CIO Strategy Bulletin

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Asked and Answered: Your Questions

China, the US Election and Trade Wars, Ukraine, and Whether Investors Should Go Away in May

Our clients have many great questions that reflect a wide range of uncertainties that are generally always present. This week, we address questions on investments in China, Europe, US trade policy and elections.

Have Chinese equities bottomed? We believe the answer is "yes". The bigger question is how long can this rally last? The longevity of the rally would depend on a potential rebound in earnings growth as current valuations remain historically low.

What if the US pursues a trade war with China again? A tit-for-tat trade war could lead to another round of fears over consumer prices in the US. The possibility of a renewed "US/China trade war" with retaliation on US companies operating in China is a risk we must account for in our asset allocation. However, a very large increase in tariff collections in 2018 had remarkably little impact on price measures.

What would a fresh Russian offensive into Ukraine mean for Europe and global markets? European leaders are gearing up for the defense challenge with increased spending to shield "against the winds of political change." NATO Secretary-General Jens Stoltenberg has proposed a US$100 billion, five-year fund for Ukraine. However, geopolitical shocks and threats to security have generated remarkably few cases of lasting impact on a global scale.

Should I sell in May and go away? The third quarter of the year has the weakest on average historic return for equity markets. Yet selling the S&P 500 in May and buying back in November would have underperformed a "buy and hold" strategy by about 1.4% per annum since 1990.

What can investors do ahead of potential US Election related volatility? With key US bond yields literally 10X higher than 2020 lows, a balanced portfolio of bonds and equites together should see diminished correlation and stronger risk adjusted returns. Beyond this, direct hedging costs remain near all-time lows.

Potential Portfolio Implications

Risk events, and what it does to investments, can lead to sub-optimal decisions. With a number of events on the horizon, investors might be tempted to wait it out. In our view, investors need to stay invested. And it begins with a balanced and diversified portfolio comprised of investments that do not move precisely in lockstep.

Our own view of US indices is moderately bullish – but with higher volatility likely. If correct, an investor may be well served by coupling downside protection at the cost of limiting upside return for a period. For the S&P 500, we expect new record highs in EPS in both 2024 and 2025. However, an index return as strong as last year's 26% seems unlikely.

On China, we have highlighted several outstanding long-term challenges. However, the price to pay for a potential return to earnings growth remains historically low amid a more stable time for the Chinese market.

Answers To Your Top Questions

Q1: Have Chinese Equities Bottomed?

We believe the simple answer is yes. The bigger question is how long can this rally last? The recent rally is well supported by macro data, property and tech policy easing, capital market reforms and fund inflows from government and private sources. Several structural problems we're watching have not been addressed but may be mitigated. The longevity of the rally would depend on a potential rebound in earnings growth as current valuations remain historically low.

We believe that China is returning to a more normal range of valuations after the worst bear market in two decades. This is because the domestic policy and macro backdrop has stabilized, which could enable the return of earnings growth. Structural impediments and external risks remain but investors could still find lucrative opportunities as we potentially enter a stable era for China equities.

First, the rally so far has been well supported. Macro data such as manufacturing PMI, where March activity was strongest in 13 months, tourism, and exports have shown some improvement. But deflation and unemployment remain challenging. Perhaps most importantly, investor inflows have turned positive. The so-called "national team", including sovereign funds and large state-owned enterprises, invested both in the onshore A-share market via ETFs and in the HK-listed market. Then, during the Labor Day in early May, foreign funds entered the HK market, as well as the US listed ADRs. Some of these flows went to cover short positions, but whether more investors follow through would depend on how corporate earnings shape up.

