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The Dutch Economy and the Investment Outlook into 2020

The Netherlands has a prosperous and open economy which depends heavily on foreign trade. In 2018, the Netherlands exported €641bn in goods and services, with goods representing 75% of the total export value and services representing 25%. The total export of goods and services accounted for 88% of the Netherlands' Gross Domestic Product (GDP) with goods representing 66% of the GDP and service 22%.

The Dutch economy is expected to grow by 1.6% in 2019, fuelled by strong domestic private consumption, higher business investment and employment. This is moderately lower than 2.5% growth rate it achieved in 2018. In 2020, the Dutch GDP is expected to grow by 1.4%, in line with the Euro area but considerably below the average of 2.23% it has achieved since 1989.

Factors Effecting the Dutch Economy
The deceleration in the Netherlands' GDP growth rate in 2019 and 2020 is attributed to general weakness in international demand and in particular in the growth of export of goods to its top five trading partners, namely Germany, Belgium, UK, France and the U.S. - most of which are having to deal with their own economic difficulties.

Germany, the largest economy in Europe, and another major export driven economy, is on the brink of recession with the latest factory orders down 6.7% on a year-on-year basis. Its GDP declined by 0.1% in the second quarter of this year reducing its annual growth to just 0.4%. Furthermore, the German economy is under phycological pressure of no deal Brexit, softening Chinees demand and the constant threat that the U.S. President Donal Trump might decide to impose tariffs on its car industry.

In the UK, GDP declined by 0.2% in the second quarter of this year, the worst performance by the UK economy in almost seven years. However, the UK is expected to avoid recession as a result of better than expected growth in the service industry in the third quarter.

In China, the slowdown in economic activities are gathering steam. Manufacturing activities contracted for the fifth consecutive month and its exports and imports were worse than expected in September, as existing U.S. tariffs and the ongoing slowdown in global trade combined to weaken demand. In U.S. Dollar terms, exports decreased by 3.2% from a year earlier versus a decline of 3.0% expected by economists, whilst its imports declined by 8.5% versus 5.2% expected.

China's GDP rose by 6% between July and September period from a year ago; the weakest since 1990 and lower than the consensus forecast of 6.1%. Looking at the breakdown, the very strong industrial production growth of 5.8% on a year on year basis seem to be boosted by infrastructure activities, as China has embarked on infrastructure investments including large transport projects.

Retail sales held up well at 7.8% on a year on year basis and higher than the previous month of 7.6%. However, retail sales figures don't represent pure personal consumption. The figure also includes business consumption and infrastructure projects buying their material in the market. Fixed asset investments came in at 5.4%, slightly lower than 5.5% achieved in the previous period; an indication that perhaps the ongoing investment in infrastructure programmes for future is slowing down.

China's economy seems to be divided into two large segments; one affected by the trade war and weak manufacturing and the other supported by fiscal programmes and infrastructure projects. In order to boost domestic demands, China is very likely to cut interest rates. This will lower interest rates for local government bond issuers and help to finance further infrastructure programmes.

Looking ahead, China needs to actively control its credit growth, boost investments in 5G infrastructure in its services and increase domestic consumption for next year. Relying purely on infrastructure programmes whilst in the midst of a trade war is unlikely to boost economic growth from current levels.

In the U.S., the sugar high corporate tax cuts have faded, and signs of fatigue and slowdown have started to percolate through the economy. In October, the latest survey of the American manufacturing sector by the Institute of Supply Management pointed to the second consecutive month of contraction with the pace of expansion the lowest for a decade. The survey also showed that the manufacturing downturn is more widespread than either of the mid-cycle slowdown in 2012 or 2015/16. Of particular concern was new orders, backlog, raw materials, inventories, exports and imports contracting across the board, suggesting activity is likely to decline further in the short term.

The U.S. service sector grew at its lowest pace in three years during September. Although the reading still showed expansion for the services sector, it also showed growth was not widespread, and that the deeper contraction in the manufacturing and the global trade war were spreading into the more stable services sector and the boarder economy.

