2 SEPTEMBER 2019

Staying Defensive on Trade Conflict Uncertainties

The past week has seen several turns of tone/tactics from the US and Chinese administration.

On Aug 23, China announced retaliatory tariffs of 5-10% on $75bn of US imports, including resuming 25% tariffs on US made autos from Dec 15. In response, US President Trump announced pending tariffs would be increased to 15% (from 10%) on Chinese goods to be implemented on Sept 1 and Dec 15, while the $250bn in existing tariffs would rise to 30% (from 25%) from Oct 1.

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Market Performance

In the US – the Dow Jones Industrial Average, S&P 500 and Nasdaq Composite fell by -1.72%, -1.81% and -2.60% respectively in August.

In Europe, the European Stoxx 600 fell -1.63% with the FTSE100 declining -5.00%. In Japan, Nikkei 225 and Topix traded down -3.80% and -3.40% respectively.

MSCI Emerging Markets also had a weak month, down -5.08%, led by MSCI Latin America (-8.54%). MSCI Emerging Europe was down -5.68% for August.

In Asia, MSCI AsiaXJapan retreated -4.61%. Hong Kong's Hang Seng Index was the worst performer, sliding -7.39% for the month.

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- Waxing/waning signals. The “tit-for-tat” appeared to be a sharp turn in the approach to trade resolutions by both countries, but was soon confounded by messages that the negotiations could be back on the table.

- Should tensions escalate further, more drastic actions could be on the cards. Trump referred to the International Emergency Economic Powers Act of 1977 (IEEPA) as an option for him to force US companies to detach from China. Should conditions be met for the US to declare a national emergency, the law would give the US president authority to block real or financial transactions, as well as freezing assets – effectively blocking China’s access to US (financial markets).

> “A non-linear path – markets have been quick to feel shock, and relief almost as suddenly.”

VIC vs. Trade Uncertainty Index

Source: Citi Private Bank. As of 26 August 2019.

- Impossible to predict the next “tweet”. Trade war actions have not followed a linear path. As such, investors should first price in a higher degree of trade and economic risk before expecting a period of relief. Citi analysts advice caution before extrapolating the latest news forward and using it as the basis for any large portfolio decision. As we have seen before, it can prove to be a mistake to assume the US administration’s next step.

- The deterioration of international cooperation should not be ignored as a source of global slowing and increased source of global risk. Business connections between US and China amount to greater risks for multinational firms and the multiplier effect can spill over to many others in a larger wave of impact than tariff collections imply.

- Preferring to stay moderately defensive in asset allocation, Citi continues to maintain a modest underweight in global equities, and neutral global fixed income.

Switching to Neutral in Global Fixed Income

As a greater proportion of the global bond market moves into negative yield, Citi analysts see decreased opportunities in the asset class and have turned neutral.

- For much of the year global bond yields have been moving lower. It has been five years since the European Central Bank has introduced negative interest rate policies (NIRP), while others like Bank of Japan, Switzerland and Sweden have also jumped on the NIRP bandwagon. Meant to be temporary, central banks have not had a chance to wean their economies off them, and more recently have become likely to push policy rates deeper into negative territory. September sees several key central banks' meetings, which are widely expected to introduce additional easing.

- 25% of the world's bond market (50% of non-US investment grade bonds) currently trades with a negative yield. The global bond market now yields around 1.4%, down 100bp over the last 12 months. As a whole, Citi analysts see decreased opportunities in global fixed income, given that central bank easing is aggressively priced in. As such, Citi's Global Investment Committee has shifted its overweight position in global fixed income to neutral.

"Global yields (ex-US) are at historical lows, with higher yields found in USD bonds."

Bloomberg Barclays Bond Indices

Source: Citi Private Bank. As of 29 August 2019.

