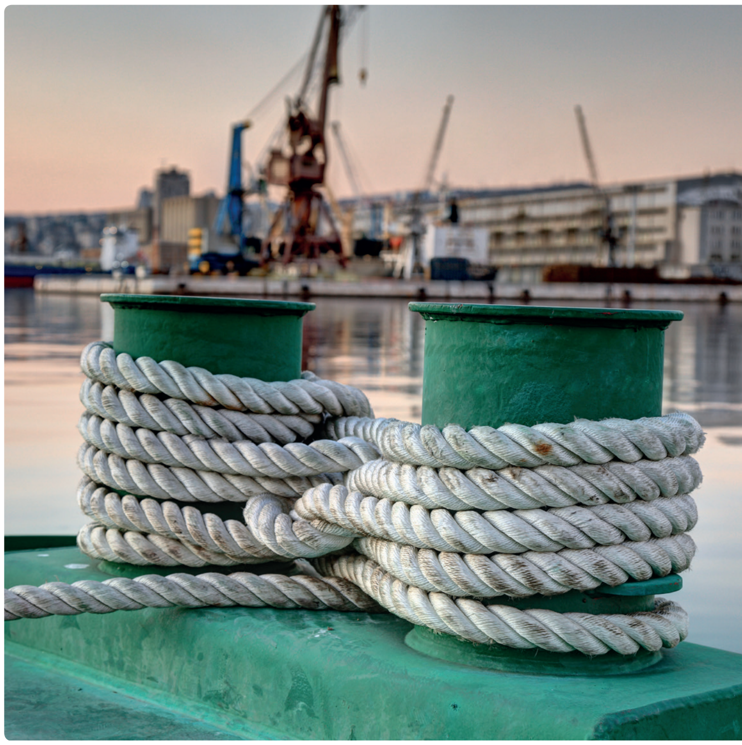
Q3 market outlook:

Good growth, poor politics

Developments in trade tensions, emerging markets and European politics may determine the trajectory of markets over the coming months.

Emiel van den Heiligenberg joined LGIM in August 2013 as Head of Asset Allocation with responsibility for asset allocation, strategy and multi-asset macro research.



Two countervailing forces have kept markets in something of a holding pattern since March: growth in the global economy and company earnings, versus the ascent of populist economic policies. We are due to learn soon which one will gain the upper hand.

Though short-term recession risk remains low, global growth is likely to stutter over the longer term. Indeed, we expect the US to suffer a recession around 2020, by which point the world's largest economy will have enjoyed its longest post-war expansion. The fiscal stimulus that will probably pep up growth this year and next will wane by this point, as the US Federal Reserve continues to march slowly towards a more restrictive policy stance.

But other factors are likely to sway asset prices over the coming months, not least the nascent trade war triggered by the Trump Administration, the resilience of emerging economies and the evolution of political risk in Europe. We delve into each of these issues below, albeit the last one through the lens of Greece – which is becoming a good-news story, while crises in the far more systemically important nations of Italy and the UK vie for investor attention.

Given the backdrop of a mid-to-late cycle economy, with healthy profits growth, we have been long risk assets over the past few years. And within our allocation to risk assets we have favoured equities over credit due to the tightness of spreads in the latter and the more symmetric return prospects in the former. Both positions have worked very well as equities have enjoyed a fantastic rally, while corporate bonds have underperformed recently.

It is tempting to start taking profits on this trade, but we believe it is too soon for such a move. Rather, we see the trend as a warning: weakness in credit markets often presages weakness in the real economy. Much of the spread-widening is likely due to tightening global liquidity conditions, which our CIO has **recently reiterated** will probably exacerbate market volatility in the months and years ahead, as well as impacting business sentiment.

While we believe it is still too early to turn overly defensive, we are likely nearing the end of the spectacular bull market that started in 2009. We remain alert to the risk of late-cycle asset bubbles as interest rates drift higher, the yield curve flattens and nauseating market gyrations become more commonplace.

