“Objection” to Trade Race Detente

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Just like the disqualification of the apparent winner of the Kentucky Derby, Maximum Security, this past weekend, China and the U.S. appear to be veering out of their running lanes as we come down the homestretch of the trade negotiations. With some differing views on the status of the negotiations evolving last week (e.g., reports that a deal could be done by this Friday versus Vice President Pence downplaying some of the optimism in an interview last Friday), we had noted in our *Weekly Headings* publication (May 3, 2019) that “with growing expectations of the framework of a trade deal being finalized as early as next week, any breakdowns in the discussions could lead to a negative market reaction.” And that is exactly what has transpired over the last 24 hours with the Chinese markets down 5%-7% and U.S. equity markets down 1%-1.5%.

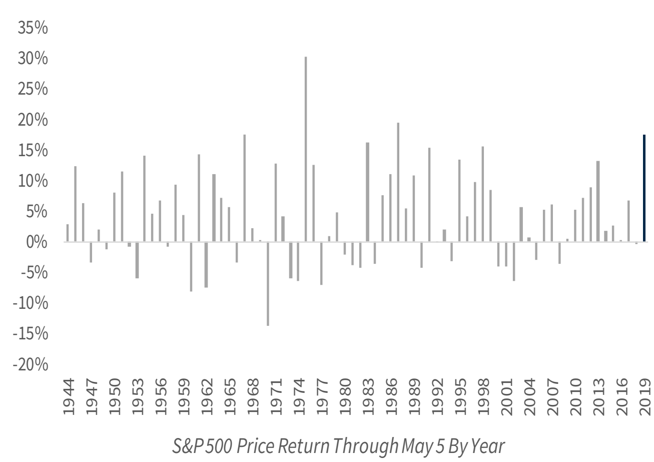
Ed Mills, our Washington Policy Analyst, distributed his thoughts last night. To summarize, he stated:

“The progress towards a U.S./China deal has been up-ended with renewed tariff threats by President Trump (25% tariff on $200 billion in Chinese goods by Friday and 25% on $325 billion more), apparent balks by the Chinese (especially on tech transfers), and the threat of the Chinese delegation canceling this week’s round of negotiations. We have previously seen President Trump threaten a new tariff package in the lead up to last year’s G20 meeting, only to use it as negotiating leverage, leading to speculation that this is President Trump seeking to use the new tariff threats to get a deal across the finish line. Based upon our conversations with our trade contacts, there appears to be a universal belief that this is not negotiating leverage; but what was almost a done deal last week has derailed in recent days. There is some hope that negotiations could be salvaged, but this situation highlights how tenuous any U.S./China deal remains.”

We think the big question for the market is whether or not President Trump is putting pressure on China to get a deal done this week (or very soon) or if there is something more long-lasting such as an impasse in enforcement of intellectual property provisions. A second question is whether or not this is a harbinger of more aggressive action with auto imports. Following the mid-February submission of the concluding report stemming from the U.S. Department of Commerce’s section 232 investigation into whether imported fully-assembled vehicles and auto parts pose a threat to national security (similar to the process used for the steel and aluminum tariffs last year), President Trump has until May 18 to act on the investigation’s findings and decide whether to impose tariffs of up to 25% on these products. The market had priced in a high probability of a favorable outcome with both China and autos so this potential “change in attitude” could lead to a market pullback.

Looking at the broader picture, with the equity market off to its best start to a year since 1987 (figure 1), we were essentially at our year-end target.

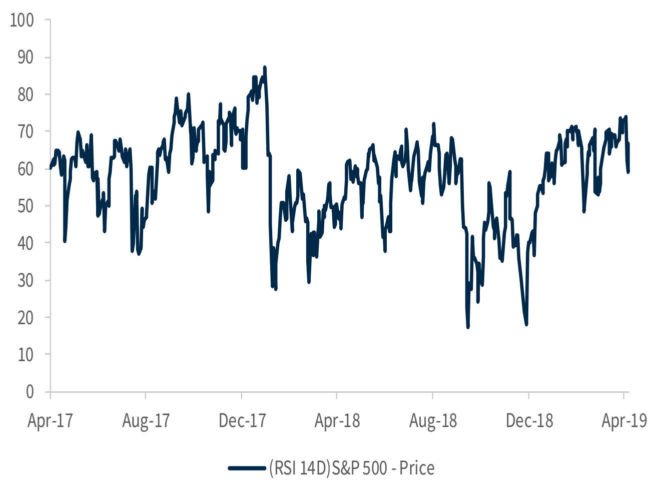
Figure 1: S&P 500 posts best start to a year since 1987



Source: FactSet

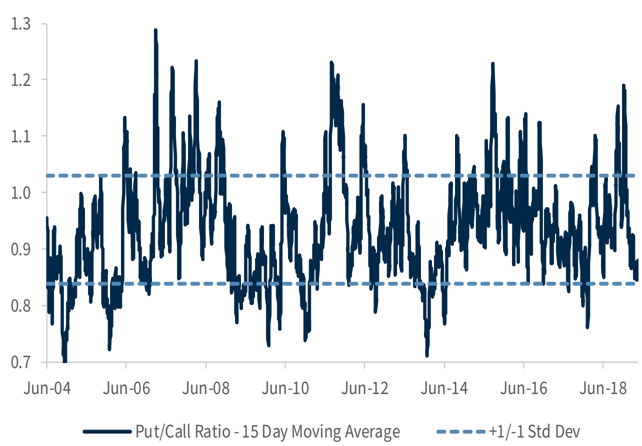
In fact, in our *Weekly Headings* (May 3, 2019), we wrote "with the S&P 500 nearing our year-end target of 2,946, the risk/return profile of equities is less attractive. With our expectation for a potential period of consolidation or pull-back, we would use weakness in the market as a buying opportunity as long-term fundamentals remain solid." Driving our near caution was some overbought technical indicators that included the relative strength Index (RSI) rising into "overbought" territory (a level above 70, figure 2), a declining put/call ratio (figure 3), depressed volatility and historically challenging seasonality that tends to begin in May and last over the summer months. As a result, trade deal uncertainty may very well be an excuse for a mild pullback.

Figure 2: RSI rises into overbought territory



Source: FactSet

Figure 3: Put/Call ratio falls one standard deviation below the historical average



Source: Bloomberg

Bottom line: In the end, we still think a trade deal gets done and equities ultimately move higher. President Trump knows the negative consequences to the economy from tariffs and will need a strong economy to get re-elected. China, on the other hand, was just starting to get some economic momentum (figure 4) and cannot afford to keep stimulating with its own budget deficit nearing a record high.

Figure 4: China economic surprise index rises into the highest level in a year

Source: FactSet

So our more optimistic hope is that this is probably some near-term rhetoric and a negotiating tactic before a deal gets done and not a "disqualification." However, if trade talks continue to deteriorate, the spring and summer months could prove to be more difficult and challenging.

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