Yuan for the Money, Two for the Tariffs...

August 5, 2019

In the wake of the fall in the yuan and the reescalation of the trade war that has fueled the market selloff, the Investment Strategy Committee shares its thoughts:

Scott Brown, PhD, *Chief Economist, PCG Investments*

Tariffs are a misguided tool to address bilateral trade deficits and bad behavior on the part of our trading partners. Tariffs are a tax paid by US consumers and businesses. They raise costs, disrupt supply chains, invite retaliation, and dampen business investment. The latest round (a 10% tariff on the remaining $300 billion in Chinese goods, effective September 1) applies more to consumer goods.

The escalation of trade tensions will further slow global growth, add to uncertainty, and increase downside risks to the US economic outlook — key factors behind the Federal Reserve's (Fed) recent cut in short-term interest rates. The central bank is expected to take further action in response to these issues, likely lowering rates in mid-September or late October.

Household sector fundamentals remain sound, and consumer spending should continue to support overall growth in the near term. However, the pace of job growth has slowed this year and can be expected to soften further in the months ahead. Stock market participants have been hypersensitive to changes in the Fed policy outlook and have reacted closely to the ups and downs in trade tensions. That is likely to continue.

It bears mentioning that the Chinese currency (the yuan) is managed (rather than free-floating). Were the yuan to float freely, it would be a lot weaker. Given that the natural outcome of trade tensions is downward pressure on the yuan, its fall is not surprising. It is less a concerted devaluation so much as a reluctance to support the currency in the wake of such pressures.

Chris Bailey, *European Strategist, Raymond James Euro Equities**

Both Asian and European equity markets have been hit hard by Thursday's tariff announcement by President Trump, and China's decision on Monday to talk tough, suspend agricultural purchases, and allow the yuan to slide below a key level against the dollar. This is no great surprise as both regions are relatively open and trade disruption between the US and China has both direct and indirect impacts.

China's reaction is not too hard to fathom; stability is the most prized aspect of the Chinese regime. Given that Mr. Trump upped the ante, a firm public reaction was a given, especially in light of events in Hong Kong. Behind the scenes, Beijing would have probably been happy to continue exploring compromise in the wake of the June G20 meeting in Osaka and the recent trade negotiations in Shanghai. However, they will be prepared to play high stakes diplomatic and economic poker if required. Chinese growth is slowing, but Beijing retains economic stimulus options and the political establishment still believes the upcoming election will make President Trump blink. Trade wars are almost never anything but a lose-lose for all. Any improvements in trade terms are quickly whittled away via inefficiencies and higher prices over time.

Ed Mills, *Washington Policy Analyst, Equity Research*

Trade tensions with China continue to flare following last week's announcement of the Trump administration's intent to implement a 10% tariff on a new tranche of $300 billion of Chinese imports starting September 1. President Trump expressed his frustration early Monday morning, accusing China of currency manipulation as the yuan depreciated to its lowest level since 2008.

Currency questions have been central to ongoing trade talks, and are likely to strengthen Mr. Trump's resolve to maintain pressure on China in the near-term. With the caveat that Mr. Trump can be unpredictable, we believe the base case remains that tariffs are implemented on or around September 1.

A negotiating round with Chinese officials is expected in Washington around the time of the implementation date. Mr. Trump could decide not to impose tariffs on imports that are in transit as of September 1, delaying the actual implementation to later in September. This would give him more time to get China to commit to progress at the negotiating table.

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For tariffs to be delayed, the US would likely need China to commit to a significant purchase of agricultural goods, a commitment to purchase more in the future, and a Trump-Xi phone call that agrees to restart the trade talks. Any restart would require a hard deadline. Should a deal not be reached, tariffs would likely be escalated again, essentially restarting the same process that we saw from December-May.

The negotiating dynamic we have seen demonstrated throughout the trade fight is that China does not want to be seen as caving to pressure from the Trump administration. That, along with a leadership conference during this month in China that is expected to focus on developing China's strategy on the trade fight, may delay action that would move the two sides towards de-escalation and makes the 10% tariff implementation increasingly likely.

Michael Gibbs, *Managing Director of Equity Portfolio & Technical Strategy*

Given that the dovish tone of the Fed in early June and the resumption of US/China trade talks following the G20 were key catalysts for the recent 11% rally to all-time highs, it is little surprise that stocks have deteriorated so rapidly. A less dovish than expected Fed and new tariff announcements have sent the S&P 500 down over 5% from its all-time high.