Better Policies, but Structural Impediments

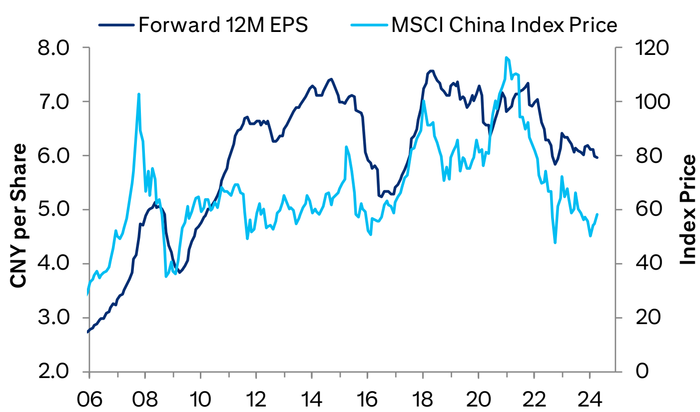
Property policies have eased notably, with the Politburo, the highest decision-making body in the Chinese government, aiming to "digest housing inventory". Major cities have lifted purchase restrictions, and the central government is planning to fund local governments with special bond issuances while pausing land sales. Tech regulations may be seeing some respite, particularly on data security. Looking forward, the Third Plenum planned for July (rescheduled from last November) may reveal additional policies to restore economic growth.

That said, the structural impediments to investing in China have not yet been addressed. China's policies to boost self-sufficiency and industrial upgrades are producing overcapacity and exporting deflation. This has increased trade tensions. Potential US protectionism remains a risk, particularly to the Chinese yuan. However, President Xi's visit to Europe did bring about some curbs on its own battery production capacity, which is a good signal. Meanwhile, the US share of Chinese exports had already fallen from 20% in 2017 to 15% now as businesses find other markets and channels.

So far, earnings remain in the doldrums (**FIGURE 1**). 2023 annual reports gave no hints of stronger corporate outlooks. Consensus estimates were revised lower year-to-date for all sectors except Consumer Discretionary, which reflected the recovery in travel and leisure. First quarter results are being reported now, but recent policy shifts are unlikely to be reflected in these numbers until the next quarter.

Looking at past several rallies, those that were followed with earnings growth (2009-11, 2016-17, 2020-21) lasted one to two years, while those that weren't supported by earnings (2014-15, 2022-23) fizzled out in about six months. Still, the price to pay for a potential return to earnings growth in China remains historically low. MSCI China forward PE ratio just rebounded to 10.2x, which is still at the bottom of the range of the past two decades (**FIGURE 2**). A potential return to 10% EPS growth and average valuations would be about 21% higher on the index.

FIGURE 1: Earnings expectations have yet to respond to recent positive developments



Source: Bloomberg, as of 8 May 2024.

FIGURE 2: Chinese equity valuations remain compelling, if earning growth follow through

Source: Bloomberg, as of 8 May 2024.

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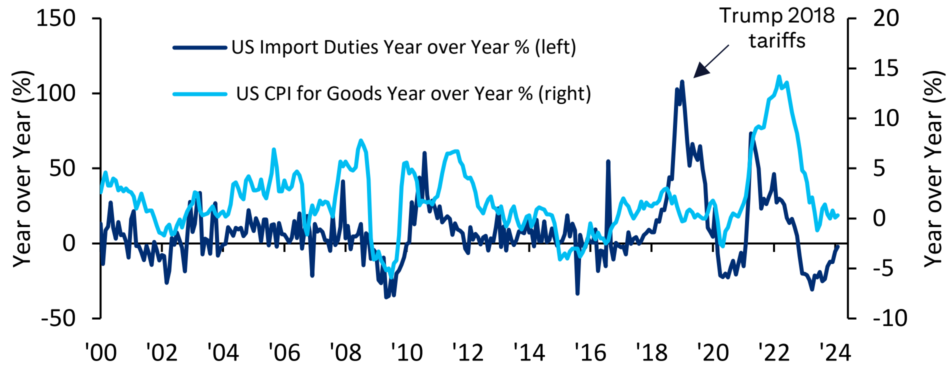
Q2: What if the US pursues a trade war with China again?

