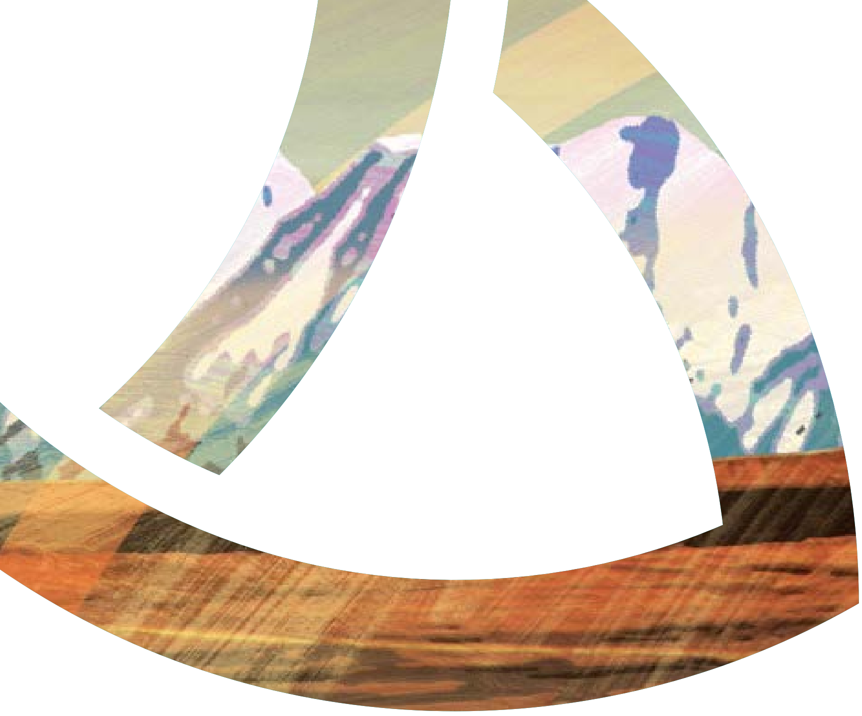

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Winter 2018

The Geo Political Environment and Trade Wars: Are there Winners and Losers?

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2018 Research Update

The Geo Political Environment and Trade Wars: Are there Winners and Losers?

The news recently has been full of accounts of a growing level of trade tensions around the globe, particularly with the United States wanting to renegotiate existing trade agreements with its main trading partners, China, the Euro Zone, Canada and Mexico in particular.

The most prominent issue is the widening trade dispute between China and the United States. On July the 6th the U.S. imposed a 25% tariff on $US34 billion of Chinese imports, ranging from machinery to electronic componentry. In response, China responded with a similar level of tariff, targeting U.S. farm goods such as soya beans, and pork products, with a focus on states that were supporters of Donald Trump at the last presidential election in 2017. This is a tactical approach from the Chinese, with an eye to influencing the midterm Congressional elections in November this year. In macroeconomic terms, these tariffs are insignificant, estimated to amount to 0.1% of Gross Domestic Product for both countries.

The United States are currently considering tariffs on an additional US$16 billion of Chinese goods to be implemented in the coming months. China has indicated that it will retaliate dollar for dollar. The United States has indicated that if China does retaliate, it will in turn do the same, sparking the risk of heightened trade tensions, and ultimately the worst case scenario of a global trade war. On the 10th of July, the Trump administration pushed ahead with plans to impose tariffs on an additional US$200 billion in tariffs on Chinese products by releasing a list of targets, marking a sharp escalation in the trade war between the two countries. These tariffs could take effect after public consultations end on the 30th of August.

The proposed list of goods includes consumer items such as clothing, television components, refrigeration products, as well as other high tech goods. President Donald Trump has threatened to extend tariffs to almost all Chinese trade with the U.S., currently worth around US$500 billion dollars annually. At the present time an initial $400 billion in tariffs is being considered.