On the positive side, in the U.S., the consumer side remains very strong and confidence is high. The U.S. economy is 70% consumer driven and bearing in mind that current indicators of consumer spending, unemployment and wage growth all remain very robust, which is an indication of continued growth in the economy. As a result of higher tariffs, however, and prolonged trade policy uncertainty damaging investment and demand for capital goods, the manufacturing and the industrial side are clearly in contraction.

According to the latest report by the International Monetary Fund (IMF) the weakness in global growth is driven by a sharp deterioration in manufacturing activity and global trade. The service industry, however, has held up well, but there are initial signs of softening, notably in the U.S. and Euro area. Monetary policy of low interest rate and quantitative easing has played a significant role in supporting growth so far, however, growth in advance economies is slowing towards the lower end of their long-term potential.

Root Cause of the Global Trade Contraction

The U.S.-China Trade war

The trade war between the world's two largest economies started in February 2018 by President Trump implementing 'global safeguard tariffs' – placing a 30% tariff on all solar panel imports. This was followed by signing a memorandum in March 2018 to file a case with the World Trade Organisation (WTO) against China for discriminatory licensing practices. Mr Trump restricted investment in key technology sectors and imposed tariffs on Chinese products such as aerospace, information communication technology and machinery.

There is more to the U.S. – China conflict than just a trade war. It's a rising power challenging an established power. It is a conflict of culture, structure and business of two systems with each system having its own pros and cons. China is challenging the existing world power and inevitably there will be many areas of friction.

The root cause of the trade war between the U.S. and China is related to three areas of Technological Innovation, Geopolitics & Security (South China Sea), and Trade with technology being the most important consideration and trade the least.

Technological Innovation

Technology gives all kind of strength to a nation including economic, military and world influence and China has invested $100s of billions to challenge the U.S. supremacy in this sector. China's technological advancement gives it access to four most important future industrial areas of AI, robotics, space technology and autonomous vehicle.

Technological innovation such as G5, G6 (in a recent interview Huawei CEO indicated the company has already spent billions in research and development of G6 technology), AI and China's subsidy for its technology companies has helped China's technology sector to reach a critical mass of expertise, talent and financial firepower that could realign the power structure of the global technology industry in the years to come.

The U.S. response to this challenge so far has been defensive in strategy and one of containment, by blacklisting leading Chinese technology companies and requiring U.S. companies to apply for export license for certain products and services. Whilst this defensive tactic may somewhat slowdown

China's progress in the very short term, it won't stop China's technological progress over the medium to longer term.

To challenge China in the long term, the U.S. needs new drivers of growth and investment programmes, particularly in its science and technology sectors. It should perhaps setup a technology fund to invest in future technologies, similar to China $15bn fund, and shorten the time between innovation and operation. The U.S. has long held the lead for AI talent and research, but China is moving faster in putting AI to work.

The U.S. can argue that it's an uneven playing field. Chines tech companies are benefiting from massive government support, whereas the U.S. has to rely on the private sector. Clearly this is one of the contention issues in the trade war and can only be resolved through mutual respect and an emphasis on win-win rather than lose-lose. Tough negotiation with an exchange of ideas is good, beyond that and inflicting harm is not such a good idea for the world trade. There seems to be ample respect but lack of proper diplomacy and an emphasis on win-win.

Geopolitics & Security
The South China Sea is one of the world's busiest waterway and is subject to several overlapping territorial disputes involving China, Vietnam, the Philippines, Taiwan, Malaysia and Brunei. The South China Sea has become intertwined with the power struggle between the U.S. and China. At stake is freedom of navigation, access to its natural resources and maritime security.

The U.S. Energy Information Administration estimates the area contains at least 11 billion barrels of oil and 190 trillion cubic feet of natural gas. Other estimates are as high as 22 billion barrels of oil and 290 trillion cubic feet of gas. The South China Sea also accounts for 10 per cent of the world's fisheries, making it a key source of food for hundreds of millions of people.

