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Maximum pressure equals maximum risk

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U.S. has put maximum pressure on China in this trade war

Trade war crossfire has intensified. Trump announced a new tariff of 10% on the remaining $300bn imports from China, which we believe will become effective on Sep 1. China allowed CNY to devalue above 7.0, and the U.S. Treasury declared China a currency manipulator. U.S. is putting maximum pressure on China to reach a deal. However, we think this tactic won't succeed, at least in the near term, and tariffs could go to 25% on all imports from China and remain for a long time. We believe that more pain needs to be felt on both sides for this to be de-escalated, which will take time. Cross asset volatility is likely to remain heightened for the weeks to come.

Renminbi depreciation beyond 7.0 is a bad sign in many ways

If deliberate devaluations of currency occur, this would turn the trade war into a currency war. A weaker CNY will make oil more expensive to China, which will weaken its demand and perhaps cause China to turn more fully to Iranian supply. If capital flight fears return in China, it could depreciate CNY more than the Peoples Bank of China (PBOC) can contain. China's economy can probably handle the impact from tariffs and a volatile CNY and still deliver 5.5%-6.0% gross domestic product (GDP), but economies elsewhere with large exports to China could be tipped into a recession. The trade war has caused slower trade, weaker investment spending and slower manufacturing activities globally. And now introducing tariffs on consumer goods will rattle U.S. consumers.

More Fed cuts are priced in, but will it be the antidote for the slowdown?

The market is pricing in a 100% probability for a September U,S. Federal Reserve (Fed) cut, up from 40% after the July Federal Open Market Committee (FOMC). Also four rate cuts are now expected by 2020 end, up from three. But is easier monetary policy enough to offset a likely S&P profit recession and a darkening global economic outlook? The 10Y-3M yield gap is -30 basis points (bp). We have argued repetitively that a slight inverted yield curve (up to ~50bp) is not a strong signal for recession but a market indication that the Fed is at or slightly above its neutral rate. But if the inversion gets close to -100bp, then it becomes a strong recession signal. Global purchasing manager indexes (PMIs) are weak and most regions are below 50. Further deterioration will mean more of a slowdown is likely underway. 2Q bottom-up earnings per share (EPS) in the U.S. and emerging markets (EM) are flat on a year-over-year basis, and all other regions are down. The world is almost in a profit recession already. Accommodative monetary policy is helpful, but it takes time to work through the system, and we expect it to be better for the economy than for corporate profits.

Are low interest rates good for S&P PE? Not necessarily

The U.S. 10-yr treasury yield dropped to 1.6% and the yield on 10-yr Treasury-Inflation Protected Securities (TIPS) is 0.0%. Very low interest rates have been supportive of higher price-to-earning (PE) multiples than history at the S&P 500, but can they push PEs higher? Secularly lower interest rates are good for equity multiples, but cyclically lower interest rates are not. Cyclical economic and corporate profit downturns are usually accompanied by simultaneous lower interest rates and equity multiples. In this cycle there are two instances when interest rates have been as low as today: 2012 and 2015-16. In 2012, the S&P PE was compressed to 12x amid double-dip recession fears. And during 2015-16, the S&P fell into a profit recession caused by the oil price collapse and dollar surge. The S&P PE was compressed from its high of 18x to a low of 16x. In our view, today's low interest rates reflect both secular and cyclical forces, but the recent moves are more cyclical. The Fed suggested that the July rate cut was a course correction adjustment, not the start of a long easing cycle.

Risk of 10% correction high, sector tilts are helpful to weather the pullback

This significant trade conflict escalation hurts profits at trade sensitive industries, pressures oil prices and poses upside dollar risk. These very low interest rates threaten Bank net interest margins. We cut our 2019E S&P EPS from $165 to $163, flat y/y; and our 2020E EPS from $175 to $173, 6% y/y. The average S&P trailing PE this cycle (since 2010) is 16.7x. We think this could be a reasonable PE support level. We expect the S&P to soon fall to about 2750, i.e. 17x our 2019 EPS estimate, or 10% selloff from the peak of 3025. However, if recession fears flare up and the 10yr yield sinks below 1.5%, then S&P PE can compress to about 15x or lower, i.e. 2450 or 20% selloff from the peak is possible. Several other major risks are also on the horizon: a more likely no-deal Brexit, worsening conflict in Hong Kong, possible U.S. tariffs on Europe, and upcoming Japan consumption tax rate hike. We continue to believe that the risk of a near term S&P correction is high. Our sector tilts are positioned for this pullback. We are overweight (OW) Health Care, Communications, Utilities and Real Estate, and we are cautious on all other sectors.

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Definitions

One basis point (bp) equals 1/100 of a percentage point.

Brexit is a combination of the words "Britain" and "Exit" and describes the possible exit of the United Kingdom from the European Union.

CNY is an abbreviation the Chinese yuan, legal tender on the Chinese mainland, also referred to as the renminbi (RMB).

Earnings per share is calculated as a companies' net income minus dividends of preferred stock all divided by the total number of shares outstanding.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Inverted Yield Curve is an environment where long-term debt instruments offer interest rates than short-term debt instruments.

People’s Bank of China (PBOC) is the country’s central bank.

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

The S&P 500 Index includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.