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Market Update: 7th August 2019

A Turbulent Week in Markets as the US-China Trade Conflict Wages On

Just as trade tensions looked set to reduce as US-China trade negotiations resumed, President Trump delivered a swift blow to equity markets on Thursday evening as he announced that a further round of tariffs on Chinese goods would be implemented within a month unless progress is made on getting a trade deal. The surprise announcement came as it became clear that the two sides remained far apart on key trade issues, and as it appeared that the Chinese may be waiting out for a potential change in US leadership to make progress on talks. Following this week's events, it now appears that the conflict between the two powers is likely to become a long and protracted trade war which is expected to weigh on the global economy over the second half of the year.

A Long and Dragged out Trade Conflict

When Xi Jinping first met Donald Trump in 2017, the Chinese leader highlighted that there were "a thousand reasons to make the China-US relationship a success, and not a single reason to break it". Just two years on, the relationship between the world's two largest powers is at its worst in decades, with tensions between the two worsening as the days go on. Although apparently only intended to bring China back to the negotiating table, the most recent move by Trump to increase tariffs has only exacerbated tensions, resulting in a series of retaliatory measures on trade and currency policy that risk accelerating a wider geopolitical conflict.

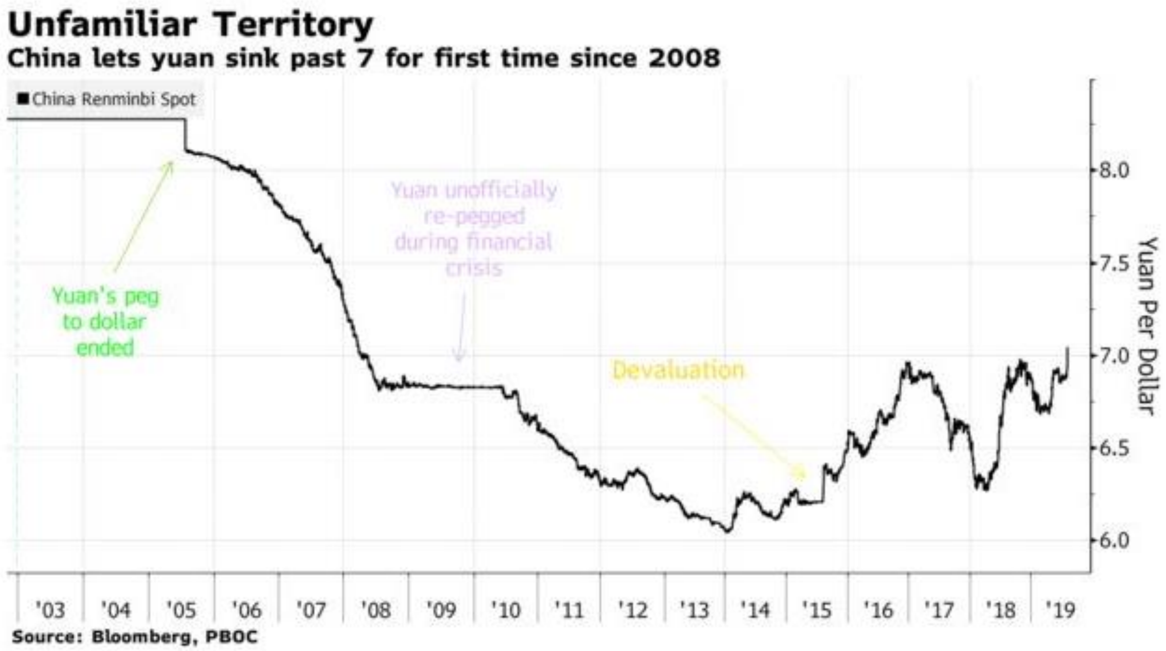
After announcing a fresh bout of tariffs on $300 billion of Chinese imports earlier this week, President Trump's escalating trade war with China is looking increasingly likely to drag on into next year, pulling down economic growth expectations in the process. As it stands, the US and China appear further apart than ever on a deal that would reshape the trade relationship between two sides and end a dramatic slowdown that threatens global growth. Recent data suggests that tariffs on Chinese goods are now back to levels we associate with pre-1930s protectionism. According to the Peterson Institute for International Economics, before Trump's latest announcement, the average tariff on Chinese goods imported to the US was 18.3%, up from 3.1% in 2017. After the next proposed round of tariffs in September, this will increase the average tariff to 21.5%.

A significant problem is that neither leader appears serious about making a deal. China sees Trump taking a hard position ahead of the 2020 election, while the US thinks that Xi is attempting to wait out for a change in leadership for a better deal. Either way, neither seems prepared to make concessions, prompting investors to consider the effects of a long and dragged out trade conflict on the global economy.

With the worsening trade conflict continuing to weigh on the global economy, increasing the risk of recession given the backdrop of cooling global growth, both sides have plenty at stake, with signs of weakness continuing to feed through into the economic data for both countries. In response to the announcement of fresh US tariffs, China retaliated by suspending purchases of American farm crops while also allowing the value of the Yuan to fall, effectively making Chinese goods cheaper to buy and negating some of the damage from US tariffs.

