After The Close

Investors seek safety in U.S. Treasuries as trade tensions worsen

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The market has started to price in a protracted U.S./China trade war – regrettably, we should expect more volatility

Risk assets fell on Thursday due to rising expectations for longer-lasting trade tensions, a brewing 'tech war,' growth fears, and a sell-off in oil. Energy stocks fell hard on the day (down over 3.0%), as crude prices broke below $60 per barrel for the first time since March. Technology and Industrials were also weaker. U.S. Treasuries, as well as gold, rallied during the session, leaving only Utilities and Real Estate in the green by the closing bell. Interestingly, the 10-year U.S. Treasury yield fell to its lowest level since October 2017, finishing at 2.31%, highlighting the increased risk aversion among investors as of late.

Major Domestic Equity Indices - Today

Benchmark	Index Level	Net Change	% Change
S&P 500 Index	2,822	-34.0	-1.2%
Dow Jones Industrial Average	25,490	-286.1	-1.1%
Russell 2000 Index	1,499	-32.3	-2.1%
NASDAQ Composite	7,628	-122.6	-1.6%

All data via FactSet as of approximately 4 PM ET

Though equities finished well off their lows for the day, global stocks reacted negatively to a series of potentially harmful headlines related to trade and growth. First, more U.S. tech companies are backing away from supplying Huawei Technologies (China's telecom giant) with critical chip/tech components it needs for its products. Based on new U.S. sanctions, the move has the potential to turn the current U.S./China 'trade war' into a 'technology war' as well. Second, a batch of manufacturing and services data in the U.S., Eurozone, and Japan on Thursday came in weaker than expected. Some measures showed activity has been contracting for several months, supporting concerns that rising trade frictions are starting to slow global growth.

In our view, the trade war appears to be taking a more pronounced shift into the technology space. The U.S. decision to blacklist Huawei and limit or eliminate U.S. tech companies from supplying the company with technology could make a near-term trade settlement unlikely. Nevertheless, it is also just as likely the White House is hoping the additional pressure on Huawei will prompt Beijing back to the negotiating table. Since investors are uncertain about the outcome, risk assets declined on today's negative headlines.

Importantly, China does not have the necessary leverage to strike back similarly for the Huawei move. However, Beijing could target U.S. companies with more regulations, support consumer bans against U.S. products, and limit rare-earth minerals used for a vast array of technology components. The country controls 90% of rare-earth minerals, and at least temporarily, could make it more difficult for the U.S. to produce a variety of everyday technology products, such as smartphones, batteries, laptops, and tablets. Markets around the world are starting to respond poorly to these growing threats, as they could lower global growth and hurt corporate profitability more than expected this year, particularly in the Technology sector.

The S&P 500 Information Technology sector is lower by over 7.0% on a price basis over the last month, with the PHLX/Semiconductor Index down by nearly 16.0%. Over the last few weeks, performance across semiconductor stocks has been ground zero for the deterioration in trade talks, an escalating threat of a U.S./China tech war, and slower global growth. Based on the poor performance across Tech, investors presently do not appear very optimistic any of these key macros will be sorted out soon.

In the last edition of this report, we noted: "*Expect markets to react in unpredictable and potentially volatile ways due to rising trade tensions*." At this point, it is impossible to predict how trade talks will develop with any degree of confidence or if the trade war will morph into a tech war as well. Therefore, investors should expect risk assets to be more sensitive to trade headlines and see downside pressure if discussions between both countries stall. Since highlighting that view on May 13th, that's precisely what markets have done. Stocks have moved back-and-forth, sometimes erratically, based on incoming trade headlines. Today's trading patterns are a perfect example. Over the near-term, we expect more of the same.

Committee View

Earlier this week, we lowered our odds of a U.S./China trade deal before the end of June. *Please see the 5/20/19 Before The Bell for more details*. We believe odds of a 'Trade Deal' or 'Talks Continue' by the end of the second quarter have fallen to 50% from 70% before President Trump's May 5th tweet threatening more tariffs against China. Interestingly, odds of a deal could be more binary at this point — meaning the U.S. and China agree to a deal, or they don't. In our view, odds of a middle ground, where talks drag on and tensions do not escalate, seem less likely in the current environment.

Conversely, odds of a 'No Deal' scenario have risen substantially over the last few weeks. We now believe the chances that President Trump and China President Xi Jinping escalate the trade war from here currently stands at 50%, up from 30% previously. Over the last few weeks, we have seen the U.S. increase tariffs on $200 billion in Chinese imports to 25% from 10%, Beijing respond with $60 billion in new tariffs on U.S. imports, and the White House impose sanctions against Huawei. Simply put, these are not the actions of two countries on the verge of a trade agreement.

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