EDGE CAPITAL GROUP

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Trade Concerns Intensify

What you need to know

Given the dynamic nature of recent policy decisions and headlines related to trade, we are highlighting several notable events that we believe are pertinent to understanding the nuances of the current trade war. U.S. investors awoke this morning to plummeting bond yields (10 Year U.S. Treasury Yield at 1.6%) and weakening equity prices, forecasting that recent policy decisions are raising the recession odds. Following a recent round of dovish policy decisions by other central banks, the pressure on the Fed will intensify to act more aggressively to support the administration's policy initiatives. The market is forecasting nearly a 100% probability of at least one 25bps cut in September and nearly a 95% probability of at least one 25bps cut in December. Recent actions will add deflationary pressure to the economy and likely force the Fed to transition from a "mid-cycle adjustment" to an extended easing cycle. As pressure on the U.S. and China builds, we cannot rule out a trade resolution sooner than previously expected, stabilizing fixed income and equity markets. A deeper retrenchment by both sides could also nudge the global economy closer to a recession. The situation remains fluid. Here is a brief summary of the last two days of policy actions…

August 6th 2019

The U.S. Treasury Department retaliated to China's Yuan devaluation by labeling China, a "currency manipulator." In response, China reset the USD/CNY exchange rate to a level stronger than analysts expected and is viewed as an olive branch from Beijing to U.S. regulators. We do not believe this is a long-term resolution as China's economy still suffers from a number of economic and social imbalances. Nonetheless, global equity markets (ex-China) reacted positively to the news but remain volatile as trade tensions are high.

Here are a few ongoing challenges (sources of headline risk) China's policymakers face:

- Rising food costs as a result of tariffs and African Swine Flu
- Hong Kong protests for greater independence
- Slower growth
- Increased risk aversion following the takeover of Baoshang Bank in June – heightened liquidity risk at small banks

Should social or economic risks increase, we expect China's policymakers to provide fiscal and monetary stimulus.

August 5th 2019

China surprised investors when they devalued the Yuan relative to the USD in response to the additional trade tariffs announced Friday. This is a significant market event and could change quickly, but here are a few points to note:

This is a significant evolution in trade tensions between the U.S. and China.

In response to the devaluation, global risk assets moved lower, volatility is higher and safety-assets were higher overnight.

Although trade discussions will likely be fluid, here is what can be reasonably expected:

- The Yuan devaluation was intended to support slowing growth in China; however, it will export deflationary pressures globally.
- As such, this action <u>may</u> support PMI data from China in the short run, but presents a net negative on the global growth outlook.
- Powell's "mid-cycle adjustment" is almost certainly going to become a rate cutting campaign. Positive economic data may delay the next cut, but market-based measures will probably just push out the expectation (and increase the magnitude).
- Therefore, U.S. Treasury yields are significantly lower as investors: (1) flock to quality (2) real rates decline in step with deteriorating growth outlook as a result of those deflationary pressures:
- We still do not forecast a recession, but investors should expect lower (positive) growth.
- In step with falling growth estimates, WTI and Brent oil prices are likely to trade lower which will drag inflation expectations down (further pressuring the Fed to cut rates in Q3).
- One of the most important data points to watch is the HKD peg. If China devalued as a result of tight financial conditions, the HKD peg will probably wobble and break soon. The result would intensify deflationary pressures globally. While not a base case at this time, the probability is higher than it was before China devalued the Yuan.

ABOUT EDGE CAPITAL

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