MARKETS & INVESTING

Analysis. Equities

Wary investors await China-US dialogue on trade impasse

Climate change: China's Xi Jinping welcomes Donald Trump to Beijing in November 2017
Andy Wong/AP

Source: Bloomberg

Analysts think a deal between Trump and Xi unlikely but are betting on pause in tariff wars

EMMA DUNKLEY — HONG KONG

The stage is set in Buenos Aires for a performance of warm smiles and hearty handshakes between the presidents of the US and China at the G20 meeting next week.

But investors expect that there will be a different dynamic playing out behind the scenes, based on months of tension over power and trade between Xi Jinping and Donald Trump.

During a year in which trade spats have become increasingly fraught, investors have suffered from rising uncertainty and a turbulent ride in global markets.

Chinese stocks have plunged by 27 per cent since their peak this year in January, making China the worst-performing big equity market in 2018.

The largest technology stocks in the US, meanwhile, have tumbled into a bear market with more than $1tn wiped off their value.

All eyes are now on the G20 gathering at the end of this month to see whether the trade tension will be resolved, paused or escalated. Combined with rising interest rates, clouds over global economic growth and political tension elsewhere, investors are awaiting the meeting with a degree of trepidation.

The US has this year announced three rounds of tariffs on China, amounting to levies on about $250bn of goods while China has retaliated with tariffs on $50bn of US products and plans for a further $60bn.

Mr Trump's 10 per cent tariff on $200bn of Chinese products is set to jump to 25 per cent in the new year, unless a deal is struck in the coming weeks.

"The meeting of the two presidents is increasingly seen as an important opportunity to break a negative spiral in financial markets," said Andrew Milligan, head of global strategy at Aberdeen Standard Investments.

"Although full agreement or complete resolution is seen as rather unlikely on all the issues — trade, technology, intellectual property, security . . . even a temporary ceasefire — an agreement to keep talking and sort out some of the easier issues — would help calm market nerves."

Investors are trying to see past the steady stream of accusations of predatory trade practices being unleashed by the two super-powers.

On Tuesday night, the Trump administration said China had taken "further unreasonable actions in recent months" in terms of intellectual property.

Any ceasefire, along with signs of an upturn in global activity, could prompt investors to invest cash that they have sitting on the sidelines, fuelling a year-end rally.

But if the two presidents cannot agree or "even deliberately find areas of disagreement in order to give messages to their domestic audiences", then Mr Milligan said many investors would stick with a much more defensive stance, such as holding cash. "Cash levels are above average but not very high in fund manager portfolios," he said.

Optimism that a resolution could be struck at the G20 meeting was tempered by the recent Asia Pacific Economic Cooperation summit.

For the first time in its three-decade history, the Apec meeting failed to issue a joint communiqué while Mr Xi and Mike Pence, the US vice-president, clashed over trade and security.

Tai Hui, chief market strategist for Asia Pacific at JPMorgan Asset Management, said the Apec meeting revealed significant differences between Washington and Beijing on trade issues, meaning a "material breakthrough" on tension is "highly unlikely".

The most likely outcome of the G20, he said, is that China and Washington maintain an open dialogue even if the leaders "agree to disagree", which the market would receive as a "mild positive" in spite of the tariff increase set to take effect next year.

Although bankers are forecasting a range of potential scenarios at the G20 meeting and over the next few months, some think a "pause" in the trade spat is the most likely result.

> 'Even a temporary ceasefire would help calm market nerves'

Analysts at Goldman Sachs forecast just a 10 per cent probability of a comprehensive deal and a rollback of tariffs in the next few months, and expect a 40 per chance of a "pause" over this time, to allow for further discussions.

Meredith Pickett, a strategist at Morgan Stanley, and her team said that, while a "constructive US-China statement or a tariff pause are rising possibilities" at the G20, she still expects further escalation before an endgame becomes possible.

Ms Pickett said the base case was for trade tension to escalate until substantial market or economic weakness causes China or the US to take action.