Stocks will remain pressured as investors move to protect portfolios until either, the Fed rides to the rescue again (with dovish commentary) or there is positive progress on trade. Since the Fed made it clear that trade will influence its monetary policy, the increased tension will likely lead to more dovish commentary than delivered last week (eventually). With non-manufacturing for July coming in below expectations, the Fed has another incentive to offer a more dovish message. Additionally, the Trump administration has a history of toning down the aggressive trade talk and actions if the markets take a major hit. Given our belief that the Fed will act and that the Trump administration will tone down the rhetoric if stocks move too far, we expect stocks to return to rally mode at some point. Determining how much pain will be inflicted upon equity investors until the Fed acts or the Trump administration backs down is impossible to ascertain. With currencies joining in the trade-war fray (with China letting the yuan fall to its lowest level in over a decade against the dollar) only adds to the uncertainty. Our best guess is equities will test and possibly undercut the June low (mid-to-low 2700s) during the current down wave before staging a meaningful rally.

At this point, we don't envision damage on the same scale as last fall (-19.5%). Then, trade tensions flared as well, but the Fed was in tightening mode, interest rates were moving higher, and economic readings surprised on the downside. Now, the Fed is easing, interest rates are much lower, and, although economic data is softening, it is not coming as a surprise. Also, with a healthy labor market, fears of a recession are low.

If conditions deteriorate more than we anticipate, an area of focus will be near the mid 2600s level on the S&P, which is near the 5-year average P/E (i.e., 15x next twelve-month consensus earnings estimates). Over the past five years, the most stressed times to the equity market found support near this level.

For the tactically minded, our suggestion is to keep cash available for buying, given that market conditions are ripe for additional weakness. Watch for intra-day recoveries from deep sell-offs, and positive news regarding the Fed and/or trade before aggressively buying.

James Camp, CFA *Managing Director, Strategic Income, Eagle Asset Management**

Risks to sustained economic expansion are rising. The Fed's 'capitulation' cut has accelerated the rally in US Treasury assets, but left risk markets unsettled as forward guidance was not reassuring. On top of this, the latest escalation in the trade conflict with China is met with a PBoC response to further weaken the yuan. This is the single biggest risk to global growth from the trade war, and the yuan now sits at the lowest level in over a decade. Other currencies will be under pressure to maintain competitiveness. The corresponding strength of the US dollar further strains our export competitiveness.

A stronger dollar is bad for commodities, foreign profits, and emerging markets with high levels of dollar-denominated debt, an overall negative for global growth (which is already under pressure). Domestically, the offset is strong labor and consumer markets and modest wage growth. While the economy averted the policy mistake of the Fed tightening into this slowdown, the trade war's resolution grows more uncertain and responses in the currency markets are negative for growth.

All told, positive for US treasuries, negative for commodities and EM.

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Doug Drabik, *Managing Director, Fixed Income Research*

President Trump has found the 'trigger' agenda that moves the market with his call for additional tariffs on Chinese imports. Given the White House broadcasted its desire for the Fed to cut rates by at least 50 basis points (bps), it is not surprising a tweet on trade followed the actual 25 bp cut by the Fed. Given that the market remains incredibly sensitive to trade tensions, a rollback of tariffs or progress on trade negotiations might be necessary to reverse the direction of the market. There is an abundance of global conditions that are fostering lower interest rates, not the least of which are expanded quantitative easing plans by the European Central Bank (ECB) and continued muted inflation.

Pavel Molchanov, *Senior Vice President, Energy Analyst, Equity Research*

Despite the relentless macroeconomic and geopolitical headlines that have caused volatility in oil prices, the global oil market's overall supply/demand balance looks essentially the same as it did three months ago. Our team is modeling a global inventory drawdown of 1.0 million barrels per day (bpd) in 2019 (same as we did three months ago). In short, we maintain that this is a fundamentally undersupplied market. Our latest numbers include a haircut to global oil demand growth, from 1.4% to 1%, reflecting the US-China trade-related headwinds. On the flip side, the extension of the OPEC production cuts, steeper-than-expected declines from Iran and Venezuela, and the recent Russian pipeline outage are all helping from a supply perspective. Looking ahead to next year, we continue to forecast the market remaining undersupplied, particularly bearing in mind the implementation of the IMO 2020 low-sulfur fuel regulations as of January 2020.

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