

Monthly Macro View

The Asset Allocation Team

In early August, the US government unexpectedly announced tariffs on the remaining US\$300 billion of Chinese imports. These levies, which could impact the consumer, were scheduled to begin on 1 September. However, the start date for duties on certain goods was deferred to 15 December in order to mitigate the potential impact on Black Friday and Christmas sales.

This game-changing development alters our earlier, more bullish view of the markets. In addition to our traditional thoughts about the impact of tariffs on the global economy, we are now considering additional factors that create nonlinear headwinds to growth. Furthermore, we now expect the Fed to cut interest rates by 50 basis points in September with the potential for more further reductions down the line.

US-China trade war: A framework for thinking about new tariffs

What a difference a day makes.

The last day of July brought the first US interest-rate cut in more than a decade—an event that was widely expected, marred only perhaps by an unusually robust accompanying press conference that confused markets briefly. But a sense of positivity returned quickly, and investors were getting ready to down tools and settle into the lazy, hazy days of summer. Then, without a word of warning, everything changed.

On 1 August, the Trump administration announced a new set of tariffs on the remaining US\$300 billion of Chinese imports to be imposed on 1 September. Even if the announcement was subsequently amended to defer tariffs on certain goods until 15 December, this development is in our opinion game changer that single-handedly alters our earlier, more bullish view of markets. We had previously expected US growth to accelerate as domestic business investment stabilised along with improvements in global trade activity, supported by a stabilising China—in short, a scenario that was supportive of risk. The new tariffs, however, substantially weaken our argument and, by extension, our view that risk assets can outperform, particularly over the next three months.

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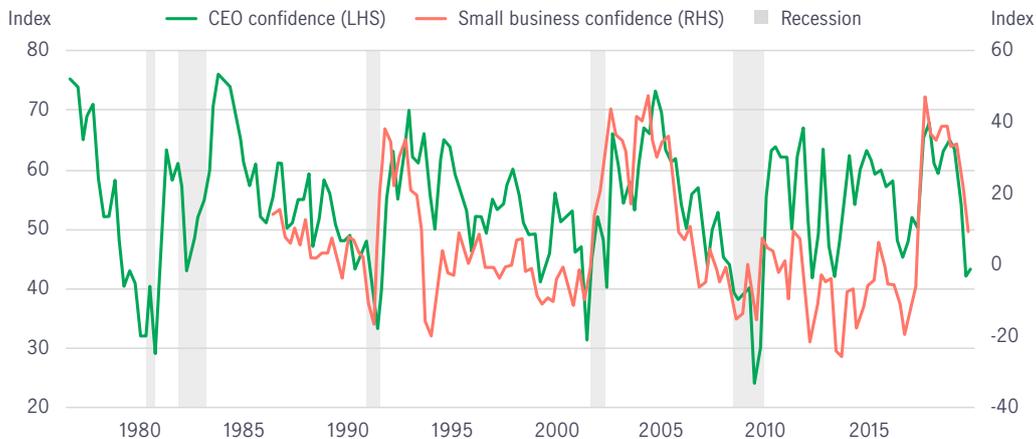
We suggest thinking about the impact of impending tariffs in two phases.

- **Phase 1:** We believe it'll be very difficult to get a clean read on the global economy through economic prints for the months of August and September. Even with the scaled-back tariffs, this data will likely reflect renewed uncertainty like it did in May after US President Donald Trump threatened to impose tariffs on Mexican imports. We expect to see (i) weakened business confidence, (ii) stalled hiring activity, and (iii) the front-loading of selective trade and other economic activity. Critically, regardless of whether the new tariffs are ultimately implemented, we expect companies to delay hiring and capital expenditure decisions until they have more clarity.
- **Phase 2:** If additional tariffs are indeed imposed, their impact on growth in 2020 and 2021 will need to be

assessed in addition to the weakness they're likely to cause as a result of the associated confidence shock. This is challenging because we're in uncharted territory and there are few historical examples that can provide clues in regard to what could happen next. Crucially, economic models typically struggle to properly capture the multiplier effects of trade tensions and tariffs.

Prior to the 1 August announcement, our research had found some preliminary green shoots, suggesting that the macroeconomic environment—particularly in the areas of business confidence, business investment, global trade, and global manufacturing—might have been stabilising, with growth potentially accelerating during the latter months of the year. We now think that chances of stabilisation in these areas are at risk, and we'll experience continued weakness in the global economy—particularly in the United States and China—for the remainder of the year.

Chart 1: US business confidence



Source: Refinitiv, Manulife Investment Management, as of 29 March, 2019

Nonlinear headwinds to growth

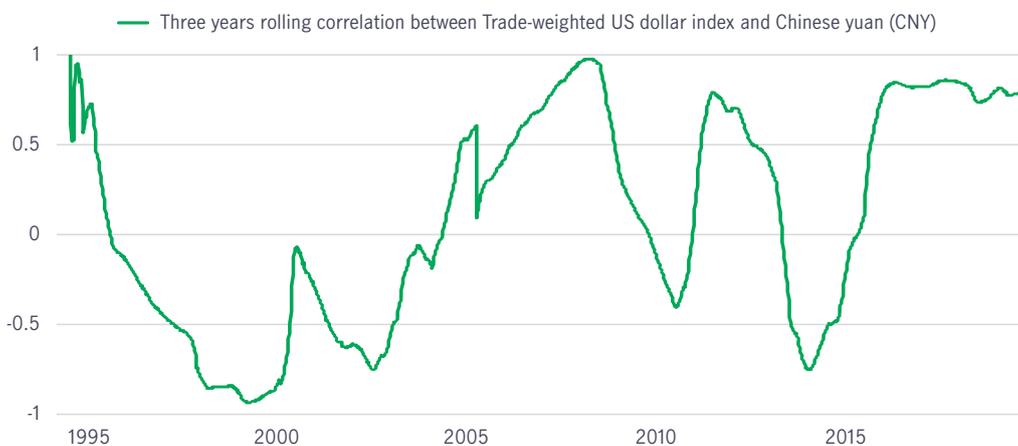
In addition to the more “traditional” economic consequences of trade tensions and tariffs, this new round comes with additional factors that, in our view, are creating nonlinear headwinds to growth.

