The Trade War with China Remains a Stiff Headwind for Economic Growth

U.S. equities established new record highs last week, even though the two most important issues they face got considerably more complicated. On Wednesday, ahead of the Independence Day holiday, the S&P 500 closed at 2995 before ending the week at 2990, both records for daily and weekly closes. But a strong jobs report on Friday dampened expectations of any aggressive shift toward lower rates by the Fed. On the same day, China made it clear that it wants all existing tariffs on its exports to the U.S. to be lifted as part of any trade, something the U.S. is not prepared to do.

The 224,000 new non-farm jobs created in June far exceeded the 160,000 that was expected, and at least temporarily eased concerns that the economic slowdown was expanding. In doing so, it also raised questions about Fed’s rate-setting calculus as it prepares to meet at the end of the month. The CME FedWatch tool still places 100 percent odds on at least a quarter-point rate cut this month, but the odds of a half-point cut have fallen to roughly 5 percent from almost a one-in-three chance before the jobs report.

Bonds reacted sharply to the jobs data. The yield on the ten-year Treasury note jumped by eight basis points to 2.03 percent on the day (a basis point is 1/100th of a percent), while the two-year note yield climbed ten basis points to 1.86 percent. The yield curve between the two maturities flattened to 17 basis points, down from 25 the prior week, and the narrowest since the end of May. The three-month to ten-year curve remained inverted, but the inversion narrowed to -19 basis points from -26 as the three-month yield barely moved. Fed chairman Powell testifies before Congress this week to provide his latest assessment of economic conditions and any hint of how he may be leaning in the rate cut debate, as he continues to be the target of criticism by president Trump. Minutes of the June Federal Open Market Committee (FOMC) meeting are also scheduled for release on Wednesday.

Uncertainty with Trade Lingers; Tensions with Iran Increase

Despite the strong employment report, the trade war with China remains a stiff headwind to economic growth. The reopening of negotiations following the G-20 meeting is a welcome development, but it is important to note that so far nothing has changed, as tariffs remain in place and business uncertainty remains elevated. And Chinese media is reporting that any trade deal must include the lifting of all tariffs, while the U.S wants to leave at least some in place as a means of enforcing compliance. While both sides would presumably prefer to strike a deal, how soon and what that deal would include are the critical questions.
President Trump is no doubt mindful of the approaching 2020 election and must weigh the economic impact of the trade dispute against the desire for a credible and lasting agreement. The Chinese must also weigh the economic impact, and decide how patient it can be, including to the point of slow-walking negotiations until after the U.S. election. China’s official manufacturing sector PMI contracted for the second straight month in June despite its efforts to stimulate the economy. Manufacturing accounts for just over 40 percent of China’s GDP. And while that is down from close to 50 percent ten years ago, it is almost four times as much as in the U.S.

Tensions are also rising between the U.S. and Iran. Last week an Iranian oil tanker headed for Syria in violation of U.S. sanctions was seized by Great Britain off the coast of Gibraltar, in response to which Iran has threatened to do the same to a British tanker. This follows a series of confrontations in the Gulf of Oman, including attacks on ships and the downing of a U.S. drone. The sanctions are beginning to bite, and in response, Iran has announced its intention to enrich uranium beyond the limits set in the 2015 nuclear agreement, which the U.S. abandoned in 2018. The price of oil has pushed modestly higher but worries about demand in the face of a slowing global economy have limited the impact.

**Investors will Soon Learn if High Equity Prices are Justified with Q2 Earnings**

Meanwhile, stocks are at record highs. Second quarter earnings season starts next week and will help to determine whether such lofty expectations are justified. With expectations of a modest decline year-over-year, it is likely that aggregate results will ultimately turn out to be flat to slightly positive. Whether that will be enough to support equity prices in the absence of a trade deal is questionable.

And the dismissal of the Turkish central bank governor has investors wondering if that could happen elsewhere. Central bank independence is a critically important aspect of their credibility. Interference in monetary policy deliberations to achieve short-term political objectives is a dangerous development. In the case of Turkey, according to a Bloomberg report, president Erdogan has insisted that, “Politicians and bureaucrats need to get behind his conviction that higher interest rates cause inflation.” Milton Friedman is no doubt rolling over in his grave.

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