Investment Insights

News From the (Trade War) Front

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Highlights

- The S&P 500 fell 2.4% Monday for its worst day since January 3, alongside increased worries that the ongoing U.S.-China trade war could broaden and last notably longer than expected.
- The bounce in global equities Tuesday, however, also apparently in part on (more hopeful) trade rhetoric, is a reminder of how sensitive sentiment is to each twist and turn in the negotiations.
- An increase in volatility-related and systematic trading strategies seems to be exaggerating short-term market swings — we expect these bursts of volatility to remain a part of the investment landscape.
- Our base case remains that the U.S. and China will resolve this dispute as it is in both sides' political and economic interests; our somewhat more defensive posturing should help us navigate through the volatility relatively well.

The extraordinary strength in equity markets for the first four months of the year, with global equities up some 15%, came on the back of three main factors: increased hopes that the U.S. and China would resolve their trade dispute, more dovish central bank policy, and positioning and valuations from late 2018 that left cyclical assets attractive.

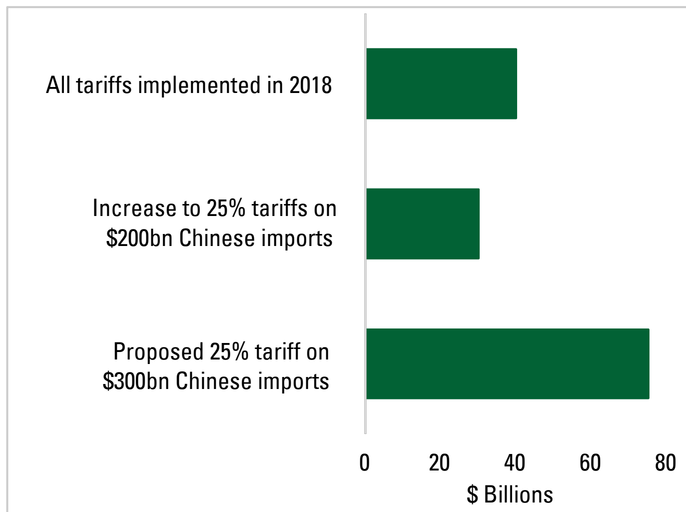
May so far has seen a sharp reversal for equities, thanks to two of those three factors: trade and positioning.

Trade news took a decisive turn for the worse last week when President Trump said he was unhappy with trade negotiations, and as a result, he was increasing tariffs on $200 billion of Chinese imports from 10% to 25% starting last Friday. He also suggested he could increase the scope of tariffs to include almost everything else China sells in the U.S. (worth more than $300 billion). Not surprisingly, the Chinese announced at the start of this week that they would retaliate, raising tariffs on $60 billion of U.S. goods.

The increased U.S. tariff rate goes into effect around June 1, as do the higher Chinese tariffs — that suggests a small window for a de-escalation and change of plans from both sides. The new U.S. tariffs, meanwhile, have to go through a process that suggests they would not take effect until mid- or late July (and such a broadening of tariffs would clearly only occur should no progress on talks transpire earlier).

The broader set of tariffs and higher tariff rate, if all become reality, is meaningful. Estimates from one U.S. investment bank this week put all tariffs implemented last year at a value of roughly $40 billion (the tariff rate multiplied by the level of impacted imports). Adding the higher tariff rate announced on Friday, plus the increased set of goods impacted, would take that total to more than $140 billion (Exhibit 1). As a reminder, tariffs are collected at the border and paid for by the importer. Assuming China doesn't lower the cost of its goods to keep the post-tariff rate unchanged, the tariff is paid for by U.S. firms. That cost is in turn either passed on to U.S. consumers (through higher prices) or is absorbed by the importing firm and reflected in lower profit margins. China suffers as well, as U.S. firms hold back on new investment plans in China, reduce purchases of tariffed Chinese goods when substitutes exist, or move facilities out of China to non-tariffed locations.

Exhibit 1: Estimated Tariff Values



Source: Goldman Sachs Global Investment Research. 2018 includes tariffs on solar panels, washing machines, steel and aluminum, 25% tariffs on $34 billion and $16 billion of tranches of goods for China, and 10% tariffs on the $200 billion tranche of goods from China.

In recent months, White House officials have suggested the U.S. is collecting significant revenue from the tariffs — that is true. However, two different academic studies (both published in March) looking at very detailed data on trade volumes and price trends before and after the trade war began show that at least to date, the costs of the tariffs have fallen on U.S. businesses and consumers, and that impacted imports are translating into higher prices and subsequently higher inflation for Americans.

It is not clear if the proposed new tariffs would have the same result or if the Chinese would at some point start cutting prices more to protect market share. Assuming the trends seen over the last year remain constant, however, it would imply a drag on U.S. growth and support for inflation — something we strongly believe the White House would want to avoid going into an election year.

The hit from tariffs and trade-related uncertainty should not only be seen through a narrow U.S. economic lens. There are second and third-order impacts as well. For instance, to the degree investors expect slower growth and potentially lower profit margins, they are more likely to reduce expectations for equities overall, potentially selling and moving into more defensive assets, such as Treasuries. In addition, the Chinese may feel more inclined to take additional steps to support growth at home, including more interest-rate cuts and/or allowing its currency to weaken. A weaker renminbi and stronger U.S. dollar could impact other currency markets (especially Chinese trade competitors such as those in Asia). Currency contagion can force respective central banks to act and can motivate dollar-based investors to take profit on those countries' assets given that the currency moves could erode total returns. Put another way, the trade war could quickly spread to a number of emerging markets and their underlying economies.