An estimated U.S.$3,37 trillion worth of global trade passes through the South China Sea annually, which accounts for a third of the global maritime trade. 80% of China's energy imports and 39.5% of China's total trade passes through the South China Sea.

The U.S. has wide-ranging security commitments in East Asia and is allied with several of the countries bordering the South China Sea, such as the Philippines, Singapore and Vietnam. Furthermore, the South China Sea is a vital trade route in the global supply chain, used by American companies who produce goods in the region. Although the U.S. does not officially align with any of the claimants, it has conducted Freedom of Navigation operations, designed to challenge what it considers China's excessive claims and grant the free passage of commercial ships in its waters.

With the ongoing trade war and tariffs, China sees very little reason for the U.S. to have freedom of navigation in its backyard. In essence, what is taking place in the South China Sea is a constant power play between the reigning power and the rising power.

Trade
The trade war between the U.S. and China started 18 months ago with the U.S. vowing to investigate the longstanding complaints about China's trading practices of tapping into American knowhow, including access for tech transfer and intellectual property. This initial targeted trade complaint was supposed to encourage China to further open its technology market to the U.S. companies, however, the focus rapidly changed to other areas of trade and contentious issues such as geopolitics and the Chinese government owned enterprises. The broadening of mandate by the U.S. created a hostile and distrustful environment between the two countries and opened a "Pandora's box" on a potential reversal of global trade openness.

Many U.S. tech executives now fear that their world may have changed for good. Instead of gaining further access to the Chinese market, the U.S. defensive strategy of containing China may have had an opposite effect with increasing number of U.S. companies reporting that they are no longer being invited to bid for Chines state-own enterprises.

Recently, after thirteen rounds of talks and five months of constant escalation in their long running trade war the U.S. and China finally secured a respite. In return for a series of modest concessions, most of which had already been offered by China in previous negotiating rounds, the U.S. President agreed to suspend another set of tariff increase scheduled to take effect in October.

Details of the phase one trade deal are still scarce. It seems as part of phase one, China has agreed to buy between $40 billion and $50 billion in U.S. agricultural products (without the application of tariffs on the U.S. agricultural products), takes measure to open its financial sector, and to address intellectual-property concerns raised by the U.S. In return, the U.S. agreed to hold off on a tariff hike scheduled for October 15.

The two sides are still a long way from final settlement that address much more contentious issues, such as Chinese government support for strategic industries like information technology and state-owned enterprises. As a consequence, the final agreement may take many years to achieve.

Financial Markets Performance so far in 2019

Boosted by an unusual combination of steady economic growth and Federal Reserve rate cuts, the yield on the benchmark 10-year Treasury note now stands around 1.7%, within 0.4% point of its all-time low. At the same time, the extra yield investors demand to hold both investment and speculative grade corporate debt instead of relatively safe Treasury notes, stands near multiyear lows.

These factors have helped the U.S. government bonds to deliver a performance of around 7% and corporate bonds of about 13% this year. European high yield bonds have also performed well with a return in excess of 8%, so far this year.

After a rather subdued performance in 2018, the same factors – low bond yields and stable economic growth – have helped developed stock markets to perform very well this year. In Euro terms, the S&P 500 Index is up +23.95%, MSCI World Index is up +21.34%, MSCI Europe Index is up +16.03% and the Dutch AEX Index is up +18.11% this year.

By contrast the Emerging markets have delivered 9.23% in Euro terms. This underperformance has been mostly due to macroeconomic, trade uncertainties and geopolitical factors. In a most recent publication, the IMF has lowered its growth projection for Hong Kong for this year from 2.7% to 0.3% and for 2020 from 3% to 1.5%. Growth is South Korea could fall to 2.2% for 2020 and in Singapore the economy could grow by 0.5% for this year and 1% for 2020, both substantially lower than its initial projections earlier this year.

On a slightly longer-term time frame, i.e. since January 2018, the S&P 500 Index and much of the developed stock market indices have been trading sideways. The S&P 500 Index price to earnings ratio (PE) has been trading between 17x and 22x of its actual earnings during this period with 17x defining the lower support level and 22x the upper resistance level. The Index PE is currently standing at around 19.3x, moderately above 16x five years average and in the middle of its trading range since January 2018.

