Trump, tariffs and trade

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Two inter-related issues dominate the economic and financial market outlook in the final quarter of 2018: the US midterm elections and escalating trade tensions between the US and China.

Midterm elections
The US midterm elections on Tuesday 6 November will provide a judgement on President Trump’s first two years in office. All 435 seats in the House of Representatives and 35 of the 100 seats in the Senate will be contested. The big issue is whether the Republicans will retain control of both houses; or whether one or both will fall into the control of the Democrats. In the latter case, the ability of President Trump to implement new policies would be curtailed; although overturning those already implemented would be difficult.

1. Midterm elections and President’s approval rating
It is unusual for the midterm elections to see seats gained by the party of the incumbent president (see Figure 1). That has only happened twice since 1982: in 1998 (when President Clinton was in office) and in 2006 (when George W. Bush was president). Both of those presidents had a very high approval rating at the time; in both cases the economy and stock market were strong, but, more ominously, in both cases the midterm elections were two years before a stock market boom turned to bust. President Trump’s approval rating is low – lower than that of any other president since the early 1980s. Yet, in common with the Clinton and Bush midterm elections, the economy and stock market are strong. A simple, albeit weak, relationship between approval rating and seats gained or lost (in both houses) suggests that the Republican party could lose as many as 50 seats.

A more detailed analysis shows that 43 seats in the House of Representatives and 7 seats in the Senate are hard to predict. The number is relatively low because, in the midterm elections, many seats are safe and voter turnout tends to be quite low. In that sense, losing 50 seats may be considered a ‘worst case’ for the Republicans. However, the 2016 presidential election itself showed just how unreliable standard polling techniques can be in predicting electoral success. President Trump pulls many surprises.

Tariffs and China
If President Trump’s first year in office can be characterised as one in which he failed to deliver on many of his election promises, the second year has seen a big catch-up, especially in the area of trade and tariffs.

2. US tariffs on China
The latest round of tariffs on China came into effect on 24 September (see Figure 2). They are imposed on almost US$200bn of imports from China, at a rate of 10%. President Trump intends to raise the rate to 25% on 1 January 2019 if a trade deal between the two countries is not reached. China has retaliated and the vast majority of Chinese imports from the US are now subject to tariffs.

3. US and China stock market indices
Although most economists would say no one wins in a trade war, President Trump clearly takes a different view. The stock market is his favourite barometer of success and on that basis, the US is ‘winning’. China’s main stock market index (see Figure 3) is down 20% from its peak, whereas the US S&P500 index has recently

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1 Source: Real Clear Politics and EFG calculations.
reached new highs. Furthermore, China’s economic growth has slowed recently, whereas US growth has picked up (see Figure 4). The US unemployment rate is at new lows and many voters have seen the benefit of personal income tax cuts this year.

A simple message that tariffs on China protect US growth and jobs, even though there is almost certainly no causal relationship, may well prove to be effective messaging for President Trump in the midterm elections.

Can this last?
Nevertheless, there are already signs that world growth is slowing and at least some of this is due to the disruption of global trade flows. In the 24 September tariff round, the goods covered are more difficult to replace with US domestically-produced goods so may well have a more disruptive effect on supply chains.

Furthermore, the US dollar has strengthened once again (see Figure 5). These developments may well start to constrain US economic growth and, we think, could lead to a tempering of the rate at which US interest rates are increased.

That could mean that the increase in government bond yields seen recently (see Figure 6) may already be discounting the likely increase in short-term interest rates that will take place in the Fed’s tightening cycle.

If that proves to be the case, then the pressure which a stronger dollar and higher US borrowing costs have exerted on emerging markets may well ease as we move into 2019.

US equity market
If that were to happen then it may well also provide support for the US equity market. One major source of support this year has been the extent of stock buybacks. Total authorised stock buybacks stood at US$741bn in the year to end-July, the highest ever amount, according to Birinyi Associates.

Looking in a much longer-term context, although the US equity market has recently reached new highs, the general pattern has been for long, essentially sideways movements in the market to be followed by long periods of appreciation (see Figure 7).
The strength of the US equity market, the rise in US Treasury bond yields and the pressure on several emerging markets were the important themes across asset markets in the first nine months of 2018.

Asset market performance
World equity and world bond markets produced modest positive and marginally negative returns, respectively, in US$ terms in the first nine months of 2018 (see Figure 8). Returns in US dollar terms were lower, in most cases, than in local currency terms given the general rise in the value of the US dollar.