1. The US consumer impact. The US consumer has been fairly well insulated from previously imposed tariffs. To date, only US\$50 billion of Chinese imports that have been subjected to tariffs were consumer goods¹ while most have been industrial and capital goods. This next set of tariffs, however, will impact US\$120 billion of consumer goods. In particular, these new tariffs are set to hit electronics, apparel, and toys. We would note that the push back to 15 December on these goods are likely designed to mitigate any tariff-related impact on the consumption of durable goods around the holiday shopping season, but the fact remains that if these tariffs are implemented, the ultimate impact will be the same. Moreover, the effect on retailers might not end there: it’s worth highlighting that demand for nontariff goods (and even services) may feel pressure as well. The reason is fairly straightforward—all else being equal, if phones cost more, will consumers have less money to spend on other items, such as having meals at restaurants? While some of these tariffs might be absorbed by companies, profit margins are in weaker shape today than they were a year ago² and we’re concerned that a large chunk would be passed on to the US consumer.

This development would represent an important downside risk to the US economy. Consumer spending, which accounts for roughly 70% of GDP, has held up particularly well over the past year and has been a key support for the economy. Notably, consumer confidence has remained high and wage growth (at around 3%) has been decent.³ Similarly, the labour market is in good shape even if job growth has slowed down slightly. But without business investment and trade, the US economy is leaning fairly heavily on one pillar of growth that now looks as if it could experience a little wobble of its own soon.

2. The Chinese yuan (CNY) fell below the sensitive “seven-to-the-dollar” level shortly after the tariff announcement. We view this as being more psychologically significant than economically important. However, the move cements two risk-off narratives that further exacerbate the risk-off tone. First, markets will fear the possibility of further substantial CNY depreciation, which could lead to capital outflows. While we expect the CNY to depreciate against the US dollar, we believe the move will occur slowly over time, instead of taking place in a linear fashion. That said, even a gentle, gradual weakening of the currency could spark investor concern. Second, the global economy has yet to witness what could be perceived as substantial retaliatory measures from China—we must now monitor how Chinese policymakers choose to respond to the latest tariff threats, be it through currency or other channels. Retaliatory measures will hurt global business confidence and trade activities.

Chart 2: Trade-weighted US dollar index correlation with Chinese yuan (CNY)



Source: Refinitiv, Manulife Investment Management, as of 12 August, 2019

¹ “How Trump’s Tariffs on Chinese Goods Will Hit Your Shopping Cart,” New York Times, 10 May, 2019.

² FactSet, as of July 2019.

³ Bloomberg, 8 August, 2019.

It's also worth highlighting that the CNY represents 16% of the US dollar's trade-weighted basket and has an increasingly strong influence on the other currency components of the basket. Investors are right to focus on US dollar strength because it's an important headwind to US (and global) growth since it also represents a tightening of financial conditions.

That said, we'd also note that China's policy responses can also have risk-on implications—particularly if they include direct domestic growth stimulus. Indeed, we're expecting further easing from the People's Bank of China and additional fiscal support for the economy. How the market interprets these possible measures will likely depend on their size, scope, and timing (as usual).

3. The US yield curve—and indeed, many others—has flattened significantly after the 1 August announcement. Aggressive global yield curve flattening reignites recession probability and increases the likelihood of a curve-driven recession in the US next year. We're not currently expecting a technical recession in 2020, but the confidence shock arising from higher tariffs could bring US growth down to 1% (or slightly less) in 2020, depending on its magnitude. It's hard to tell if the recent yield curve inversion will turn out to be an accurate recession indicator, but it'll certainly send recession fears into overdrive in the coming months.

A change in our Fed expectations

As a result of recent developments, we now expect the US Federal Reserve (Fed) to cut interest rates by 50 basis points (bps) with the potential for more further down the line, up from our original forecast of a 25bps cut followed by an extended pause. We'd also suggest monitoring for an increasing dialogue about an intra-meeting cut, though that is not our base case.

In our view, in addition to broad concerns about growth and inflation, the Fed will likely be moved to cut 50bps in order to:

- Provide specific “insurance” against the expected hit to the US consumer—a new economic threat we don't believe the Federal Open Market Committee as being overly concerned about at its July meeting
- stoke some yield curve steepening and reduce concerns about the inverted yield curve
- support financial conditions, particularly in the event of further strengthening of the US dollar and a marked deterioration in broad market sentiment to avoid knock-on effects from either development

To be clear, we don't believe that a 50bps interest-rate cut will single-handedly salvage business or consumer confidence (or inflation for that matter), but it could provide some support for market sentiment and economic growth, which look particularly vulnerable at the moment.

Chart 3: The US 3-month-10-year yield curve



Source: Refinitiv, Manulife Investment Management, as of 12 August, 2019.

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