Catalysts for Stock Market Rally

Since January 2018, the S&P 500 Index and much of the developed stock markets have been trading sideways. Looking ahead and into 2020, what are the catalysts that could help the S&P 500 Index to breakout from its 21 months trading range?

Earnings Growth

The S&P 500 Index earnings growth has steadily decelerated from 2018 tax infused 22% to a mere 2% expected growth for this year. Analysts expect an earnings growth of around 10% for 2020 and 2021 respectively. Experience of the past few years has shown that these estimates are likely to slide as we move into the new year. Furthermore, based on the subcomponents of the recent manufacturing activities report, in particular its weak new orders component, it is very likely that current earnings estimate for 2020 and 2021 will be revised lower in the months ahead.

For the current quarter, the S&P 500 Index is expected to show a reduction in earnings of as much as -4.6% according to FactSet. There is an expectation amongst analysts, similar to previous quarters, that reported earnings will be better than expected lowered estimates and we may just avoid negative earnings growth for the 3rd quarter.

For Europe, analysts expect an earnings contraction of -3.7% for the third quarter. However, according to IBES, earnings growth is expected to accelerate in the final quarter to 9.1% for the current year and 8.9% for 2020.

The S&P 500 earnings growth of 2% for this year and 10% for next year on its own is unlikely to propel the market out of its 21 months range. After all, analysts have been predicting these earnings for some time and the market reaction to this has been quite muted. In fact, there is an opposite argument that the U.S. stock market is very much over valued considering the economic outlook. The expected earnings growth for this year and 2020 puts the S&P 500 12 months forward PE on 16.6x, in line with its 5 years average – hardly cheap and perhaps a justification for the stock market to have a correction or at most continue to move sideways.

Adding to this argument, the market is also concerned with profit margins. Rising profit margins have been a key driver of the current bull market. There are tentative signs, however, that profit margin of the U.S. companies is coming under pressure instead of holding up. They have moderately declined from 12.1% in 2018 to 11.7% more recently. If this decline were to gather pace, it will become harder and harder to justify current stock market valuation.

Fed Policy

Another possible catalyst to propel the market in a sustainable way to new highs could be the substantial reduction in interest rates by the Fed and the restarting of quantitative easing programme (QE).

In its September meeting, the Fed reduced the federal fund rates by 0.25%. In October the Fed unveiled plans to expand its balance sheet by purchasing $60 billion Treasury bills from mid-October to mid-November in response to spike in short term lending between banks and other financial institutions that spilled over into the money markets, pushing the Fed’s policy rate temporarily above the range that policymakers were targeting.

The Fed insisted that this is not quite the same as the quantitative easing that it initiated after the 2008 economic crisis. The difference between the two is that back then the Fed purchased long dated Treasury notes to stimulate demand, pushing prices higher and sending yields lower. This time around, the Fed is buying short dated Treasury bills.

Targeting Treasury bills is a very clever move by the Fed. Not only does this policy injected much needed liquidity into the overnight money market, it also un-inverted the yield curve; triggering a mini phycological boost to investors who chased the long-dated Treasury yields and global stock markets higher.

Barring a massive deterioration in global economy, the Fed is unlikely to cut interest rates substantially, as U.S. consumer spending has held up well so far this year. The market is currently expecting three interest rate cuts into 2020. Anything beyond one or two rate cuts, however, is very unlikely, as the Fed does not believe in negative rate philosophy and prefers to use QE to interest rate cut.

Quantitative Easing

One of the major differences between now and 2008 debt market is that currently we are late in the debt cycle. As a result, cut in interest rates and or additional QE that targets the debt market alone is less effective.

