LOMBARD ODIER
INVESTMENT MANAGERS

Investment viewpoint

Trump takes on tech and trade

Asset Management

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After stabilising in mid-February, equity markets are once again correcting. We believe the driving forces behind the current correction are:

1. Increased concerns regarding US trade policy and the associated rising risk of a global trade war; and
2. The fallout from the Facebook-Cambridge Analytica scandal; namely, the potential impact of increased governmental scrutiny on big technology corporations' way of doing business. In addition, President Trump's continuous attacks on Amazon and questions regarding Tesla's use of cash are also weighing on the tech sector.

Despite the increase in market volatility and the equity sell-off, we believe the underlying global macroeconomic outlook remains positive. Here, we look at some of the recent macro risks in the context of investment markets, and discuss developments that we believe investors should keep an eye on.

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Technology stocks – more stock-specific than macro

In recent days technology stocks have come under significant pressure, dragged down by the sharp fall in so-called "FAANG" stocks (Facebook, Apple, Amazon, Netflix and Google).[1] Exposure to momentum risk has played a role. However, the potential for increased regulatory scrutiny is the real driving force behind the stock price moves of these mega-cap tech stocks.

We think the most serious case among the various bottom-up stories is that of Facebook, where potential changes in privacy laws in the wake of the Cambridge Analytica scandal have the potential to put into serious doubt Facebook's current business model – a model predominantly based on monetising user data.

Beyond the emerging questions around Facebook's long-term fundamental value lie broader concerns. Fears of wider regulations (e.g. tax treatment of e-commerce) and the contagion effect within the whole sector – and, by extension, the market – are noteworthy. In our view, these concerns are connected to both current high valuations and past momentum, i.e. the technology sector is a recent winner in terms of performance. We do not think that the current wobbles (which may continue) pose any macro threat per se, especially as the nature of different tech businesses varies widely and any regulatory shifts – which are still uncertain in terms of scope and timing – are likely to focus on individual companies.

[1] Any reference to a specific company or security does not constitute a recommendation to buy, sell, hold or directly invest in the company or securities.

LIBOR-OIS – benign explanations behind the "death spread"

In the fixed income space, the sharp rise in the USD LIBOR-OIS (London Interbank Offered Rate -Overnight Indexed Swap) spread has started to attract a lot of attention. This so-called "death spread" was a key barometer of systemic risks in the financial sector during the 2008/9 crisis. We agree with the emerging consensus that the current sharp rise in this spread is driven by market-specific factors and has little informational value in terms of the health of the financial sector.

Key drivers behind the current widening of the LIBOR-OIS spread include:

- The sharp increase in Treasury bill issuance following the rise in the US debt ceiling; and
- The repatriation of USD from US corporates. This relates in part to the "base erosion and anti-abuse tax" (BEAT) which makes it more expensive for non-US corporates to raise USD offshore via cross-currency swaps post the December 2017 tax reform.

Furthermore, we find no evidence of similar moves in other currency crosses, which further supports our thesis of this being a USD-specific phenomenon.

The key risk here is that the offshore USD weakness turns into a sharp strengthening of the USD, which we believe would add further pressure on risky assets in the current environment. Overall, we do not see the sharp moves in this spread as systemic and we are monitoring the situation carefully to see if the sharp rise in offshore USD funding costs start to influence currency dynamics.

Trade – more bark than bite

Increased protectionist threats are rattling markets. The probability of a full-blown trade war has increased in recent weeks, following the US imposition of tariffs on imports of steel, aluminium and some USD 60 billion worth of Chinese goods and China's response by imposing tariff on USD 50 billion worth of US goods.

We have focused on the threat of rising protectionism since the Autumn of last year and, as such, we have held the view that the current NAFTA renegotiations offer a good proxy of the Trump administration's broad approach (see **NAFTA 2.0: The impact is unlikely to be contained to North America**).

Looking at the issue through this lens, a negotiating pattern seems to be emerging, whereby the US makes strong demands that grab media attention, then threatens to abandon talks before finally softening its demands. This is what seems to be happening with the rules of origins clause in NAFTA. And it is echoed in steel and aluminium; after announcing wide-ranging tariffs and subsequently learning of the possible retaliatory measures from trade partners like the EU, the US then announced a list of exemptions, which includes its main trading partners for these materials.

We believe that President Trump's announcements are aimed at showing his base supporters that he is serious about protectionism. However, the ultimate results are much softer that the original demands. Moreover, now that China has announced its retaliation to the US tariffs, the ball is in the Trump administration's court as to whether they want to escalate the conflict. (see **The death of Goldilocks?** and **"America First": the bear who might scare Goldilocks away?**).

Inflation – the forgotten risk

With the increased volatility in financial markets, inflation risks have taken the backseat in terms of investors' concerns. This is interesting considering that the surprise strength in US wage growth was blamed for initiating the first phase of the market correction in early February.

The moderation in wage growth in the March report is perhaps helping to assuage inflation concerns. However, our long-held view that inflation will pick up this year remains intact, and we continue to believe that inflationary pressures are likely to strengthen starting mid-year (see **Inflation Risks Rise as US Economic Slack Erodes**). We believe that the ongoing tightening of the labour market, where the market is just not reaching equilibrium, will continue to put pressure on wage growth and inflation. Moreover, the depreciation of the USD and the strengthening of commodity prices over the past year will also play a role in pushing core inflation higher (see **Commodity prices and inflation**), in our view. This will continue to put pressure on US Treasury yields, via inflation expectations, and underpins our view that the Federal Reserve will hike rates three more times this year.

Risk aversion, US Treasuries and USD – foreigners still shunning US Treasuries

The behaviour of the USD and US Treasuries has been very interesting in the recent episode of investor risk aversion. Normally, higher risk aversion and an equity sell-off lead to increased demand for both assets, resulting in price gains. However, in the current market sell-off, the USD has remained stable, after having been on a depreciating trend for about a year, while 10-year US Treasury yields have been mostly stable since February and only declined by about 10bp over the past week, at the time of writing.

This is a small drop compared to the decline of about 30bp in Bunds, Gilts, Canadian and Australian bonds since mid-February. This suggests that some of the factors that have pushed the USD lower and caused US Treasury yields to drift higher are likely to still be at play. The implication is that foreigners' demand for these assets remains weak, in part driven by the political uncertainty and the cost of hedging.

The muted moves of the USD and US Treasuries could have an impact on investors who rely on these historical relationships to hedge their portfolio; in the past, falling yields and rising bond prices partly compensated investors at times of falling equity markets. Moreover, it suggests that, once risk sentiment stabilises, we could expect the USD to continue to depreciate and US Treasury yields to continue to drift higher.

Investment implications

As we have been saying for some time, the benign investing environment that we saw in 2017 is over. However, considering the continued positive macro environment with ongoing robust global growth and rising interest rates, we retain our positive outlook on risky assets. That said, with higher volatility here to stay and continued high political uncertainty, investors need to be discerning regarding their exposure, as opportunities may arise in the current environment. We remain cautiously positive on emerging markets, but the increased risk of a trade war is likely to continue to weigh on performance until the uncertainty dissipates.

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