

ON THE ESCALATION PATH

For now, the trade conflict between China and the U.S. is unlikely to ease. Markets are understandably nervous.

Last week, the U.S. President once again shocked the markets by announcing that all imports from China will be subject to punitive tariffs starting in September. China swiftly responded: the Middle Kingdom has suspended the purchase of U.S. agricultural products, a measure that particularly affects farmers in the Midwest of the United States. These states in turn are important for Trump's re-election. The fact that the Chinese Renminbi depreciated by a good 2% against the U.S. dollar completed the picture. Trump promptly took it as another provocation.¹

We have seen several waves of escalation in recent years, followed by phases of gradual easing. In May, the U.S. announcement to increase the punitive tariffs on 200 billion dollars worth of Chinese imports from 10% to 25% caused unrest in the markets. The American stock market subsequently fell by more than 6%. When an easing for the G20 summit in Osaka at the end of June became apparent, the markets found their footing again. The prospect of a more expansive U.S. Federal Reserve (Fed) path did the rest. The S&P 500 subsequently gained 10% and reached new highs in July, before Donald Trump's Tweets sent it down again in August.

It is tempting to imagine that we might see a repeat of that pattern. That is, that the latest escalation might be followed by more conciliatory tones. At least in the short term, however, that appears unlikely. First, every unexpected turnaround by the U.S. administration increases the risk that Beijing will lose interest in a speedy resolution of the conflict. Instead, China might be tempted to wait for a change of leadership in Washington. If necessary, China might react with targeted measures designed to endanger Trump's re-election, even at the risk of collateral damage to the global economy and financial markets.

Second, the trade dispute has taken on a new quality with the recent announcement. Previously, only industrial goods were affected by the punitive tariffs. The latest threat implies that from September onward, the U.S. administration will also impose tariffs on a wide range of consumer goods. Their prices would rise, which would be a bad omen for the Christmas shopping season. The central banks could ease the pain somewhat with further interest-rate cuts, but cheap money alone cannot undo the economic damage trade conflicts cause. Further escalation could be especially painful for export-oriented countries like Germany and Japan.

As a result of all this, we will remain defensively positioned in the short term. Existing overweights in corporate bonds have been reduced again in recent weeks. Among government bonds, we now have a preference for longer maturities. The Japanese yen has once again proven itself as a diversification instrument in times of rising uncertainty. We have also pointed out the potential for a setback in equity investments for some time: see [Investment Traffic Lights as of 8/2/19](#) or [CIO View – More troubles ahead as of 6/17/19](#). Here we stick to our cautious attitude.

In the longer term, however, our base case continues to rest on the assumption that neither the White House nor the Beijing leadership will want to plunge the world into recession. We also hope that both sides will be able to leave the trade-war path they have now embarked on in time before either loses control over the situation. Financial markets, a sensitive indicator of the business cycle, have an important role to play here. Since 2017, escalations in the trade dispute were observed in an environment in which risky assets were in high demand and U.S. equities were trading at record highs. On the other hand, at times when the markets weakened, more conciliatory tones could be heard, especially out of Washington. The pressure from the markets thus appears to have a certain disciplining effect. This suggests that a sensible compromise might yet be reached in the longer term, but that the way there may well cause some headaches for investors. The risk that the conflict takes on a momentum of its own and gets out of control has risen significantly.

¹ <https://twitter.com/realDonaldTrump/status/1158350120649408513?s=20>

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GLOSSARY

Corporate bond

A **corporate bond** is a bond issued by a corporation in order finance their business.

G20

The **Group of 20** are the largest industrialized and emerging economies in the world.

Japanese yen (JPY)

The **Japanese yen (JPY)** is the official currency of Japan.

Renminbi (RMB)

Renminbi (RMB) is the currency of the People's Republic of China.

S&P 500

The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

U.S. Federal Reserve (Fed)

The **U.S. Federal Reserve**, often referred to as "**the Fed**", is the central bank of the United States.

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