

# Geo-Markets

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## Market Risk Outlook

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## Nerves of Steel

US launched trade disputes on multiple fronts, risking higher cost of goods for companies as peak-margin fears already weigh on markets.

**First salvo came as US announced tariffs and investment restrictions aimed at China. A prolonged China-US trade dispute, in which tech policy plays a larger role than the trade deficit, favors small- and mid-cap stocks.** A trade deal focusing on US agricultural and energy exports looked plausible, which would be a win for the president's political base. But hopes that a transactional approach ends the China-US trade dispute were dashed when the US slapped \$50 billion of tariffs on tech imports and new restrictions on foreign investment ahead of high-level negotiations. China surprised with patience. The deal may be salvageable, but the White House's hard line on intellectual property will frustrate rapid resolution.

**Second salvo was fired at Europe, Mexico and Canada, which were quick to announce reciprocal tariffs. Cost of manufactured goods could increase.** Citing slow progress in discussions, the US waived exemptions on steel and aluminum tariffs. Imports account for one-third of total US steel consumption and duties impact 47% of that. Canada quickly announced a symmetric \$16.6 billion of tariffs on US goods. The EU offered a more tailored tariff response and looks to WTO complaints. NAFTA negotiations are on hold.

## Rome Burns, Spain Falls?

**Italy moved forward with populist, anti-austerity coalition while Spain's government collapsed following corruption charges. Risk to regional financials is elevated, but more fiscal spending could be a tailwind.** Left- and right-wing parties combined in Italy to form a government based on increased spending and lower taxes. It could likely expand the deficit beyond EU limits. In response the European Central Bank (ECB) could stop buying Italian debt, but that seems unlikely. Socialists also took over in Spain following a "no confidence" vote. The distorted EU incentive structure encourages periphery countries to run deficits motivated by low rates, the ECB's record as a buyer of last resort and, contrary to EU rules, lack of labor mobility. Brussels may be forced to reconsider austerity.

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Topic	Commentary	Conclusion
<b>Trade</b>	Trade supplants Europe as risk to the stock market after US announced measures aimed at China, Europe, Mexico and Canada. The US diplomatic trip to China ended with little hope for a trade breakthrough. Transactional agreement about agriculture and energy exports looked possible, but US moved ahead with \$50 billion of tariffs on tech. This was subsequently followed with imposition of steel and aluminum tariffs against Europe, Mexico and Canada. Each quickly responded with retaliatory tariffs. Investors should expect a prolonged dispute and resolution process in China and more complicated NAFTA negotiations	Continue to short Chinese equities because of slowing economy (Nov. 16, 2017). Prolonged trade dispute adds risk. US small- and mid-caps are less vulnerable; Europe potentially benefits. Expect higher costs of goods sold for large US firms with the most-vulnerable supply chains (March 18)
<b>Europe's Fiscal Dilemma</b>	New government run by coalition of populist left- and right-wing parties could drive Italy's deficit about 6% higher in violation of EU rules. The ECB could stop buying Italian debt, but we believe this is unlikely given the market size of €2.3 trillion. Anti-austerity and populist politics could drive capital flight from Italy and increase financials risk around autumn budget time. In Spain, a corruption finding resulted in a "no confidence" vote, toppling the government and bringing a Socialist party to power. Spain's debt market is €1.2 trillion, which adds to macro risk	Remain overweight European equities on lower rates and weaker currency (March 14), but risk in periphery is elevated. Closely monitor geopolitical developments that could weigh on financials. Prefer core countries to periphery and Spain over Italy
<b>North Korea</b>	After calling off negotiations for mid-June summit, wheels of diplomacy moved ahead this past week. Investors generally welcomed the recent US-North Korea-South Korea détente. This could be a positive development, but we believe the outcome is likely to hinge on differing definitions of "denuclearization." Progress toward lasting peace would generate strong returns. All but the most speculative investors may choose to wait before betting on diplomatic success	Stick with the holding pattern on South Korean risk assets (May 8). A major reunification project leaves plenty of time to get upside after potential deal. On-again, off-again, on-again pattern of negotiations is simply too uncertain
<b>Energy</b>	Disintegration of OPEC-Russia production quotas should relieve some tension in the oil market coming from a reduction of about 1 million barrels a day from Iran and Venezuela. Main players likely looking to forecasted supply-demand imbalance in which global overhang leads to a shortfall, resulting in price stability even in the absence of a deal. We believe that US shale production serves a swing function, causing price cycles of shorter frequency but greater amplitude	Remain long oil and oil-exposed companies (Jan. 10) even though catalysts for higher prices have weakened. Consider income-generating assets like master limited partnerships that have less upside with higher prices but can generate income in the current range of \$65 to \$75 per barrel
<b>Emerging Markets</b>	Pressure on EM continues with greatest volatility in fiscally weak countries like Argentina and Turkey, but some oil importers have also struggled. Primary flash points are upcoming elections in Turkey, a truckers' strike in Brazil and debate over tax policy in Argentina	Maintain EM overweight, but tighter financial conditions, a stronger dollar and high oil prices do pose risks. Middle East/North Africa positions include long Egypt (Jan. 31) and short Turkey (Jan. 31). Asia positions include long India (March 14) and short Malaysia (May 22)