Tariffs and defense alliances could differ widely post November, depending on which nominee wins the US Presidential election. Potential changes will have to be discounted by investors.

Candidate Trump has again pledged large tariff increases that might amount to as much as 2% of US GDP, paid for by importers of foreign goods and some services. This includes a 60% prospective tariff on China and 10% for all other trading partners, regardless of existing tariff agreements (please see the section above on China's US trade share). Like 2018, its imposition is likely to lead to tit-for-tat retaliation. President Biden is also reportedly considering severe but more targeted tariffs on electric vehicles along with other key clean energy materials. This is not, however, where the largest risk lies. It's consumer price and inflation expectations in a world that has recently experienced negative, and sometimes crippling, consequences of higher inflation.

Yet as **FIGURE 3** shows, the sharp increase in tariff collections in 2018 delivered remarkably little impact on consumer prices. The same was true of wholesale prices. Modelled estimates of potential forthcoming tariffs should bear this experience in mind. Large tariff increases might also offset other forms of US fiscal tightening, allowing for Federal revenue gains without some other forms of increased taxation. However, the scale of the proposed increase on Chinese goods imports is dramatically higher than any in recent history and is enough to make a substantial amount of trade with China uneconomic. It may catalyze a weaker Chinese currency and asset price movements.

FIGURE 3: Customs duties % change vs CPI



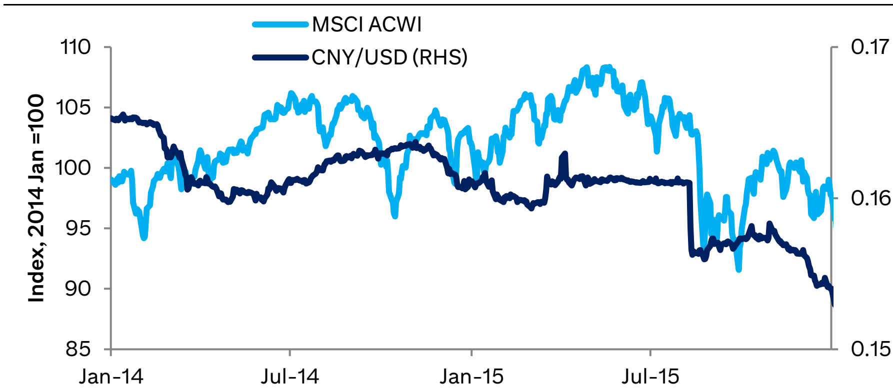
Source: Haver analytics through May 9, 2024. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees, or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

As **FIGURE 4** shows, a lurch lower in China's currency in 2014/15 had a dramatically larger, if short-lived impact on global equities than the scale of the exchange rate movement itself.

The possibility of a renewed "US/China trade war" with retaliation on US companies operating in China is a risk we must account for in our asset allocation.

In our view, portfolios should be constructed for a range of possible positive and negative outcomes in mind, not just the highest returns. Growth amid concerns over trade continuity, civil unrest, security risks and technological possibilities - such as a state-sponsored cyber-attacks - call for a combination of higher and lower risk investments in portfolios. Fortunately, growth and solid yields for safer income now coexist (please see last week's bulletin). We have also argued for hedging portfolio risk as hedging costs are historically low.

FIGURE 4: CNY/USD vs global equities 2014-2015



Source: Bloomberg as of May 7, 2024. Data rebased to 100 as of January 1, 2014. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees, or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Q3: What would a fresh Russian offensive into Ukraine mean for Europe and global markets?

Geopolitical risks are elevated in Europe. However, the situation has been broadly stable for some time allowing financial markets to focus their attention on the improving global corporate earnings narrative and expectations that global central banks will soon begin easing.

In the fairly near term, financial markets could have to pay more attention to the war in Ukraine, with the biggest risk being a significant summer offensive by Russia, In the meantime, Ukraine is telling its allies it needs more ammunition and defense hardware. It is also seeking the release of delayed promised financial assistance from the US and Europe.

