Economic Commentary

Third Quarter 2018
Volume 18, Issue 3

Investors had plenty to contemplate over the last quarter, including an escalation in President Trump's protectionist agenda, turmoil in the emerging markets and a politically charged environment in Europe. Specifically, President Trump has now imposed tariffs on a total of $250 billion worth of Chinese imports, while China has retaliated with levies on a total of $110 billion worth of US imports. Furthermore, Trump has ratcheted-up his aggressive posturing and has threatened to slap tariffs on an additional $267 billion if China retaliates further.

However, notable progress has been made elsewhere. After several months of persistent stalemate in NAFTA negotiations, policymakers succeeded in securing a revamped trilateral accord, while a new round of tariffs have been sidelined as the US and European Union undergo trade talks – essentially allowing Trump to shift his focus back to China, the primary target of his protectionist agenda since day one.

Finally, diverging views on the fiscal rules of the European Union are testing the region's financial stability after Italy proposed a much larger than expected budget deficit, while the future of the UK remains frustratingly uncertain as Brexit negotiations linger on with little in the way of progress.

	Q4 2018 THEMES	MACROECONOMIC VIEWS	STRATEGY IMPACT
ECONOMIC FUNDAMENTALS	GLOBAL GROWTH OUTLOOK REASONABLY BRIGHT	While global Purchasing Manager Indices have indeed peaked, leading economic indicators are not suggestive of an imminent downturn or recession at this time	+
CENTRAL BANKS	LESS INTERVENTION BUT FISCAL IMPULSE OFFSETS	Self-sustaining global growth and building pricing pressures reduce the need for ultra-accommodative policies, though the fiscal impulse extends the cycle	+
VALUATIONS	FAIRLY VALUED	With little room for multiple expansion in these later stages of the business cycle, earnings expansion should drive equity returns in the coming year	=
TECHNICALS	BREAKING DOWN	S&P 500 broke below its 200-day moving average; long end of the yield curve finally breaking out of its multi-year range	=
CONSENSUS	OPTIMISM FLUSHED OUT	Approaching pessimistic territory (contrarily positive)	=
VOLATILITY	NEW NORMAL	Sporadic episodes of volatility likely as investors adjust to rising interest rates, lingering global trade uncertainties and political upheaval in Italy and the UK	–

Outlook and Investment Strategy

The good news is that the direct economic impact from these geopolitical tensions is likely to be manageable.

Despite the hostile trading environment, we expect the global economy to continue thriving. Encouragingly, economic momentum remains fairly robust in general, allowing the economy to absorb both higher interest rates and gasoline prices. The fiscal stimulus from both the US and China is set to extend the economic upturn well into 2019 and provide a buffer as major central banks take coordinated steps towards monetary policy normalization.

Our base case remains that the environment of synchronized global growth will outweigh the uncertain geopolitical backdrop at hand. That being said, the potential for periodic bouts of volatility prevails heading into 2019 as visibility of the economic cycle shrinks in time and as monetary policy transitions from accommodative to neutral, which warrants a cautious approach at this time.

Source: Fiera Capital

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Our current scenarios are for a synchronized global expansion (60%), which is a continuation of the current environment that benefits equities, trade protectionism (15%), which would be negative for equities and positive for bonds, stagflation (15%) which would be detrimental for both bonds and equities, and finally, geopolitical instability (10%) that would introduce significant financial market volatility.

MAIN SCENARIO
SYNCHRONIZED GLOBAL EXPANSION

PROBABILITY 60%

The global economy continues to grind higher in a synchronous manner, with all major regions contributing to the advance. The US leads the global charge, thanks to widespread momentum across both the consumer and manufacturing space, while the double-dose of fiscal stimulus boosts an already-buoyant economy. Meanwhile, the Canadian economy moderates towards a more sustainable, albeit still above-trend pace. Finally, policymakers in Europe and Japan ultimately prove successful in reflating growth, while emerging market economies prosper in the environment of improving global demand, ample liquidity, and rising commodity prices. Taken together, the lucrative combination of synchronized global growth and a revival in commodity prices should bolster inflation expectations across the world, though not to levels that would threaten the status of the economic recovery. This reflationary backdrop bodes well for equities and commodities (ex-gold) at the expense of fixed income and the US dollar.

SCENARIO 2
TRADE PROTECTIONISM

PROBABILITY 15%

The biggest risk to our base case scenario is a rise in protectionism stemming from the US and the threat of a trade war that would derail the synchronous global expansion. Specifically, President Trump's rhetoric on protectionism has translated into action ahead of the midterm elections, with the US imposing tariffs on a variety of imports including solar panels, washing machines, steel and aluminum – which have been met with retaliatory measures from some of America's closest allies in response. Mr. Trump has since upped the ante by imposing tariffs on a total of $250 billion worth of Chinese goods (of which China has retaliated), while threatening to slap tariffs on an additional $267 billion of imports as well as levies on global auto imports – which would be detrimental for trade flows and the global economy alike. In this scenario, anti-trade rhetoric in the US becomes a reality and results in tariffs being imposed on economies such as China, Canada, Europe, Japan and Mexico, with further retaliation igniting a full-blown global trade war.

SCENARIO 3
STAGFLATION

PROBABILITY 15%

After an extended period of undershooting central bank inflation targets, policymakers tolerate higher inflation (overshoot) and monetize inflation by letting the economy run hot. As a result, inflation expectations start to de-anchor from current subdued levels and surge higher. This would come at the same time that fiscal stimulus is being reigned-in (2020) in the later stages of the economic expansion, causing growth to moderate to well below potential levels in response. In the Stagflation scenario, a stagnation in growth occurs concurrently with an acceleration in inflation as a result of previous excessive monetary stimulation and an exhaustion of productive capacity - creating a tumultuous financial market landscape whereby both equities and bonds experience broad based declines.

SCENARIO 4
GEOPOLITICAL INSTABILITY

PROBABILITY 10%

Political upheaval in Europe and vulnerabilities in the emerging world could ignite a crisis in confidence – disrupting the global economy and financial markets alike. Specifically in Italy, the Five Star and League parties have formed a coalition government with Eurosceptic tendencies, with plans to expand fiscal policy that would go against the fiscal rules and threaten the relationship with the European Union – which risks throwing the region into political disarray at the same inopportune time that a lack of progress in Brexit negotiations has raised the odds of a "hard Brexit" scenario. Meanwhile, emerging market economies remain susceptible to a strengthening greenback, particularly those countries with high levels of external debt. An increase in debt-servicing costs raises default risks and capital outflows for the weaker links, with the potential for contagion to spread more broadly across the developing world.

Source: Fiera Capital

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