"This appears to us to be what's happened over the past few weeks," she said, noting that the phone call between Mr Trump and Mr Xi in early November, and the move by the US to sign off on waivers for Iran oil sanctions, came after the S&P dropped more than 10 per cent from its year-to-date highs.

But uncertainty caused by the trade impasse among other factors has spooked investors, leading them to take profits in sectors such as technology which have rocketed over the past decade. Oliver Jones of Capital Economics said that technology is "among the most vulnerable" to a further escalation of the US-China trade war.

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Tail Risk

Growth rates look ominous for Fed's tightening cycle

JOE RENNISON

Investors are almost certain that the US Federal Reserve will raise rates in December. Regardless of markets tumbling, or credit spreads widening, December appears to be a done deal. But after that, despite the Fed forecasting three more rate rises in 2019, the outlook is less sure.

One indication of this is the decline in Fed funds futures, which are derivatives that gauge investor expectations for where the Fed's target rate will be in the future.

The yield on the contract expiring in December next year has fallen 20 basis points from its peak this month to 2.73 per cent, suggesting that investors expect only one, or maybe two, rate increases next year.

The primary reason, say analysts, is a slowdown in global growth stemming in part from the tightening in financial conditions that has already occurred.

The Fed's rate rises were first felt abroad, sending shockwaves through emerging markets. But the prospect of weaker economic conditions has now shown up on American shores.

A widely tracked measure of US inflation expectations fell to a fresh 2018 low yesterday as fears intensified over a slowdown in global growth.

US 10-year inflation break-evens, a measure of inflation expectations derived from inflation-protected government bonds, dropped to 1.97 per cent, dipping below the Fed's important 2 per cent target. Further pressure came as oil prices continued to decline, with energy an important input into inflation measures.

"It is ominous," said Jonathan Hill, an interest rate strategist at BMO Capital Markets. "It is consistent with the global growth slowing trade. Investors are concerned we may be approaching the end of this economic cycle."

While the Fed remains committed to raising interest rates in the near term, the global growth slowdown, amplified by the recent turmoil in US markets, may force the central bank to pause earlier than it has forecast.

With this in mind, next Thursday investors will examine the minutes from the previous Fed meeting for any sign that a shift in policy is on the horizon. A day earlier, a speech from Fed chair Jay Powell will also be keenly watched.

"If he gives any sign over the central bank's willingness to look through slowing global growth, that will be an important signal for the market," Mr Hill said.

The decline in crude oil prices has had a damping effect on inflation

Trading structures

ABN Amro's clearing business seeks London licences to prepare for Brexit

PHILIP STAFFORD — LONDON

ABN Amro has applied for UK licences to guarantee it access to the country's critical market plumbing after it leaves the EU.

The Dutch bank intends to set up a new London-based unit of its clearing business, one of the largest middlemen on global markets, according to a senior executive.

Robbert Booij, head of ABN Amro Clearing Europe, based in the Netherlands, told the Financial Times it was in discussions with UK authorities and exchanges about new local licences and exchange memberships. The bank is not seeking a full UK banking licence.

ABN's move underscores concern among European banks over the impact of Brexit next March, even though both sides have provisionally agreed a political withdrawal deal.

"In the absence of details, we will continue to prepare for all scenarios to avoid disruption to our customers," said Mr Booij. In spite of the EU's pledges to ensure that the market is not disrupted, "it's not enough to say the problem is solved", he said.

This month Handelsbanken, the Swedish lender, received a UK banking licence to ensure that it can continue operating without interruption after Brexit. At the same time, many banks that have used Britain's EU membership to access the single market are looking to secure new licences to operate in the bloc.

ABN's clearing unit sits between exchanges and clearing houses, and handles more than 20m securities and derivatives trades a day on behalf of customers such as high-frequency traders and market makers. Many of them are based in the Netherlands.