The money for Ukraine was being looked at very seriously in Europe in April as NATO foreign ministers met in Brussels to mark the 75thyear anniversary of the US-led alliance. On the agenda was the coordination of arms supplies to Ukraine, a process which is currently managed by the US. This might be at risk if Trump wins in November (please see the section just above).

According to the Financial Times, one of the dominant concerns for NATO is to shield the “mechanism against the winds of political change”, prompting NATO Secretary-General Jens Stoltenberg to propose a US$100 billion, five-year fund for Ukraine.

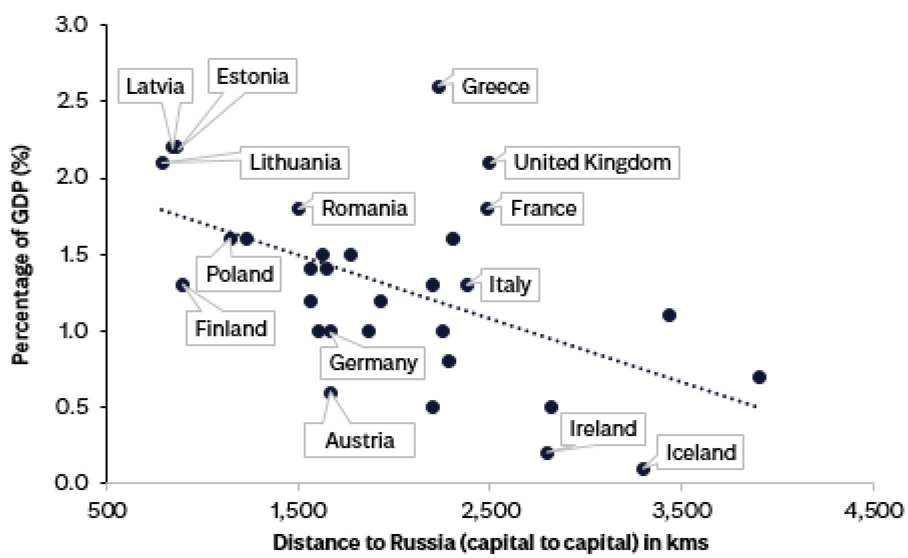
Russia’s expected counter-offensive in the summer of 2024 could worry investors. The hope is that the provision of supplementary military aid and financial assistance to Kiev will avoid a negative scenario. The risk of escalation remains sizeable and would most likely weigh on the euro and dampen appetite for European assets after a period of positive surprises for the region.

Defense Spending to Rise in a Less-Than-Ideal World

We believe that European defense spending will increase sizably in the coming years, irrespective of who the next US President will be. Broadly speaking, countries further east on the continent spend more on defense as a percentage of their GDP. The need to be compliant with NATO commitments will see expenditure on defense equipment increase materially (see **FIGURE 5**).

The war in Ukraine is forcing many European governments to rethink how much should be spent to help Kiev and for how long. We think that there is a growing possibility of common debt issuance to finance EU support for Ukraine and renewed focus on common defense programs and joint procurement.

FIGURE 5: Eastern skew among countries meeting their 2% of GDP NATO defense spending commitment.



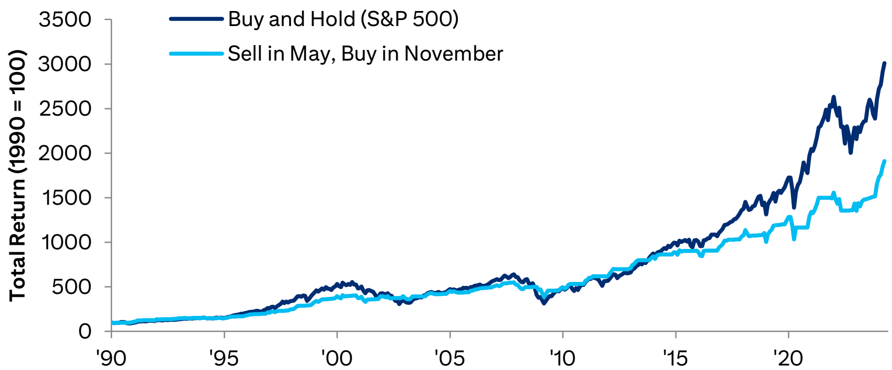
Sources: Eurostat and Citi Global Wealth Investments, as of March 28, 2024.