The dollar’s strength was seen against most currencies, with the exception of the Swiss franc. Emerging markets were under pressure from the rise in US interest rates, the strength of the US dollar and country-specific issues (notably in Argentina and Turkey).

Most bond markets were adversely affected by the rise in US bond yields, with the benchmark 10-year US Treasury bond yield rising from 2.4% at the end of 2017 to over 3% at the end of September. Bond prices fall as yields rise, so negative total returns were seen in local currency terms across most bond markets (see Figure 9).

Australia and New Zealand bond markets ran counter to this general trend, with bond returns positive in local currency, although in both cases currency weakness meant these translated into negative returns in US dollar terms.

Overall global government bonds produced negative returns (-2%) in US dollar terms. Boosted by their higher income, the return from global high yield bonds was marginally positive (0.6%). Global corporate bonds, however, produced negative total returns of -2.7%, and global emerging market bonds of -5.1%.2

In the eurozone, most 10-year government bond yields were stable to slightly higher (German yields rose from 42 to 55 basis points) with Italy being the notable exception. Concern about political developments there saw a rise in bond yields, although pressures eased towards the end of the period.

Equity markets
The US was by far the strongest performing major equity market during the first nine months of the year, with total returns of 10.6% (see Figure 10). In local currency terms, India and Brazil produced positive returns; but in both cases this was offset by currency losses, making returns in US dollar terms negative. Total returns in the Chinese market were -9.0% in US$ terms, on the basis of the MSCI China index shown in Figure 10, which includes a large proportion of Hong Kong-listed stocks. Returns from domestically-listed Chinese stocks were weaker.

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2 All based on Merrill Lynch indices in US$ terms.
The US Fed is steering a course to higher interest rates, guided by assessments of the long-run and normal levels of several key economic measures. What do they suggest about the future path for interest rates?

Navigating by the stars
US Fed Chairman Jerome Powell recently described the conventional approach to setting US interest rates as “navigating by the stars”. With this approach, developments in the economy are assessed in relation to their long-run, neutral or normal levels to provide a signal for interest rates.

So, for example, the long-run potential growth rate of the economy, is termed y* (pronounced “y-star”); the natural rate of unemployment is termed u*; the long-run real rate of interest is r*; and π* (“pi star”) is the inflation objective.

Currently, the economy is growing at a faster rate than its long-run rate; and the unemployment rate is below its long-run rate. Both would suggest there is a danger of economic growth being too strong, inflation rising and hence the need for higher interest rates.

However, the long-term trend in the real interest rate has also come down over time: r* is now just 1% (see Figure 13). That is a real rate of interest, so adding to that the Fed’s long-run inflation projection of 2% indicates an equilibrium level of the nominal short-term interest rate of 3%.

These star values are not like those used by ancient navigators. Rather, they have changed over time. This is evident from the changing median estimates of their values in the Fed’s Summary of Economic Projections. The estimate of long-run real growth, y*, has trended down from 2.5% in 2012 to, currently, 1.9% (see Figure 11). Estimates of the long-run unemployment rate (u*) have fallen from 5.5% to 4.5% (see Figure 12).

Given that the Fed’s latest rate increase took the upper limit for the Fed Funds rate to 2.25%, this suggests there may not be much further to go in terms of rate increases.

Furthermore, while real GDP growth in the third quarter of 2018 may again be close to the 4.2% rate seen in the second quarter, after that growth looks set to slow towards its longer-run rate. Partly, that is likely to be a result of slower world trade growth under the impact of trade tensions and tariffs.

Additionally, it is due to the lagged effect of the interest rate increases that have already taken place and that are also already starting to impact domestic growth.

A softer tone
For these reasons, later in 2018 and into next year, we expect to see a softer tone in expectations for short-term US rate increases.

That would suggest the rise in longer-term government bond yields may not progress much further. If so, that would underpin the equity market and provide relief to emerging markets.
Late 2018 and early 2019 will see the focus remain very firmly on the terms of the UK’s exit from the EU, which is scheduled to take place on 29 March 2019. Uncertainty remains high.

**Path to Brexit**
There are many ways in which the Brexit situation could evolve over the period up until the UK’s formal withdrawal from the EU on 29 March 2019.

It could be that, contrary to current expectations, the process goes smoothly. That would involve Prime Minister Theresa May coming to an agreement with the EU on the terms of withdrawal at the EU Council meeting on 13 December, the withdrawal agreement being passed by the UK parliament and ratified by the EU parliament in early 2019 and the UK starting its transition phase on 30 March 2019.

