Asset Allocation

This month's topic

Can global trade become an engine of growth with consumption, investment and fiscal and tax policies?

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Growth in the euro area is on the rise, reinforcing our opinion on risky assets in the zone. Investment is recovering little by little, consumption remains solid and the prospects of fiscal and tax support improve the prospects... trade is the missing part.

Economic growth is becoming more solid, particularly in the euro area, and it is legitimate to be relatively optimistic

Indeed, growth engines resurface one by one. Certainly, nothing spectacular at the moment, but a trend nonetheless interesting.

- **Consumption**, which is already quite robust, remains at a sustained pace Low inflation, low interest rates, but also the ability of the European countries to correct inequalities (an efficient welfare state), redistribute wealth and smooth out shocks, have made the euro area a more resilient area during the period of crises. The rigidity of the model has however one defect, that of slowing down the recovery phases. In sum, economic activity in the euro area is protected during the crisis phase, but slowed down in the growth phase. This partly explains the lag that the Eurozone may have experienced since 2009 (comparing to the US, for example), the other explanation of which is of course the onset of a second crisis, the debt crisis.
- **Investment**, sluggish since the Great Recession, also recovers softly.
- **Fiscal and tax policies** are on the way to accompany a little more the economic activity, thanks to 1) the margins of maneuver obtained by the decline in interest rates (which was not endangered by the French elections), 2) a stronger will to better fight the widening of inequalities, visible over the last decade, and (3) the gradual abandonment of austerity, which on the one hand are no longer necessary, and on the other hand, have not shown their inefficiency, especially on the political and social level.
- **Exports** remain, the last engine of growth, a rather stalled engine over the past decade, particularly since 2001. The trend remains sluggish, except perhaps for a part of the world, Asia.

It should be noted that in the last few years, growth – at low levels- has been mainly (or exclusively) based on consumption. It is in this sense that the relay of investment, fiscal policies and possibly world trade is crucial, as this has major consequences for financial assets:

All this confirms the investors - of whom we are - who have decided to remain overweight European equities (and risky assets) despite the electoral environment of France;

- Cyclical stocks should take advantage of the situation,
- Value themes remain relevant, especially in comparison with US markets,
- The outlook for profit is improving (see article n °6 of this review).

Can global trade, with investment, accelerate these trends?

First of all, let us return to the determinants of the downturn in world trade. No fewer than ten contraction factors can be highlighted (for more details, refer to

The essential

Growth in the euro area is on the rise, reinforcing our opinion on risky assets in the zone. Investment is recovering little by little, consumption remains solid and the prospects of fiscal and tax support improve the prospects ... trade is the missing part. Will it contribute to the acceleration of growth soon?

Not sure, given the structural headwinds that we have identified in this article. With regard to world trade, the "new normal" for the next 15 years may well look like the past five years (growth of world trade far below the growth of the world economy), not the 30 years which preceded this period (with world trade growth much stronger than world GDP growth.

Fiscal and tax policies are on the way to accompany a little more economic activity

The current environment reinforces the investors - of whom we are - who have decided to remain overweight in European equities despite the electoral environment of France

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our Discussion Paper: "The Global Trade Slowdown: Structural or Cyclical?", Amundi DP series # 22, May 2017).

1. **The decline in potential growth.** Potential growth across the world has declined, whether in Europe, Japan, the United States, China and most of the emerging countries. The "major" structural factors behind this falloff include, i) the decline in the working-age population and/or falling activity rates, ii) the massive increase in inequalities which severely impacts on potential economic growth, iii) the drop or stagnation of real disposable income (here we see the potential effects of wage and taxation polices), iv) the impact of the debt burden (constrained by the high levels of debts, lots of countries cannot counter economic cycles as they did in the past).

   1. **Weak investment**, investment being one of the key factors for the development of trade. Some believe that this is due to the severity of the financial crisis and lack of available credit for new companies. Others point to weak domestic demand, while still others suggest that broad demographic trends are to blame.

> "Tariffs no longer fall, and non-tariff measures proliferate"

2. **It would be hard for tariffs to get any lower,** which explains the stagnation in progress made in reducing tariffs and liberalising trade policies. The GATT and WTO negotiations resulted in substantial reductions in tariffs after the Second World War. Since the early 1990s, average rates in emerging countries have fallen by three-quarters to below 10%. Tariffs between advanced economies have been halved and are now below 2.5%. However, since the 2008 financial crisis, tariffs have remained generally stable between emerging countries, with rather modest reductions among advanced countries. Tariffs have been considerably reduced over the course of the last two or three decades. As they are now so low, trade agreements have less of an impact and serve more to create a framework for trade than to increase volumes.

