FORSYTH BARR

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Currency Wars Self-Destructive

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So far in 2019, 16 central banks around the world have cut their official cash rates. Last week, Beijing devalued its currency by fixing the official level for the RMBUSD above 7.0, the RBNZ implemented one of the most aggressive easings in its monetary policy history, and the central banks of India, Thailand and the Philippines all cut their official cash rates. Central banks are cutting rates to ensure their currencies remain globally competitive in a slowing global environment. The last bank standing may well be the US Federal Reserve. The market was disappointed with the Fed's 'mid-cycle' rate cut at the end of July. Higher relative US interest rates and a stronger USD continue to tighten global liquidity. Emerging markets, including China, have large exposures to USD debt. If the trade war has widened to include currencies, the global economy will be vulnerable to a major USD credit crisis. The aggressive cut in domestic cash rates and falling global bond yields underpin our decision to reduce cash and increase exposure to fixed income assets and higher yielding defensive domestic equities, including listed property. We also reduce exposure to global equities as the wider macro outlook continues to deteriorate.

Increasingly defensive positioning

Our recommendation is to reduce overall exposure to equities. Cash offers no value apart from temporary capital protection, as official rates head towards zero and below. The reach for global yield is increasing in pace with either bonds or equities that offer decent dividend yield in demand. This underpins our recommendation to increase the overweight to fixed income assets and increase exposure to domestic higher yielding equities, including listed property.

Challenging macro environment

The Fed may be forced to ease more aggressively. The 12-month forward futures Fed funds rate shows the official rate heading towards 1.0% next year, a cut of at least 100bp from the current level. The trade-war is detracting from demand all over the world, with the decline in global trade hitting economies from Germany to South Korea and Singapore. For the trade-war to calm down and détente to prevail, either the US or China needs to make major concessions. Neither looks likely to do so in the near-term. As this conflict widens from trade to technology and now currencies, it looks more like a strategic confrontation that could last for years.

While an escalated global conflict would hit commodity currencies initially, the Fed may be forced to allow the USD to depreciate in order to reflate the global economy. Deteriorating global fundamentals and the unpredictability around currency volatility supports our decision to reduce exposure to global equities in favour of a 'home market' bias.

Investment View – tactical asset allocation

Cash	Increase underweight
Fixed Income	Increase overweight
Property	Increase to overweight
New Zealand Equities	Increase to neutral
Australian Equities	Neutral
Global Equities	Reduce to underweight

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Macro background

Fed disappoints the market

While the latest Fed rate cut of -25bp was widely expected, the characterisation of the move by Chairman Powell as a 'mid-cycle adjustment' dented hopes for a full-blown easing. This was a disappointing performance from Powell, in our opinion, similar to that in October last year when he indicated the Fed had a lot more tightening to do.

Trump escalates the trade war

The day after the disappointment from the Fed, President Trump announced a fresh round of tariffs on Chinese imports (possibly in response to Powell mentioning 'trade' about 25 times in his post-FOMC press briefing as a key risk to the Fed's outlook), increasing the fears that the trade war could become the status quo.

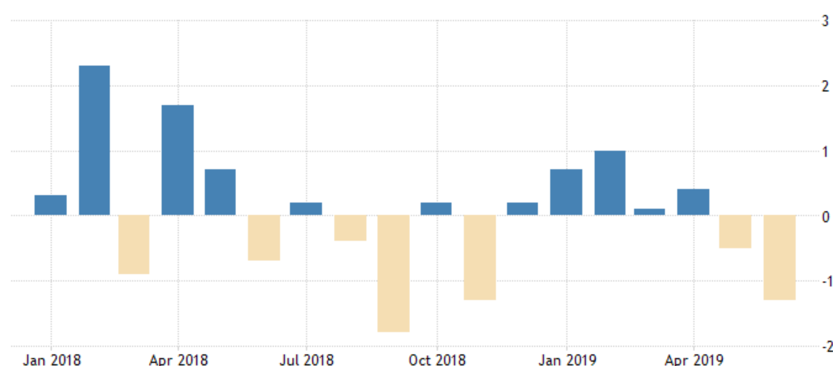
Further escalation occurred when the PBOC set a lower level for the RMB, breaking above 7.0 to the USD. While this depreciation was only -2.0%, the US quickly fired back, designating China as a currency manipulator. This is a major escalation of the US trade and technology war with China, which has quickly evolved into a currency war. While there are a number of reasons why Beijing will want to limit the depreciation of its currency — exposure to USD debt and risks of domestic capital flight being two important ones — the wider risk of a weaker RMB is that it will trigger a global race to the bottom, as central banks battle to keep their currencies competitive. Last week, New Zealand, India, Thailand and the Philippines all cut their official cash rates, most by a wider margin than expected. Australia has already cut rates aggressively this year and the ECB and BOJ are likely to follow suit. The PBOC may also be preparing for its first official rate cut in four years.