However, China cannot retaliate to the same extent of the US$500 billion export tariff on goods to the United States, as imports from that country are much lower in absolute terms. (An alternative for China would be to make business and trading conditions much more difficult for U.S. companies in China.)

The last perspective on the escalating trade environment is that the United States is looking for ways to curtail Chinese power on the global stage, particularly around their rising technology dominance. To this end, the United States has sought to restrict foreign investment in the country, so that it can prevent foreign companies from violating intellectual property rights of American companies. Initially, it appeared that the United States would only target China, which would have raised tensions to a new level. Fortunately, the United States has taken a more measured approach by seeking to tighten current laws. This is much less confrontational towards China, and has helped ease tensions for the time being.

These tariffs are in addition to the US$50 billion of tariffs on steel and aluminum imports to the United States announced earlier in the year, which affects all trading partners.

What are the macro economic impacts?

There is no doubt that China has more to lose from escalating trade tensions and an outright trade war. As history has demonstrated many times, there are no winners from a trade war, but the United States would be the least impacted globally, given that exports do not make up a large part of the United States economy. In addition, the economic stimulation from the increase in Government spending and tax cuts will assist in softening any negative impacts. In contrast, Germany would be exposed to a much higher level of risk given its large trade surplus.

The overall economic impact from an escalation in trade tensions would include softer global economic activity, higher prices for goods and services, and a resultant rise in interest rates.

At this stage, based on initial estimates, the impacts from a full scale trade war on global economic activity are estimated to be modest. However, it is unlikely that trade tensions have peaked, and are therefore likely to be an ongoing source of market volatility. Whilst economic impacts may be modest, the effect on investor and business sentiment in the short term may be more significant. Only time will tell as to how this will play out. Overall, it is not expected that a full scale trade war will occur, and this is reflected in the sanguine response from Global Share markets to date.

How have markets reacted to date?

The Chinese share market has fallen by over 20% from the peak. There are a number of reasons for this, including the escalating trade dispute with the United States. In anticipating the ramping up of trade tensions, China has allowed its currency, the Yuan to depreciate by more than 3%. This has the effect of making goods and services cheaper in export markets.

There has been an increase in volatility in other currencies, particularly the Australian dollar, and a rise in volatility in global commodity prices. Global share markets have also experienced an increase in volatility in recent months.

What about other countries?

Italy

This country has been in the news recently, with the Italian political scene being in a state of turmoil. After months of negotiations since the elections in March, a coalition between the Five Star Movement (a populist party) and the League (right wing, anti-immigrant, and anti-Euro) has finally been formed.

Global financial markets were rattled however when the President voted the appointment of Paolo Savona, a Eurosceptic, and Finance Minister (the President must approve every major position in government). These developments have highlighted the unstable nature of Italian politics, a problem which has dogged Italy since the Second World War. In this context, it needs to be remembered that over that time, (70 years) the country has had 64 governments. The current government may not last long either. Overall, it is important to maintain some perspective on the influence of Italy. Whilst it is the third largest economy in Europe and the ninth in the world, the EU is unlikely to fragment because of the Italian political situation.

Of greater concern within the European Union is the rise in populism. The big market fear is that developments in Italy could be a catalyst that could lead to the demise of the Eurozone. In the three years since the refugee crisis, concerns and resentment over immigration remain. These issues continue to simmer and continually provide the potential for the unexpected. For example, in recent times, Angela Merkel's government in Germany and her position as Chancellor have come under pressure over this issue.

What about the United Kingdom and Brexit?

The rise of populism in Europe manifest itself when the United Kingdom voted by a very slim margin in June 2016 to leave the European Union.

Since then, the battle lines have been drawn in the U.K. as various political factions have taken entrenched positions over Britain's future. Teresa May's government has been struggling to finalise Britain's position before final negotiations with the European Union.

