Tariff Tug of War

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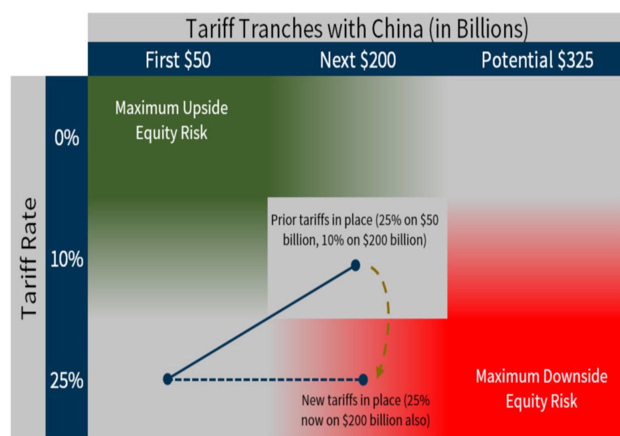
A Market Miscalculation Last Week?

Last week, after the U.S. officially raised the tariffs on $200 billion in Chinese imports from 10% to 25%, the equity market surprisingly (at least to us!) brushed off the tensions and rallied back (S&P 500 down ~46 points at its lows) to close up more than 10 points. Driving Friday's rally was an increase in optimism that a deal could still be struck. This optimism was reflected in language from Treasury Secretary Mnuchin and tweets from President Trump that suggested the meetings were "constructive."

Figure 1: The Dynamics of the Deal



Tweets and Threats Turn Terrible

However, another week brings more tweets, threats and retaliation. With this, the S&P 500 declined 2.4% on May 13, the largest one-day decline since January 3. Looking at the Dynamics of a Deal Chart (Figure 1), the move today is essentially a delayed reaction to the realization that the trade friction between the U.S. and China is getting more intense and presents downside pressure to equities. Tweets from President Trump this morning "that China will be hurt very badly if you don't make a deal," and responses from China that it will "never surrender" suggest the path to compromise has become more clouded. China's decision to raise tariffs on $60 billion of U.S. goods to 25% from 10% in retaliation highlights the tit-for-tat moves being employed by the two largest economies in the world. The decline in the global equity markets today (and over the last week) is a combination of two dynamics:

Trade Troubles | The market had convinced itself that a favorable outcome to the U.S.-China trade discussions would result. Not only is there the disappointment of no deal, but the growing size of the potential tariffs (the U.S. threatening an additional $325 billion) appears to have changed the direction of the discussions. The risk that this could be a harbinger of more challenging discussions with Japan and Europe over auto imports (deadline: May 18) increases uncertainty.

Time | The S&P 500 was off to its best start since 1987 and had already reached our year-end target of 2946. Technical indicators were overbought and suggested a modest pullback was likely. However, pullbacks after such fortuitous rebounds should be viewed as normal, as equity markets, typically, incur two pullbacks of 5% or more, on average, in a given year. Also keep in mind, that May, historically, has been the start of a more challenging six-month period for the equity market.

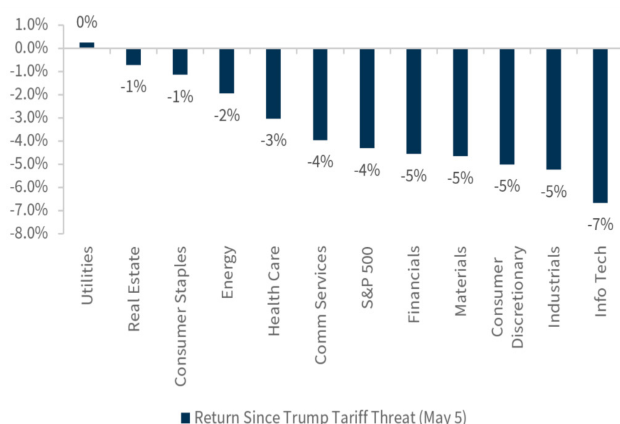
A Positive End to the Story

Overall, given that we were tactically more cautious on the equity market as we approached our year-end target of 2946, we believe a modest pullback of 5-10% should be viewed as a buying opportunity.