If economic growth in the U.S. were to deteriorate substantially, a new round of QE to stimulate the economy is the preferred choice of Fed’s Chairman, Jerome Powell, to cut in interest rates. This time around, he may not only target corporate borrowers through lower yield, but also individuals with the aim of spurring business and personal spending. He may also introduce equity purchases as part of QE (preferred choice of President Trump), similar to October 2014 quantitative and qualitative easing (QQE2) programme introduced in Japan (Japanese stocks climbed 33% in the ensuing eight months of QQE2).

This type of QE, however, tends to expand stock market valuation.

Currency Intervention
There is a danger that some countries might try to stimulate their economy by entering into an environment of currency intervention to weaken their currency. This is becoming a rising risk as economies struggle to grow.

The U.S. Dollar is near a multi-decade high on a trade-weighted basis, and President Trump is not happy about it. Currency intervention tend to work best in conjunction with other central banks. The U.S. is in trade war with China and very soon with it will be with Europe. China has already devalued its currency. There is also little evidence that the European Central bank or the Bank of Japan will support a U.S. Dollar devaluation move by the Treasury. This raises the prospect of tit-for-tat competitive devaluation. Such a move by the U.S. will not be without a price. It could severely harm the international monetary system and make it difficult for the U.S. administration to label other countries as currency manipulators.

Fiscal Policies
Fiscal policy focuses economic growth away from international trade to domestic demand and infrastructure investment. In its recent report the International Monetary Fund (IMF) warns that economic policy should support activity in a more balanced manner. Monetary policy cannot be the only game in town. It should be coupled with fiscal support where fiscal space is available, and policy is not already too expansionary. Countries like Germany and the Netherlands should take advantage of low borrowing rates to invest in social and infrastructure capital, even from a pure cost-benefit perspective.

A few European countries including the Netherlands, France and Finland have responded positively and announced a fiscal expansion in their latest budget to be implemented in 2019 and 2020. In the case of Netherlands, the fiscal expansion is estimated to be 0.7% of GDP, which could help to create further domestic demand and maintaining current GDP expected growth rate of around 1.4% for 2020.

In Germany, the policy makers are against fiscal expansion. In a recent interview the German Finance Minister Olaf Scholz made it clear that Germany is “not willing to have extra debts”. According to Scholz much of the economic slowdown seen in Germany throughout 2019 has been caused by external factors, such as the trade war. It is the trade war that should be resolved not taking on more debt.

China is already engaged in fiscal stimulus and is likely to implement more later this year and into 2020. Furthermore, China is preparing the groundwork to lower interest rates, which in turn will lower interest rates for local government bond issuers and help to finance further infrastructure programmes.

U.S.-China Trade Agreement
This is unlikely to be resolved any time soon and any mini deals struck between the two nations is likely to be limited in scope. It is likely that China will wait with any serious negotiation until after the U.S. general election in November 2020.

Investment Outlook into 2020
So far around 100 S&P 500 companies have reported their third quarter earnings. They are generally beating the already lowered earnings estimates, but the rebound has been modest and below the first and second quarter at this point in the reporting cycle.

There is a strong possibility that as we approach 2020, the stock market may perceive the recent rapprochement between the U.S. and China as a sign of reduced political risk with potential improvement in trading outlook and global economic growth. If so, stock markets may rally to the top of their trading range, resulting in valuation expansion. The rally in S&P 500 Index will push up its PE to 22x of its current earnings (19.3x its 12 months forward earnings) with the index value of around 3300.

The rally may prove unsustainable if it is not supported by a combination of a few of the factors discussed above, notably another mini trade agreement between the U.S. and China in which some of the past tariffs are cancelled, more spending by China and Europe, lower interest rates in the U.S. and China, a smooth Brexit transition between the UK and the EU and rising 10 year bond yields to above 2%.

In such circumstance, equities would see stronger leadership from cyclicals and companies exposed to the economy, which means emerging markets and European stocks will outperform the U.S., and higher long-dated bond yields will favour financials and industrial companies.

For the moment, we believe investors should remain in a well-diversified portfolio but stay vigilant. They should focus on the fundamentals and avoid overvalued companies until the fog of uncertainty, in particular in relation to trade war and fiscal policies, has lifted a little.

Author
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