view from the OUTER

EVANS & PARTNERS

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Events dominating again

We have entered another period where event risks are heightened and appear set to dominate market outcomes over the rest of the year.

Equities have a better *relative* valuation than bonds and represent the only major asset class where investors have the potential to make decent returns on capital over the next years in our view. However there are other factors to bear in mind:

1. Trade war issues. The next key events are the APEC meeting on 16-17 November where US President Trump and Chinese President Xi are likely to meet and 15 December when the next round of tariffs are due to start.
2. Brexit issues will be receiving much attention as the current deadline of 31 October approaches.
3. Middle East tensions could flare up over the next month as Iran restarts its nuclear program.

Key risk dates ahead

Issue	Date	Event
Trade war	November 16-17	APEC Leaders Meeting
	December 15	Next round of tariffs
Brexit	October 17-18	European Council Meeting
	October 19	UK Parliament deadline
Middle East	Early November	Iran restarts nuclear program

Source: Various media reports, Evans and Partners

Recommendation

This large number of events on the horizon presents a challenge for investors. At a minimum it suggests greater volatility ahead, but it could also mean a downside to markets if some of the events are not effectively resolved.

Markets could be particularly vulnerable because valuations remain elevated. Full valuations and heightened risk is not a healthy combination. We continue to recommend an underweight position in Australian equities in particular.

Events dominating again

We have entered another period where event risks are heightened and appear set to dominate market outcomes over the rest of the year.

The table below lists some of the events in coming months and the rest of this note provides our comments on some of the major issues.

Trade War vacillations

The Phase I trade deal was not much of an advance. China agreed to buy more agricultural products that they desperately need and were probably going to buy anyway. There was no progress on the significant issues such as intellectual property rights, enforcement mechanisms and freer access to the Chinese market for US companies. The next big date is the APEC summit in mid-November where Xi and Trump are likely to meet.

President Trump has not cancelled the round of tariff increases due to start on 15 December, so this is looming as another important date. These tariffs could have a bigger impact on the US economy than previous rounds because they target consumer goods — previously these have generally been excluded.

Our view continues to be that the chance of a comprehensive deal is slim before the next US election. The difficulty for Trump is that any deal would involve some compromise and might come across as weak. Trump may prefer to run the campaign with China as the 'enemy' and tout the tensions as evidence of the strength of his leadership. However he is also keen to divert attention away from the impeachment issue, so announcing progress on the trade deal could be a good distraction.

A sustained stand-off with the US plays into President Xi's hands. Xi is pursuing a harder line communist agenda than his predecessors and is returning to many Maoist principles. One of these is the concept of leadership as a constant ideological struggle against internal and external forces that seek to undermine the socialist goal. Trump is giving him easy ammunition.

On the economic side, Xi also feels that China is better placed to withstand a long war given its greater ability to provide stimulus, and it also senses that Trump's obvious fear of a fall in the stock market is a weakness that can be exploited. It is also likely that China will never agree to US officials being allowed on the ground in China to monitor enforcement, which appears to be a major sticking point.

Brexit angst

The Brexit outcome remains highly uncertain and there are a number of key events over the next few weeks that will bring the issue to a head. A meeting of European leaders will consider the UK's proposal and, if this is rejected, UK Prime Minister Johnson is required by law to ask for an extension. He has previously indicated he might follow this law. There are a range of other possibilities as well, including UK elections or another referendum.

Key risk dates ahead

Issue	Date	Event	Comment
Trade war	November 16-17	APEC Leaders Meeting	Next date in which Trump/Xi could organise to meet
	December 15	Next round of tariffs	Unless a deal is done, tariffs will be introduced on $300 billion of US consumer goods imported from China
Brexit	October 17-18	European Council Meeting	European leaders meet to consider the UK's Brexit proposal
	October 19	UK Parliament deadline	Johnson is required by law to ask for an extension unless a deal is approved by this date. Johnson may break the law and not do this
Middle East	Early November	Iran restarts nuclear program	Iran may restart its nuclear program and there may be a military response from Israel or Saudi Arabia
Other Potential Events			
US earnings	Mid Oct to Mid Nov	US reporting season	There are earnings risks from deteriorating macro conditions and higher costs due to rising wages and tariffs
US policy	October 29-30	Federal Reserve meeting	Investors are uncertain about the extent of future rate cuts
Chinese economy		Potential stimulus announcement	The economy has been weakening and there is the chance of further stimulus announcements now that the National Day holiday is over
US impeachment	ongoing		Pressures for impeachment appear to be growing

