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# Market Update: 22nd August 2019

**Choppy waters ahead for the US economy**

Recessionary fears were heightened last week after risk off sentiment in financial markets triggered a series of recessionary indicators, weighing on the global economic outlook and highlighting economic weakness in key global powers. Despite the strength of the US economy relative to the Eurozone and Chinese economies, evidence now suggests that the ongoing trade war with China and a global slowdown in economic growth is beginning to weigh on the US economy, with corporates beginning to suffer as a result of lower demand and higher input costs.

Earlier this year, we identified sources of weakness in the US economy, however highlighted that the domestic economy remained resilient, offsetting global headwinds. Since then, data suggests that the domestic economy is coming under strain, and new tariffs scheduled for December are expected to hit the US consumer, potentially removing the benefit of a strong consumer from the equation. Given fading fiscal stimulus and the ineffectiveness of the Fed's recent interest rate cut, should the economy continue to weaken and recessionary fears grow, equity markets are likely to be dragged lower on a more negative outlook.

**What are the key problems?**

As it stands, the two key problems facing the US economy are a strong dollar (which is reducing the competitiveness of US exports), and uncertainty over trade policy. After the last cut, it became clear that the US economy would require aggressive cuts to combat dollar strength, given the fact that other key trading partners around the globe are also cutting, and at a faster rate. Additionally, given the recent escalation of trade tensions, with little expectation of a resolution this year and evidence of ingrained weakness within the US economy, it can be argued that even an aggressive cut would not be enough to prevent near term weakness. The US economy is facing an inflection point, with the economy displaying weakness after 10 years of growth. Factory output and consumer confidence have declined after an escalation of the trade conflict with China, and it is becoming clear that an economic slowdown could be accelerated. As the two key problems remain, with the main source of the problems being external and the domestic economy beginning to falter, it is our expectation that a subsequent equity market decline will occur in the near term.

**Trade war with China**

Earlier this week, President Trump acknowledged that his aggressive China trade policies may result in economic pain for Americans, but insisted that they were needed for long term benefits. The President showed little indication that the trade war with China would be resolved in the near term on Tuesday, indicating that he would not back down on China, even at the expense of the short term health of the US economy. Trump indicated that he had no choice but to impose tariffs, and instead attributed a cooling in the economy to the Federal Reserve's lack of action on interest rates.

After ratcheting up the trade tensions at the beginning of this month with further tariffs to be implemented by 1st September, Trump announced last week that he would delay tariffs on $156billion of the proposed

$300 billion in Chinese goods until 15th December to avoid impacting US consumers during the all-important Christmas trading period. At the same time, he also delayed the decision on whether to allow Huawei Technologies to continue to do business with US companies to allow them more time to prepare for the disruption. It was initially hoped that this was because progress was being made in the negotiations, however it appears that this was more down to pressure from corporates and political advisers. In the meantime, economic fears could give China greater leverage in negotiations. China has already put retaliatory tariffs in place and stopped buying US agriculture products earlier this month.

Within the White House, there is growing acknowledgement that the trade war risks dragging down the US economy, and while reaching a deal with China is important for Trump's 2020 campaign, a significant decline in economic health poses a risk to his re-election. Additionally, divisions are forming within the White House, as key figures including Vice President Mike Pence are increasingly pushing for a deal (given Mr Pence's position as the main point person for those in agriculture states which are being badly affected by the trade war). Trump has a battle on his hands since he has taken such a hard line on China, and pressure is likely to continue to mount in the coming weeks/months for him to make a deal given economic weakness. To add another level of complexity to the trade tensions, the US has also said that trade talks would be negatively impacted of protests in Hong Kong weren't resolved peacefully. Despite concerns, the president has been quick to dispel suggestions from key economists that recession is looming, however the evidence suggests that unless something is done, the US economy is likely to cool further in the near term.

