Daily Note

WHERE WE STAND - OUR HIGHEST CONVICTION VIEWS

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- **Trade war Trumps all**
- **Growth slowdown to intensify in Q2 and Q3**
- **Fed now pushed into two rate cuts in 2019, RMB to break 7 vs USD**
- **Despite the constant noise US and EM stocks are still too richly priced**

The trade war continues to dominate the headlines and will do so for at least 12 months more. Investors continue to focus on the medicine (easier Fed, Chinese stimulus etc.) and less so on the underlying disease. This is a dangerous thing to do. US equities are not pricing enough risk and nor, with a few exceptions, are EMs. This note shows how our view on trade war influences our global, regional and market calls, highlighting those in which we have highest conviction.

Recession risks have risen. The most important note that we have recently published is The View entitled Trade War Raises Recession Risks. In which we stress test our core views by examining the potential risks arising from the US-China trade war and how they affect our primary expectations. Unusually we have allowed all our analysts to express their differently nuanced conclusions on the likely outcome as there are various very real risks which are not discounted by markets. Our base case remains that the trade war and technology transfer issues are inextricably entwined but that some form of fudged agreement will be reached before next year's US presidential elections, quite possibly triggered by a shift towards a temporary truce at the Osaka G20 meeting. However the effect of this overall will be more depressive for the world economy, especially global value chains, than seemed likely before the trade war acrimony blew up again in May.

Trade deal remains a long way off. The fundamental asymmetry between the US and China in their respective attitudes towards the trade war remains the long term irreconcilable flashpoint. What the US sees as broadly negotiating positions, China views as a fundamental threat to the power and control of the government and President Xi in particular. Risks are further heightened by China's misreading of the shift in US politics and the extent now of bipartisan hostility in Washington, together with Robert Lighthizer's strategic objective to dismantle the role of the Chinese state within its economy through US-approved enforcement mechanisms. In this respect the treatment of Huawei is also transformative, unlike that of ZTE a year ago, with US export controls set to get much tighter.

China ready to add stimulus and allow RMB weakness. We predict that China's economic response will be to tone down its rhetoric on 'structural deleveraging' in favour of 'measured easing' and continued targeted fiscal stimulus. Should the existing tariffs remain in force post the G20 meeting then a further broader easing bias will be seen and the RMB will be allowed passively to devalue beyond the USD/CNY 7.0 level. This all means that the world continues to resynchronize but at a much lower growth rate.

Two Fed rate cuts in 2019. We were early in calling the top in US economic momentum (Q3 2018) and the current slowdown to barely 1% real GDP growth, both in terms of cyclical leading indicators and more importantly corporate profits and the stalling of capex. We believe that the Fed is now faced with a dilemma as to whether it has landed at its targeted neutral destination (courtesy of its last two rate hikes of 2018) or whether it is passing through neutral to an even weaker pace of growth. Given a still strong USD, the inventory work-down having barely begun and Q1's disinflation not proving transitory, the only reason not to cut in June is that the FOMC meeting precedes the G20. The longer the Fed delays the more it will have to cut rates. We are now forecasting a Fed cut in July with September more likely than December for the second cut.

US stocks need to price more risk. Our strategy team contends that markets have overreacted to Powell's speech on 4 June given that the growing expectations for three or more rate cuts would require a considerably sharper economic slowdown than the 1% real GDP growth we expect in Q2 and Q3. However real rates have continued to fall endorsing our positive call on TIPS; but concomitantly our analysis is that equities are not sufficiently pricing in the likely profit growth slowdown suggested by the inverted yield curve.

European stocks remain a 'value trap'. European growth has been hit by fallout from the trade war. German exports have struggled except for a one-off boost in exports to the UK, global car sales have weakened and domestic demand has fallen. We expect further real GDP downgrades in the Eurozone given that the ECB is insufficiently dovish and severely short of monetary toolbox policy options and the less than generous terms of TLTRO-III. We still hold our long-term gloomy view about the euro area's structural growth challenges and suggest that given that the region continues to lack genuine domestic growth drivers, European equities remain cheap but for good reasons.

Further export declines still not priced in for some EMs. Lastly given our below consensus global growth projections, our assessment is that, broadly, EM equities are not discounting the expected deeper decline in EM export growth nor the potential for an acceleration in EM outflows.