3. **While tariffs continue to decline, non-tariff measures (NTMs) have been rising since 2012**. NTMs include all measures that restrict or distort trade flows, such as export subsidies, national clauses in public contracts and restrictions on granting licenses, technology transfer or FDIs. The financial crisis and the period known as the "great recession" (2008-2010) had major consequences on trade. It can easily be demonstrated that countries implement more restrictive trade policies during recessions or during periods when they are less competitive. Over recent years, it has been the G20 countries (with the US and Russia leading the way) which have introduced NTMs on a massive scale. The role of NTMs should not be overestimated because overall, their impact on the volume of world trade has been relatively modest, with average estimated tariff equivalents of all measures remaining low. There is, however, a clear trend. Germany, the United Kingdom, China and France, for example, which had around 50 NTMs in 2009, created around 200 since then. As for the United States and Russia, they have now over 600 NTMs (United States) and over 500 (Russia) in 2016 (with less than 100 each in 2009). What is striking is that since 2009, the number of discriminatory measures on world trade has become far superior to measures to promote trade liberalization

4. **The moderation of foreign direct investments** (FDIs) has also played a role in explaining the low growth in trade. Empirical data tend to suggest that FDIs and trade have a complementary relationship. Following strong growth in the 1990s, worldwide FDIs have fallen off over recent years, which could also be an explanatory factor for the modest expansion of world trade.

5. **A trend towards local production influences trade volumes**. Dynamic interaction between trade and foreign investment lies at the heart of globalisation as investments abroad generate trade, but they can also reduce it. Over recent decades, many companies have also introduced consumer-proximity strategies. This proximity means that there has been a shift towards local production which means that trade is drying up. What has happened is that in the 20th and 21st centuries, we have shifted from a form of trade that helps to "sell" goods to a form of trade that helps to

"manufacture" goods (this phenomenon is referred to as the global value chain). Over the last few decades, the rapid integration of the emerging markets into the world economy has stimulated the expansion of global value chains. This process of cross-border production fragmentation appears to be mature as labour costs in the main emerging markets have increased. Companies have also taken another look at the risks of long supply chains and are increasingly tending to produce within export markets.

6. **The development of services, in particular financial services, plays a not insignificant role**. Deciding to export products abroad means thinking about the substantial initial costs involved, such as an analysis of the export market and the establishment of international distribution networks. Working capital requirement is often much higher as a result of the longer periods involved in international transactions. Companies had to deal with these issues and costs early on in their contribution to globalisation, and they are – except for new entrants – well identified and already amortised. It should also be noted that international shipping takes longer than domestic shipping, which means that producers have to incur production costs before receiving any income. Exporters approach banks seeking assurances and payment guarantees. The development of the financial sector has always been considered as an important factor in bolstering export capabilities in a number of industrial sectors. Finance plays two key roles: it provides working capital to support international commercial transactions and it provides the means of reducing payment risks. Banking systems are highly developed in all countries: i) it is no longer necessary to approach foreign banks for these requirements, unlike in past periods which were dominated by US and UK banks; ii) however, since the financial crisis, these developments have experienced a hiatus which is not facilitating trade as much as before; iii) across the world, including in emerging countries, the rate of indebtedness has increased markedly – over two-thirds of countries have reached a private debt/GDP ratio of over 100%, a threshold which limits activity and trade. If one-third of countries with a ratio of below 100% could fill the gap, the impact on trade would be marginal.

> "The trend of local production affects the volume of international trade"

7. **The role of China in world trade** has changed substantially over the last decade. For over 20 years, China was the main supplier of consumer goods to the world. Accordingly, the very rapid development of China increased supply of and demand for trade. During this period, this development acted as a global supply shock. It contributed to the fall in relative prices of exchangeable goods and stimulated world trade. China very quickly became the largest consumer of raw materials (see graph below and in appendix). With the exception of oil and gas, China is the largest consumer of most raw materials in the world.

   Before the Great Recession, China expanded its export capacity considerably. It specialised in industries that were highly labour-intensive in which it had a comparative advantage in terms of production. This exports-driven growth strategy resulted in the rapid expansion of the manufacturing base in China, which sustained the growth of world trade. These factors are, however, diminishing: the current rebalancing of the Chinese economy and the shift in its model towards an economy that is driven more by consumption than by exports, have gradually slowed the growth of imports from China. This is how the income elasticity of demand for Chinese imports has dropped sharply, contributing to a falloff in world trade. Imports and exports fell sharply, as did market shares. The cause is the low level of competition during this period, especially wage rises, the arrival of new competitors and the appreciation of the real effective exchange rate in China (close to 25% since 2005). The Chinese exports sector (10% of worldwide exports), could quite simply have reached maturity (the exports/GDP ratio has continued to fall since 2010). Its export capacity has gradually been reduced as a result of its development and the rise in its production costs (China is no longer really competitive compared with Vietnam or Mexico for example). Its growth model has evolved and is no longer linked to world trade.