In that phase the UK would continue to adhere to EU rules. That transition period is scheduled to last until 31 December 2020, with the UK’s new relationship with the EU starting on New Year’s Day 2021.

However, there are many other ways in which UK-EU negotiations may evolve: a deal may simply not be agreed; there could be a general election with a possible change of government; it is still possible that there is an extension to the two-year withdrawal process; and there could be a second referendum on Brexit.

**Sterling and equities**
Sterling has been the key barometer of success in the negotiations – weakening when the negotiations are not going well. Given that more than 70% of the revenues of companies in the FTSE100 index come from overseas, that index has typically risen as sterling has weakened (see Figure 14).

The loosest type of arrangement being considered is a Canada-style free trade agreement with the EU. With such an agreement, there would be no tariffs on EU-UK trade and the UK would be able to set its own regulations and immigration and trade policies. Trade with the rest of the EU would be impeded by various non-tariff barriers, however.

The next few months will be a difficult period for UK-EU relations. The most likely outcome, we think, is that some modification of the Chequers plan is agreed.
Just as the Greek crisis was finally deemed over, tensions in the eurozone have re-erupted. Italy is the focus of attention, with concerns about it adhering to EU budgetary rules.

### Italian tensions
For many years after the euro’s formation in 1999, Italian government bonds were seen as hardly riskier than German bonds. The yield spread between the two was small (see Figure 16). Recently, however, in response to concern about the new government’s policies, the spread has widened out to levels last seen during the eurozone crisis.

#### 16. Government 10-year bond yields: Italy and Germany
![Graph showing the bond yields of Italy and Germany](source)

The concern is that the coalition government (of the anti-establishment Five Star Movement and the right-wing League) has agreed a budget which will see the government’s deficit rise to 2.4% of GDP. Although still within the 3% limit set in the EU’s Stability and Growth Pact, the move is a significant fiscal expansion. It will fund Five Star’s pledge for a ‘citizens’ income’ for the poor and the League’s pledge for tax cuts. Accumulated debt is well in excess of the 60% eurozone limit (see Figure 17). The European Commission will review the budget and can, in principle, reject it; but that seems unlikely.

#### 17. Government debt in Italy and Germany
![Graph showing government debt](source)

Italy has a much bigger economy (almost ten times larger) and bond market (more than six times larger) than Greece, so the potential for disruption if things were to go awry is much greater.

### Eurozone in aggregate
The aggregate picture of the eurozone is one of relative tranquillity: growth is expected to slow a little in the coming years to just under 2%; inflation is expected to pick up a little to almost 2% (see Figure 18). But it is the divergence within the eurozone (see Figure 19) that is increasingly an issue.

#### 18. ECB growth and inflation projections
![Graph showing ECB projections](source)

Although German growth has been strong and is well above its pre-crisis peak, its performance has been exceeded by two economies outside the eurozone: Switzerland and Sweden. That maybe illustrates that issues lie with the eurozone itself.

#### 19. European GDP recovery
![Graph showing GDP recovery](source)
Almost six years after the election of Shinzo Abe as prime minister, Japan’s economy has seen remarkable change in some respects. Yet two of the three aims of Abenomics remain elusive.

Abe on-track to be the longest-serving prime minister
After Shinzo Abe’s re-election as leader of the Liberal Democratic party in September, he looks likely to remain as prime minister until the Tokyo Olympics in 2020 and even beyond. That puts him on track to be Japan’s longest-serving prime minister ever. When he came to power, his policy of Abenomics had three key ‘arrows’: to achieve 2% inflation, to consolidate fiscal policy and bring about structural reform of the economy.

Inflation and interest rates
The 2% inflation objective remains elusive. Despite continued easy monetary policy, underlying inflation remains only barely in positive territory. Formally, the target remains intact but few expect it to be reached. There has been no substantial change in monetary policy for almost three years, with the official interest rate kept at -0.1% and government bond purchases at Yen 80trn per year. The target range for the 10-year bond yield was widened to 20 basis points around zero in the summer (see Figure 20). Some saw this as a sign of a modest tightening, but in practice bond yields have been little changed and the impact on the economy is unlikely to be great.

Fiscal consolidation
There has been limited progress with fiscal consolidation. Government debt is no longer rising as a share of the economy, but at well over 200% of GDP it is far above the level in all other developed economies. An initial phase of reform saw the sales tax increased to 8% in April 2014. But the second increase, to 10%, has been delayed several times and may still not go ahead, as currently planned, in October 2019.

