for firms of the other country. Chinese companies seeking to invest in the U.S. are increasingly likely to have their purchases challenged by U.S. government investment protections while existing assets are increasingly likely to be pressured into divestiture. Meanwhile American companies operating in China should anticipate even less readiness to protect their intellectual property rights or to secure market access from the Chinese Government. Going forward, portfolio managers would be prudent to dig deep into their holdings' business models for such firms that depend on cross-border operations for their financial success.

Heightened Sino-American rivalry will also serve to increase un-

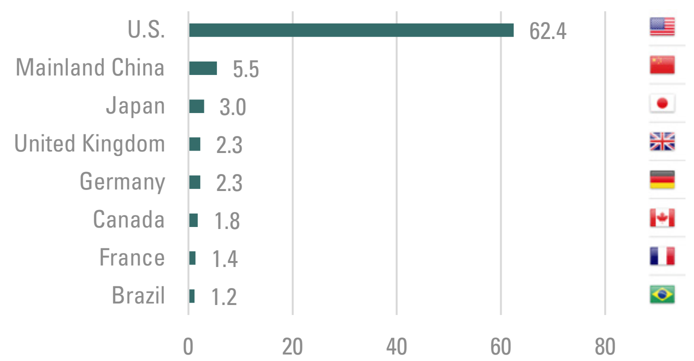
certainty in markets in general, and thus drive volatility higher. We believe this is what happened in Q3 to the New China stocks as American owners of these stocks sought to quietly trim their exposure only to find a paucity of buyers in the market. But fundamentally, this rivalry should matter little to Chinese corporate earnings. For all that is made by the Trump Administration and certain media outlets about the importance of the U.S. market to China (a claim with little merit by itself as total Chinese exports comprise less than 10% of overall GDP), the American market is nearly irrelevant to the earnings of listed Chinese companies. In fact, the S&P 500 has twice the revenue exposure to China as the MSCI China has to the United States (see CHARTS 9-11). Indeed, according to the revenue exposure of its listed corporates, the Chinese market is the most insular of all the world's major markets with an estimated 93% of corporate earnings emanating from its own domestic market (including Hong Kong). Indeed among all developed and emerging constituent countries this is second only to Indonesia's 95% and significantly in excess of almost all global peers (Phillippines has 91% domestic revenue exposure, Thailand has 85%, and then no other emerging or developed market has more than 70%).

CHART 9 | MSCI China: Revenue Exposure By Country
% of Total Revenue



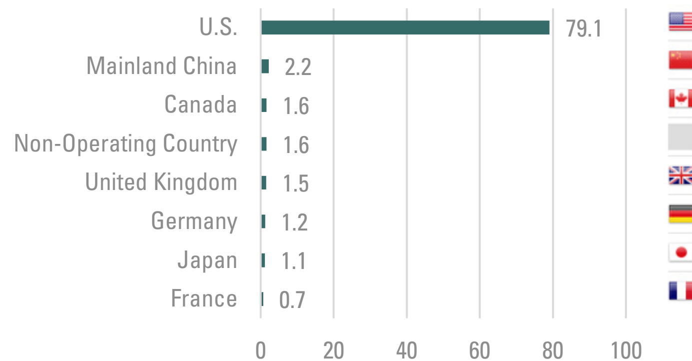
Values are estimated based on FactSet's proprietary algorithm.
Source: FactSet

CHART 10 | S&P 500: Revenue Exposure By Country
% of Total Revenue



Values are estimated based on FactSet's proprietary algorithm.
Source: FactSet

CHART 11 | Russell 2000: Revenue Exposure By Country
% of Total Revenue



Values are estimated based on FactSet's proprietary algorithm.
Source: FactSet

Q4 2018 POSITIONING SUMMARY

With this backdrop, and given the nature of the selloff in New China stocks, we are happy to continue to favor New China sectors over Old China, and have added incremental exposure on price weakness. While we expect more volatility in this theme in the future compared to the recent past, we continue to find the fundamental case based on underlying economic trends too compelling when compared to Old China corporates. As such our Q4 positioning within China remains essentially unchanged from last quarter.