> "The current rebalancing of the Chinese economy, the shift from an export-led model to a consumer-driven model has gradually diminished the growth of China's imports, exports and market shares"

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8. **The structure of world trade has changed.** Empirical data show that composition effects have played a major role in the slowdown of world trade. Firstly, the shift in economic activity from advanced economies to emerging economies, which generally have weaker trade elasticities, has had a negative impact on the elasticity of world trade. This geographical composition factor is responsible for around half of the decline in world trade elasticity over recent years. Secondly, we see that trade elasticities have also declined in most countries. This composition of demand effects has also been a drag on world trade.

9. **The increase in behavioural protectionism and hostility towards free trade and globalisation have become tangible realities.** This is what the graph below shows (IMF). Here we see that emerging or developing countries are more favourable to free trade, and that the USA does not see many advantages in it, not in terms of job creation and even less so in terms of wage rise prospects. The temptation to "buy national" (and now even local), a "historical" trait of the Japanese, has spread across the continents.

The rise of behavioral protectionism and hostility towards free trade and globalization have contributed to the decline in trade

The 10 factors explaining the contraction in world trade and the prospects for development

Factor of contraction in world trade	Rationale	Trend reversal factors	Is a trend reversal credible?
1. Lower Potential Growth	Global growth pulls down global trade growth	Intensive use of pro-growth economic policies	Yes and no, because heavy factors (demographics, inequalities, debt burdens ...) drew potential growth downwards
2. Weak investment	Investment is a powerful driver of trade between countries	Low interest rates, profit prospects ...	Yes, because the investment is resurfacing
3. Low point hit on tariffs	Lower tariffs have taken place... trade agreements are now setting trade constraints more than lowering tariffs	A new wave of free trade	Not really, except for trade agreements between emerging countries, where tariffs are on average 4 to 5 times higher than in developed countries
4. Proliferation of non-tariff measures (NTMs)	Countries, notably the United States and Russia, have created new NTMs over the last decade, which represent a (moderate) barrier to trade	A reversal of protectionist attitudes	No ... this trend seems well established in many countries
5. FDIs decline	Foreign Direct Investment flows are usually accompanied by trade flows	A resumption of FDIs	Yes
6. Increased use of local production	The desire to get closer to local consumers, the need to produce cheaper, and the decision to produce locally eliminate by definition some of the trade	Producers deciding to produce in their home country, the decision to produce in the country and then export... tax incentives, overseas wages less attractive for producers, quality of the product?	Probably not even with tax incentives
7. Developments in local financial services	Use of local financial services avoids trade in services	Lack of trust in local institutions	No
8. New role for China and new growth model	China's growth model changes, and wage levels are no longer as competitive	A new model change	No, no risk... China is engaged in a more balanced, more diversified growth...
9. Changing patterns in world trade	Much stronger growth in emerging countries with lower trade elasticities	Collapse of emerging countries, no relay from "new frontier" countries...	Pretty little conceivable... the current trend is a heavy trend
10. Hostility towards globalization	Behavioral protectionism extends, as does mistrust on globalization, especially in advanced countries, a little less in emerging countries, and not at all in developing countries	A new confidence in globalization	Very unlikely, because the negative impacts are now clearly visible (employment, wages, distribution of wealth...)

Conclusion

Overall, world trade is no longer a growth factor and among the many factors explaining the weakest growth in trade (rising protectionism and massive use of non-tariff measures, China's new role, low investment, the floor reached on tariffs ...), some of them, and not the least, are structural. This suggests that **the "new normal" for the next 15 years may well look like the past five years (growth of world trade well below the growth of the world economy), not the 30 years prior to this period (Trade growth twice that of global growth).. The IMF examined the issue and assessed the challenges of the three groups of countries, advanced economies, emerging economies, and developing and low-income countries:**