This has led to a divided cabinet, and recent resignations of Boris Johnson, a leading Brexiteer, and Foreign Secretary, and David Davis, Brexit Secretary. Ultimately, this could well claim the scalp of another U.K. Prime Minister as the current political disarray over Brexit is proving to be difficult and drawn out. This is an unfortunate situation for the U.K., as this is largely a local issue. Although there are major future ramifications for the U.K. economy, the potential impact on the global economy is likely to be minimal.

Summary

There are a number of factors outlined above, along with developments in North Korea, and the mid-term elections in the U.S. which have the potential to unsettle global financial markets at any time. So far, however, outcomes to all of these events have been much less than the worst case scenario initially feared by global markets.

From this perspective, this is a time for investors to remain focused on sound global economic fundamentals, which are encouraging. Although the pace of global economic activity has slowed, the global economy remains robust and resilient enough to weather ongoing skirmishes on the geo-political stage.

Bonds. What are they and how do they work?

The inclusion of bonds in portfolios is an essential component of diversification within the Accordia portfolios. But what exactly are they, and how do they work?

Many people are confused by the apparent complexity of the bond markets and terminology. In reality, bonds are actually very simple debt instruments. Listed below are 4 basic things to know about them.

1. Basic Bond Structures

A bond is a type of loan taken out by companies or governments (known as the issuers). Investors lend the issuer money when they buy the bonds on offer. In exchange the issuer pays an interest “coupon” (the annual interest rate paid on the bond, expressed as a percentage of the face value) at predetermined intervals, usually six monthly or annually. The principal is repaid on the maturity date, ending the loan obligation of the issuer.

Unlike shares, bonds can vary significantly based on the terms of the bond, as outlined in the legal document at issue outlining the characteristics of the bond issue.

Maturity

The maturity date of the bond is the date when the principal or par value of the bond will be repaid to investors, and the issuer’s obligation will then end.

A bond can be secured, or unsecured. Unsecured bonds are called subordinated issues, which mean that they rank behind other higher ranking debt obligations of the issuer, and are therefore by default more risky than secured bonds. In the event that the issuer fails, an investor risks getting little or none of their money back. In contrast, an investor who has purchased a secured bond has the comfort of knowing that specific assets are pledged to bondholders if the issuer cannot repay the obligation.

Liquidation priorities

When an issuer goes bankrupt, it will repay money back to investors in a particular order on liquidation. After the issuer has sold off all realisable assets, they will begin repayments in order of priority. Senior or secured obligations must be repaid first, followed by lower ranking subordinated debt. Shareholders receive whatever is left.

Callability

Some bonds can be paid off early by an issuer before maturity. If a bond has a call provision, the option exists for the issuer to repay, usually at a slight premium to the face or par value.

2. Bond Risks

Credit or Default Risk

Credit or default risk is the risk that interest and principal payments due on the bond will not be made on due dates.

Prepayment risk is the risk that a bond with a call provision allows the issuer the option to repay early when interest rates have fallen substantially. This incentive to repay leaves the investor to reinvest the proceeds at a lower return in a lower interest rate environment.

Interest Rate Risk

This is the risk that interest rates will change significantly from what was expected when the bond was purchased by an investor. If interest rates fall, the investor faces the possibility of early repayment if the bond is callable. If the bond is not callable however, the investor will experience a rise in the value of the bond, as other investors will pay a premium to purchase a higher yielding asset. Conversely, if interest rates rise, the investor will be holding a bond yielding below market rates, and a subsequent fall in the face value if it is sold before maturity.

3. Bond Ratings

Rating Agencies

There are a number of rating agencies around the world who rate bonds. The most prominent are Standard and Poor’s, Moody’s, and Fitch. These organizations rate an issuer’s ability to repay its obligations.

Ratings can vary from ‘AAA” to “Aaa” for high grade securities, with a very high likelihood of repayment, to “D’ issues that are currently in default. Bonds rated “BBB” to “Baa” or above are regarded as “investment grade. These issues are regarded as having a low default risk. Ratings below these, such as “BB” to “Ba” are generally regarded as “Junk bonds” which means that there is a significantly elevated risk of default.