This slowing global economic threat is similar to what was feared at the end of 2018 — prompting a change in tone from central banks and both President Trump and President Xi. We are fairly confident that any market or economic trends that emerge today that are reminiscent of late last year will quickly refocus Trump and Xi on finding a path forward toward compromise.

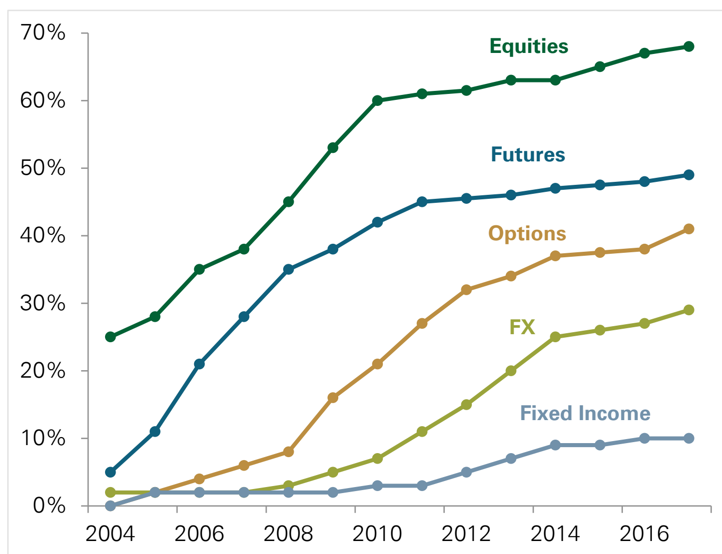
The timing around a trade truce is tricky, and this week alone has been full of often-conflicting headlines. Just Tuesday morning, media outlets talked about Trump and Xi meeting around a Group of 20 multilateral conference in late June in Japan, meetings between negotiators in the next few weeks, and meetings possibly as late as August. Until there is greater clarity around timing and concrete signs that a deal is coming, investor sentiment is likely to stay anxious, and markets choppy.

That gets us to the second component of market trends this year that should be highlighted: positioning and market structure. As of end-April, data suggested that both retail and institutional investors held U.S. equity exposure similar to levels seen last September (before the fourth-quarter selloff). Those positions made sense in a world where a trade deal was in sight and the global growth outlook was improving. However, with an abrupt escalation in the trade conflict and risk that such

prolonged tensions could weigh on growth, investors would be prone to reduce exposure and/or move it to defensive assets.

Also noteworthy is the evolution of market structure behind the scenes. The depletion of market reversion forces over time has been driven by a decline in "active" managers, a reduction in human risk-taking activity following the 2008 crisis (proprietary trading desks, for example), and a shift of assets from public to private equity. As a result, the amount of daily equity trading volume driven by algorithmic strategies (rather than human, "active" managers) has grown substantially. Indeed, since 2004, the share of algorithmic trading as a percentage of total equity trading has nearly tripled; algorithmic strategies comprised roughly 25% of total equity trading in 2004 and now represent closer to 70% of daily volume (Exhibit 2).

Exhibit 2: Market Share of Algorithmic Trading by Asset Class



As of 2017.
Source: Goldman Sachs, AiteGroup

A number of these strategies work on the basis of very short-term momentum. When equities start falling, momentum models are triggered at certain price thresholds, which prompt more selling when breached. This selling can continue until an "oversold" signal is reached, at which point the model's signals flip the other way. A similar short-term strategy with volatility as a primary input is known as "volatility targeting," where exposure to stocks versus bonds is determined by the level of overall market volatility (often viewed via the VIX index). A step up in realized volatility prompts a shift in the model's allocation from stocks to bonds, and vice versa. Given the feedback loop between liquidity and market volatility, the increased presence of short-term momentum- and volatility-based strategies amidst a falling number of "active" traders increases the probability of outsized market moves on any given day.

With more volumes tied to these short-term strategies, what might otherwise be viewed as an incremental trade headline can have a short-term reaction that feels outsized. Our team believes this structural shift in markets is not likely to go away anytime soon and that we and our clients need to be aware that volatility bursts may well remain part of the market landscape for the foreseeable future. We need to look at each one and analyze whether we think the selling is more technical and related to these strategies, or if it reflects a material and real underlying change in economic conditions that could warrant an allocation shift in portfolios.

Pulling all this together, we are left with a few key assumptions looking ahead:

First, we believe a U.S.-China trade deal will be reached this year, and probably sooner rather than later. That suggests that the recent equity decline should reverse.

Second, we believe the short-term volatility created in part by evolving market structure is here to stay, and that we and our clients should expect it and appreciate that a sudden change in market trend does not necessarily reflect an equally large change in the macro- or policy outlook.

Finally, we continue to believe that while there is more upside for equities in this cycle, it is growing more limited, especially as we look toward 2020 with what we expect will be moderating global economic growth. With that in mind, we are inclined to view further bouts of equity strength as potential opportunities to incrementally reduce portfolio risk.

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