To ward off instability from Brexit, UK and EU regulators have pledged to supply the licences that will give banks access to systemically important UK clearing houses. London is the home of the European trading and clearing market, processing billions of equities, swaps, futures and repo trades.

Dutch bank ABN is in discussions with UK authorities and exchanges

However, the EU's pledge this month applies only to derivatives sent through clearing houses and did not specify if it would cover other asset classes, such as equities or repurchase markets.

Nor is it clear whether EU banks and traders would have permission to use all parts of UK market infrastructure once it becomes a "third country", a non-bloc state that has a formal relationship with the EU. Dutch laws place restrictions on its banks being members of overseas exchanges. That has led to concern there could still be a violent reaction from Brexit. Some Dutch companies, such as Optiver and All Options, are among the market's biggest traders.

One ABN customer, Flow Traders, is opening a London office to prepare for Brexit. ABN activated its plans two months ago and will guarantee it can gain access to clearing houses such as LCH and ICE Clear Europe.

The UK ABN Amro subsidiary is expected to begin with just one client, the Dutch clearing arm of ABN Amro. "London would be the executing agent," Mr Booij said.

Fixed income

Dreams turns to Sweden for high-yield deal as UK retailing debt feels strain

ROBERT SMITH

With sterling debt investors shaken by the growing strain on the UK high street, British bed seller Dreams is turning to an unusual source of funding: Sweden.

Owner Sun Capital Partners this week began marketing a €175m high-yield bond under Swedish law to fund a "dividend recapitalisation" of Dreams — a term for when private equity groups layer debt on a company to take money out for themselves.

The Florida-based firm bought the bed retailer out of administration five years ago and unsuccessfully sought to sell the business last year.

While the company's management met with potential investors in London on Monday and Tuesday, Dreams is primarily targeting fund managers from colder climes.

To manage the bond sale, it has hired Pareto Securities, a Nordic broker that has built a niche in bringing international companies to the lighter touch Scandinavian bond markets. Sun Capital declined to comment.

The bed company might face a tricky task. "Dreams ticks every single box you don't want to tick," said one London-based portfolio manager, whose firm attended an investor meeting — referring to the steep losses debt investors have seen on UK retailers as trade for bricks and mortar shops slows.

The more than 7 per cent yields on offer might seem more appealing to Swedish fund managers, who are facing deeply negative base rates in their home country. But Norwegian furniture retailer Ekornes pulled a bond sale yesterday on the back of weak demand. And several investors cautioned that the fallout from a bond sale by Lebara earlier this year, managed by Pareto as well, could have also damaged Nordic demand for racier foreign credits.

> 'High-yield bonds offer high returns . . . but it is of course unfortunate when our clients suffer losses'

Lebara, which offers migrants across Europe cheap international phone calls, tapped the Norwegian bond market last year. This year, its bonds have plummeted in value to trade at around half of face value as the company has been unable to file audited annual accounts it originally promised in April.

Pareto ran that bond sale and faced questions over how much due diligence it did on Palmarium, the little-known Swiss family office that bought Lebara.

While the group has been reluctant to publicly disclose its other investments, the two heads of Palmarium have held stakes in a number of Middle Eastern businesses, according to people familiar with the matter, such as private security firm Erinys Iraq and Jordanian insurer Frontier Insurance. Palmarium did not respond to requests for comment.

Among Pareto's other Nordic debt deals, Oro Negro has twice defaulted on its debt since the broker helped the Mexican oil driller raise $900m in 2014. The company argued last year that a default on the Norwegian law bonds was unenforceable in Mexico. The broker also sold a Nordic bond for Genel Energy in April 2015, less than a year before the London-listed oil company admitted that its main producing field had about half the oil previously thought.

Inge Edvardsen, head of fixed income sales at Pareto Securities, said some of these companies had "experienced challenges" but noted that his firm had "placed about 200 high-yield bonds exceeding €11.5bn" since 2014. "High-yield bonds offer high returns with associated risks but it is of course unfortunate when our clients suffer losses."