**Fed rate cuts**

After last month's interest rate cut proved to be ineffective in boosting economic activity amid trade tensions, market expectations for rate cuts were little changed following the release of the minutes of the July FOMC meeting last night. Committee members viewed the rate cut as insurance against low inflation and the risk of a deeper slump in business investment stemming from trade uncertainty, labelling the rate reduction a 'mid-cycle adjustment' rather than the start of a rate reduction cycle as market participants (and the White House) had hoped. As it stands, market expectations are consistent with a 65 basis point rate reduction by the end of the year.

At the much-anticipated annual Jackson Hole Economic Symposium tomorrow, Fed Chair Powell is expected to open the symposium with a speech on monetary policy. Against a backdrop of growing global recession fears and tumbling bond yields, Powell is expected to try to reset expectations to keep the central bank's policy options open, however faces a difficult balancing act amid growing market and political pressure, while trying not to indicate a significantly weaker economic outlook.

It is expected that Powell will open the door for an interest rate reduction cycle, however he will also not want to signal further economic weakness given already heightened recessionary concerns. He is likely to highlight challenges for the US economy given the unusual growth divergence facing the advanced world, as well as the need to insure against the detrimental effects of trade uncertainty.

To add more elements to the balancing act, Powell also faces challenges as the effectiveness of policy is being doubted, or more particularly the role of monetary policy in supporting economic growth and hitting the inflation target, undermining the potency of guidance. Trade uncertainties are expected to cloud economic forecasting models which are already challenged by structural shifts in the global economy. With the unpredictability of trade policy, any aggressive rate cuts could be difficult to justify.

Political and market pressures are pressing hard for lower rates given downside risks and existing economic weakness, with expectations exceeding what the Fed appears to be willing to do, and what is warranted based on economic data. It should also be noted that other stimulus methods may be needed, however a lack of action could also fuel market instability and aggravate the White House. At the end of the day, markets and politicians will always press for more stimulus regardless of what the economic data suggests, threatening the credibility of the central bank, particularly after its recent pivot from tightening to neutral and now potentially from neutral to loosening. It can be argued that markets will decline regardless on either a more negative outlook for the US economy warranting aggressive rate cuts, or a lack of action from the central bank to combat economic weakness in the face of continued pain from trade uncertainty, exacerbated by tariff increases. Either way, Powell is in a lose-lose scenario so is likely to give very little away on future guidance tomorrow.

**Tax cuts**

Donald Trump announced yesterday that he was weighing a payroll tax cut in a bid to introduce more stimulus into the US economy, despite his advisers insisting it was not under consideration, given its potential to signal concern over a weakening economy. In the same speech, he also insisted that the US is "very far from a recession" and dismissed the idea that a dramatic emergency measure would be required. The president is sending mixed messages to markets, resulting in a high level of volatility as the US economy deteriorates as a result of the continuing trade war.

**The G7 meeting**

This weekend's G7 meeting in Bairritz, France is expected to be a tense moment for international relations clouded by transatlantic rifts over trade, Iran and climate emergency. We are expecting fireworks as contrasting views are held by the leaders, with President Trump expected to ruffle feathers with his controversial views. President Macron has said he plans to use the meeting to attempt to de-escalate tensions between the US and Iran and seek to overhaul corporate tax to make digital corporations such as Google and Amazon pay more. No substantial developments are expected to come out of the meeting.

**Overall**

It is clear that the US economy is beginning to cool, however with the key problems in the economy remaining and with the root causes being a reduction in external demand and increased costs (as a result of a strong labour market and protectionary tariffs), the problems are unlikely to be resolved in the near term, reinforcing our expectations for a decline in equities in the near term based on an increasingly negative outlook for the US economy. It appears unlikely that there will be a resolution to the trade war this year, and the ability of the Fed to effectively stimulate the economy given current conditions is doubted. As we analyse markets movements ahead of the Jackson Hole symposium it should be noted that having been excessively viewed as an effective repressor of volatility, the Fed may now be increasingly becoming seen as a risk to financial stability. In our view, any further downward revision to guidance on economic weakness or more hawkish than expected response from the Fed is likely to be received negatively in equity markets, resulting in a deteriorating outlook.