China strikes back as the trade fight deepens

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The U.S. and China dig in for an extended trade war
The S&P 500 posted its worst day of 2019, closing down for the sixth consecutive session – its longest losing streak since 2016. All sectors were lower on the day, with trade-sensitive/cyclical stocks among the worst performers. With investors clamoring to buy bonds, the yield on the 10-year U.S. Treasury sank to 1.73%, its lowest level since November 2016.

Overnight, China let the yuan weaken versus the U.S. dollar. Note: The level of the yuan is heavily regulated by Chinese officials. Beijing’s decision to let its currency weaken against the greenback and below psychologically important levels was viewed by the market today as a direct response to last week’s White House decision to increase tariffs on Chinese imports beginning on September 1st. Last Thursday, the White House announced it would impose a 10% tariff on the last remaining tranche of roughly $300 billion in Chinese goods entering the U.S. If realized, essentially every good entering the U.S. from China will now have a tariff applied.

This is the first time the yuan has weakened to such a level since offshore trading began in Hong Kong in 2010 and is the lowest level in onshore trading since April 2008, according to FactSet. Hence, the development in dollar/yuan levels did not go unnoticed by investors who have already become cautious about the global landscape. Additionally, reports during the day suggest China will halt U.S. agricultural purchases, reversing a previous commitment to add to its purchases. Beijing is also not ruling out imposing tariffs on U.S. farm products purchased after August 3rd. As expected, the reports added to declines on the day.

The People’s Bank of China (PBoC) said the drop in the yuan was in reaction to “unilateral trade protectionism,” as well as expectations of more tariffs on China. Nevertheless, the central bank said it could keep the yuan exchange rate stable and at a reasonable equilibrium level. We believe the intermediate-term risk for the global economy is a flight of capital out of China, which could be disruptive for U.S. companies operating overseas as well as investors as a whole. Although we expect China officials to curb capital outflows from the country where they can, it may become more difficult in a deteriorating trade environment.

Importantly, Beijing may seek to keep its currency weaker versus the U.S. dollar as a means to mitigate the effects of increased U.S. tariffs on its goods and maintain a degree of competitiveness on the global stage. In our view, this action only widens the gap between U.S. and China trade officials and is likely to draw increased rhetoric from President Trump and the U.S. Treasury that China is a ‘currency manipulator.’

Bottom line: the trade war has quickly intensified over recent days leaving both the U.S. and China in difficult positions. For the near-term, it seems unlikely the two sides will find common ground that deescalates tensions. Investors should expect trade headlines to be more volatile and risk assets to increasingly become susceptible to near-term selling pressure if trade machinations look likely to erode economic growth/corporate profits further. It is our view asset prices will be quicker to react to building trade frictions and headlines than the global economy itself.

A small bright spot: Market odds of another 25 basis point cut in the fed funds rate at the Federal Reserve’s September meeting now stand at 100%, up from 56% a week earlier. If the U.S. economy remains on stable footing, as we believe it could, easier monetary policy may help cushion the blow here at home if trade tensions remain heated. With that said, just a few weeks ago, investors were pushing stocks to new all-time highs on the back of sanguine trade headlines and easier monetary accommodation. Today, it appears this accommodation may come because of a worsening outlook for the economy, due to building conflict between the U.S. and China. As expected, this scenario has been met with lower stock prices over the last few sessions.

Committee View
If further rate cuts are needed, due to deteriorating economic data and a building trade war, new stock market highs over the intermediate-term will be difficult to achieve. With that said, we believe one or two ‘insurance cuts’ with a backdrop of stable economic data could help support risk assets through year-end.

However, the bond market is telling investors it believes growth and inflation in the future will be slow or even lower than it is today. In our view, the disconnect between the still rather optimistic stock market and pessimistic bond market could narrow further depending on how the data plays out over the coming months. Consequently, investors should favor quality investments, align portfolios with the desired risk, and be comfortable holding investments for the long-term.

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