
A modern-day War of the Roses: Is a real winner possible in the US-China trade war?

Weekly Market Compass: In an era of globalization, trade wars mean losses for all sides

Jan 7, 2019 | Kristina Hooper, Chief Global Market Strategist

Students of history may recall the War of the Roses, which was waged more than 500 years ago. It was an epic battle between two rival branches of the English royal family that both had claims to England's throne – the House of Lancaster, represented by a red rose, and the House of York, represented by a white rose. While the House of Lancaster ultimately won the War of the Roses, by some measures there was no real winner. The war lasted for many years and resulted in very significant damage to both houses. In fact, by the end of the war, the male lines in both houses had been eliminated.

I think the War of the Roses is an appropriate analogy for the burgeoning US-Chinese trade war. While many presume the US will win this war, I believe there will be no real winner: Everybody loses in a trade war in an era of globalization, and it seems we are already seeing this war take its toll on both sides:

- **China.** Last week, disappointing Chinese data was released: Manufacturing PMI for December clocked in below the critical 50 level, indicating contraction.¹ However, before anyone assumes China has lost the trade war and is ready to capitulate, please read President Xi Jinping's New Year's speech. The speech doesn't sound like it's being given by the leader of a defeated nation. Xi recognizes the challenges ahead, but he promises that China will remain steadfast in its pursuits, and also pledges more stimulus in reductions to taxes and fees. We are seeing many forms of stimulus in China as the Chinese government is pulling out all the stops in an effort to counter the negative effects of the trade conflict: The People's Bank of China (PBOC) announced last Wednesday that it would provide support to Chinese small businesses by changing its rules in order to encourage more lending to these entities. And on Friday, the PBOC helped ease lending conditions by cutting reserve requirement ratios for banks. Not surprisingly, services data remains stronger than manufacturing data in China, indicating that domestic stimulus is holding up that end of the economy. But it's clear China is feeling some pain.
- **United States.** The US is feeling some pain too. Apple recently provided an ominous warning on earnings: It said iPhone sales were down and attributed it in part to lower Chinese demand brought on by the trade war and the downward pressure it has placed on the Chinese economy. What's more, Kevin Hassett, the Chairman of the Council of Economic Advisers, stated publicly that he believes Apple is just the beginning, that many other US companies will also face similar headwinds as a result of the US-Chinese trade war and its impact on Chinese demand. The Trump administration said that Apple's announcement is a sign that the US is winning the trade war. But I don't see how the US can declare victory if US companies' earnings are being negatively impacted. American farmers are also feeling significant pain. They continue to be hurt by the trade war as China purchases soybeans and other food elsewhere, even though they have been receiving some aid from the US government and even though China agreed in December to purchase some soybeans from the US. The farmers' situation is likely to worsen in the future given the Trans-Pacific Partnership (TPP) is moving forward without the US. Because the US opted out, its goods will be less competitive to 11 nations in the TPP, including Japan and Canada, because tariffs were slashed among the TPP's member nations. That means a real loss in terms of market access for American agricultural products.

Signs of strength from the US jobs report, but what comes next?

Having said all that, we have to recognize that the US economy is still doing very well. Underscoring this point was last week's strong December jobs report, which defied expectations – not only did nonfarm payrolls rise by more than 300,000, but wage growth was significant at 0.4% month over month.²

But I must stress that the payrolls number is a coincident indicator – it illustrates the current state of the economy rather than indicating future growth – while the unemployment rate is a lagging indicator; it's the economic equivalent to looking in the rear-view mirror. Leading indicators such as the ISM Manufacturing Index are showing weakness, which clocked in well below consensus expectations last week. The December ISM Manufacturing Report includes some instructive comments from respondents:

- “Growth appears to have stopped. Resources still focused on re-sourcing for US tariff mitigation out of China.” (computer and electronic products industry)
- “Customer demand continues to decrease (due to) concerns about the economy and tariffs.” (transportation equipment industry)
- “Starting to see more and more inflationary increases for raw materials. Also, suppliers (are) forcing price increases due to tariffs.” (food, beverage and tobacco products industry)
- “Tariffs continue to impact business direction and profit.” (miscellaneous manufacturing industry)
- “The ongoing open issues with tariffs between the US and China are causing longer-term concerns about costs and sourcing strategies for our manufacturing operations. We were anticipating more clarity (regarding) tariffs at the end of 2018.” (machinery industry)

I must also note that, unfortunately, this jobs report does not help the cause of the many market participants who would like the US Federal Reserve (Fed) to hold rates steady this year – particularly the wage growth number. It certainly makes the Fed's role more complicated. Consider the confusion around the economic picture – the dramatic stock market drop over the past few months has caused some market participants to believe a recession is coming (this has happened in the past, but not in all cases).