Topic	Commentary	Conclusion
<b>Latin America Elections</b>	Colombia's right-leaning candidate moved closer to securing the presidency as the election moves into a second runoff. Concerns over the coming elections in Brazil and Mexico remain elevated, and a truckers' strike in Brazil has added to economic uncertainty. Historical equity performance is not kind to investors in election years: regional equities have underperformed in the months before the elections and immediately after. Additional disheartening news out of Argentina was the president's veto of a legislative measure aimed at reducing taxes. The move is good for fiscal health, but is bad for markets and sets up more confrontation between the two branches of government	Long Pacific markets (Chile, Columbia and Peru), short Atlantic (Argentina, Brazil and Mexico) on election and economic risks. Regional defensive sectors like consumer staples and health care historically outperform before and after elections (May 8)
<b>US Midterm Elections</b>	New excitement surrounds a potential infrastructure program that could be anywhere from a few hundred billion dollars to multiple trillions. We believe the likelihood of any infrastructure bill ahead of the midterm elections is low. Investors should not get excited about further fiscal spending and should instead plan for a contentious and polarized political climate leading up to November. Tax reform, passed in late 2017, is the administration's flagship domestic policy achievement, but the measure has not provided hoped-for popular support. Initial evidence does suggest that companies are investing	Infrastructure bill unlikely before midterms (April 26). Instead, consider firms that benefit from higher capital spending, which the market may be underestimating. Also, cybersecurity firms could benefit from concerns about election integrity (March 5). US defensive sectors have historically outperformed ahead of the midterm elections while cyclical does well after (May 22)
<b>Iran</b>	Europe scrambles to find a means of protecting firms from US sanctions following the president's decision to exit the Iran nuclear deal. Protective measures may have little impact given the modest investment European companies have made since entering into the Iran agreement and the potential cost of violating US sanctions. Should the possibility of foreign investment evaporate in the coming months, Iran will have less incentive to remain party to the agreement	Short Middle East equities as Iran and Saudi Arabia remain on a collision course over regional supremacy even as oil moves higher (Jan. 31). The US' unilateral withdrawal could create drag on the US and the global economy if oil prices spike
<b>Tech Regulation</b>	US regulatory risk for technology companies has receded since Facebook CEO Mark Zuckerberg's congressional testimony, but we caution that these tides are cyclical. The EU imposed the General Data Protection Regulation for improved data protection, which impacts some of the largest US tech companies	Use regulation-driven weakness as buying opportunities for top tech companies. Expect new round of debate over regulation close to US midterms. Tech also benefits from US tax bill encouraging capital expenditures
<b>Defense and Cyber</b>	Philippines President Rodrigo Duterte opened the door to conflict in South China over island building and disputed waters	Long cyber companies positioned to benefit from increased spending in latest US budget (March 15). Defense stocks also appear poised to rise

## Index Definitions

For index, indicator and survey definitions referenced in this report please visit the following: <http://www.morganstanleyfa.com/public/projectfiles/id.pdf>

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**Investing in commodities** entails significant risks. Commodity prices may be affected by a variety of factors at any time, including but not limited to, (i) changes in supply and demand relationships, (ii) governmental programs and policies, (iii) national and international political and economic events, war and terrorist events, (iv) changes in interest and exchange rates, (v) trading activities in commodities and related contracts, (vi) pestilence, technological change and weather, and (vii) the price volatility of a commodity. In addition, the commodities markets are subject to temporary distortions or other disruptions due to various factors, including lack of liquidity, participation of speculators and government intervention.

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**Equity securities** may fluctuate in response to news on companies, industries, market conditions and general economic environment.

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**Investing in smaller companies** involves greater risks not associated with investing in more established companies, such as business risk, significant stock price fluctuations and illiquidity.

**Stocks of medium-sized companies** entail special risks, such as limited product lines, markets, and financial resources, and greater market volatility than securities of larger, more-established companies.

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Because of their narrow focus, **sector investments** tend to be more volatile than investments that diversify across many sectors and companies.

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