Nominal GDP and the yen
Despite these disappointments, the economy has done well. Nominal GDP (taking into account real growth and the rise in prices) has expanded by 12% since Abe’s election. Considering that there was no growth in this measure for the two decades beforehand, the change is significant.

Partly, that growth was due to the sharp weakening of the yen which started immediately Abe was elected. This took the yen from a range of Yen75-85/US$ down to Yen115-125/US$, which helped boost exports and corporate profits.

Although the yen then recovered, we think a return to that weaker range is still likely (see Figure 21) especially if the dollar continues its general strengthening and concern about a global trade war intensifies.

Structural reform
Although a weaker yen has been helpful in boosting corporate profitability, credit needs to be given for the success of Abe’s third arrow of structural reform.

First, there has been a big increase in female employment. This has required significant cultural and legislative changes. Second, the number of foreign workers has increased, many of them on student visas (typically to study at a Japanese language school) which allow them to work up to 28 hours a week. Third, there has been an improvement in corporate governance, modelled on the UK stewardship code.

Equity market
These structural changes have been an important driver of the equity market. The broadly-based Topix index is twice its level at the time of Abe’s election but is still not, in our view, expensively valued. Japan, like other economies in Asia, is vulnerable to an escalation of trade tensions. But domestic reforms have put the economy on a firmer footing to withstand such headwinds.
As trade tensions between the US and China escalate, Asian economies are generally in a better position to withstand an external shock than in the past.

**Current account positions**
Generally, we see Asian economies as now more resilient to external shocks, such as a downturn in world trade caused by a tariff war, than in the past. Our emerging market risk scoring, which takes into account a broad range of economic, financial and credit risks, shows no major Asian economy at particularly high risk. India and Indonesia, two of the ‘fragile five’ in 2013, have notably improved on their scores since then. Both economies now have much smaller current account deficits than at that time (see Figure 22).

![22. Asia: current account balances](image)

However, this has not prevented both of them experiencing recent currency weakness. This may suggest that the threshold at which such current account deficits result in currency vulnerability is lower than in the past. It used to be the case that vulnerabilities increased when deficits exceeded 4% or 5% of GDP, but India this year should have a deficit of only 2.5% and Indonesia a deficit smaller than that.

**India’s tariff increase**
Policy makers in India are certainly concerned. India relies on imports for around 80% of its energy needs. Higher oil prices and a weaker rupee have pushed up the cost of those imports. To try to correct the deficit, the government has raised import tariffs on 19 ‘non-essential’ imports – including jet-fuel, a curious choice for such a ‘non-essential’.

The use of such tariffs, in an economy which already has one of the highest external tariff rates in the world, raises a deeper concern for those wanting to see evidence of a more free-market approach.

**Government finances**
India is also constrained in its ability to boost the economy by fiscal expansion, notably because of the deficit on its primary government budget (that is, the measure excluding interest payments). China is also restrained in this respect: it has an even larger primary deficit (3% of GDP, see Figure 23). Furthermore, in China the emphasis is on restraining, not easing, credit growth and debt levels across all sectors of the economy.

![23. Asia: government primary balances](image)

**World trade growth**
Asia as a region is still very export-dependent. Economic growth, corporate earnings and the equity market (see Figure 24) would inevitably be affected by a downturn in world trade and economic growth brought about by any escalation of the trade war. And although the region is generally on a much sounder footing than in 1997 or 2013, the ability to respond to an external shock with easier domestic policies is limited.

![24. Asian equities and world growth](image)

In selected equity markets in the region (such as Hong Kong), these risks and concerns seem to us to have been discounted.
Argentina has agreed a new package of measures with the IMF. The “best economic team in the past 50 years” is intent on putting the economy back on track. Regaining confidence, however, will be no easy task.

**Third time lucky?**
President Macri of Argentina has had three finance ministers and three central bank governors since taking office in December 2015. He has often claimed to have “the best economic team in the past 50 years” but that did not prevent a currency crisis and, now, a renewed IMF bailout.

The currency has halved in value since the start of the year and interest rates are at 60% (see Figure 25). It is hoped that the currency can now stabilise and interest rates start to come down. But once financial markets have lost confidence in an economy, it is typically hard to regain.

That interaction has been seen this year. The currency weakness that began in April brought a sharp increase in interest rates by the central bank in an attempt to protect the value of the peso. That hit consumer and business spending hard, with the latter also adversely affected by a drought which hit agricultural exports.

