US-China trade talks stumble, and stocks tumble

Weekly Market Compass: Threats of fresh tariffs on Chinese goods suggests short-term volatility

May 6, 2019 | Kristina Hooper, Chief Global Market Strategist

US-China trade talks have taken a turn for the worse in the last several days and may temporarily go off the rails.

It all started when President Trump threatened to increase the level of tariffs on $200 billion of Chinese goods to 25% by May 10, asserting that China is taking too long in the negotiations and is attempting to "renegotiate." He also threatened to place 25% tariffs on additional goods. Now China, in response, is threatening to cancel trade negotiations planned for this week between the US and China.

What can we make of these developments? First of all, it shows that the US is in a hurry to seal a deal. That suggests that the current trade situation is having a negative impact on the US economy at a time when the current administration needs to begin planning for the presidential election of 2020. Now that may seem hard to believe given the strong US economic data we have seen recently, including the much-better-than-expected first quarter gross domestic product (GDP) print and the very strong April jobs report. However, I do believe the tariff wars are having a negative impact on the US economy that could grow over time. We have seen a few recent warning signs, especially the most recent ISM Manufacturing Index. The April reading for the index was 52.8, a decrease of 2.5 points from the March reading of 55.3.[1] What is particularly worrying is the New Orders Index, which clocked in at 51.7, a decrease of 5.7 points from the March reading of 57.4.[2] Some of the comments from purchasing managers in the ISM survey support my belief that the tariffs are creating problems:

"Tariffs are resulting in increased prices on computer components, as well as manufacturers moving out of China to countries not impacted by the tariffs." (Computer & Electronic Products)

"Monitoring the tariffs and Mexico border issues, which are a potential threat. The China trade agreement getting completed will help with stability with suppliers and costs management." (Machinery)

While business investment has increased in recent months – likely due to the incentivization of capital spending in the tax reform package – business investment is still relatively low, which suggests that there is significant economic policy uncertainty brought on by the US-China trade war, which is depressing business investment. This was borne out in some of the ISM Manufacturing survey comments:

"Commodity-price uncertainty – partially driven by concerns of an economic slowdown and trade/tariff policies – has led my company to reduce its capital spend in 2019. Our 2019 capital-spend levels will be similar to 2016 levels." (Petroleum & Coal Products)

"[We are] closely watching the Mexico border situation as well as the tariff situation." (Transportation Equipment)

This is also borne out in other feedback from companies. For example, the March Federal Reserve Beige Book reported, "numerous manufacturing contacts conveyed concerns about weakening global demand, higher costs due to tariffs, and ongoing trade policy uncertainty." And a study by the Federal Reserve Bank of New York, Princeton University, and Columbia University concluded that steel and aluminum tariffs have cost companies and consumers $3 billion a month in additional costs in 2018. According to a study by the Peterson Institute for International Economics, the steel and aluminum tariffs inflated the price of steel products by nearly 9% last year, increasing costs for steel users by $5.6 billion.

While China has had some better economic data recently – including a good GDP print – its most recent PMI data has been disappointing. China would clearly like to reach a deal as well, as the trade wars are negatively impacting its economy. However, China certainly does not want to be forced into an agreement with undesirable terms. And so, not surprisingly, the People's Bank of China (PBOC) announced early on Monday morning a targeted reserve ratio requirement (RRR) cut that would inject RMB 280 billion in the market, suggesting that China is not backing down but instead is attempting to boost Chinese economic growth in order to counter headwinds created by any possible additional tariffs.

It seems China's policy makers will stand ready to soften major volatility swings in the financial markets with monetary stimulus if needed. This is in keeping with the significant monetary and fiscal stimulus China has been injecting into its economy for nearly a year. And China will likely continue to stimulate its economy, so that it can ensure that the US will not be able to force its hand to accept a trade deal that it deems unfavorable.

Unfortunately, a successful US-China trade agreement had been priced into US and China equities and so we have seen a significant sell-off. This turn of events injects substantial uncertainty into the outcome, forcing investors to now factor in the possibility that a near-term trade deal may not be reached and that tariffs may be increased. Given these developments, we expect significant volatility.

We could see more actions – such as China embarking on further stimulus – and more threats, as the US could alter its export control requirements to hurt China.

The key takeaway, though, is that US and Chinese equities and Chinese bonds are unlikely to experience the same level of negative price impacts seen in the fall of 2018 for several reasons. First, the US and especially China are likely to be more proactive in countering the negative market and economic impacts of the tariff wars. Second, the Fed has taken a far more dovish monetary policy stance, which should help cushion capital markets globally.

I believe investors should be prepared for continued volatility, especially to the downside, as the situation evolves. Whether or not the US and China reach a quick trade deal, I do believe that tariff-related sell-offs could represent an attractive buying opportunity for both US and Chinese equities and Chinese bonds for those with a long enough time horizon. Of course investors need to be discerning but opportunities will present themselves with such a fear-driven sell-off.

Source

[1]April 2019 Manufacturing ISM® Report On Business®

[2]April 2019 Manufacturing ISM® Report On Business®

Important information

The **ISM Manufacturing Index**, which is based on Institute of Supply Management surveys of more than 300 manufacturing firms, monitors employment, production inventories, new orders and supplier deliveries.

The **New Orders Index** is a component of the PMI Index. It tracks the monthly changes in new orders by purchasing managers and is calculated by the Institute of Supply Management.

Gross domestic product is a broad indicator of a region's economic activity, measuring the monetary value of all the finished goods and services produced in that region over a specified period of time.

The Summary of Commentary on Current Economic Conditions by Federal Reserve District (the **Beige Book**) is published eight times per year. Each Federal Reserve Bank gathers anecdotal information on current economic conditions in its district, and the Beige Book summarizes this information by district and sector.

The **reserve ratio** is the portion of reservable liabilities that commercial banks must hold, rather than lend or invest. This requirement is determined by each country's central bank.

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