Trade remains the top concern for global markets

Weekly Market Compass: As the US talks trade with Canada and China, emerging markets feel the pressure

Sep 10, 2018 | Kristina Hooper, Chief Global Market Strategist

Every week I hope that there are no new trade developments, so that for at least one week I can spare you all from a trade discussion in this blog. Unfortunately, this is not that week – there were many trade developments over the past few days, and I feel compelled to discuss them because I firmly believe the trade situation poses a significant risk to the economy and markets.

No agreement yet between Canada and the US

Despite suggestions early in the week that Canada and the US were close to an agreement, no deal has been announced as of this writing – and I am not holding my breath for one. Chrystia Freeland is a smart, tough negotiator for Canada, and she knows that Mexico wants Canada to stay in the North American Free Trade Agreement (NAFTA), which gives her leverage to fight for Canada's key demands.

Interestingly, the Bank of Canada (BOC) may be planning for the worst-case scenario – a collapse in NAFTA talks. Last week, BOC Senior Deputy Governor Carolyn Wilkins suggested that the BOC may continue to raise rates even if NAFTA talks collapse because of the potential for tariffs to drive up inflation. But in my view, raising rates would only exacerbate the economic slowdown that is likely to occur with the imposition of tariffs. And so, if this were to happen, the BOC could find itself in a position similar to the Bank of England (BOE) where, after the Brexit vote, inflation rose (because of currency reasons) while the economy faltered and the BOE was stuck between a rock and a hard place, wanting to curb inflation but fearful of hurting the economy.

More tariffs on China?

But the much bigger issue is China. Just as the comments period was ending on the proposed US$200 billion in tariffs on Chinese goods, US President Donald Trump announced he is ready to levy another US $267 billion in tariffs on Chinese goods.[1] Some companies will be able to pass these additional costs onto customers (Apple has already announced that it would do so), while others will not. Neither scenario is a good one – either consumers' purchasing power is eroded, or companies' profit margins are eroded.

As I have said in the past, I don't believe the Trump administration is just posturing; I believe it is not only willing but eager to start a trade war with China. And I can't come up with any compelling reasons why China would acquiesce to the US' broad and confusing demands (rather than focus on intellectual property violations, the US seems fixated on balance of trade issues, which I don't believe is a worthy area of focus). So in my view, investors should understand the potential for the trade situation to worsen. That's especially so now that Trump has suggested that the US will also be targeting Japan going forward in its ongoing trade disputes with its major trading partners.

Emerging markets are feeling the pressure

The investing environment is showing some vulnerabilities. The emerging markets space is under particular pressure. It's a combination of country-specific woes and US-created pressure, primarily from the Federal Reserve (Fed). The Fed has been normalizing its balance sheet at a growing pace which, combined with greater issuance of US debt as a result of larger deficits, has created a scenario where liquidity has been vacuumed up from emerging markets. The Fed of course has also been tightening, which makes it increasingly difficult to service dollar-denominated debt. And the US dollar keeps getting stronger as the trade situation worsens, indicating that investors believe the US will win any trade war – which also has been putting pressure on emerging markets.

As I've mentioned, in this risk-aware environment, US assets have continued to be perceived as a "safe haven." And so emerging markets are likely to continue to come under pressure – at least until the Fed's anticipated rate hike in September. However, I believe that the countries that will continue to come under the greatest pressure are the ones with the greatest vulnerabilities, such as Turkey and Argentina. But while I expect a rate hike in September, I don't believe a December rate hike is a done deal. That's because the Fed has been worried about the potential for an inverted yield curve – we saw that even in the speeches and interviews around the Jackson Hole conference in August. I also hope that the Fed will take its role as a stabilizer of financial markets seriously. That would suggest revisiting its balance sheet normalization plan (the Fed reportedly plans to discuss its balance sheet this autumn) – or taking a lighter touch with tightening given the US dollar's potential to create turmoil in emerging markets.

Will the US dollar remain the world's reserve currency?

During my many years of travel, presentations and Q&A exchanges with audiences, I have been surprised by the questions I received on the US dollar as a reserve currency. Starting more than a decade ago, I would repeatedly be asked whether the Chinese renminbi would at some point eclipse the US dollar as the reserve currency of choice. I would explain that we were years away from any threat like that, and that even then it was unlikely. But within the last few years, I stopped getting that question. There is so much going on, I suppose, that no one is worrying about a more esoteric question like reserve currencies. However, I would argue that now is a more appropriate time to be concerned about this issue.

Back in 1965, France's Minister of Finance, Valery Giscard d'Estaing, described the US dollar's role as the main reserve currency of the world as an "exorbitant privilege" for the United States. Consider that while the US produces about 22% of global gross domestic product (GDP), the US dollar is used in more than half of all transactions (cross-border invoicing, reserves, settlements, liquidity and funding).[2] This is why the US dollar has been faring so well in the midst of heightening trade tensions and falling market confidence, and it's largely why US assets have been considered a safe haven.

I believe this great privilege could have lasted indefinitely. However, I worry that the US' trade policies and sanctions policies may ultimately cause countries to seek out another reserve currency – one that comes with fewer strings attached. We are already seeing signs of that: The European Union (EU) has signaled that it is looking for ways to create a non-dollar payments system. While the potential abandoning of the US dollar as the reserve currency of choice is years away, in my view, it's a scenario that could create a significant headwind for US capital markets.

US wage growth rises

Despite stocks globally moving downward last week, the trade situation worsening and the tumult in emerging markets growing, Treasury yields moved higher. The catalyst was the strong US jobs report. Nonfarm payrolls positively surprised after a disappointing number from the ADP private-sector jobs report earlier in the week.

But the big news was wage growth – at 2.9% annualized,[3] it was the highest growth rate for average hourly earnings in nearly a decade. However, this metric brought back bad memories of early February, when a similar average hourly earnings number had dramatic consequences for stocks globally, triggering a swift sell-off. This time it doesn't seem to have had the same effect. That may be the result of so much positive news flow, from the strong US ISM Manufacturing Report to Japan's strong second-quarter GDP print to news from EU Brexit negotiator Michel Barnier that the EU and the UK could reach a Brexit deal in the next two months. However, we will want to monitor the situation closely, as concerns about inflation or trade – or both – could push stocks lower and Treasuries higher.

Prayers for Japan

I would also like to note with sadness that, after a summer of terrible natural disasters, Japan experienced a tragic earthquake last week. My thoughts and prayers are with Japan.

Source

[1]CNBC, "Trump says he's ready to hit China with another $267 billion in tariffs," Sept. 7, 2018

[2]Jeffrey Sachs, "Trump's Policies Will Displace the Dollar," Project Syndicate, Sept. 3, 2018

[3]Source: US Bureau of Labor Statistics as of Sept. 7, 2018