Beyond China, our overall Q4 positioning is summarized on PAGES 5-7. We continue to favor developed markets over emerging and the U.S. and Japan over Europe. We have moved Australia and the UK back to neutral positioning while overweighting Canada given our preferences for financials, energy, and materials exposure in non-US developed markets. Elsewhere in emerging markets, we maintain our overweights in Russia, Egypt, and Thailand, though after an exceptional 14.7% excess returns in Q3 we have lowered our overweight call in Thailand. We have moved Mexico to overweight as strong economic fundamentals can now take center stage over political concerns while selling into the post-Bolsonaro market euphoria to underweight Brazil.

TABLE 2 | Global / Country Positioning

Region / Countries	-		N		+	
Developed Markets				●		**Overweight.** We remain overweight developed markets as the late cycle growth phase continues to provide support for U.S. equities while strong earnings growth and improving corporate quality continue apace in Japan. Emerging markets remain risky with the strength of the dollar and slowing Chinese growth providing strong headwinds.
United States				●		**Overweight.** US fundamentals may peak over the next 1-2 quarters, but we expect the market to keep apace while growth remains strong and inflation relatively in check. In the event that geopolitical risks cause a market pull back, the safety of the Dollar will provide strong excess returns in a down market.
Core Europe		●				**Underweight.** While valuations are tame, we do not see a near-term catalyst for European equities relative to other major markets. Within Europe we have tempered our overweight to financials and further reduced our overweight to small caps and closed our overweight to Swiss equities all in favor of a broader positioning in value stocks and materials and energy in particular.
Japan				●		**Strategic Overweight.** Japan continues its multi-year course to arrest decades of languid growth and restrictive monetary policy. Valuations are still very attractive while ROEs, dividend yields, and other metrics continue to close the gap with European and American equities. Within Japan, we remain overweight Japanese financials based on extremely low valuations and policy tailwinds and small caps based on valuation and greater improvements in quality.
U.K.			●			**Neutral.** Our Q3 tactical call on a rebound in sterling did not come to fruition. For Q4 we continue to see uncertainty around Brexit, but without a clear view on equities.
Australia			●			**Neutral.** Consensus estimates are for further weakness in the AUD, which has historically boosted equities to yield positive USD excess returns. Moreover, the increasing possibility of stimulus from China (which could also boost Aussie exporters) keep us neutral despite highly uncompelling valuations.
Canada				●		**Overweight.** We have initiated an overweight to Canada due to removal of trade related risks and the favorable sector positioning of the index (70% financials, energy, and materials).

CONTINUES ON NEXT PAGE

● Strategic (6-12 months+) ● Tactical (3 months)

Region / Countries	-		N		+	
Emerging Markets		●				A strong USD and a general slowdown in Chinese growth will continue to weight on EM relative to DM for the time-being.
Emerging Markets Asia						
China			●			**Neutral.** Chinese growth continues to ratchet down, but there is an increasing risk of a stimulus to the market in Q4 or Q1 that keep us in line with the benchmark. The Q3 and early Q4 selloff in China hit "New China", was driven more by short-term sentiment and profit-taking than any change in earnings fundamentals. We continue to favor "New China" in particular the tech/consumer and healthcare stocks, over "Old China" names and will look for a tactical rebound in these positions in Q4.
Korea			●			**Tactically Neutral with Strategic Overweight.** Dividend yields and ROEs have quietly nearly converged with their EM peers, while valuations remain at 40-60% discounts to EM. But in the near-term, we see few catalysts to warrant an overweight.
Taiwan			●			**Neutral.** We have closed our Q3 underweight to Taiwan. While there remains 2nd order risks associated with a Sino-American trade war, the market has been less sensitive than expected.
India			●			**Tactically Neutral with a Strategic Overweight.** Indian corporates still look poised for a long runway of earnings growth on the back of structural economic reforms and modest interest rates, but the turmoil in the non-bank financial sector has given us pause due to the inter-connected nature of these firms, mutual funds and local investors.
Thailand				●		**Strategic Overweight.** Our overweight in Thailand for Q3 paid off handsomely as the market delivered 14.7% excess returns over the EM index - the best performing market globally. We continue to see positive economic fundamentals in Thailand, but we have trimmed our exposure following last quarter's strong showing.
Emerging Markets Europe						
Russia				●		**Overweight.** Despite the geopolitical noise around the Russian market, it has quietly outperformed its EM peers by +16.8% YTD, nearly keeping pace with the US and well ahead of non-US developed markets. But while Russia deserves to trade at a discount, it's discount remains too cheap and so we will continue to hold this overweight as we have for all of 2018. Moreover, we remain constructive on oil prices which should continue to support Russian earnings and the economy for at least another quarter or two.
Emerging Markets Africa						
South Africa		●				**Underweight.** Economic fundamentals remain mediocre and the politics are not yielding any visible catalysts. So we use an underweight to fund higher conviction calls elsewhere in EM.
Egypt				●		**Strategic Overweight.** Egypt is amid a classic cyclical turnaround. A previously unstable macroeconomic situation has given way to a stable currency, falling inflation and interest rates with a market that is trading at a discount to EM with much higher growth prospects. While Egypt has suffered recently on short-term sentiment, we expect further interest rate cuts and an improving balance of payments to drive earnings expectations and reverse sentiment in a hurry.

