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Market Update: 21st November 2019

Fasten Your Seatbelts, It's Going To Be A Bumpy Ride!

At the New Economy Forum (NEF) in Beijing this week, industry leaders have been debating on key issues driving financial markets, with discussions on topics ranging from geopolitical risks to climate change. As day one of the forum drew to a close yesterday, delegates and speakers had so far painted a picture of an increasingly fragile global economy, fraught with uncertainty over trade tensions and a deteriorating growth outlook. As expected, concerns over global trade and US-China relations took centre stage.

Opening the forum yesterday, China's Vice President Wang Qishan expressed the country's support for globalisation and multilateralism, and issued a warning against adopting a Cold-War mentality given obvious strains in US-China relations. In his address to the forum, former US Secretary of State Henry Kissinger highlighted the need for greater communication between the two sides. He stated that that the US and China were in the "foothills of a Cold War", warning that if left to run, the conflict could be worse than the first world war.

US-China Trade: Where are we now?

As it stands, the US and China are struggling to agree on a long-awaited phase one trade deal amid wider tensions ranging from human rights concerns over pro-democracy protests in Hong Kong to competition in the South China Sea. After optimism earlier in the month over a phase one agreement, doubts have re-emerged this week as the two sides struggle to put pen to paper on the agreement. The tentative deal is supposed to be the first step towards a broader, more significant deal between the world's two largest economies, however given the time taken to agree on these much smaller issues, a meaningful deal still appears far off.

Global Growth: Trade Uncertainty Erodes Forecasts

Earlier today, the Organisation for Economic Co-Operation and Development (OECD) downgraded their global growth outlook for 2020 from 3.0% to 2.9%, noting that it did not see a strong rebound in 2021 owing to risks stemming from trade tensions. It was noted that central bank intervention had partially offset negative effects of trade tensions, however the organisation reduced its forecast due to "persistent policy uncertainty and weak trade investment flows". The OECD now forecasts the global economy to expand at the weakest rate since the global financial crisis. This increasingly bleak outlook is likely to benefit safe haven currencies and assets, emphasising the need for defensive assets during increasingly uncertain economic conditions.

Progress Towards A Phase One Deal

After extreme optimism over a phase one trade agreement observed in markets earlier this month, it now appears that the future of the deal hinges on the US delaying some pending tariff increases and China agreeing to buy a certain amount of US Midwest farm crops. This is proving difficult to overcome, with the two sides struggling to even get that modest compromise to the line. Additionally, Chinese leaders are now insisting that the US rolls back existing tariffs as part of a phase one deal. President Trump is reportedly open to a rollback of existing tariffs as part of a larger agreement, but only in return for more concessions from China. Investors are still hoping for an agreement in the coming weeks, however it is likely that we will continue to observe a high level of volatility in markets while the two sides hash it out prior to the introduction of new tariffs in mid -December.

Should a deal not be reached and tariffs be raised further on US trade with China and Europe, the global economy would almost certainly continue to slide, with the threat of recession in 2020 looming over markets. A re-escalation of tensions from here would likely impact consumers to a higher degree, with tariffs planned for December expected to directly impact US consumers.

Despite the challenges, we still see a "skinny" phase one deal being agreed before the end of the year. In a speech in Beijing last night, China's chief trade negotiator, Vice Premier Liu He commented that he was "cautiously optimistic" about reaching a phase one deal, and outlined China's plans for reforming state enterprises, opening up the financial sector and enforcing intellectual property rights – issues at the core of US demands for change in China's economic system. Earlier today, China invited US negotiators to Beijing, suggesting that a phase one deal remains high on the agenda.

A Longer-Term Solution

Given the time taken to get even a partial trade deal approved by both parties, a more significant US-China trade deal is likely to be much further down the road. Modern trade deals take years to thrash out, evidenced by efforts to replace the North American Free Trade Agreement and of course the deal to follow the UK's exit from the European Union. In comparison to trade deals within the same continent, the US and China are much further apart in geography, culture and political systems, and it remains to be seen how they will tackle the thornier issues over trademark rights and forced transfer of technology. As a result, over the longer term, the trade truce is unlikely to last in our view, with both sides digging themselves in for long-term hostilities.

Muddying the Waters

While we see a phase one deal as being likely in the coming weeks, it should be noted that there are other factors at play which could derail talks. Adding to a combustible situation in US-China relations are fresh protests in Hong Kong and a potential US reaction if China resorts to a violent crackdown. The US Congress passed a series of bills this week aimed at backing pro-Democracy protesters, and the President has made it clear that in the event that the matter is treated improperly or inhumanely by the Chinese government, a trade deal would be off the table.

Positioning

It is clear that there is a bumpy road ahead for US-China trade talks, and given the volatility experienced in markets so far this year owing to trade developments, it is fair to expect further uncertainty and volatility in the near term. As it stands, we still expect a phase one "deal" to be agreed before the end of the year, but do not expect the deal to contain any real substance. We still expect the global economy to cool as a result, with a substantial trade deal appearing far away on the horizon, and subsequently expect markets to decline, noting that sentiment created by a phase one deal could buoy markets in the near term as we have seen earlier in the year.

Overall, markets are highly volatile and lacking any direction at this stage, with economic fundamentals remaining depressed. For this reason and given the risks in equity markets, we retain a defensive positioning, with very low exposure to US and Global equity markets as we await further clarity on the state of the global economy and the future for US-China relations.