



A U.S.-China Truce Could Stimulate A Recovery

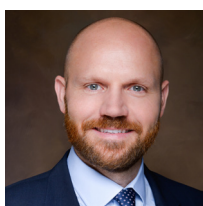
The fate of the global economy rests upon trade talks.

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Trade talks between the U.S. and China at last month's G-20 meeting seem to have ended in an uneasy truce, which was probably the best we could have realistically hoped for. It's unclear how things will progress from here—there are some knotty issues still to be worked out—but if the two sides remain at the table and further progress is made, I believe the global economy could be heading toward a recovery.

Why do I hold this relatively upbeat view when many market participants worry about an impending recession? Because I don't think the preconditions for a recession are in place. The global economy has been hit by a series of shocks that have slowed capital formation over the past 18 months, leaving the manufacturing sector looking very "recessionary" indeed. However, there has not been a major investment or consumption boom that has left the economy with the kind of imbalance that would need to be cleansed by a recessionary purge. While corporate debt levels have risen, this has been offset by rising and stable profit margins, and the cost of servicing debt remains low due to low rates and tight credit spreads.

It's true that the U.S. Treasury yield curve is inverted at certain points, which is usually regarded as a sign of impending



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trouble, but I'm not convinced that the yield curve can tell us much in isolation. Additionally, we need to recall that the yield curve remains distorted by the swaths of quantitative easing that the central banks have administered over the past years. To me, the yield curve is a part of the mosaic rather than the full picture.

In the absence of any obvious catalysts for, or signs of, recession, I believe that the seeds for recovery lie in two factors: a reset of monetary policy to ultra-loose and a reduction in uncertainty. The first of these is occurring: The U.S. Federal Reserve is loosening its monetary policy, as is the People's Bank of China (slowly) and the European Central Bank. If the U.S.-China trade truce holds, progress will also be made in reducing uncertainty.

A great deal rides on the U.S.-China trade talks, however. If last month's G-20 talks had gone badly, leading to new

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tariffs and export bans, then we would likely be staring at rapidly tightening financial conditions and a looming global recession. The performance of the global economy over the next few years very much depends on the outcome of these discussions—and they remain delicately poised. I think it helps to break the situation down into two main elements: first, the pressing issue of trade and, second, the much deeper issue of how the political relationship between the U.S. and China will be defined over the longer term.

I believe that progress is being made on the first of these issues because it is clearly in the interest of both parties to find a resolution, and both President Xi and President Trump have the domestic policy space they need to make the appropriate amount of concessions. A workable trade deal of some kind or another remains on the cards.

The second part is more complicated because the two countries' long-term ambitions are largely incompatible: China wants to become the dominant player in the Indo-Pacific region while

remaining a one-party state, while the U.S. political system seeks to support the spread of democracy. Over the longer run, it is likely that the U.S. and Chinese economies will get dragged into a battle over political and economic spheres of interest. In fact, this battle is already on, as shown in the thorny problem of what to do about Huawei, the Chinese telecommunications giant that the U.S. regards as a threat to global security.

Within our investable horizon, however, and assuming the U.S.-China truce holds, I expect the global economy to show signs of improvement soon. The great thing about a major slowdown is that it creates the space for a recovery. It is likely that we have accumulated some pent-up demand for capital goods, and if we avoid a recession in the near term, the current slowdown will help to extend the longevity of any subsequent expansion. Overall, I believe the conditions are in place for a very supportive environment for risk assets, of which I favor emerging markets and equities over credit.

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