Delayed, Not Derailed, Deal | Ultimately, we believe President Trump will want to get a deal done that will lower the tariffs below where they were before last Friday morning. Similarly, we believe an auto deal with Japan and Europe will be consummated or the deadline for a decision will be delayed. The President has already proven he can be "tough" on trade, especially with China, which should help him with his political base and a deal should reduce any downside risk to the economy in the short run. With the President often using the stock market as a barometer of his success, further weakness in the market may spark a deal. Ed Mills, our political analyst, notes "A positive signal in the latest move by Beijing is an effective tariff increase date of June 1, leaving room for some progress in back-and-forth negotiations over the course of May."

Market vs. the Economy | Overall, trade between the U.S. and China is relatively small and China alone should not tip the U.S. economy into a recession. China represents ~7% of total U.S. exports or only ~1% of GDP. So the reality is that trade with China is a very small component of the U.S. economy. However, U.S. companies receive 6% of their revenues from China which is more meaningful and reflects the negative response to the equity market. Incidentally, the sector with the largest exposure to China-Technology (which gets ~15% of its revenues from China) has experienced the largest sell-off of any sector since President Trump's tariff threat on May 5 (Figure 2). The biggest risk to the U.S. economy is that a declining equity market and fears of a trade war lead to negative sentiment that causes both consumers and businesses to reduce their spending.

Figure 2: Returns Since Trump Tariff Threat



Fed Impulse. We do not think the Federal Reserve (Fed) will alter interest rates this year. In fact, the Fed suggesting at their last FOMC meeting that the downside risk from trade frictions was improving only strengthen our view. However, with those improvements potentially premature, the consensus has raised the probability of a rate cut to 71% by year end. In addition, increased concerns about the economy have caused the 10-year Treasury yield to fall below 2.4%, down ~85 bps from the 2018 high. Lower interest rates make equities more attractive on a relative basis.

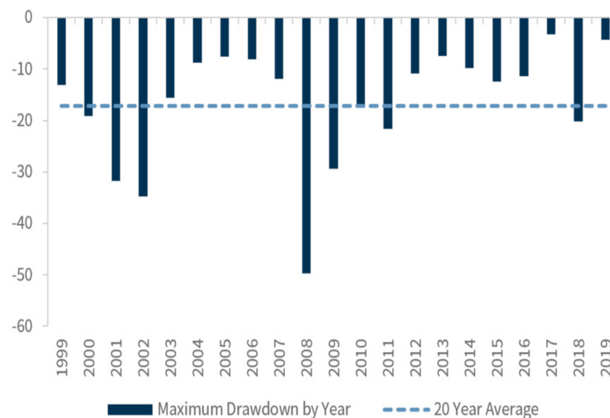
What to look for going forward?

We will continue to monitor the ongoing development of meetings between the U.S. (Treasury Secretary Steven Mnuchin and Trade Representative Robert Lighthizer) and China (Vice Premier Liu He) to see if any progress is developing. The good news is that both sides appear willing to engage further at the negotiating table. Additionally, Presidents Trump and Xi are scheduled to meet at the G-20 Summit (June 28-29) and President Trump has noted that this meeting between the two could be "fruitful". From a market perspective, Ed Mills notes that the next move is likely to be the official initiation of the process to levy a 25% tariff on an additional $325 billion Chinese imports by the U.S., which will invite an additional response by China and generate negative headlines. As a result, tensions could get worse before they get better.

Bottom Line:

First and foremost, it is important to put the pullback we have received in perspective. As of the close today, the S&P 500 is less than 5% away from its record closing high on April 30. From a historical perspective, today's S&P 500 decline is the 15th largest daily point decline (-71 points) and the 331st largest daily percentage decline (-2.4%) since 1936 (Figure 3).

Figure 3: Maximum Drawdown



Amidst the recent volatility, the S&P 500 remains up ~16% year-to-date (YTD). While it is impossible to pick a near-term bottom in the equity market given the plethora of headlines coming out via leaks, tweets and numerous interviews (both in the U.S. and China), levels of the market are important to assess. Given our earnings estimates ($166 in 2019 earnings) and economic forecasts (very low probability of recession over next 12-months) we remain confident in our year-end target of 2946. As a result, at 2946 (our year-end target) on April 30, the risk/reward was less attractive for both fundamental and technical reasons and we suggested caution. However, at 2800, the S&P 500 is more attractive as it represents 5% upside on a fundamental basis. Any overreaction to levels below 2700 (~10% upside) would only increase our enthusiasm for a buying opportunity.

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