- **Advanced economies** can further reduce remaining protection in traditional sectors such as agriculture and textiles, open up their service markets (e.g. transport), make their regulatory systems more coherent, and reduce boundaries of trade policy. To achieve this, these countries should instead adopt non-discriminatory approaches that minimize fragmentation and facilitate multilateral initiatives.
- **Many emerging and developing countries,** including Latin America and South Asia, can still benefit greatly from integration through traditional liberalization, including on a unilateral basis. They should seek to anchor their economies to global value chains, move away from import substitution policies and avoid protectionism through opaque non-tariff measures. Trade reform would complement the strengthening of policy and institutional frameworks.
- To foster development and growth, most **low-income countries** must prioritize trade facilitation in order to integrate into global value chains, in particular by improving their trade infrastructure and institutional structures. They should also tackle traditional trade barriers and promote competition in service industries that are essential to local participation in global value chains, such as transport and financing services. Technical assistance (e.g. international organizations) can support the development of the necessary infrastructure for this trade organization, identify the budgetary implications of the reform and help to sequence and coordinate the reform process.

A new impetus for global trade will require new trade agreements and closer integration of the countries of the southern hemisphere into the global economy. It will also be necessary that the protectionist temptations visible in many countries fade behind collective interests: it is indeed the struggle between the temptations to withdraw into oneself and the necessary international cooperation. **In other words, growth will henceforth depend more on consumption, investment and the policy-mix led by the government, fiscal and tax policies in particular.**

> The" new normal "for the next 15 years may well look like the past five years, not the 30 years that preceded that period

> In order to foster development and growth, most low-income countries must prioritize trade facilitation in order to integrate into global value chains

> A new impetus for global trade will require new trade agreements and closer integration of the countries of the southern hemisphere into the global economy

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Asset allocation

Summary tables

Asset allocation: multi-class outlooks and convictions

	1 month-change	---	--	-	0	+	++	+++
Equities/gov. bonds	→						■	
Corp. bonds/gov. bonds	→						■	
Equities/corp. bonds	→					■		
Duration	→				■			
Corporate bonds	→					■		
Oil	↘				■			
Gold	→				■			
Cash EUR	→			■				
Cash USD	→					■		

Asset allocation: relative outlooks and convictions by major asset class

		1 month-change	---	--	-	0	+	++	+++
Equities	US equities	→			■				
	Japanese equities	→					■		
	Euro equities	→					■		
	UK equities	→				■			
	Pacific excl. Japan	→					■		
	EMG equities	→					■		
Gov. Bonds	US bonds, short	→		■					
	US bonds, long	→			■				
	Euro core, short	→			■				
	Euro core, long	→				■			
	Euro peripherals	→					■		
	UK bonds	→			■				
	Japanese bonds	→			■				
Corp. Bonds	US IG	→					■		
	US HY	→					■		
	EURO IG	→					■		
	Euro HY	→					■		
	EMG debt hard currencies	→					■		
	EMG local debt	→				■			
FX	USD	↘				■			
	EUR	→				■			
	JPY	→				■			
	GBP	→			■				

The table above represents an investment horizon of six to 12 months. The changes reflect the outlooks expressed at our most recent investment committee meeting. The different lines provide relative outlooks for each major asset class and absolute outlooks for forex and commodities. The outlooks, changes in outlooks and opinions on the asset classes reflect the expected direction (+/-) and the strength of the convictions (+/++/+++). They are independent of the constraints and considerations concerning the construction of portfolios.

Macro Hedging Strategies

	one-month change	0	+	++	+++
Long US Treasuries	→		■		
Long Bunds	→	■			
Long USD	→		■		
Long JPY	→	■			
Long volatility	→		■		
Long cash USD	→		■		
Long Gold	→	■			
Long US TIPS	→	■			
Long puts equities	→		■		

The election of E. Macron to the French presidency and the prospect of an absolute majority in the legislative elections virtually eliminated the French political risk of the financial market environment. Discussions on the end of QEs (in the US, the Fed would be prepared to reduce its balance sheet) or the mitigation of purchasing programmes (the ECB would prepare a further reduction in its asset purchase program) are, with the Fed's monetary tightening and the risks of misleading communication the most important risks, currently. We keep some macro-hedging strategies in order to deal with them if need be, including long volatility strategies, long US Teasures.

The table above represents a short investment horizon of one to three months. The changes (column 2) reflect the outlooks expressed at our most recent investment committee meeting. The lines express our aversion to risk and our macro-hedging strategies. They should be viewed in relation to the asset allocation tables. A negative outlook in terms of asset allocation will not lead to hedging. A temporarily negative outlook (negative in the short term but positive in the medium term) may lead us to protect the portfolio, without affecting our long-term outlooks. The application of the strategy is expressed by a position (+), and the scale of the position is expressed by a graded scale (+/++/+++). These strategies are independent of the constraints and considerations concerning the construction of the initial portfolio subject to protection. These are overlay positions.

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