The economy contracted by 4.2% year-on-year during the June quarter. Argentina has issued US$80bn in US dollar sovereign bonds to finance its fiscal deficit in recent years, which will be much harder to re-finance or repay given the sharp fall in the peso.

The expanded IMF package (US$57bn) comes with some typical IMF conditions and some new ones. Fiscal tightening is required with a zero deficit budget required for 2019. Inflation targeting has been replaced by monetary targeting. Monetary targets were, of course, abandoned by most developed countries in the 1980s when they were often seen as unworkable: maybe this time will be different for Argentina?

The measures are, clearly, unpopular and it remains to be seen whether they can be implemented successfully. The next Argentine general election takes place on 27 October 2019: that does not provide long for conditions to stabilise or, even, recover.

**Mexico**
Although Argentina and Venezuela attract much attention when foreign observers look at Latin America, other economies are generally much better run. Many have fiscal rules which constrain government excesses and have central banks which are well run. Mexico, for example, despite being the focus of much of President Trump’s ire, has seen a relatively stable currency, success in bringing down inflation and a bond market which offers an attractive yield in such circumstances (see Figure 27).

George Soros developed the concept of ‘reflexivity’ to describe the difficulties of managing an economy in such circumstances (see Figure 26). Market perceptions of conditions, whether accurate or not, can have a powerful effect on actual fundamentals; and those fundamentals can feed back to market conditions and perceptions, in an adverse feedback loop.
Disruption of existing working practices is being seen in many sectors of the economy. So far, there has been relatively little impact on the healthcare sector. We think that is about to change.

The healthcare sector has become progressively more important in all economies around the world in recent years. In the US, the sector has become the largest employer, with more people employed in it than in manufacturing or retail trade (see Figure 28).

### 28. US employment in healthcare

![Bar chart showing US employment in healthcare, manufacturing, and retail trade from 1970 to 2015.](chart)

US healthcare spending amounts to 17% of GDP (see Figure 29), almost twice the OECD average. In 1960, such spending was just 5% of GDP. Growing healthcare spending, partly as a result of ageing populations with longer life expectancy, and partly because of the improved technology now available, is an issue in advanced and emerging economies alike.

### 29. Healthcare expenditure: public and private

![Bar chart showing healthcare expenditure by public and private sectors in selected countries from 1970 to 2015.](chart)

US healthcare

Although many perceive the US healthcare sector as one with relatively little public sector involvement, spending is broadly equally split between the private and public sectors. Public sector provision covers four health insurance programmes. Medicare, which provides health insurance for those who are aged 65 and over or who have disabilities; Medicaid (which helps with medical costs for some people with limited income and resources); the Children’s Health Insurance programme; and marketplace subsidies under the Affordable Care Act (‘Obamacare’). In total, spending on these amounted to US$1trn in 2016, more than a quarter of federal government spending.

Over the last twenty years, price inflation for medical care and hospital services in the US has run well ahead of general price increases. Furthermore, there is a mounting concern that many of the services provided are not strictly necessary.

The US National Academy of Medicine estimates that the US healthcare system wastes US$765 bn per year (one quarter of all the money spent) on unnecessary or needlessly expensive care.

In 2015, an investigation by an independent research firm found that since 1980, the number of CT scans had grown from fewer than 3 million to more than 80 million, with a third of them judged unnecessary. Warren Buffet regards such high levels of healthcare spending as a serious impediment to US companies’ competitiveness in world markets.

**Competition and digitisation**

What can be done to curtail costs and provide a more efficient service, not just in the US, but globally? The solution, we think, is on two fronts.

First, greater competition. In the US, for example, the provision of healthcare can be very fragmented, with few providers in some states, limiting the scope for competition. A new joint venture between Amazon, J P Morgan and Berkshire Hathaway is a key development in this respect.

Second, digitisation, which would further help competition. Digitisation can take three main forms. Making healthcare records available in digital form; using digital technologies in the management of that information (for example, in identifying diseases and medical conditions); and digital transformation – developing new forms of digital technology. In the latter category, enhanced facilities on smart phones and watches are a rapidly-developing area.

We think we are just at the start of exciting new developments in this sector. Even more important than the investment opportunities they provide, they have the potential to improve the wellbeing of mankind.

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1. Source: Reuters Buffett targets CEO for Berkshire-Amazon-JPMorgan healthcare venture 5 May 2018.
2. Washington Post Millions of people have CT scans that serve little if any medical purpose 20 April 2015.