A Potential Currency War

Beijing's decision to allow the value of the yuan to fall on Monday resulted in a sharp decline in stock markets, as the US formally accused the Chinese government of currency manipulation. Global markets were thrown into panic after the announcement from the US Treasury, which followed the decline of the yuan to below seven to the dollar. The depreciation of the currency was widely regarded as a retaliation to President Trump's tariff threats, however the People's Bank of China insists that the weakness was caused by foreign exchange traders taking a negative view of the Chinese economy "due to the effects of unilateralist and trade-protectionist measures". On Tuesday, the Chinese central bank set its daily price target at 0.6983 to the dollar (stronger than the 7 level), indicating that it will limit the currency weakness going forward, however the fact that it was allowed to depreciate below 7 marks a stark escalation in China's response to US threats, which had been restrained for months.



After past US administrations avoiding the 'currency manipulator' designation for 25 years, this week's events alarmed fund managers, with the prospects of a dramatic worsening of US-China trade tensions. The PBoC's moves over the week opens the door to a potential currency war, which would ramp up the trade war significantly, however China must be cautious to ensure that any retaliation doesn't backfire. It does not want to risk surging capital outflows like those that took place in 2015, draining hundreds of billions of dollars from foreign exchange reserves and increasing default risk for companies with dollar denominated debts. Labelling China as a currency manipulator puts pressure on the IMF to look into the claims, with a risk that the US could seek sanctions or increase tariffs, however this is unlikely to be immediate.

Going Forward

President Trump continues to insist he wants a deal, and the US is still expected to host Chinese negotiators in September, however the President has also indicated that he will not back down, suggesting that further tariffs will have a significant negative impact on the Chinese economy. President Trump has taken a hard position on this and any weak moves are likely to weigh on his chances for re-election next year. For this reason, it looks likely that the trade war will escalate further rather than peter out, with changes of a resolution this year very low in our view.

The breakdown in relations is likely to result in further action in the coming weeks, with both sides clearly considering their options on how to respond to recent threats. For the US, they may consider the opportunity to tighten restrictions on Huawei, follow through on selling F-16 fighter jets to Taiwan and signal support for Hong Kong protesters. The US has already indicated that it will base intermediate-range missiles in Asia and potentially take further action against Chinese students and scientists. On the other hand, China could take punitive action on US business interests in China, undermine American efforts to isolate Iran and North Korea, and even take more drastic measures to block US companies from recently opened sectors such as Finance.

Market Reaction

In reaction to the ramping up of tensions, stock markets declined sharply while bonds rallied and investors flowed into safe haven assets such as gold. The best historical market comparison to Monday's stock market selloff is August 2015 when the S&P 500 declined by 6.3% and had several days of 3% moves. Both 2015 and 2019's declines started with a sharp devaluation of the Chinese Yuan. The stark difference is that this time it comes as part of the US-China trade war, leading expectations for further stock market declines.

One of the key reasons behind the decline in US markets is that data already suggests that the US economy has suffered since the trade spat flared up one year ago. Farmers, exporters and manufacturers have all taken a hit and business investment is declining. With the positive effects of fiscal stimulus fading while the trade war escalates further, greater uncertainty is likely to weigh down the US economy in the second half of the year. Additionally, the most recent bout of tariffs proposed to come into effect on 1st September would be felt by households, with tariffs extending to consumer electronics such as mobile phones and telephones. This is likely to impact on consumer spending, which has so far been a resilient pillar of US growth.

The US Federal Reserve is being increasingly called upon to support the US economy going forward given the escalating trade conflict, however St Louis Fed President James Bullard said yesterday that the bank can't be expected to react to twist and turns in the trade war. In an interview, he highlighted: The Fed "can't realistically move monetary policy in a tit-for-tat trade war". This indicates that the central bank would not significantly cut just because of the trade war escalation, disappointing investors who had been hoping for aggressive cuts to counteract increased trade tariffs.

Overall

Our expectation is that given the position of both sides and their unwillingness to make concessions, we are unlikely to have a resolution to the US-China trade conflict this year, with a resolution in early 2020 a more likely option, ensuring a positive backdrop for the US election. With trade tensions continuing to drag on economic growth for the remainder of 2019, downside risks are significant and increasing, and there is little positive sentiment or data to push markets higher at this point. While the immediate focus is on the US-China trade dispute, there is also concern that trade conflict is becoming a broader global theme. Investors are evaluating the impact of the trade dispute between Korea and Japan and are standby for any resumption of US global actions on autos or US-Eurozone trade conflict. It is clear that the global outlook remains increasingly uncertain, with investors moving away from risk-on assets over the week. With these risks in mind, we remain defensively positioned for now, expecting further stock market weakness over the next week. In the meantime, we continue to benefit from downward pressures on stock markets, with portfolios performing strongly as markets decline.