
Tariffs, earnings and politics: What's moving markets this week?

Weekly Market Compass: Global summits and key data releases
top the list of what to watch

Jul 17, 2018 | Kristina Hooper

There is no shortage of events to watch this week: The European Union and China will meet to discuss foreign investment, Russian President Vladimir Putin and US President Donald Trump are meeting in Finland, and US Federal Reserve Chair Jay Powell gives his semi-annual testimony to Congress. But can any of these events direct the market's attention away from the strong second-quarter earnings season?

Before we discuss what's on the agenda this week, it's important to give some context into the key events of last week:

- 1. The trade wars ratcheted up.** Early last week, the Trump administration announced new proposed tariffs on \$200 billion of Chinese goods.¹ This represents a significant and rapid expansion in the trade wars, coming closely on the heels of the July 6 imposition of \$34 billion in tariffs on China by the US, and rapid retaliation by China.² As I expected, this announcement placed downward pressure on stocks, but that pressure was short-lived as investors turned their attention back to earnings – which have been very strong thus far. Helping the situation is that China has not yet announced any retaliatory action. It seems likely that these new tariffs could move through the comment period quickly and be implemented as early as September.

While it's hard to quantify the impact to gross domestic product (GDP) growth just yet, I believe business investment will be impacted significantly given the high level of economic policy uncertainty created by the trade situation. Some insight can be found in comments from the Institute for Supply Management's June US ISM Manufacturing Report,³ which were made before the flurry of July tariff activity: One company explained, "US tariff policy and lack of predictability, along with (the) threat of trade wars, (is) causing general business instability and (is a) drag on growth for investments." Another company commented, "We export to more than 100 countries. We are preparing to shift some customer responsibilities among manufacturing plants and business units due to trade issues (for example, we'll shift production for [the] China market from the US to our Canadian plant to avoid higher tariffs). Within our company, there is a sense of uncertainty due to potential trade wars." Yet another company commented: "The uncertainty of US tariffs and the Canada/Mexico/EU retaliatory tariffs continues to cloud strategic planning efforts. Contingency planning (for tariffs) is consuming large amounts of manpower that could be used for more productive projects."

In addition, for many consumers, tariffs could negate all the benefits of the tax reform legislation by creating higher prices for goods. Another company reported in the June ISM Manufacturing Report,³ "The Section 232 steel tariffs are now impacting domestic steel prices and capacity."

Base steel prices have already increased 20% since March.” And certain industries could be hurt by demand destruction, as we have seen with washing machines in the US (a target of earlier tariffs). We can’t ignore the very significant threat that protectionism represents to the global economy, even if investors continue to try to ignore it. Today, July 16, the International Monetary Fund, in introducing its revised World Economic Outlook, focused heavily on growing trade conflicts, explaining that growing trade conflicts “could derail the recovery and depress medium-term growth prospects, both through direct impact on resource allocation and productivity and by raising uncertainty and taking a toll on investment.”⁴ This problem is not going away, but is instead metastasizing. I believe it will be a recurring force placing downward pressure on stocks globally.

- 2. More indications of fear appeared in markets.** While global equities moved back into positive territory for the year (as measured by the MSCI All Country World Index), there have been other signals of fear that I believe are more accurate. As of this writing, the 10-year Treasury yield is at 2.831% - well below the 3% level it was at just a few months ago.³ And the spread between the 2-year and the 10-year Treasury yield continues to narrow, and is now down to 25 basis points - its lowest level in more than a decade.⁵ Some are suggesting the US Federal Reserve (Fed) could end balance sheet normalization in the next year, which could hasten an inversion of the yield curve. I don’t expect the Fed to end balance sheet normalization any time soon (although I do believe the unwinding is an experiment in and of itself, so there is the potential for lots of surprise). However, I do believe the yield curve is in danger of inverting - and it could occur by the end of 2018. In addition, some futures markets are suggesting there will be an economic slowdown by the end of 2019 as both eurodollar futures and fed funds futures are signaling a possible end to rate hikes by the end of 2019.
- 3. France is a winner - again.** For France, the most positive news of the week was its World Cup victory. In my view, France’s win on the playing field echoes some of its recent wins in the worlds of politics and economics. France’s recent winning streak began with the election of Emmanuel Macron, a political outsider who created his own political party and was elected the country’s prime minister just a year later. Macron has championed reform for both France and the European Union (EU). There have been some missteps along the way, but business confidence has risen significantly since he came to power, and GDP growth is expected to return to nearly 2% in 2018-2019.⁶ Macron has become the de facto head of the EU by virtue of Chancellor Angela Merkel’s eroding strength within Germany, and France is also picking off a few corporate headquarters from London as a result of Macron’s courtship of corporations as Brexit nears. His ascendancy to power is a powerful example of how an electorate, frustrated by the status quo, can embrace an outsider whose economic policies have the potential to improve economic growth in the short- and longer-term.