Tim Drayson,
Head of Economics

CAN TRADE TENSIONS BE TRUMPED?

Trade tensions appear to be on the rise, posing the greatest near-term danger to the otherwise solid underpinning of global growth.

The early skirmishes have seen the US impose tariffs on steel, aluminium, lumber, solar panels and washing machines. These were based on tenuous national security grounds and other obscure trade laws, but we believe the overall macroeconomic impact is negligible.

Washington has since intensified the conflict by slapping 25% tariffs on $34 billion of Chinese imports. China has announced it will retaliate proportionately. And while the direct impact on US growth is unlikely to be any greater than 0.1%-0.2% of GDP, in our view, we are concerned that further escalation will follow, involving widespread tariffs on cars and retaliations as already threatened by the US, EU and China.

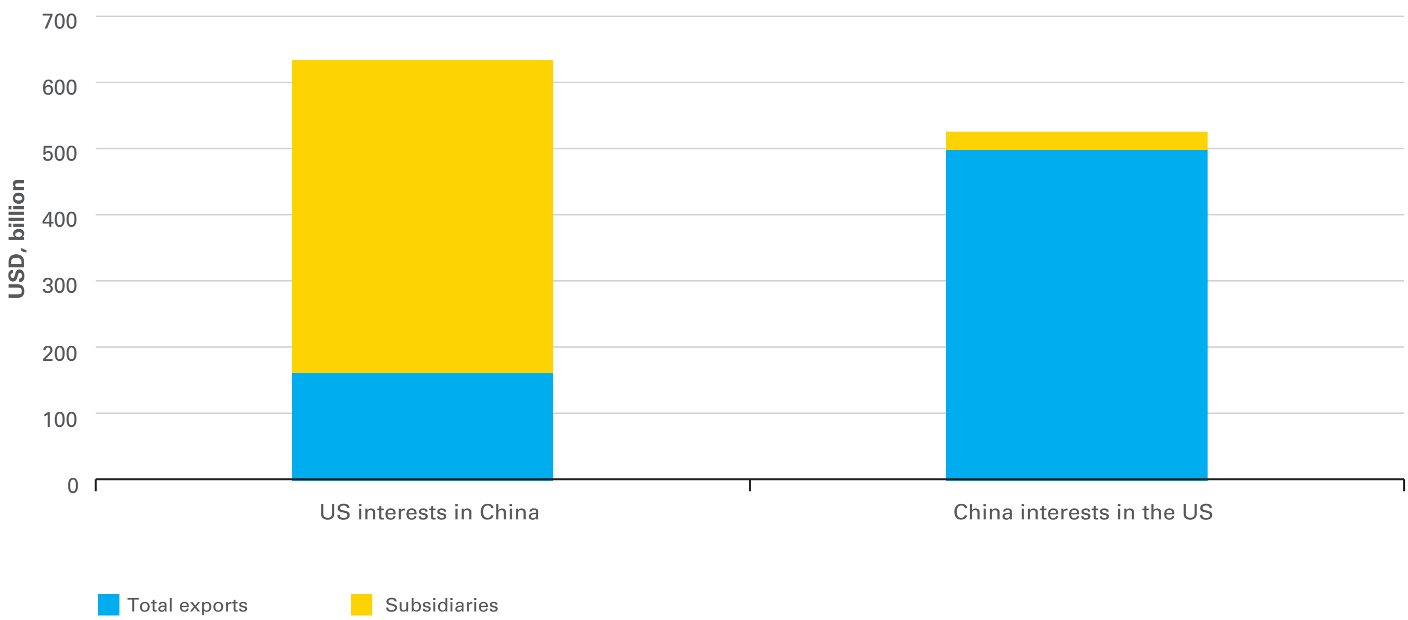
Announced tariffs – including planned countermeasures – could cover virtually all of China's $500 billion of goods exports to the US and raise prices on high-profile consumer goods. However, the biggest uncertainty is the indirect effect: financial conditions and business morale could be shaken by changes to the global trade order.

