Manulife Investment Management

Market Note

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A trio of market-relevant news hit the headlines within the space of 24 hours on Thursday: a trade agreement between Washington and Beijing, a decisive UK vote, and more monetary easing from the US central bank. Our Global Chief Economist Frances Donald assesses if this will translate into a sunnier outlook for 2020.

US-China trade agreement, UK election, Fed easing: stronger base case, but risks remain

A "phase 1" trade deal between the United States and China was reached last week, which means the much talked-about tariff hike scheduled for 15 December will no longer come into place. Meanwhile, the Conservative Party in the United Kingdom has won a healthy majority in a closely watched election, thereby removing market uncertainty regarding Brexit, at least for now. Crucially, the US Federal Reserve (Fed) announced that it'll add US$500 billion to its balance sheet[1]—where markets are concerned, what's not to like?

The removal of these tail risks certainly strengthens our conviction in our cautiously optimistic base-case scenario: The global economy is approaching an important inflection point after which we'll see economic growth/stabilisation taking place first in Europe, followed by the United States, and then China and the broader Asian region. These developments are supportive of our belief that it could be time to bring a little risk back to the table, particularly as the Fed and other global central banks are likely to maintain their extraordinarily accommodative stance and balance sheet expansion initiatives for a while. These exercises should keep bond yields stable and low.

However, while the threat of fresh tariffs and yet another inconclusive election in the United Kingdom had weighed on the outlook for 2020, we must note that they were by no means the biggest risks to our expectations for an economic rebound next year. While undoubtedly positive, Thursday's news developments do little to reduce the fundamental risks to our outlook, namely, a double dose of economic weakness in China, a weaker US consumer, and the structural ramifications of trade tensions and supply chain readjustments.

Notably, where the US-China trade agreement is concerned, we don't think it's time to pop the champagne just yet. Here are three reasons why caution might still be warranted:

1. This isn't a finalised deal—even if both sides have agreed to complete discussions "as quickly as possible" and China has said it'll work to set a date for signing a deal.[2] In our view, there remains plenty of scope for things to go awry. In particular, details are particularly fuzzy on whether there will be rollbacks of existing tariffs.

2. Phase 2 negotiations are only set to begin after the 2020 presidential elections, meaning

[1] Bloomberg, as of 12 December 2019; Financial Times, 13 December 2019. The new plan includes overnight lending across New Year totalling US$225bn and US$190bn in longer-term repo loans, starting this week that will provide cash to borrowers into 2020. Together with $75bn of cash already provided to the market to cover year-end, the Fed will have $490bn in lending outstanding over 31 December — close to double the scale of its recent repo interventions.

[2] "US and China Reach Initial Trade Deal", New York Times, 13 December 2019.

uncertainty will return in the next 12 months – the "phase 1" trade deal isn't likely to define future US-China trade relations.

3. From a macroeconomic perspective, the most important issue here isn't the impact of tariffs but the cost of shifting global supply chains and lost productivity as we embark on the multi-year transition to a new trade paradigm that'll be ultimately be defined by trade relations between a few key countries.

Within this context, here's a quick look at how the way we see the world has changed in the past week.

Our key investment views:

Core investment theme	Change in conviction	Our view
An inventory rebuild will support a mild-to -moderate H2 2020 recovery in global growth	**Modestly higher**	We believe the global manufacturing recession is partly a function of a front-loaded inventory shock that had been exacerbated by the trade shock. In our view, the restocking cycle was always going to proceed with or without a trade deal, but the removal of tariffs that were set to be implemented on 15 December could imply a faster inventory rebuild at the margin.
Business confidence has bottomed in Europe and the United States; business investments begin trickling in thereafter	**Higher**	The deterioration in business confidence globally was also likely to be front-loaded and had begun to turn positive. However, the latest developments probably imply the worst of geopolitical uncertainty is over (i.e., we should now see second derivative improvements on this front). This should contribute to a faster rebound in business confidence globally.
Central banks to remain extraordinarily accommodative	**Higher**	Lower geopolitical risk doesn't imply less support from the Fed. With an additional US$500 billion of bill-buying adding to the Fed's balance sheet through to year end, the U.S. central bank will have almost reversed its previous "taper" attempt entirely. We expect this to keep bond yields at the front end contained and becoming slightly steeper. We also continue to expect further Fed interest-rate cuts on the back of persistently weak inflation.
Fiscal policy to become increasingly relevant	**Higher**	We'll add the United Kingdom to the growing list of countries likely to expand fiscal spending in the year ahead.

Key risks:

Key risk theme	Change in conviction	Our view
A double dose of weakness in China	**Unchanged**	Our concerns about China relate mostly to domestic policies and the local economy—the absence of a massive stimulus program to revive growth, the weak earnings picture in the industrials sector, and diminishing strength in the real estate segment. These relate to the domestic economic cycle, not trade. We believe this is the biggest risk to the global macro story in 2020.
US job growth loses momentum; a weaker US consumer	**Unchanged**	Leading indicators continue to suggest we're in a late cycle and weaker structural growth in the United States could mean fewer job gains and a less active US consumer.
Geopolitical risk events remain elevated; supply chain disruptions continue	**Unchanged**	We're no closer to understanding what the long-term US-China trade relations will look like. Similarly, as Washington continues to reassess its trade relations with its partners, trade tensions could easily return to the fore.

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Manulife Investment Management

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