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- 4. Global currencies respond to geopolitics.** There were significant currency developments during the week, largely due to geopolitical developments. The pound sterling enjoyed a brief bout of strength early in the week on news of the Chequers deal, which outlined terms for the UK's post-Brexit relationship with the EU, given it was a business-friendly "soft Brexit" arrangement. However, that strength was quashed by the resignations of several Cabinet members as well as comments from US President Donald Trump suggesting the US would not make a trade deal with the UK. In addition, given concerns about an escalation in the trade wars, the US dollar strengthened while other currencies such as the euro and the yuan continued to weaken. In my view, this is at least partially a function of market participants expecting the US to win these trade wars - or at least fare better than its trading partners. However, I expect the US dollar to slightly weaken relative to these other currencies as market participants may begin to view the risks to the US economy as more balanced versus risks to other economies.
- 5. China shows solid growth.** Second-quarter GDP growth for China clocked in at 6.7%, as expected. Retail sales clocked in at 9%, which was better than expectations, while industrial production was worse than expectations at 6%.⁷ What this suggests to me is that China is in a position of strength, enabling it to challenge the US in its burgeoning trade war - and so we should believe the Chinese Ministry of Commerce when it says it will "fight back as usual."

What to watch this week:

- 1. The EU-China summit.** This meeting occurs at a critical time for some of America's key trading partners. The meeting will cover a number of topics including securing foreign investment in China. However, it seems clear that tariffs will be a hot topic of discussion. The Chinese government has already made overtures to the EU about forming a tighter trade relationship. I expect China to achieve some degree of success at this summit, given that it has been trying to soften its position on its Made in China 2025 agenda and offer small incentives to the EU. The EU, for its part, may want to move closer to China in the wake of continued criticism by the US for its trade practices.
- 2. Important US growth data.** US retail sales data was just released today, July 16, indicating strong consumer spending. We will be getting US industrial production data later this week, which I believe is likely to indicate moderate improvement. This data will likely support my view that the American economy is experiencing accelerating growth - although risks are rising. Just as important will be the Federal Reserve Beige Book, which typically provides insights into the mindset of businesses. We will get a sense of whether the fear we seem to be seeing in bond markets will also be captured in comments from business contacts around the US. I expect that will happen, as it has in the ISM Manufacturing Report, suggesting a real threat to strong economic growth in subsequent quarters.

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- 3. A week of Fed insights.** The Fed released its most recent Monetary Policy Report, which will be followed by Fed Chair Jay Powell's semi-annual testimony to Congress this week. I expect him to be queried extensively on tariff war concerns, given that many members of Congress are worried about the trade situation. I expect the yield curve will also be covered, given that it has been an important topic in recent Federal Open Market Committee meetings. I am hopeful Powell will provide some insight into whether the Fed is considering doing anything to prevent an inversion, given that its actions are likely hastening the possibility of an inversion - and given comments by Atlanta Fed President Raphael Bostic that "it is my job to make sure that" the yield curve doesn't invert.⁸ I also hope he will share his views on balance sheet normalization - whether the Fed will continue to accelerate normalization given global liquidity concerns, or whether there's any possibility the Fed may end balance sheet normalization next year, as some are suggesting. Another important question that will hopefully be asked and answered is whether the Fed believes it has enough dry powder to counter the next recession, if it were to occur as early as next year.
- 4. Brexit drama.** The UK's new Brexit Secretary released a white paper on the UK government's proposed plan for a "soft Brexit." It was largely overshadowed by Trump's visit to the UK, although it did receive some harsh criticism. Look for UK Prime Minister Theresa May and her Cabinet to strongly defend the plan this week, as it likely receives greater scrutiny. In contrast to conventional wisdom, I don't believe May's leadership was weakened by Trump's comments last week. In fact, I do believe there's a better chance than not that she is able to shepherd a soft Brexit plan to fruition - especially given that hard-line Brexiteers have not offered an alternate plan - and that should be a positive for UK businesses and economic growth, in my view.
- 5. The Helsinki summit.** As of this writing, Putin and Trump are meeting in Finland. As with the US-North Korea summit last month, this will be a non-event for markets, in my view.

Source:

¹The Wall Street Journal, "U.S. Unveils Additional Tariffs on \$200 Billion More in Chinese Imports," July 10, 2018.

²CNBC, "Trade War begins: US and China exchange \$34 billion in tariffs," updated July 6, 2018.

³Institute for Supply Management.

⁴International Monetary Fund.

⁵Bloomberg, L.P. as of July 15, 2018.

⁶Organisation for Economic Co-operation and Development, May 2018.

⁷Bloomberg, L.P.

⁸Bloomberg News, "Fed's Bostic Says Job is to Prevent Inversion of the Yield Curve," May 16, 2018.

Important information

The opinions referenced above are those of Kristina Hooper as of July 16, 2018.

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