Escalation of the Trade War with China

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After President Trump expressed his frustration on Thursday with the lack of progress in the trade negotiations with China and announced his intention to impose tariffs on additional Chinese imports, the Chinese government over the weekend gave the markets a glimpse of their ultimate retaliatory response.

While the official exchange rate between the Chinese renminbi and the dollar, which is set by the Chinese government daily, only weakened to 6.923 from 6.899 on Friday, the offshore market broke through the psychologically important level of 7.00 overnight and it appears the government is doing little to stem the depreciation. There have also been reports that the Chinese government has asked certain state-owned enterprises to stop buying agricultural products from the U.S. with private enterprises in China also slowing down their purchases due to trade uncertainty.

This proposed new round of tariffs will finally begin to impact the prices of many consumer goods manufactured in China and imported to the U.S. Previous rounds of tariffs were concentrated on capital goods and intermediate goods used in the ultimate manufacture of consumer products. The currency depreciation of the renminbi against the dollar can theoretically contain the price increase to a certain extent. The primary concern of depreciating the currency is that it could cause an unwanted amount of capital flight out of China. This occurred in 2015/16 the last time the renminbi approached 7.0 to the dollar.

The Chinese government may believe they have implemented effective capital controls to prevent the recurrence of such a move of foreign reserves out of the country, but restrictions on capital movement would likely scare many potential investors from future investments in the country. Currency depreciation in China also has an impact on other emerging market currencies and would produce ample headwinds for both the equity and debt markets in these countries.

The impact on the U.S. economy is a bit more nuanced as exports are a much smaller percentage of U.S. GDP although the consumer will effectively be taxed on purchases of Chinese products. The larger concern is the impact a broadening and protracted trade war will have on business and consumer confidence. The U.S. consumer is in very good shape now with a robust savings rate and strong job and wage growth driving nice annual increases in spending through most of this decade.

American businesses also have relatively healthy balance sheets with ample cash and the ability to access cash at historically low interest rates. What they do with that cash is the major uncertainty. They can continue to buy back shares or increase their dividend which would be met with the immediate approval of shareholders. They could increase employment although higher wages without accompanying productivity would negatively impact margins and risk incurring the ire of security analysts and investors.

Our contention has long been that the best use of this cash to which U.S. corporations have access would be for investment in productivity enhancing capital equipment. In a service-oriented economy such as the U.S., this would largely be reflected in increased purchase of and investment in intellectual property products. The resulting enhancement of employee productivity would allow for non-inflationary wage growth which would keep this record-breaking expansion alive for at least a few more years. To the extent that the uncertain outcome and potential economic impact of the trade war discourages greater capital investment, the closer we may be to an actual recession.

The reaction to the tariff announcement and the subsequent Chinese retaliatory response was a steep selloff in global equities, a further decline in intermediate and longer-term interest rates, a decline in energy and industrial commodities, and a notable rise in gold. This market reaction came on the heels of the disappointment surrounding the Fed announcement and Chairman Powell's press conference last week which was not viewed as dovish enough.

As the Fed did cite uncertainties around the outcome of trade negotiations as one of their main rationales for easing rates by 25 basis points last week, the subsequent escalation of trade tensions may force the Fed to reduce rates again as early as the September meeting.

With the Fed as a tailwind and the U.S. economy in reasonably good shape and less affected by trade issues, we are not calling for a near term recession in the U.S. or the beginning of a bear market in U.S. equities. We are more likely experiencing another one of the many 5-10% pullbacks we have experienced throughout this bull market. The impact of the higher tariffs on capital spending will be closely monitored, but we recommend continuing to hold U.S. equity positions at current levels.

We have become more concerned with the emerging markets and the impact the escalation of the trade conflict could have on investor psychology, the currencies, and the economic growth rates not only of China, but their Asian neighbors and the Latin American commodity producers. The fiscal expansion in China this year has been powerful and has led to strong performance in their equity markets. Increased tariffs on their exports to the U.S. could blunt the positive impact of these spending and tax initiatives.

We will continue to monitor the situation over the coming days and notify you of any suggested allocation changes. Please refer to our commentary about the importance of staying invested, or contact your advisor if you have any questions or concerns.

Ben Pace is the Chief Investment Officer and a member of the Investment Committee. Prior to joining Cerity Partners, Benjamin Pace was Chief Investment Officer and Head of Global Investment Solutions for Deutsche Bank Private Wealth Management in the U.S. Ben has more than 25 years of experience in investment management. Prior to joining Deutsche Bank in 1994, he managed equity income funds for two investment organizations.

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