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Trade war re-escalation brings renewed volatility

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As recently as a week ago expectations were high that a critical US-China trade deal was virtually complete. Together with mounting evidence of a pick-up in global growth into mid-year, equity markets and other risk assets were recovering solidly. However, over recent days trade talks between the US and China have broken down. Once again, we are confronted with an escalation in the trade dispute and the rising risk of an all-out trade war between the US and China. Where to from here?

Over recent days trade talks between the US and China have broken down, with the US increasing tariffs on Chinese imports last Friday and China retaliating this this week with higher and new tariffs on US imports. The last time the trade war escalated we quickly moved tactically underweight equities, retaining that position for much of Q4 2018 as markets corrected lower.

From a very short-term tactical position, possibly over several months, equity markets are likely to again be subject to downward pressure as China and the US re-establish their positions and negotiations restart. Some of the key 'sticking points' preventing a deal appear to be that China is unwilling to purchase more US goods than its domestic economy can support. China is seeking assurances that US tariffs will not rise further post any deal, while the US (according to UBS) wants China to "admit it sponsors the transfer of intellectual property" and to work to terminate that activity. An eventual trade deal, before year-end, remains broadly anticipated by most analysts. Still, the risk that these divides can't be bridged, and a persistent, broader trade dispute could erupt has increased.

On balance, and for a number of reasons, we are choosing to retain our tactically neutral equity position this time. Our overweight to emerging market equities, as well as our neutral European equities and underweight domestic equities positions, may face pressure if trade tensions rise. But they will almost certainly deliver strong gains should a US-China trade deal be negotiated.

- **We believe China and the US have a strong incentive to finalise a deal**. President Trump faces an election next year and, despite his rhetoric around tariffs boosting US growth, the negative impact on business confidence, US exports (especially agriculture, to secure the vote of farmers) and inflation is not without risk. Making a deal and moving on to other matters—such as boosting growth through a bipartisan infrastructure package—appears to be a more consensus path among geo-political strategists. For China, given exports remain a significant share of its growth, a deal is key to sustaining its targeted 6% growth for the next year or so.
- **Comments from both President Trump and President Xi** in the days immediately after the renewed dispute (and failed near-term deal) indicate that talks have not completely broken down. President Xi sent President Trump a letter seeking to "work together [to] see if we can get something

done." Trump noted that he would meet Xi at the 28-29 June G20 Summit and that he expected their discussions would be "very fruitful".

- **In contrast to last September when the trade war escalated**, both inflation and central bank policy tightening looks certain to be in retreat this year, removing the historic catalyst that typically ends the macro cycle. This, together with tight jobs markets and rising wages globally, as well as supportive fiscal policy, suggests the global growth outlook has a greater prospect of absorbing much of the negative growth impact of the current trade skirmish.

According to UBS, for the US economy, "the next stage of tariffs, 25% on $200bln, will have large effects, although the ever-dynamic US economy diminishes the effects. The most susceptible firms have failed, and others are diversifying supply chains." UBS sees the growth impact at around 0.3% off annual US growth. For China, it sees the impact at 0.4% of growth. With renewed stimulus from China, 2019 growth forecasts have only been trimmed from 6.4% to 6.2%.

The notion that the latest hike in tariffs by China and the US should cause global growth to be lower, but not materially so, is supported by global research firm, The Bank Credit Analyst, who notes that "in a worst-case scenario where the trade talks break down completely, the combination of aggressive Chinese stimulus and a still-dovish Fed will likely preclude a major global economic downturn." Credit Suisse agrees that "the economic impact [of higher tariffs] is less now than last year".

Over recent days, strategists have been trimming year-end index targets to embody heightened risks of moderately slower global growth or a further broadening of the trade dispute. However, despite this, equity returns are still expected to deliver modest annual returns for 2019 of 5-8%, as a whole. Credit Suisse sees "a 70% chance of a compromise eventually leading to a partial reversal of tariffs", but also believes the equity market near term is showing 'signs of complacency' to trade war risks.

In summary

It has been the persistence of geo-political risks over recent months that has underpinned our reluctance to take a more aggressive overweight position in equities. Instead, we have remained cautiously engaged with a neutral tactical weighting to equities. On a more traditional six to 12-month tactical position, our central case is that a US-China trade deal will be forthcoming, although this remains uncertain. If it does not eventuate, although the impact on global growth would be significant, it appears unlikely that it would terminate a modest global growth trajectory. Reflecting this, we remain neutral equities, with an overweight to international and underweight to Australia, despite some likely short-term pressure on risk markets. We remain tactically underweight government bonds, domestically and internationally, given yields are low and likely to shift higher on improving global growth and a trade resolution.

We will continue to monitor developments closely over coming weeks. For those with significant cash balances who can gain comfort that a further escalation in the US-China trade dispute can be avoided and global growth can recover moderately into mid-year, the current period may represent an opportune period to reduce these cash weightings, given domestic and global cash returns are likely to be relatively low over the coming year.

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