Investment Insights

How to Think About Trade Tensions

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Highlights

- Tuesday saw equity volatility return with a vengeance, with the VIX equity volatility index rising to an intraday high of 21.84 before ending the day just under 20 (up from levels closer to 13-14 just a few days earlier).
- Short-term investor fears, reflected in lower stocks and bond yields and higher volatility levels, followed suggestions that the U.S. could increase and possibly broaden tariffs on Chinese imports this Friday, with Chinese retaliation likely to follow.
- No one can predict the ins and outs of these negotiations; however, when we go back to first principles, we believe that a deal is ultimately still the most likely outcome — the bigger question is around the path to get there and timing.
- Further out, we believe that renewed equity strength around confirmation of an eventual deal may well provide an opportunity to incrementally reduce equity risk in portfolios.

Tuesday saw global equities fall sharply, as investors digested (1) the possibility of higher tariffs — increasing from 10% to 25% — on Chinese imports to the U.S. starting Friday, (2) possibly a broader set of tariffs (on more goods that could impact U.S. consumers), and (3) Chinese retaliation (likely to follow immediately after any U.S. escalation). Tuesday saw the S&P 500 close down 1.65% and the Nasdaq close down nearly 2%; U.S. 10-year Treasury yields fell to 2.45% while the VIX flirted with levels above 20. High levels of VIX short positions likely exacerbated the price action as positioning was unwound or hedged via the selling of equity futures. Wednesday has seen a continuation of the trend, with cyclical assets continuing to fall.

Media reports suggest the Chinese trade delegation returned the roughly 150-page draft agreement with changes that were not acceptable to the U.S. Reportedly, the negotiators are stuck on a few key items:

1. Chinese laws and regulations around certain trade topics (like tech transfer) that U.S. officials want to be changed as part of the final agreement. China has objected to at least part of the U.S.'s list.
2. Timing of removal of U.S. tariffs currently in place on Chinese imports. The Chinese would like tariffs lifted as part of the agreement; the U.S. has suggested at least some level of tariff should stay in place until the Chinese show that they are adhering to the terms of the deal.

We think there are at least two "inner workings" here to consider. First, the U.S. trade team includes officials with different agendas. U.S. Trade Representative Lighthizer wants the broadest deal possible — he likely wants to claim responsibility for structurally improving U.S.-China trade relations. He's the so-called trade hawk. Meanwhile, Treasury Secretary Mnuchin also wants a deal but is relatively more focused on doing everything he can to support equity markets and economic growth, in turn to help President Trump get re-elected in 2020. A win on China matters, but a prolonged trade war that could weigh on growth and markets could prove a cost too

big to pay for the perfect deal. From this perspective, it may be better to get 80% of objectives met and move on rather than hold out for 100% and have to endure another market meltdown and/or slower growth.

Second, both countries' leaders have somewhat divergent agendas. President Trump, as noted earlier, wants political wins but also strong economic growth and markets. He also knows, however, that being tough on China plays well with many U.S. voters (from both parties). This is pulling him in different directions, so he may be influenced by arguments from both Lighthizer and Mnuchin. Meanwhile, Chinese President Xi needs to show he won something with the Chinese people at the end of all this. Getting tariffs lifted in part or completely would show he "beat American protectionism." He also doesn't want the Chinese people to think that America can dictate Chinese law to the Chinese.

At the end of the day, both leaders need solid growth. While recent months have certainly been smoother sailing than the fourth quarter, we would think both remember the challenges of late 2018 and do not want to go through that again. With that in mind, we do believe that the most likely outcome is still a trade deal. What is more a question now is timing and the exact details of the deal. With the most senior Chinese trade negotiator, Liu He, arriving only this Thursday, it seems quite possible that tariffs do escalate Friday (unless market volatility prompts President Trump to give China a bit more time and extend the deadline a few days).

That said, continued market volatility could refocus both sides on getting to a deal quickly. As things get back on track, we expect equities will resume their recent climb. At that point, with more "good news" back in market valuations, our inclination would be to consider another small, incremental move to reduce equity risk in portfolios. While a deal should help global sentiment for some time, we believe that much will be discounted in valuations at that point, while a number of other risks remain, from other trade issues (including global autos) to the debt ceiling to Italian politics, Brexit, and Middle East oil supply. That, along with our view that global growth (including the U.S.) will slow into 2020, leaves us with a view that equity upside on a medium-term basis is fairly limited.

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