- Relative value in USTs, US IG and EM debt. Global rates are expected to remain low and uncertainty high, but the search for yield is likely to remain a key market theme. On relative value, US bond market yields still appear globally attractive. US treasuries (USTs) yield 130bp higher than the average non-US developed sovereign bond market, while in US investment grade (IG) corporate bonds, the differential exceeds 225bp. Emerging market (EM) debt also looks attractive relative to their developed market peers.

- Reflective of the typical bond investor's primary objective of receiving cash flow, Citi is underweight all negative and ultra-low yielding bond markets and has further deepened their underweight in European sovereign debt. With the average Eurozone yield at -0.5%, investors may need to look elsewhere in their search for yield.

Commodities: Bullish Gold Outlook; Oil Enters a New Era

Citi's Global Investment Committee has increased allocation to gold as a portfolio risk hedge. Meanwhile, the US looks well on its way to becoming a net oil exporter.

- Gold sees support from falling rates: Gold is negatively correlated with equities and benefits from large declines in real interest rates. The potential for lower yields in the US and OECD, among relatively weak carry across emerging markets FX, has reduced the opportunity cost of holding a safe haven hard currency such as gold.

- Gold prices have advanced close to 15% after breaking through their half-decade ceiling of US$1,350-1,375 in June. Historical data shows that it has rallied more than 50% over one-year periods in four instances over the past 15 years. Risk aversion could help to support the yellow metal and Citi analysts upgrade their 6-12 month point price of US$1,600/oz.

"Gold has lagged behind the sharp move lower in rates."

Gold Price YoY vs Real US and Euro Area 10-Year Bond Yields (Inverted Scale)

Source: Citi Private Bank. As of August 2019.

- Start of a new era for oil? The first crude oil exports were delivered on the Cactus II pipeline (Corpus Christi, Texas) recently, marking the start of what appears to be the second phase of US "Shale Gale". Additional pipelines could see total Texas crude export capacity potentially exceeding 6m bpd (barrels per day) by year-end. This has global impacts, as the US oil sector is now likely to sprint towards becoming a net oil exporter and could also consolidate its role as a leading petroleum hub by year-end or next year.

- All in all, US supply growth has an open highway to global markets, challenging Atlantic Basin balances and moving into the Asian market. This has created challenges for OPEC+ which has been trying to manage oil inventories and ultimately, price. Global oil markets look well supplied and OPEC+ efforts to target higher prices in the short-term could ultimately see a loss of market share. Citi analysts have a 6-12 month point price target of $60/bbl (Brent).

Strong USD for Now, Not Forever

The USD could see some near-term strength, although the longer term outlook is less clear.

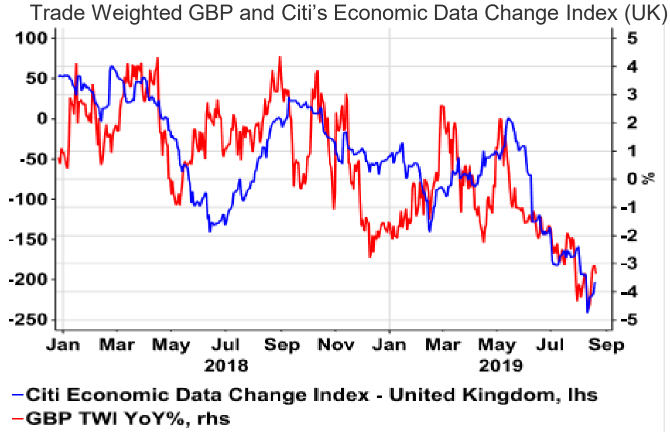
- USD: A number of factors could help sustain near-term USD strength. First, the EUR/USD relationship is still trending lower. Second, CNH weakness in response to US trade tariffs. Third, US budget deal has reduced fiscal drag going into 2020, making growth convergence to the Euro Area a bit less likely. The longer-term outlook though, is less clear.

