# Quarterly review for WAY investors

for the three months to 30 June 2018

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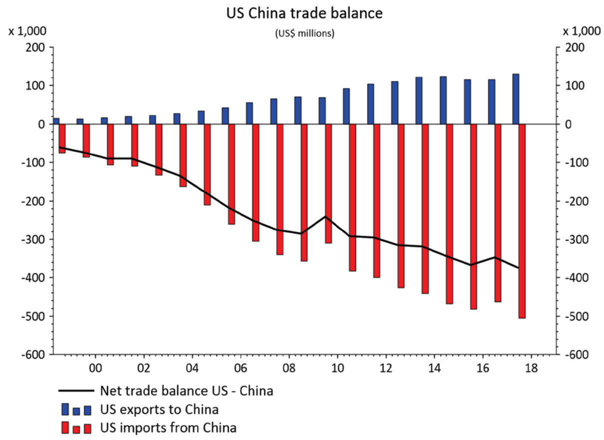
Chief investment officer

Global equities and bonds rose 7.01% and 3.30% respectively in sterling over the quarter, with returns enhanced by the pound's 5.88% fall against the dollar. Central bank announcements confirmed the gradual pace of global monetary tightening. The Federal Reserve chairman, Jerome Powell, announced a seventh quarter-point US interest rate rise since 2015, saying the US economy was "firing on all cylinders". The European Central Bank plans to cease quantitative easing later this year although the first interest rate rise is not likely until late 2019. The Bank of England kept rates on hold as Brexit uncertainty persisted. The monetary policy committee was divided, however, and an interest rate rise later this year appeared likely. US and UK equities outperformed, rising 9.90% and 9.40% respectively in sterling.

US-China trade tensions affected investor sentiment over the quarter as the scope of US tariffs increased and investors feared the onset of a trade war. In March, President Trump's opening salvo included steel and aluminium tariffs. These measures were aimed at China, the world's largest steelmaker, and will affect about $1 billion of US imports from China. US steel shares rose in response and rust-belt voters assessing Trump's performance relative to his "made in America" election pledges may show their approval in November's mid-term elections.

In June, Trump introduced tariffs on a further $50 billion of Chinese exports, equivalent to a tenth of the $500 billion of China's exports to the US in 2017. Beijing retaliated, imposing tariffs on US exports of equal value. In July, Trump announced tariffs on a further $200 billion of Chinese exports although these latest measures will not be enforced until later in the year after a period of consultation. If, however, a settlement is not reached, approximately 50% of China's exports to the US will incur increased tariffs. Chinese officials were considering countermeasures over the summer. The following chart shows how the China-US trade imbalance has grown over the last 20 years. In 2017, the imbalance was $375 billion.

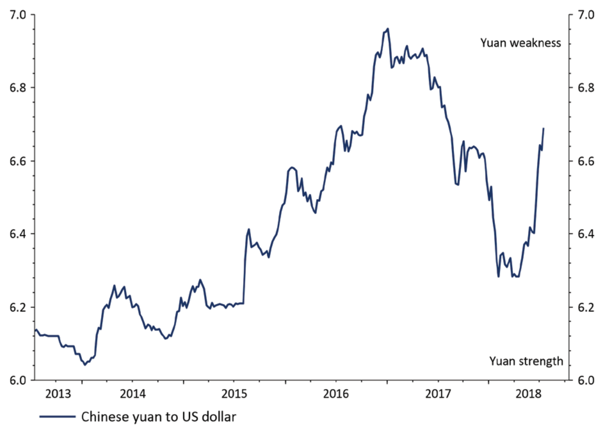
As well as addressing trade, Washington wants to protect US companies' intellectual property. China aims to shift its economy from low-margin labour-intensive goods to products with greater added value. In 2015, Beijing launched its "made in China 2025" initiative, wishing to achieve greater self-sufficiency in sectors such as robotics, semi-




Source: Thomson Reuters Datastream

conductors and electric vehicles. US companies seeking to expand in China risk losing intellectual property because they have to enter local joint ventures and may face unfair competition from heavily-subsidised domestic competitors. China has, however, shown willingness to negotiate, having announced reforms such as ending the requirement for US motor companies to operate in China through joint ventures with local partners.

America's trade tariffs may bring Beijing to the negotiating table. Any gain for its economy from falling imports may, however, be more than offset by higher consumer prices and lower consumer spending. Beijing, meanwhile, may seek to protect its economy by easing monetary policy. In April, it cut its reserve requirement ratio to encourage bank-lending and soften the impact of planned public and private sector deleveraging. As the chart below shows, Chinese export competitiveness has increased as the yuan has weakened against the dollar.




Source: Thomson Reuters Datastream

# Quarterly review for WAY investors (continued)

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The recent fall against the dollar has awakened memories of the sharp share price falls that accompanied the yuan depreciations in 2015 and 2016. At that time, investors feared the yuan's fall would add to the deflationary effects of low oil prices and falls in real wages. Inflation has risen since then and commodity prices have strengthened but it is possible deleveraging may slow China's economic growth, which may drop significantly from the official 6.8% year-on-year rate reported from the first quarter of 2018.

US tariff increases on European Union (EU) steel have attracted retaliatory EU tariffs. The unintended consequences of protectionism were apparent when Harley-Davidson accelerated plans to increase overseas motorcycle production to avoid increasing prices or taking a hit on margins. The chart below shows the relatively-low percentage of the US and Chinese economies accounted for by exports. China's transformation is sharply reducing its dependence on exports in favour of domestic consumption.

Exports as percentage of GDP


Source: Thomson Reuters Datastream

A trade war would, however, have damaging consequences for the EU because exports account for a significant percentage of some EU economies. German exports, for example, represented 39% of its economy in 2017. Equities in Europe excluding the UK underperformed over the quarter, rising only 3.80% in sterling as investors weighed the vulnerability of the EU to tariffs and the formation of a Eurosceptic government in Italy. Equities in Asia excluding Japan and emerging markets were also hit by the rise in protectionism and the dollar's strength, rising only 0.61% and falling 2.09% respectively in sterling.

Since Adam Smith wrote "an inquiry into the nature and causes of the wealth of nations", many economists have supported free trade. Milton Friedman said import tariffs and export subsidies were "an indirect and concealed form of devaluation", a form of protectionism that served principally to "protect" consumers from low prices. Trump's protectionist rhetoric may ultimately prove to be an attempt to coerce the Chinese into buying more US goods and easing restrictions on US companies seeking to expand in China as opposed to a rejection of free trade principles. In the meantime, markets will remain volatile and capital flight from emerging market assets into safe-haven currencies such as the dollar may continue. Over the longer term, a potential Chinese economic slowdown may be more concerning than the trade spat. Some developed economy equity markets posted strong quarterly gains despite the trade frictions as economic growth recovered somewhat from the weak first quarter and central bank policy tightened while remaining accommodative. A swift resolution to the US-China trade dispute may in time confirm the recent sell-off in some emerging markets as a buying opportunity.



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