Occasionally some issuers will not have their bond offers rated, in which case, it is up to the investor to determine whether the issuer is likely to meet their obligations.

4. Yield to Maturity

Bond yields are measures of return. The yield to maturity is the measurement most often used. It measures what the internal rate of return on a bond will be if it is held to its maturity date, taking into account all cash flows.

There are a number of other yield calculations that can be used to assess the performance of a bond. However, these are subject to a number of uses, which are usually the domain of investment professionals.

Summary

Bond markets can be a volatile and complex environment, and subject to as many dynamics and pressures of other sectors of the financial markets around the world. It is interesting to note that global bond markets are vastly bigger that share markets, but the latter are much more reported than bonds. At Accordia, the manager for the portfolios, Caliber Investments Limited, has the resources and research capabilities within their team to manage this vitally important asset class. This ensures that only appropriate high quality bond issues are used in our portfolios.

Our National Balance of Payments. What does it tell us?

The balance of payments is the record of all international financial transactions made by the residents of New Zealand. The Balance of Payments is recorded every quarter and annually. A balance of payments deficit means that we import more goods, services and capital than we export.

This leads on to New Zealand's current account. This is an important indicator of New Zealand's economic health. It is defined as the sum of the balance of trade of trade (goods and services exports minus imports), net income from abroad and net current transfers. In other words, it defines whether we are living within the collective means of the country, by earning sufficient foreign exchange to purchase goods and services from our trading partners.

Since the early 1980's, New Zealand has tended to have a deficit of 5 to 6% of Gross Domestic Product on its balance of payments current account. Many commentators think that this is unsustainable, while others observe that New Zealand continues to be able to borrow to make up the difference.

In the early 2000's there were sharp increases in our current account deficits. The New Zealand Dollar was floated in 1985. The floating currency should in theory, now ensure that balance of payments problems no longer occur as in the past because the currency self corrects. For example, a high demand for imports creates the demand for foreign currency to pay for these imports. This higher demand increases the price of that currency in New Zealand Dollars - a depreciation of the New Zealand Dollar. Consequently, a balance of payments deficit, which might have been created by the high import demand under a fixed exchange rate, may be pre-empted by a depreciating New Zealand Dollar, making imports more expensive.

In practice, balance of payments deficits have persisted in New Zealand, but the country has up to now, been able to borrow to cover them, thereby avoiding payments crises of the kind that were common before the 1980's.

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Caliber recently held meetings in Sydney with a number of current managers in the Accordia portfolios. These included Magellan, AQR and Blackrock. These managers are included in the Specialty component of the portfolios, and have an important role in providing additional diversification, but contribute to overall long term performance. They also have an important role to play in portfolio risk management. Caliber also visited potential new managers as part of the investment screening process for identifying new managers to meet on the research trip planned later this year.

Caliber is in the process of organizing the 2018 annual research trip to the Northern Hemisphere. This year, Mark Wooster and Michael Gray will attend meetings in London, New York, Greenwich Connecticut, and Toronto. The focus of the trip is three-fold. Firstly, they will meet with current managers such as AQR, headquartered in Greenwich, and the Blackrock team within the multi-opportunity sector of the portfolios. This will involve meetings in London and New York.

The second phase of the trip will be to meet other fund managers to explore new investment opportunities while they are in both cities.

The last part of the trip will involve attending a research conference in Toronto. This will be an important conference, with a focus on investing late in the economic cycle, bearing in mind that the U.S. Share market has had one of the longest runs in history without experiencing a bear market (a fall of 20% or more). The U.S. economy is into its second longest period of economic expansion without encountering a recession.

Other topics covered will include the outlook for China, the overall global economic environment, current and future investment strategies, and the geo-political environment. Of particular interest will be a keynote presentation by Janet Yellen, the former chair of the U.S. Federal Reserve.

The Caliber team will update our readers on the research trip in the Spring edition of Accordia Advantage.

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