- EUR: Since May 2018, EUR/USD has been trending lower, reflecting the combination of an accelerating US economy and a sharply decelerating Euro Area (EA) output trend. EA activity remains weak, inflation low and boost from China almost invisible. This has prompted ECB to signal another round of easing in September. Overall, Citi analysts see the EUR trending lower.

- GBP: Trade weighted GBP remains close to its all-time low, steadily pricing in PM Johnson's desire to enact Brexit at all costs, including risking a no-deal "hard" Brexit. UK data has also been particularly poor – a contraction in 2Q GDP along with a partial inversion of the Gilt curve have raised concerns whether a UK recession is on the way. Political uncertainty remains an obvious downside risk.

"Trade weighted GBP remains close to its all-time low"

Trade Weighted GBP and Citi's Economic Data Change Index (UK)



Source: Citi Research. As of 21 August 2019.

- AUD: Escalating US-China trade tensions and resulting CNH weakness remains AUD negative. Domestically, Citi analysts expect more economic spare capacity than the RBA forecasts – Citi analysts have increased their RBA rate cut call from one to two this cycle (terminal rate of 50bp in Feb 2020). With two cuts already priced in the next 6 months, less aggressive action by the RBA could provide a firmer floor for AUD at lower levels.

- Asia: Asian currencies are expected to first weaken slightly in 3 months, then remain relatively flat in 6-12 months. This is largely due to the CNY, which is expected to weaken further assuming escalation of trade tensions.

World Market at a Glance

	Last price	52-Week	52-Week	Historical Returns (%)			
	30-Aug-19	High	Low	1 week	1 month	1 year	Year-to-date
US / Global							
Dow Jones Industrial Average	26403.28	27398.68	21712.53	3.02%	-1.72%	1.60%	13.19%
S&P 500	2926.46	3027.98	2346.58	2.79%	-1.81%	0.87%	16.74%
NASDAQ	7962.88	8339.64	6190.17	2.72%	-2.60%	-1.55%	20.01%
Europe							
MSCI Europe	435.64	471.81	390.84	1.33%	-2.95%	-6.45%	7.86%
Stoxx Europe 600	379.48	395.10	327.34	2.19%	-1.63%	-1.53%	12.39%
FTSE100	7207.18	7727.49	6536.53	1.58%	-5.00%	-4.11%	7.12%
CAC40	5480.48	5672.77	4555.99	2.88%	-0.70%	0.04%	15.85%
DAX	11939.28	12656.05	10279.20	2.82%	-2.05%	-4.44%	13.07%
Japan							
NIKKEI225	20704.37	24448.07	18948.58	-0.03%	-3.80%	-9.47%	3.45%
Topix	1511.86	1838.30	1408.89	0.64%	-3.40%	-13.07%	1.19%
Emerging Markets							
MSCI Emerging Market	984.33	1099.18	929.90	1.10%	-5.08%	-6.95%	1.92%
MSCI Latin America	2600.89	2980.17	2366.54	2.71%	-8.54%	6.62%	1.36%
MSCI Emerging Europe	167.04	184.96	148.12	1.01%	-5.68%	8.69%	9.80%
MSCI EM Middle East & Africa	243.56	266.27	229.47	0.48%	-7.44%	-1.67%	1.30%
Brazil Bovespa	101134.60	106650.10	74274.51	3.55%	-0.67%	32.37%	15.07%
Russia RTS	1293.32	1413.82	1033.31	1.96%	-4.91%	20.25%	21.02%
Asia							
MSCI Asia ex-Japan	609.01	687.70	568.61	0.53%	-4.61%	-9.00%	2.08%
Australia S&P/ASX 200	6604.22	6875.50	5410.20	1.24%	-3.06%	3.97%	16.96%
China HSCEI (H-shares)	10083.20	11881.68	9731.89	-1.09%	-5.55%	-8.06%	-0.41%
China Shanghai Composite	2886.24	3288.45	2440.91	-0.39%	-1.58%	5.42%	15.73%
Hong Kong Hang Seng	25724.73	30280.12	24540.63	-1.74%	-7.39%	-8.66%	-0.47%
India Sensex30	37332.79	40312.07	33291.58	1.72%	-0.40%	-3.51%	3.51%
Indonesia JCI	6328.47	6636.33	5621.60	1.16%	-0.97%	5.14%	2.16%
Malaysia KLCI	1612.14	1823.24	1572.03	0.17%	-1.39%	-11.40%	-4.64%
Korea KOSPI	1967.79	2356.62	1891.81	1.00%	-2.80%	-14.72%	-3.59%
Philippines PSE	7979.66	8419.59	6790.58	1.14%	-0.82%	1.61%	6.88%
Singapore STI	3106.52	3415.18	2955.68	-0.12%	-5.88%	-3.70%	1.23%
Taiwan TAIEX	10618.05	11097.11	9319.28	0.76%	-1.90%	-4.29%	9.16%
Thailand SET	1654.92	1766.62	1546.62	0.50%	-3.33%	-3.81%	5.82%
Commodity							
Oil	55.10	76.90	42.36	1.72%	-5.94%	-21.57%	21.34%
Gold spot	1520.30	1555.28	1180.76	-0.43%	7.53%	26.70%	18.55%