Source: Various media reports, Evans and Partners

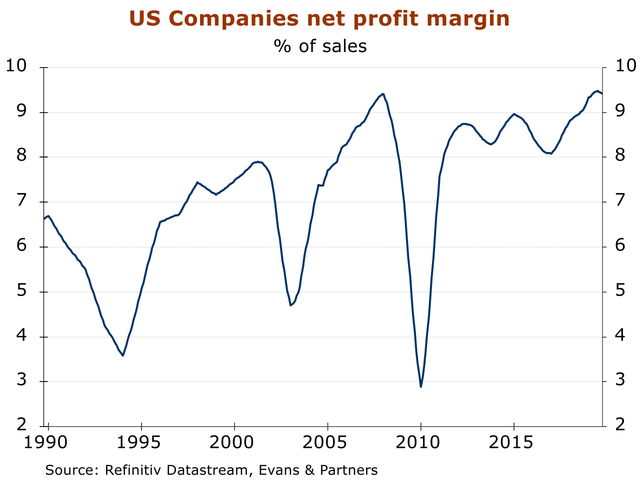
Middle East tensions

Middle East tensions have been rising all year and further escalation could easily occur if Iran officially restarts its nuclear program as it has threatened to do in November, if US sanctions are not lifted. There is the possibility that Israel might launch an attack on Iran if this occurs, particularly if Prime Minister Benjamin Netanyahu manages to retain power. Saudi Arabia and Iran have effectively been at war in Yemen and Syria for five years.

Iran is retaliating to sanctions by disrupting the passage of oil through the Strait of Hormuz – which is the narrow passage out of the Persian Gulf through which 20% of the world's oil travels. There have been a number of attacks on tankers in recent months and a seizure of one tanker. The aim is to disrupt supply to push up prices and cause pain in the West. It seems likely that these tensions will continue unless Trump backtracks on Iranian sanctions. This stands as a major economic and political risk that markets appear to be ignoring.

US earnings season

The other looming risk is for US profits as a reporting season is getting under way. There are pressures from deterioration in the economic environment, rising wages growth and higher input costs due to tariffs. It is remarkable that US profits have been so resilient in the face of these threats. The chart below shows that margins are close to a record high.



These pressures will only intensify if the next round of tariff increases proceeds. The pressures could come through three channels.

- Nationalistic backlash against US companies trying to sell into China.
- Higher costs from imports into the US, or from moving supply chains.
- Retailers may have to take a hit once more consumer goods face tariffs.

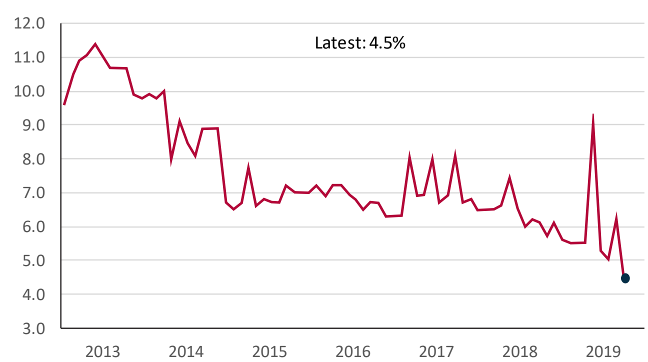
Chinese stimulus announcement

One potentially positive event could be policy stimulus from China. The Chinese economy has been showing more signs of pressure from the trade war in recent months. This is most obvious in manufacturing, where growth rates have dropped to multi-decade lows. Manufacturing has been most affected as US companies shift production to other countries, particularly Taiwan.

Chinese authorities have been slow to address this slide. All efforts have been focussed on preparations for the 70th anniversary of the People's Republic that was held on 1 October. These celebrations have also exacerbated the weakness as many factories had been required to shut in a move to reduce pollution levels in the capital.

The expectation is that a significant stimulus program will be announced over the next few weeks now the anniversary is over. The State Council recently made comments to this effect, pointing to a major program of urban rail construction. There have already been some monetary policy announcements including cuts in reserve ratio requirements and benchmark lending rates.

China Manufacturing Production YoY



Source: Wall Street Journal

Recommendation

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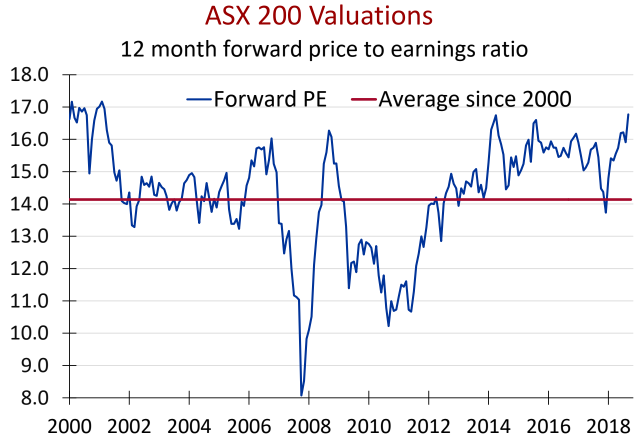
Markets could be particularly vulnerable because valuations remain elevated. Full valuations and heightened risk is not a healthy combination. We continue to recommend an underweight position in Australian equities in particular.



Source: Refinitiv, Evans & Partners

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