Close Brothers
Asset Management

Investment **Insight**

Market update

6 August 2019

Trade tensions cause markets to correct

Year to date, market performance has been very strong, with all main indices delivering double-digit returns in Sterling terms to the end of July. However, at the beginning of August, market sentiment began to wobble, with a significant correction this week.

Trade tensions serve as a catalyst for a correction:

- US President Trump announced that 10% tariffs would be imposed on USD300bn of Chinese goods on the first of September, in response to a lack of progress in trade negotiations.
- In retaliation, China suspended imports of US agricultural products and allowed the Chinese Renminbi to devalue versus the USD.
- President Trump accused China of currency manipulation.

What are the implications of these recent events?

After a stalemate in March, trade negotiations seemed to be back on track following the G20 meeting at the end of June. However, these recent actions demonstrate that the US and China are far from finding a common ground.

The devaluation of the Renminbi effectively makes Chinese goods cheaper for Americans to buy, offsetting the impact of the imminent tariffs. Moreover, the US has long been sensitive to the issue of currency strength – in the past President Trump has accused not only China but Europe of keeping their currencies artificially weak in order to boost competitiveness. Trump has also encouraged the Fed to cut interest rates, a measure that would likely have the side effect of weakening the US dollar. In light of this, China's devaluation is unmistakably politically charged.

Do these trade tensions matter?

Trade tensions can and have had an impact on economic growth. Already in 2019, global growth weakened due in part to weakness in global trade (impact of shifting supply chains as trade tensions took hold) while manufacturing growth also decelerated.

Hence, economies like Europe, China and Japan, where exports and manufacturing represent a large portion of GDP, have been negatively affected. Fortunately, the service side of most global economies has held up relatively well and the fact that services is such a large part of the US economy helps to explain the US's relative economic strength and seeming upper hand in negotiations.

But there is a risk that sustained trade tensions and a concomitant weakening in global manufacturing could have an impact on the service side of global economies and labour markets as well.

Central banks and governments to the rescue

Central banks are well aware of the impact that these tensions and other factors have had on growth. Inflation has also been benign, with falling bond yields suggesting markets see greater risk of weakness ahead and deflationary forces at work.

To prevent these factors undermining the expansion, central banks across the developed world, led by the US and Europe, are providing further accommodation. China itself has also embarked on a range of fiscal and monetary stimulus measures this year.

Markets are still underpinned, in our view, by accommodative central bank policy, which will continue to support economies for as long as these trade tensions rumble on.

How have markets reacted?

At the close on Monday 5th August, markets were down -1% to -5% in Sterling terms since the end of July. This is a significant move, with emerging markets hardest hit. Bonds benefitted from the news, with bond yields falling lower on weaker risk appetite. As investors sought safe haven assets, the yield on a US 10-year Treasury reached a low of 1.7% on Monday, the lowest level since the summer of 2016.

While asset moves have been pronounced, in a longer-term context, the recent declines have not undermined the strong year-to-date gains, as the below table shows.

Performance as at 5 August 2019	YTD	August – Month to date
Start date	31 December 2018	31 July 2019
UK Equities	10.01	-4.7
European Equities ex UK	16.21	-2.4
US Equities	20.17	-3.7
Japanese Equities	10.99	-0.6
EM Equities	7.12	-5.2
UK Government Bonds	9.08	1.7
UK Corporate Bonds	8.70	0.5
European Government Bonds	8.52	0.5
US Government Bonds	6.99	1.8
Oil	20.44	-6.6
Gold	14.56	2.6

Source: Bloomberg Finance L.P., Morningstar. Equities in GBP. Bonds in Local currency. Commodities in USD.

Our view?

Market performance has been remarkably strong this year and, even after the recent correction, has delivered some of the strongest returns in this bull-market cycle. Traders may rush to sell assets in order to protect profits but, as long-term investors, we view recent events as part and parcel of market volatility. Indeed, we were expecting some kind of market pull back and indeed had already reduced risk where appropriate in portfolios, giving us some dry powder to put to work if the market moves to lower levels, presenting an attractive buying opportunity.

Looking at the political landscape, any further escalation of trade tensions makes central banks more likely to ease further, providing a counterbalancing support for asset prices. Additionally, we remain cognisant of the fact that Trump faces the polls in late 2020 and he will not want to bring about a trade induced recession, as this would be unpopular with voters and harms his chances of re-election.

What of the outlook for corporate earnings? While growth has been on the weaker side this year, earnings growth in the companies we own is still, by and large, beating expectations. Indeed, a world of modest growth and low yields remains a good environment for the kind of high-quality names we favour in client portfolios.

In conclusion, we think markets could remain choppy for a while and seasonally this is a weaker time for share markets. However, we remain steadfast in our strategy of focussing on high quality global companies counterbalanced with conservative positioning in bonds, with some exposure to alternatives to limit volatility, particularly precious metals, such has gold, which has rallied nicely in the face of market tensions.