There is some validity to these concerns, as US gross domestic product growth estimates for 2019 have been downwardly revised. And that, by the way, is the collateral damage of a trade war. It's not just the US and China – I believe the overall global economy will be damaged by such conflict. Reflecting concerns about the economic picture, fed funds futures currently indicate that the market expects zero Fed rate hikes in 2019. Fears were running so high earlier last week that I received questions about whether I expected the Fed to actually cut rates in 2019. It seemed like the sky was falling as the new year began. The yen, commonly viewed as a safe haven, was rallying dramatically (although there were admittedly other reasons for the dramatic currency move). And then sentiment changed during the week. Not only did the price of crude oil rally, but we got that strong US jobs report.

So where are we today? The global economy remains solid but is slowing – and runs the risk of greater deceleration if the trade wars escalate and/or Fed policy is too tight. Those two risks remain very real. However, I am optimistic that the Fed will be data dependent, which at this juncture likely means one or two rate hikes. Recent comments from Fed Chair Jay Powell suggest the Fed could hit the “pause button” for rate hikes at some point next year. Last Friday, Powell took a reassuring stance, stressing flexibility and explaining that, “We're always prepared to shift the stance of policy and to shift it significantly if necessary.” I will reiterate that I do not believe the Fed will cut rates this year unless the economic situation changes dramatically. The key takeaway is that this is a very fluid situation – today's leading indicators are tomorrow's coincident indicators, and we must hope the Fed is very holistic in the data it reviews to make its decisions.

US-China trade talks begin this week

And so, as the US-China trade talks get underway this week, I will take the approach of hoping for the best but preparing for the worst in terms of negotiations. As I've said before, there are few reasons to believe China is willing to make any major concessions. China's recent actions to stimulate the economy, both monetary and fiscal, suggest to me that it is preparing for an extended fight. As Xi's speech laid out, China will continue its efforts to institute reform and open up its markets – but that will clearly be on China's timetable and will follow China's preferences. And China has the ability to play a long game, which the US does not; Xi is president for life, while President Donald Trump is preparing for a reelection bid in less than two years that will likely ultimately hinge on the state of the US economy. This suggests to me that the US will ultimately have to capitulate; the question is how long it will take and how much damage will be done first.

To me, success will be the US accepting small concessions from China and ending the trade war soon; that is my best-case scenario in this modern-day War of the Roses. The good news is that, if this were to happen soon, much of the economic damage could be reversed relatively quickly, and markets, which seem to have priced in a significant trade war, would likely rebound dramatically, in my view.

Happy anniversary to the euro

I would be remiss if I didn't mention that the euro celebrated its 20th anniversary on Jan. 1. Conceived many years ago, this common currency did not come to fruition until 1999. The euro has had its challenges over the years – not the least of which is that it is the currency of a monetary union that does not have a corresponding truly fiscal union. However, to paraphrase Mark Twain, reports of its demise have been greatly exaggerated.

I do expect continued challenges for the eurozone and the European Union in 2019: Eurozone Purchasing Managers' Index data remains disappointing, political disruption appears on the rise, and there is uncertainty over who will replace "Magic" Mario Draghi at the helm of the European Central Bank. However, even as more Europeans reject their traditional political parties in favor of more populist parties, they overwhelmingly support the euro. In an October 2018 European Commission poll, 74% of respondents across the eurozone said they believed the euro was good for the European Union – the highest level since the annual survey began in 2002.

Looking ahead

- **FOMC meeting.** We will want to focus on the Federal Open Market Committee (FOMC) minutes to be released this week, which should provide some insight into how Fed participants perceive the state of the US economy – and how worried they are about a global deceleration
- **Bank of Canada.** We will also want to closely follow the Bank of Canada's (BOC) meeting this week. At its December meeting, on the heels of three rate hikes in 2018, the BOC noted that it "continues to judge that the policy interest rate will need to rise into a neutral range to achieve the inflation target." However, in the face of lower oil prices and a slowing global economy, the Canadian economy could benefit from the BOC hitting the "pause button" and offering more dovish language on future monetary policy – especially as the yields on 2-year and 10-year Canadian government bonds moved within several basis points of each other in recent days, coming dangerously close to inversion.
- **US government shutdown.** We will also continue to closely follow negotiations around the US government shutdown. As this domestic War of the Roses continues with no end in sight, I expect the biggest casualty could be business confidence. Business leaders may wonder what might happen in the face of a crisis such as 2008, when both parties needed to work together to pass legislation in order to combat the Global Financial Crisis.

Source

¹Chinese National Bureau of Statistics, as of Dec. 31, 2018

²US Bureau of Labor Statistics, as of Jan. 4, 2019

Important information

Purchasing Managers Indexes are based on monthly surveys of companies worldwide, and gauge business conditions within the manufacturing and services sectors.

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.

Fed funds futures are financial contracts that represent the market's opinion of where the federal funds rate will be at a specified point in the future. The federal funds rate is the rate at which banks lend balances to each other overnight.

The Eurozone Manufacturing PMI® (Purchasing Managers' Index®) is produced by IHS Markit based on original survey data collected from a representative panel of around 3,000 manufacturing firms. National data are included for Germany, France, Italy, Spain, the Netherlands, Austria, the Republic of Ireland and Greece.

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

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