The lasting focus on deterring Russia may ultimately boost defense shares. But what will it mean for global markets more broadly? As we’ve showed previously (see our April 14, 2024 Bulletin), geopolitical shocks and threats to security have generated remarkably few cases of lasting impact on a global scale. Only the advent of World War II and the OPEC embargo 50 years ago catalyze a negative turning point in the world economy.

Q4: With so many risks visible on the horizon should investors "Sell in May and Go Away"?

While the third quarter of the year tends to exhibit the poorest seasonality, strategies that attempt to avoid potential summer selloffs have a mixed track record. The famous adage “sell in May and go away” is based around the fact that the best six months for US equity returns tend to be between November and April. However, an investor who actually heeded this advice over the past 34 years and moved into cash from May to October would have underperformed by about 1.4% per annum (**FIGURE 6**).

FIGURE 6: Sell in May and Go Away Doesn’t Outperform Buy and Hold



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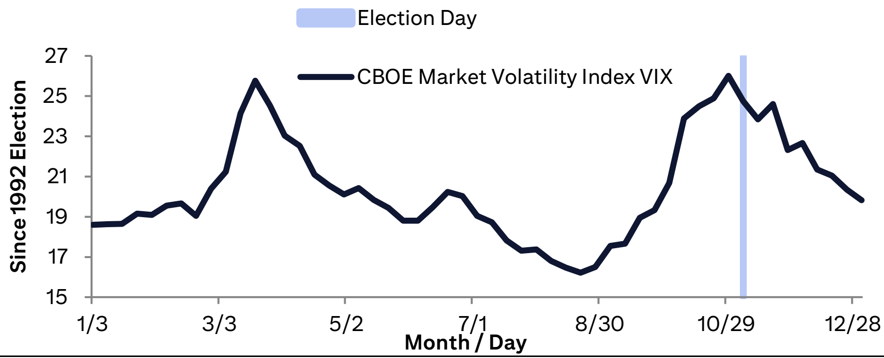
Q5: What can investors do ahead of potential election-related volatility?

Historically, volatility has indeed picked up into US Presidential elections, often peaking just beforehand, and then it has receded (see **FIGURE 7**). Since this is often temporary, many investors with longer-term time frames may choose to simply endure the ups and downs. That said, the first line of defense is a balanced and diversified portfolio comprised of investments that do not move precisely in lockstep. With some US investment grade bond coupons yielding literally 10X the record low of 2020, we should be expecting the correlation of stocks and bonds to be coming down from the pandemic period. This should allow asset allocation - the combination of low-risk bonds and high-risk equities - to yield stronger *risk-adjusted* returns.

Depending on suitability, investors can also tap into derivatives strategies that provide downside shielding in portfolios. Doing so when expected volatility is low best (historically priced as it is now).

Our own view of US indices is moderately bullish – but with higher volatility likely. If correct, an investor may be well served by coupling downside protection at the cost of limiting upside return for a period. For the S&P 500, we expect new record highs in EPS in both 2024 and 2025. However, an index return as strong as last year’s 26% seems unlikely.

FIGURE 7: A coming election day tends to drive a spike in market volatility election year averages of daily data for VIX



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Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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Individual funds will have specific risks related to their investment programs that will vary from fund to fund.

Asset allocation does not assure a profit or protect against a loss in declining financial markets.

The indexes are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance.

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