China has dug in on the trade war, banning all agricultural product purchases from the US. In the meantime, Trump has again got tough on Huawei and may be about to open a new front in the war. The US Department of Justice has requested to see the records of three big Chinese banks that have allegedly helped finance North Korea's nuclear weapons programme (China Merchants Bank Co., Bank of Communications Co., and Shanghai Pudong Development Bank Co.).

Economic headwinds

The new tariffs will be a major headwind for the US economy that is already facing a deteriorating outlook. While Trump has delayed implementation for some products until December 2019, and exempted other consumer items, the unpredictable nature of Trump's trade strategy will continue to undermine the economy. The ISM manufacturing index for July slipped to its lowest reading in three years, whilst the HIS Markit US manufacturing index fell to its lowest level since September 2009. Both suggest a deceleration in the United States industrial sector. The employment sub-indexes showed employment contracting for the first time since June 2013. Construction spending also fell sharply and unexpectedly in June.

Figure 1. United States construction spending



Source: Forsyth Barr analysis, Trading Economics

The overall US economy slowed to a +2.1% annual pace in the second quarter from +3.0% in Q1 2019, and the details showed a clear tariff impact. Exports slumped -5.1% for

the quarter and non-residential investment, a key metric for business spending, dropped -0.6% for its worst showing since early 2016.

Companies are lowering their guidance

US companies reporting for the Q2 period have been offering weak outlooks for the rest of the year. Among those who have provided forecasts for the third quarter more than half were below analyst's estimates, the worst since 2015, according to data compiled by Bloomberg.

Yet the S&P 500 index is up nearly +17% this year, despite little profit growth to speak of, while valuations have expanded at the fastest pace in years. At just under 17 times forecast earnings, the index is trading at an +11% premium to its 10-year average. However, since January 2018, the index is only up about +3.0% (USD), which includes inflation plus dividends.

Deteriorating earnings and elevated valuations become more troubling if Trump's additional tariffs become reality. Input costs would rise and corporate confidence would weaken further, undermining the little business investment there already is.

Negative bond yields increasing

The world's huge pile of debt with negative yields continues to grow. The market value of the Bloomberg Barclays Global Negative Yielding debt Index closed at US$14.1 trillion after the Fed's last rate cut.

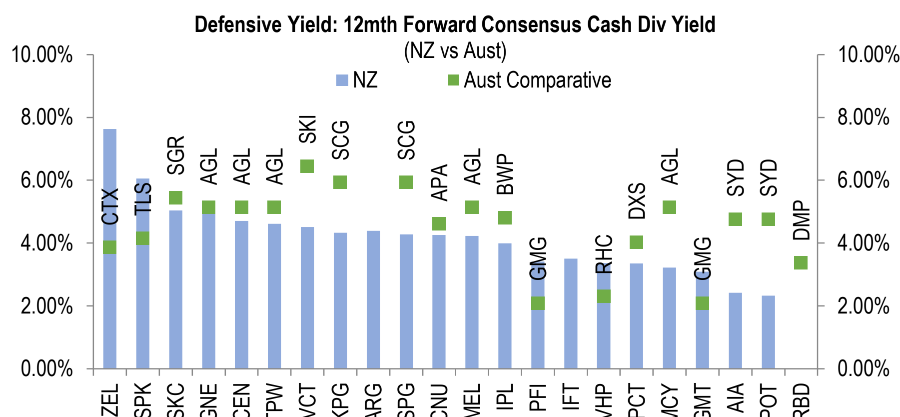
Sovereign bond yields have been negative in many EU countries for some time. Even junk bonds in Europe are offering negative yields, while in Denmark you can now get a 10-year mortgage with a negative interest rate.

Bond proxies are becoming even more appealing

With bond yields heading towards zero (NZ September 2025-year inflation linked bond traded below 0% recently), negative yields in Europe, Japan, and almost in the US, domestic NZ bonds and equities that act as bond proxies look the most attractive in this environment. Ultra-low interest rate environments, which is the consensus outlook for sometime, increase the attractiveness of defensive equity plays — those with predictable cash flows and strong and growing dividends. Examples include utilities (gentailers), property and telecoms. The New Zealand equity market still offers an average gross dividend yield of +5.0%, with the top 40 dividend yielding companies offering a gross cash yield average close to +6–7%. With the RBNZ Governor not ruling out negative interest rates in New Zealand at some point in the future, the current dividend yield of domestic equities will ensure equity risk premiums will continue to shrink.

Defensive equities also provide a form of market hedge. If central banks keep pumping liquidity in economies via lower rates, bond proxy stocks should continue to do ok. If the global economic environment deteriorates badly, bond proxy stocks should outperform beta.

Figure 2. Defensive yielding equities (NZ and Australia)



Source: Forsyth Barr analysis

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