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A Shift in the Trade Narrative

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Key takeaways

» *Financial markets were rocked last week by a falling yuan amidst rising U.S.-China trade tensions.*

» *While the yuan's fall below a psychologically important level of seven was notable last week, we view several events at the end of July as having marked a shift in the trade narrative.*

What it may mean for investors

» *We are looking to become more opportunistic in the markets as the prospect of a prolonged trade dispute is likely to bring with it periods of heightened market volatility during the latter half of 2019.*

The tenor of U.S.-China trade talks have fundamentally shifted from where they were just a few months ago, and this is not good for the economy or financial markets. Until May, the narrative surrounding negotiations had centered on what seemed to be an imminent deal. Today, a series of events have made it clear that the narrative has shifted as both Washington and Beijing settle in for a prolonged dispute. And yet, while last week's market volatility seemingly spoke volumes to this point, events at the end of July had (arguably) already validated our view that a prolonged period of negotiations had become a central trade outcome.

Not the same old trade dispute

Indeed, market attention has (for good reason) been focused on the Chinese yuan's move lower as the game changer in the trade talks. Yet, developments in late July suggested that a resumption of the previous trade narrative following the Osaka G20 meeting was likely off the table. This happened as negotiators from the U.S. and China met in Shanghai on July 30. And while talks where characterized as "constructive," the short meeting yielded no new progress and followed President Trump's personal acknowledgement just a few days prior that China would likely prefer to hold off on signing a trade deal until U.S. presidential elections conclude.

Days after Shanghai, Trump announced 10% tariffs on $300 billion of Chinese imports. Financial market volatility thereafter spiked, and risk assets sold off as Beijing retaliated by delaying promised U.S. agricultural purchases. Subsequently, holders of renminbi-denominated assets trimmed their exposures as trade tensions escalated, leading to a sharp drop in the Chinese yuan. Beijing's seeming refusal to defend the yuan at the psychologically important 7-yuan level prompted the U.S. Treasury to label China a currency manipulator. By this point, it had become clear to many market participants that a return to an imminent deal narrative was no longer in the cards.

Positioning for a narrative shift

This shift in narrative from an "imminent deal" to "prolonged negotiation" is important because the longer tensions between the U.S. and China remain unresolved, the greater the threat of slower economic and earnings growth. While the direct effects of tariffs are important, we believe that the indirect effects of weaker economic sentiment could end up dampening activity, as rising uncertainty about the future leads businesses and households in particular to delay discretionary investment and spending activity.

A risk to financial markets, therefore, is that the interplay between rising uncertainty and falling economic activity takes hold even as central banks lower interest rates. While our expectations for economic and corporate earnings growth remains positive, we are looking to become more opportunistic in light of the challenges that a trade narrative shift could bring during the second half of 2019.[1] This includes trimming strong first-half profits, aligning more tightly with long-term strategic allocations, and raising cash to provide optionality during periods of heightened volatility.

[1] For more information, read our *Institute Alert*, "Time to Reexamine the Investment Landscape," published August 5, 2019.

Economic Calendar

Date	Country	Report	Estimate	Previous
8/13/2019	US	NFIB Small Business Optimism	--	103.3
8/13/2019	US	CPI YoY	--	1.60%
8/13/2019	US	CPI Ex Food and Energy YoY	--	2.10%
8/13/2019	US	CPI Core Index SA	--	262.803
8/13/2019	US	Real Avg Hourly Earning YoY	--	1.50%
8/14/2019	US	MBA Mortgage Applications	--	--
8/14/2019	US	Import Price Index YoY	--	-2.00%
8/14/2019	US	Export Price Index YoY	--	-1.60%
8/15/2019	JAPAN	Industrial Production MoM	--	-3.60%
8/15/2019	UK	Retail Sales Ex Auto Fuel YoY	2.30%	3.60%
8/15/2019	US	Empire Manufacturing	--	4.3
8/15/2019	US	Initial Jobless Claims	--	--
8/15/2019	US	Retail Sales Advance MoM	--	0.40%
8/15/2019	US	Philadelphia Fed Business Outlook	--	21.8
8/15/2019	US	Continuing Claims	--	--
8/15/2019	US	Nonfarm Productivity	--	3.40%
8/15/2019	US	Industrial Production MoM	--	0.00%
8/15/2019	US	Capacity Utilization	--	77.90%
8/15/2019	US	NAHB Housing Market Index	--	65
8/15/2019	US	Business Inventories	--	0.30%
8/16/2019	EUROZONE	Trade Balance SA	18.6b	20.2b
8/16/2019	BRAZIL	FGV CPI IPC-S	--	0.32%
8/16/2019	US	Housing Starts	--	1253k
8/16/2019	US	Building Permits	--	1220k
8/16/2019	US	Housing Starts MoM	--	-0.90%
8/16/2019	US	Building Permits MoM	--	-6.10%
8/16/2019	US	U. of Mich. Sentiment	--	--
8/16/2019	US	U. of Mich. Expectations	--	--
8/16/2019	US	U. of Mich. 1 Yr Inflation	--	--
8/16/2019	US	U. of Mich. Current Conditions	--	--
8/18/2019	JAPAN	Trade Balance	--	¥589.5b
8/19/2019	EUROZONE	CPI YoY	--	1.30%

Source: Bloomberg as of August 9, 2019.

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