Investment Insights

Trade Turmoil Returns

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Highlights

- U.S. equities had their worst day so far in 2019 on Monday, with selling mainly driven by rising U.S.-China trade war-related fears
- The speed of Monday's selloff partly reflects the growing influence of systematic and algorithmic trading strategies; however, we would also note that summer liquidity conditions can exacerbate market moves
- We would view this, as any equity selloff, in context of the macroeconomic backdrop — while global growth is slowing, there are still significant supports for cyclical assets out there, including strong labor markets and consumers as well as easy global monetary policy
- Our decision to modestly reduce equity exposure in mid-July has benefited clients; for now we do not see any need for further allocation changes

Equity markets saw volatility suddenly return Monday following new developments in the U.S.-China trade war late last week and through the weekend. Investors were already in a downbeat mood after midweek comments from the U.S. Federal Reserve indicating that monetary easing may not be all that markets had hoped for; while the Fed cut the federal funds rate by 25 basis points, Chair Powell noted that "this is not the beginning of a long series of rate cuts like you would see in a downturn."

Equity selling gained momentum Friday and then in particular Monday following U.S.-China trade developments. After trade talks last week, U.S. President Trump initially called the discussions constructive but shortly later flip-flopped, suggesting he was frustrated that China was not living up to promises to buy larger quantities of agricultural products and block fentanyl shipments. On Friday, he announced yet another round of tariffs (10% duties on $300 billion of Chinese imports that were not currently subject to tariffs) to kick in as of September 1.

Weekend media reports suggested that most of Trump's advisors objected to new tariffs, creating greater uncertainty around policy in the eyes of business leaders and investors. Then, on Sunday evening, China retaliated with two steps. First, it issued a directive to state-owned companies to suspend imports of U.S. agricultural products. In addition, though, and in focus Monday, was a decision to weaken its currency, the renminbi, to below the psychologically notable level of 7.0 versus the dollar. Following this chain of events, Monday saw a drop in the S&P 500 of about 3%.

Currency Depreciation in Context

China's central bank noted in a statement that the renminbi's depreciation was "due to the effects of unilateralist and trade-protectionist measures and the expectations for tariffs against China." The currency's 1.9% intraday move put it on course for the largest single-day loss since August 2015, when Beijing allowed for a sudden depreciation of the currency.

Despite a slowdown in China that started at the end of 2017, Beijing has largely kept the currency

in the six percent area versus a basket of trading-partner currencies (perhaps knowing that the current U.S. administration is very focused on countries not using currencies to gain unfair export advantage over the U.S.). With Monday's move, the Chinese renminbi has breached the lower end of that range.

One might ask why a 2% exchange-rate move would cause such an outsized reaction in equities. To answer that, it's important to remember that currencies can have second- and third-round impacts across countries and asset classes.

A cheaper renminbi helps make Chinese exports more competitive overseas, all else equal. But the world is dynamic, so all else is never equal. As China devalues, countries that compete with China for global trade or try to sell to China then need to weaken their currencies as well so as not to lose export business (called "competitive devalautions"). A weaker renminbi can quickly lead to weaker currencies across a host of countries around the world. That pushes the dollar higher.

While a stronger dollar has benefits, including holding down inflation pressures and increasing purchasing power for U.S. consumers, it also can have costs within the U.S. Specifically, dollar strength can weigh on profitability for U.S. multinational companies. At times, strong-dollar environments also go hand in hand with lower commodity prices, something that can weigh in particular on energy-related firms.

China last let the renminbi weaken versus trading-partner currencies starting in August 2015. At the time, China's intent seemed to be less about export advantage and more about evolving its currency away from a heavy-handed central bank-determined rate to a more market-friendly flexible instrument (something the U.S. and other countries had been pushing for). While the initial devaluation was small (around 3% against the dollar), the suddenness of the move and change in trend from the past overly managed currency regime caught investors off guard. The following months saw global currency, interest rate, equity, and commodity markets all react — in part as fears increased that this move could be the start of a larger devaluation trend that could spur destabilizing capital flight from China with local investors seeking safer harbors offshore.

Then, as now, a weaker renminbi pushed down global interest rates and led investors to discount more potential central bank easing. U.S. 10-year Treasury yields fell 80 basis points between August 2015 and July 2016 before finding support.

There's China, but There's More

While Monday's "risk off" market action appears mainly driven by worries that the U.S.-China trade war could escalate and weigh further on global growth, there are other factors at work as well denting investor sentiment. In addition to rising tensions in the Middle East and in Hong Kong, we would highlight an escalating trade war between Japan and South Korea, the ongoing uncertainty surrounding Brexit (where the October 31 deadline is right around the corner), and renewed missile tests out of North Korea. It's also worth noting that market liquidity tends to deteriorate in August, when more investors are on summer vacation. During such periods, market events can trigger larger-than-normal reactions.

With any selloff, we want to step back and consider the macroeconomic environment. Does a worsening fundamental picture justify further selling?

The good news right now is that the global economy, while slowing, still has some important bright spots. Labor markets in most developed economies are tight, consumers are healthy, and

central banks globally are supportive. In the U.S., the latest earnings season has seen results generally better than expectations. The challenge is how to respond to the risks out there? Our view has been and continues to be that the U.S. will not want a lingering or escalating trade war into the 2020 election — history clearly shows that incumbents are more likely to be re-elected with supported equity markets and improving economies in election years. That said, we have also noted that we do not dare try to forecast the path from here to whatever that trade resolution may be. Further, we are not sanguine that all the other risks we noted above will resolve quickly or smoothly. So the bottom line is that a global recession does not seem imminent, but that the global macro outlook is mixed and at the margin deteriorating.

In the very near term, there are some potential market catalysts worth watching that might shape the duration and degree of equity selling:

- Whether the U.S. Commerce Department will issue waivers to U.S. suppliers of Huawei, the Chinese technology firm; such a move would likely signal an olive branch of sorts from the U.S. to the China in terms of negotiations.
- Commentary from the Federal Reserve's late-August retreat in Jackson Hole — dovish rhetoric would be welcomed by markets.
- A softening in language from President Trump as he refocuses on his re-election, realizing that a plunging stock market, downbeat CEOs, and agitated Midwest farmers are not in his best interest. (We saw such a change in trade tone in December after the sharp equity selloff.)

Portfolio Positioning

We can never predict with confidence exactly how long or how pronounced these bouts of equity volatility will be. However, given the market highs reached in July, we are not surprised to see some pullback now. Indeed, that thinking was behind our decision last month to modestly reduce equity exposure in client portfolios in favor of defensive, traditional fixed income.

As we look ahead, assuming the trade war does not get much worse for a prolonged period, we expect equities are likely to trade in a choppy range, with limited potential upside. However, if the trade war does intensify, our asset allocation today should help limit losses to a degree — and of course, we will carefully monitor developments to determine if further portfolio adjustments are required.

As always, please feel welcome to reach out to your client advisor with any questions.

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