Source: Citi Research as of 30 August 2019.

Currency Forecasts

	Currency	Last price 30-Aug-19	Forecasts Sep-19	Dec-19	Mar-20	Jun-20
G10-US Dollar						
Euro	EURUSD	1.10	1.08	1.09	1.10	1.11
Japanese yen	USDJPY	106	107	106	105	103
British Pound	GBPUSD	1.22	1.18	1.21	1.23	1.26
Swiss Franc	USDCHF	0.99	1.00	1.00	1.01	1.00
Australian Dollar	AUDUSD	0.67	0.67	0.68	0.69	0.7
New Zealand	NZDUSD	0.63	0.62	0.63	0.64	0.64
Canadian Dollar	USDCAD	1.33	1.33	1.32	1.31	1.3
EM Asia						
Chinese Renminbi	USDCNY	7.16	7.16	7.23	7.31	7.29
Hong Kong	USDHKD	7.84	7.84	7.85	7.85	7.84
Indonesian Rupiah	USDIDR	14,191	14489	14375	14263	14244
Indian Rupee	USDINR	71.4	71.9	71.0	70.0	69.8
Korean Won	USDKRW	1,211	1231	1238	1246	1244
Malaysian Ringgit	USDMYR	4.21	4.21	4.19	4.16	4.12
Philippine Peso	USDPHP	52.1	52.3	52.2	52.10	52.0
Singapore Dollar	USDSGD	1.39	1.40	1.40	1.39	1.38
Thai Baht	USDTHB	30.6	30.9	30.8	30.7	30.8
Taiwan Dollar	USDTWD	31.4	31.7	31.8	31.9	31.9
EM Europe						
Czech Koruna	USDCZK	23.63	24.1	23.9	23.7	23.3
Hungarian Forint	USDHUF	301	300	298	296	293
Polish Zloty	USDPLN	3.99	4.07	4.03	3.99	3.93
Israeli Shekel	USDILS	3.53	3.53	3.52	3.51	3.50
Russian Ruble	USDRUB	66.8	66.1	66.8	67.6	68.2
Turkish Lira	USDTRY	5.83	6.04	6.46	6.87	7.09
South African Rand	USDZAR	15.20	15.51	15.60	15.70	15.71
EM Latam						
Brazilian Real	USDBRL	4.15	3.95	3.91	3.87	3.85
Chilean Peso	USDCLP	722	729	724	718	711
Mexican Peso	USDMXN	20.1	20.0	20.1	20.3	20.4
Colombian Peso	USDCOP	3442	3421	3432	3444	3437

Source: Citi Research as of 30 August 2019.

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