Donald Trump says he can win a trade war. It is true that China cannot match the US president's tariff threats dollar-for-dollar, as it only imports around $150 billion of US goods. However, the trade deficit vanishes when one considers sales by US companies' subsidiaries in China, to which Beijing can apply pressure as part of its retaliation. Customs delays, tax audits and increased regulatory scrutiny are possible. China has also proven very effective in the past at whipping up the propaganda machine to encourage boycotts of goods, and could even disrupt travel to the US.

If Trump's tactics are merely part of negotiations, it should be possible to find a compromise. But if his goal is more strategic – perhaps part of an attempt to curb China's emergence as a global power – we would expect China to take a tougher stance.

While we await clarity, it is too early to declare 'peak trade war' and, as a result, remain long US inflation, underweight emerging market equities and long the US dollar against Asian currencies (the Chinese yuan and Korean won). If you have not done so already, listen to Magda's podcast on the subject: [Can some good come from a trade war?]

Business interests in other country (2015)



Source: BEA, Macrobond

Magdalena Polan,
Senior Economist

EMERGING MARKETS FACE FUNDAMENTAL TEST

Emerging market (EM) assets have been subjected to a broad-based selloff since early February. Does this reflect a general worsening in domestic fundamentals and growth prospects; an indiscriminate re-pricing on the back of higher US rates and expectations of 'quantitative tightening'; or simply a reaction to outflows from index-tracking funds?

In our view, the weakness is largely the result of outflows from emerging market funds and some re-pricing in anticipation of higher US and euro-area rates. But in a few emerging economies, weak fundamentals, together with political uncertainty, have indeed contributed to a rapid retreat in currency and bond markets.

Looking beyond broad emerging market indices – which exaggerate the impact of the largest economies – and at individual markets, however, shows that the deepest declines have been limited to a handful of countries: Argentina, Turkey, Brazil, South Africa and Russia. These countries are exactly the ones that struggle with weaker fundamentals – wide current account deficits (which require more foreign borrowing); weaker fiscal positions (again, increasing borrowing needs); or higher oil prices adding to already-elevated inflation (eroding real interest rates) or trade deficits. These economies also face policy uncertainty, largely because of elections, or the risk of more sanctions – particularly Russia.

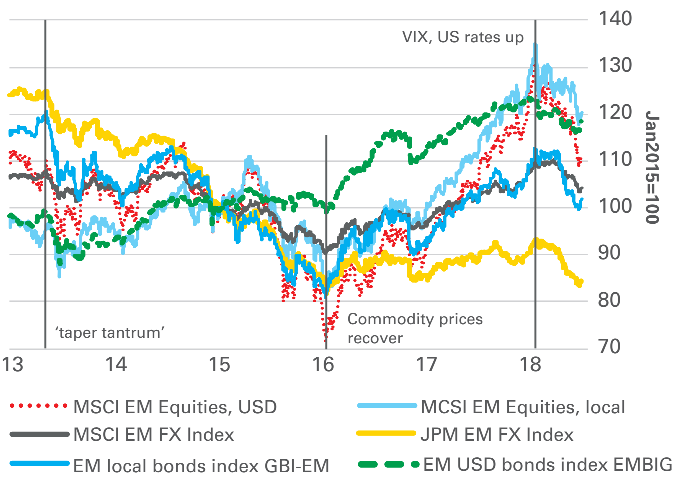
This does not mean, of course, that other emerging economies are exceptionally strong. But overall reliance on external funding has not increased; excluding China, the average emerging market current account has been broadly flat. At the same time, average inflation has been falling, reaching historic lows in 2017. And growth has been solid, even with the trade war affecting the prospects of exporters.

Yet, despite these generally solid fundamentals, emerging market assets continue to remain sensitive to what happens in developed markets, with the level and shape of the US yield curve, strength in the greenback, and stock-market volatility having an especially strong impact.

