Stock market sell-off underscores trade war dangers

Weekly Market Compass: China stands firm as Trump proposes a fresh round of tariffs

Aug 5, 2019 | Kristina Hooper, Chief Global Market Strategist

As I write this, there is a significant market sell-off underway, as fears about escalating trade tensions have caused investors to panic. This sell-off should not come as a surprise to those who recognized that stocks were vulnerable because the market wasn't fully pricing in trade tensions. I view this as a healthy re-pricing of stocks to more fully factor in the potential that the trade war is likely to drag on.

Last week, all eyes were on the Federal Reserve's (Fed's) monetary policy committee meeting. The decision was expected – a rate cut of 25 basis points – but there were a few surprises. The first surprise was that the Fed also hastened the timeline for ending balance sheet normalization. The other surprise was that many Fed watchers walked away from the press conference with some confusion about how dovish the Fed really is, and about the Fed's rationale for the rate cut.

Fed Chair Jay Powell had a very difficult task in trying to articulate the rationale for the rate cut given a still-strong US economy – while also not wanting to cause alarm. The Fed pointed to several different reasons for the cut. But I focused in on one of them: The Fed cited "uncertainties" in the global economy as one of the reasons, which is clearly a reference to the trade situation.

The trade war has elevated economic uncertainty

My takeaway from the press conference is that the ongoing deterioration in trade relations is a grave concern for the Fed; I believe the rate cut was an "insurance policy" against the negative impact of trade wars. However, at this juncture, it is difficult to quantify how damaging it may be, given that it is like a slow-motion accident unfolding before our eyes. (I must note that this situation can still be halted before maximum damage is inflicted.)

I call this a "slow-motion accident" because, as I've said before, the primary cause of the negative impact isn't actually the tariffs themselves. It's the economic policy uncertainty they create, which undermines business confidence and tamps down business investment – something Powell has pointed to in the past. (For example, second-quarter US gross domestic product indicates that the trade war has been impacting business confidence and investment, as business investment fell 0.6% in the second quarter – the worst quarter for investment in more than three years.[1]) Powell made it clear that trade policy uncertainty is more elevated than the Fed had expected, but also suggested the Fed did not need to act more boldly because the trade situation had stabilized: What he described as having previously been "boiling" was now just "simmering."

Trump announces new tariffs on China

But that was a few days ago. Since then, the "simmering" trade problems are back to a "boil." One day after Powell's press conference, US President Donald Trump suddenly announced he would impose new tariffs on $300 billion worth of imports from China.[2] This round of tariffs would impact a broad spectrum of consumer goods – if they go into effect, it will mean that the US is now effectively taxing every product that it purchases from China.

China's reaction was unsurprising. Chinese Foreign Ministry spokeswoman Hua Chunying stated last week: "China won't accept any maximum pressure, threat, or blackmailing, and won't compromise at all on major principle matters."[3] And today, Aug. 5, the renminbi has fallen through the critical exchange rate level of seven renminbi to one US dollar.[4] While this has unnerved markets, I believe it is likely to be a positive development for China. In my view, it should enable China to better weather the new tariffs announced by the Trump administration, and it suggests that China will not be forced into a trade deal with the US with terms that are unsatisfactory to China.

This is putting significant pressure on US equities – which were already spooked by the deteriorating trade situation and eager to see a deal in the near term – and I believe that is likely to continue. In my view, this underscores the reality that China is in a far better negotiating position than the US; it has far more tools it can use to combat the negative effects of tariffs, and therefore has the ability to play a "long game." I concur with former US National Economic Council Director Gary Cohn, who has asserted that the US can't win a trade war with China.[5] And so I believe there is a small but growing chance, depending on how significant the stock market sell-off becomes, that the US may capitulate in the near term and take minor concessions in order to achieve a trade deal. If not, then I expect the Fed will clearly feel compelled to act – what started as a mid-cycle "adjustment" could become a more significant attempt to bolster the US economy.

In the meantime, I expect continued volatility among a wide array of risk asset classes – and a continued move to "safe haven" asset classes.

Trade concerns are spreading

Trade concerns are not limited to the US and China. As I have said before, tariffs are like bacteria in a petri dish – they spread rapidly.

We have a very serious trade situation developing between Japan and South Korea, in which Japan removed South Korea from most favored trading partner status, setting up a scenario where South Korea is very likely to retaliate.

And then there is last week's US-European Union (EU) trade deal – a minor trade deal to sell more US beef to Europe. But don't expect this to mean that the US and EU will be able to avoid a significant trade dispute – in fact, a tariff war seems likely. As Trump explained, "The EU has tremendous barriers to us. They're very, very difficult."[6] Trump made it clear that auto tariffs remain an option: "Auto tariffs are never off the table. If I don't get what we want, I'll put on tariffs."[6] The EU struck a conciliatory tone, indicating it would like to work with the US to reform the World Trade Organization and address other trade issues, but was clear that it would retaliate if the US were to apply auto tariffs.

What does this mean for investors?

I have been sounding the alarm on trade wars and de-globalization since 2017. I even mentioned in this blog back in 2018 that the words, "trade wars are good and easy to win" were the most frightening words to be uttered that year. And, of course, I stand by that statement.

But what does this mean for investors? We could see the stock market sell-off continue for days and even weeks. But we have to recognize that the volatility we are currently experiencing creates opportunities for selective, discerning investors. Stocks are "on sale" – and US mortgage rates may be moving lower too.

Further, I believe the more severe a market sell-off, the more likely the US is to act in some way to counteract the effects of tariffs. I hold out hope that the US will recognize that winning a trade war with China is very unlikely; that should prompt it to abandon its masochistic bent and avoid any more self-inflicted damage. That could mean the US capitulating and accepting a deal with only minor concessions from China. After all, the US could always choose to address its grievances with China through the World Trade Organization. If not, it could mean the Fed turning on the monetary policy accommodation spigot. Either scenario could be positive for risk assets.

A few weeks ago, I handed the reins of my blog over to my colleague Brian Levitt, who cautioned investors to be wary of their natural instincts to run from their market fears. Now is an important time to reiterate that. I believe that the current situation warrants cautious observation – not running. And I can't stress enough the importance of staying invested and well-diversified for those with longer-term time horizons.

Source

[1]Reuters, "U.S. economy slows in second quarter; weak business investment a red flag," July 25, 2019

[2]USA Today, "Trump's latest Chinese tariffs: What we know so far," Aug. 2, 2019

[3]Fortune, "China Vows to Respond to New Tariffs Threatened by Trump," Aug. 2, 2019

[4]MarketWatch, "China's yuan falls below key level with U.S. dollar," Aug. 5, 2019

[5]CNBC, "Gary Cohn: Trump's trade war with China is hurting the US economy more," Aug. 1, 2019

[6]Reuters, "Trump says auto tariffs never off the table in EU trade talks," Aug. 2, 2019

Important information

Diversification does not guarantee a profit or eliminate the risk of loss.

Risk assets are generally described as any financial security or instrument, such as equities, commodities, high-yield bonds, and other financial products that carry risk and are likely to fluctuate in price.

Safe havens are investments that are expected to hold or increase their value in volatile markets.

A basis point is one hundredth of a percentage point.

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