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Market Update: 8th May 2019

Equity markets slump as US-China Trade Tensions intensify

After a weaker start to the month as investors began to digest weaker corporate earnings data, markets resumed trading this week with equity market declines on the back of a souring US-China trade outlook. As trade talks entered their final stages, with a deal expected as early as this Friday, it emerged over the weekend that China had backtracked on nearly all aspects of the trade deal, with edits on the draft trade agreement which could undo months of negotiations. The rapid deterioration of negotiations has clearly rattled global stocks, bonds and commodities over the week, further adding to the cloud of uncertainty over global trade and the economic outlook for the rest of the year.

What has caused the escalation of tensions?

US negotiators were taken aback at the extent of the changes Chinese diplomats made to the 150-page draft agreement in the final stages of trade talks. The changes reportedly undermine the core structure of the deal, and represent a serious backtrack on promises made up to this point in talks. Key reported edits included the removal China's commitments to change laws to resolve key issues over intellectual property, competition policy, access to financial services and currency manipulation, all of which were core concerns for the US when the trade war began.

As a result of the recent developments, in a tweet on Sunday, President Trump threatened to increase tariffs on $200 billion of US imports from China from 10% to 25% as soon as Friday in a bid to increase pressure on China to make a deal. This has since been confirmed by the office of the US Trade Representative, who today set an effective date of Friday to increase tariffs in light of China's retreat from specific commitments.

How has the market reacted?

On a global scale, equity markets fell by the most since December this week, as investors grappled with President Trump's renewed threats to impose higher tariffs on Chinese imports amidst an increasingly uncertain economic backdrop. Increased tariffs would cause significant disruption in the global economy, which is already struggling to deal with weaker global trade and growth forecasts, as reflected in the recent weaker corporate earnings data.

Given the fact that the market had already priced in a US-China trade deal, the escalation of trade tensions this week poses a significant risk to equity markets, which have enjoyed a strong rally so far this year on the back of momentum and optimism over a resolution to trade tensions between the two global powers. Potential derailment of these negotiations is likely to result in a selloff in equity markets, particularly considering already stretched equity valuations.

How does this impact the Economic Outlook?

In recent weeks, it has been widely covered by the media that the Chinese economy is beginning to rebound, however when we look at the underlying economic data, the Chinese economy continues to display weakness, with today's export data indicating a strong consumer demand, however weaker global demand for its goods. At the same time, the credit bubble in China is a growing concern for investors, with defaults hitting a record high in 2018. There is a real possibility that trade talks could break down and a trade war could continue, which would deliver a considerable blow to the Chinese economy and global trade expectations over the year.

Where do talks go from here?

China's top trade negotiator, Vice Premier Liu He is still expected to visit Washington for talks on Thursday and Friday this week as the US increases pressure on China to clinch a deal. At the same time, China is said to be preparing retaliatory tariffs on US imports should Trump follow through with his threats. Whether Liu will come with any offer which could get the talks back on track is unknown, but remains unlikely given the apparent unwillingness for the Chinese to compromise on key issues.

Investor complacency appears to have caught up with the market, which had priced in a smooth trade deal, therefore sentiment remains fragile as we await further developments over the remainder of this week. As it stands, President Trump is unlikely to go into the 2020 election with an unfavourable China trade deal, and China appears to be pushing back. President Trump's tweets have left little room for backing down, indicating that despite continuing talks, tariffs will be hiked on Friday if no agreement is made.

Our Perspective

As we await further developments in the trade talks, it is clear that investor sentiment remains weak after significant market declines over the last two days. Whether the trade tensions will be resolved with a deal on Friday is uncertain, however given current equity valuations, regardless of the outcome, this issue could become the catalyst for a sell off, as weaker corporate earnings and lower global growth feed into return expectations. With uncertainty prevailing in markets and the 'sell in May and go away' trend in the back of investors' minds, markets are likely to be twitchy over the next few days. Should the US increase tariffs on Friday, this is likely to precipitate a 5-10% selloff in equity markets due to the implications this would have on global growth and corporate revenue and earnings expectations for the rest of the year.

It is our view that risks remain high in equity markets, and that a defensive positioning is the most sensible way to navigate these uncertain times. Given the extremely low equity content within the OBI portfolios and downward tilt which seeks to benefit from a decline in equity markets, the portfolios are up over the week while markets and the benchmark declined.