This is because emerging economies' financial markets are smaller than those of their developed counterparts, with foreign and index investors holding a relatively high share of assets, thus having a disproportionate impact on prices. And with the largest investors still based in developed markets, so-called 'flights to safety' during times of uncertainty affect emerging market assets to a greater degree.

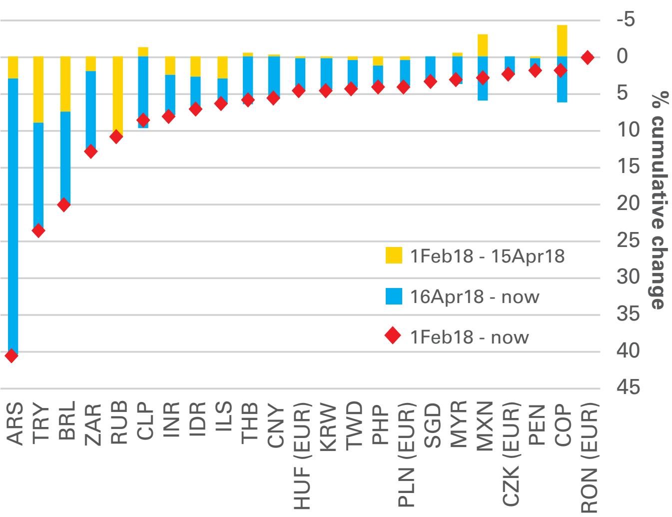
These conditions, however, also open up sizeable opportunities. Once investor sentiment stabilises, we believe emerging markets – especially those with better fundamentals and higher expected returns – will offer ample opportunity for profitable investment. We especially like dollar-denominated emerging market debt.

EM assets have fallen since early February



Source: Bloomberg

Only a handful of EM currencies have come under significant pressure



Source: Bloomberg

Hetal Mehta,
Senior European Economist

CAN WE FINALLY STOP WORRYING ABOUT GREECE?

Around this time three years ago, Greece was in the headlines, on the brink of being expelled from the euro area, again, and having to swallow yet another bailout. Within a relatively short timeframe, things have turned around significantly.

Capital controls have been loosened, sentiment is picking up and the economy is rebounding – growth in the first quarter of 2018 increased to 2.3% year-on-year, the strongest rate since mid-2008 and roughly in line with the euro-area average. Considering the country's debt dynamics, Greece now has nominal growth back above its nominal financing cost, which should lead to the primary surplus (which excludes debt-servicing costs) feeding straight into debt reduction. The independent Hellenic Fiscal Council forecasts the primary surplus to come in comfortably above the target of 3.5% through to 2022.

And with that in mind, the last Eurogroup meeting of euro-area finance ministers signed off on debt relief, including a 10-year extension for about nearly €100 billion of outstanding debt (around one-third of the total) and a longer grace period on interest payments. In addition, Greece will have a cash buffer of around €24 billion.

While some of the finer points remain unanswered, it is now very unlikely that Greece would default any time before 2032, in our view – a horizon which largely stretches beyond the attention of markets.

So what could go wrong? Greece is due to have elections by October 2019. And as we have seen with Italy and other European countries that have held elections over the past year, markets pay close attention.

Polls suggest that the ruling Syriza party would come in second behind the centre-right New Democracy opposition, though another Syriza-led coalition could gain by using budget space for some pre-election tax cuts and spending. Since Syriza has largely become a mainstream centre-left party, the risks of a populist turn are now low. Indeed, Syriza can claim ownership of the bailout programme, and the continuity of government may be a good thing.

In our more active multi-asset funds, we have held Greek sovereign debt since mid-2016. This has been a particularly successful investment so far. In the last few months, the risk-reward trade-off has become more finely balanced, as yields have dropped sharply. However, the broader market implication is that we do not see Greece as a potential source of systemic risk any more.

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