Sparinvest

Monthly comment by
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Trump's steel tariffs haunt the financial market

The leading indicators are approaching a peak and as the share markets have already started poorly in March, investors should prepare themselves for having to reduce their tactical allocations to shares by the start of April.

After some weeks of living in fear of higher inflation and a faster tightening of fiscal policy than first expected, interest rates have moderated throughout the rest of February. Even the key figures, which have been slightly more inflationary than expected, have not had any mentionable effect on interest rates. The reaction seen in the interest market at the start of February was therefore an overreaction.

Nevertheless, U.S. state bonds have been in a downward trend since September and the VIX Index is still being traded at an increased level (over 20). Even though the share market came back strongly at the end of February, the start of March has been less inspiring, with a two percent fall in the first three days of trading.

Trump's steel tariffs are still bad news

One of the causes for the fall in the share market is probably Trump's announcement of concrete proposals for a punitive tariff on imported steel, the lower price of which he sees as evidence of unfair competition with US industry. To cap it all, the proposal was accompanied by an announcement that trade wars are good and easy to win.

Economists generally agree that these statements are an expression of rampant economic illiteracy, and the EU commission did not pass by its chance to compete with Trump by announcing a potential counter-move in the form of customs barriers if Trump's proposal is adopted. Among European shares, car manufacturers are particularly hit by Trump's announcements.

The trade barrier for Chinese imports to the USA also has the potential to cause other kinds of harm. The USA has a huge balance of trade deficit with China, which, given the disparate levels of development between the two countries, is perfectly natural. Since China joined the WTO, American consumers have benefited greatly from cheap Chinese imports – as has the USA's environment, which has been spared the burden of the heaviest industrial production.

"For now, we can only hope that Trump just needs to rattle the sabre"

There are still a great many potential advantages to be gained for both Europe and the USA through increased trade with China, and it would be something of a tragedy if Trump manages to derail trade co-operation. Consumer prices would rise and productivity would fall for both western and Chinese consumers.

A full-blown trade war could cause immense damage and have an extremely destabilising effect on the world's economy. For now, we can only hope that Trump just needs to rattle the sabre, and that small initiatives can serve as a symbol that his campaign promises are being honoured. This would allow both the EU and China to limit the damage by replying with equally small symbolic initiatives.

The Italian election

After the Italian election, it is clear the 5-Star movement is the main victor with approximately 37 percent of the votes. The other big winner was Lega Nord (now simply Lega). Now with 19 percent of the votes, Lega has outgrown its "little brother" role with its traditional partner, Forza Italia, which only received around 16 percent of the votes. These two parties went to the polls with a promise of standing together, but due to the constellation of the constituencies – and the 5-Star movement's great progress in particular – there is now speculation as to whether Lega will break its promise to Forza Italia and form a government with the 5-Star movement.

A very large majority of the 5-Star movement's politicians are untried, which is also a reason for its success. The movement started as a protest party and as a backlash to what many Italian voters regarded as incompetent and corrupt politicians in the traditional parties. The Italian economy is marked by very low growth, as over the past 10 years gross domestic product has fallen by 0.5 percent per annum. At the same time, the state is still operating with a budget deficit at the limit of the permitted three percent and a 131 percent debt in relation to GDP.

These challenges will have to be addressed by the coming government, and the worry has been that a government led by the 5-Star movement will not contain the necessary competencies required to increase growth and reduce the still quite high Italian unemployment levels. However, although the movement was only founded in 2009, it has had time to mature politically. In the election campaign, its messages were already being toned down in order to attract broader voter support – which is why a referendum on Italy's affiliation to the EU was not on the movement's 20-point programme in the election campaign.

> *"My assessment is that the election can in fact contribute to getting Italy back on course"*

At the present time, a coalition between the 5-Star movement and Lega seems most likely as these two parties have more common cause than one might first assume. Both are protest parties whose mandate rests on electoral mistrust of centrism, both within Italy and with regard to the EU. Although both parties have had marked resistance to the EU as cardinal points, these have evolved into more EU-sceptical positions. Both parties are declared opponents of the tidal wave of regulations that changing governments in Rome have subjected Italian businesses to, and both parties want to lower taxes, especially for businesses.

My assessment is that the election can in fact contribute to getting Italy back on course. The 5-Star movement may have been reluctant to show how it will finance its programme, but the movement's programme points are no less well thought out than those of the other Italian parties. Also, if there is a coalition, Lega's economic policy will be a stabilising factor.

The market's reaction has also been restrained, both in Europe and in Italy. In fact, it would be difficult to distinguish the market's reaction from more or less any other trading day. It is my assessment that the same mechanisms are at work as with the Brexit referendum and the election of Donald Trump: the media peddles a notion that a deviation from the traditional parties (who are actually responsible for the poor Italian results) would be a minor disaster. But after the election, the market's reaction is negligible because the assessment among those in the market is that the situation is unchanged, or perhaps even better than before.

Still a strong economy – but peak growth approaching

The good figures caused the rise in interest rates at the start of February continued for the rest of the month. The leading index from the Conference Board increased by a full percentage point in one month (January), which has only happened nine times since 2009.

> *"The second half of the year will be sluggish for both the USA and the Eurozone, where industrial production looks like it will decelerate sharply towards the end of the year"*

However, the leading indicators are about to peak. My prediction is we will see a peak for the USA within the next two months, and one a little later in the Eurozone. The implication is that growth in BNP is likely to peak at the end of the second quarter or the third quarter.

As previously mentioned, I expect that the second half of the year will sluggish for both the USA and the Eurozone, where industrial production looks like it will decelerate sharply towards the end of the year. I will, however, qualify this by saying that Trump's tax reforms have the potential to extend the recovery by several months. Still, it is difficult to see how the various confidence and expectation indicators can remain on the high levels that we are currently experiencing.

The return of inflation – but only slowly

At this stage of the business cycle it is normal to experience higher raw material prices, higher inflation and higher interest rates. This is due to the fact that growth in consumption is normally greater than growth in production at this part of the cycle. We are currently seeing these trends, but not to the same extent as the corresponding phases of previous business cycles.

Inflation will increase over the next six months

The ISM Price Paid survey, which reflects inflation expectations for U.S. company input prices, is at its highest level since 2011. This survey has a tendency to predict changes in U.S. inflation by about six months. This would normally mean that inflation would be slightly over three percent in six months' time.

This does not seem unrealistic as the trade-weighted value of the US dollar has fallen by around 13 percent since the start of 2017. My assessment is that inflation will increase over the next six months but the economic deceleration at the end of the year will cause inflation and inflation expectations to be more moderate.

The MomVol indicator and share allocation

Our MomVol indicator showed a value of 0.75 at the end of February, which is somewhat lower than the previous month's value. It is still above the 0.6 threshold, under which one should be underweight the stock market.

As the leading indicators are approaching a peak and as sock markets have already had a bad start in March, investors should be prepared to reduce their tactical allocations to shares at the beginning of April. For now, we must wait for further data.

Editorial deadline: March 8, 2018