Monthly Letter

June 2019

Economic environment

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Until recently, most market participants anticipated a rebound in global economic growth in H2 2019 that would last until 2020, thanks in part to the easing of Sino-US trade tensions. Yet, once again, US President Donald Trump demonstrated his unpredictability by not only announcing a rise in tariffs on some Chinese imports, but also by opening a new front for his trade wars, this time with Mexico. Overall, risks to the economic outlook are firmly on the downside, as evidenced by the sharp decline in sovereign bond yields, as well as the weakening of business confidence. But to what extent can trade tensions affect global economic growth?

In terms of direct impacts, higher tariffs increase the cost of intermediate goods imported by firms and, as a result, increase their costs of production. In addition, protectionist measures in a country often give rise to retaliation by its trading partners, as observed when the US introduced tariffs on steel and aluminium imports from Canada and the EU. After initially targeting US exports, such as soybeans, China seems to have opted for non-tariff measures. For example, the authorities have floated the idea of retaliating by banning rare earth exports, an essential component for the manufacture of many electronic products for which China has a quasi-monopoly position, controlling more than 80% of the world production. If all US products containing these minerals are not locally produced, a ban on exports to the US could nevertheless destabilise production chains.

In short, as is the case with tariffs in general, consumers are the first to suffer via higher costs of consumer goods, especially in the short term as the substitutability between domestic and foreign goods is limited. That said, the negative effect on consumption may, in part, be mitigated by a transfer to households of customs revenues resulting from the tariffs.

In addition to these direct consequences, a trade war can also indirectly affect a country's economic activity. First, insofar as protectionism increases the production costs of domestic firms and reduces foreign demand as a result of retaliatory measures, financial markets tend to demand a higher risk premium for business financing. This higher cost of capital due to an increase in real or perceived risk vis-à-vis the borrower could weigh on business investment decisions and, in turn, on economic growth. The rise in market volatility that generally accompanies episodes of trade tensions is also likely to exacerbate this trend due to the tightening of global financial conditions.

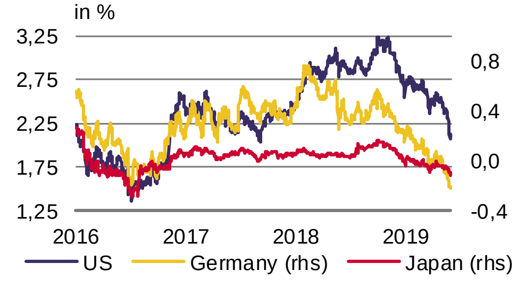
Furthermore, an increase in the uncertainty linked to the introduction of tariff barriers may lead several businesses to adopt a wait-and-see attitude, postponing or even calling into question

Performances in local currency

	Price as of 05/31/19	1 month % change	2019 % change
Equity markets			
CAC 40	5 208	-6.8%	10.1%
Eurostoxx 50	3 280	-6.7%	9.3%
S&P 500	2 752	-6.6%	9.8%
Nikkei 225	20 601	-7.4%	2.9%
Currencies			
1 € = ...USD	1.12	-0.4%	-2.6%
1 € = ...JPY	120.96	-3.2%	-3.9%

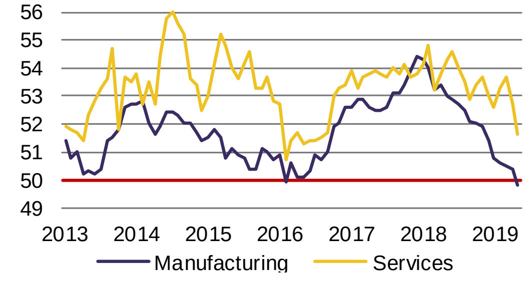
		Price as of 05/31/19	1 month bp	2019 bp
Government bonds				
3 M	Eurozone	-0.54%	3	31
3 M	United States	2.34%	-7	-1
10 Y	Eurozone	-0.20%	-22	-44
10 Y	United States	2.12%	-38	-56

World – 10-yr sovereign yield



Source Bloomberg, Rothschild & Co Asset Management Europe

World – Business confidence index



Source Macrobond, Rothschild & Co Asset Management Europe their investment decisions. Finally, protectionism tends to shelter low-productivity firms from foreign competition, thereby reducing the overall productivity of the economy. While predicting and quantifying the overall economic consequences of escalating trade tensions is complicated given the complexity and the high level of value chain interlinking, it is nevertheless recognised that indirect effects are potentially much more relevant than the direct ones.

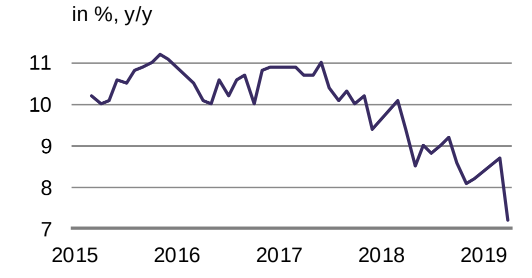
In fact, recent data showed that trade and investment have slowed sharply since the start of the year, particularly in Europe and Asia. In China, despite numerous measures, the economy is running out of steam quicker than anticipated. While some will see this as an element likely to convince the authorities to step up support efforts (i.e. bad news is good news), others will note the implacable evidence of an economy whose high level of indebtedness no longer allows an acceleration of economic activity following an increase of credit growth (i.e. bad news is bad news).

More broadly, the continuing fall in business confidence, mainly in the manufacturing sector, is a tangible manifestation of the impact of the Trump administration's decisions. Indeed, the list of countries whose Markit business confidence index has dropped below the 50-mark – that is, in recession territory – is growing and the global index reached 49.8 in May, its lowest reading since October 2012. Helped by a still buoyant labor market in most countries, the service sector is, for now, more resilient, providing a buffer. However, as the manufacturing and services sectors do not work in isolation, it is unlikely that activity will remain indefinitely decoupled. Indeed, more than a third of manufacturing exports derive from services, and services contribute to more than half of global exports.

In the short term, Mr. Trump's recent threat to impose a 5% tax on imports of goods from Mexico as of June 10, and then to increase the rate by five percentage points per month to a potential 25% in October, could ironically benefit world trade. Indeed, businesses are likely to accelerate stockpiling in order to avoid higher tariffs. Yet, as recent history has taught us, the dramatic damage will only be more visible as these temporary effects fade.

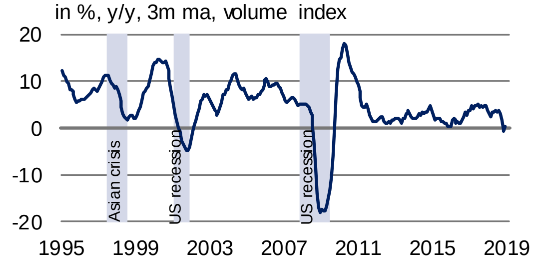
Amid low global inflation and a deterioration of the growth outlook, the prospect that the Fed and other major central banks will tighten monetary policy in the near term has faded. However, it remains to be seen to what extent central banks will be able to mitigate the risks of the global economy hitting the stall speed and then falling.

China – Retail sales



Source Macrobond, Rothschild & Co Asset Management Europe

World – Global trade



Source Macrobond, Rothschild & Co Asset Management Europe