CONTINUES ON NEXT PAGE

● Strategic (6-12 months+) ● Tactical (3 months)

Region / Countries	-		N		+	
Emerging Markets Latin America						
Brazil		● (Strategic)				**Underweight.** Euphoria over the probable election of extreme right-wing Presidential candidate Jair Bolsonaro has markets breathing a sigh of relief. We traded into this post-election euphoria to cash out from a Q3 overweight and fund higher conviction calls elsewhere in EM.
Mexico				● (Strategic)		**Overweight.** Agreement on a new NAFTA has removed the geo-economic Sword of Damocles overhanging the Mexican market. Looking ahead, Mexico is one of the few EM markets likely to lower rates in the coming quarters.
Colombia				● (Strategic)		**Overweight.** We believe rising oil prices will improve sentiment and lead to positive revisions over the short-term in Colombia while valuations and economic fundamentals remain reasonable.

● Strategic (6-12 months+) ● Tactical (3 months)

TABLE 3 | Sector Positioning

Sector / Style / Capitalization	-		N		+	
Early Cyclicals Consumer Discretionary, Financials		● (Emerging Markets)	● (Developed)			We are neutral to early cyclicals as a whole as we believe that the Fed is nearing a neutral interest rate level, which has historically moderated returns of these sectors globally. We are tactically overweight Japanese financials, which are cheap and stand to benefit from extreme policy measures by the Bank of Japan. We have shifted to underweight financials within Europe due to continued geopolitical risk clouding the credit expansion cycle of the banking sector. We have maintained our underweight to financials in EM due to the credit focused reform agenda in China.
Late Cyclicals Energy, Industrials, Materials, Technology			● (Emerging Markets)	● (Developed)		We are overweight to late cyclicals as a whole as we believe that the Fed is nearing a neutral interest rate level, which has historically supported returns of these sectors globally. We have maintained tactical overweights to energy and industrials throughout Developed and Emerging markets. The industrial positions are largely thematic; made up of European Defense companies and Chinese Environmentally focused companies. We are neutral to technology in all markets.
Counter Cyclicals Staples, Health Care, Utilities, Telecom		● (Developed)		● (Emerging Markets)		We are slightly underweight to counter cyclicals as a whole. We expect these sectors to outperform as monetary policy crosses the threshold into "restrictive" policy. We have increased our exposures to these sectors in developed markets due to the risks that the Fed will need to tighten quicker than anticipated due to inflationary pressures. Our positioning is in the defensive sectors without clear interest rate sensitivities, remaining underweight to Utilities and Telecom. We are more defensively positioned within Emerging Markets. Our largest tactical position within EM is an overweight to Chinese Health Care stocks, which are cheap and poised to benefit from structural reforms and demographic tailwinds.
Large vs. Small Cap			● (Emerging Markets)	● (Developed)		**Modest Overweight.** We are neutral to US small cap stocks due to historically high valuations. We have paired our overweights to European and Japanese small caps, but still maintain modest overweights. Within Europe, we still believe there is potential for small cap stocks to benefit from a capital expenditure cycle within Europe. We maintain our Japanese overweight due to the corporate reform initiatives presenting improving quality characteristics trading at a discount to global markets.
Value vs. Growth			● (Developed) ● (Emerging Markets)			**Neutral.** Modest overweight to value within the US, where higher inflation expectations will likely lead to the end of the growth market sooner than it will in other developed markets.

● Developed ● Emerging Markets

Important Disclosures:

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