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On 1 August, the Trump administration announced a new set of tariffs on the remaining US$300 billion of Chinese goods to be imposed on 1 September[1]. The US-China trade war further escalated on Monday with the US Treasury Department designating China as a currency manipulator and the US dollar/Chinese renminbi (USD/CNY) rose above the 7.00 level[2]. Equity markets plunged around the world. Frances Donald, Chief Economist and Head of Macroeconomic Strategy, explains why this phase of the trade war is different.

Tariff threat trips the circuit breaker, setting the scene for a 50 basis points (bps) Fed rate cut in September

We view this next round of tariffs as a gamechanger that alters our prior views regarding US acceleration and a stabilising China. The new tariffs have tripped the circuit breaker and in our view are likely to single-handedly reverse the course of both the US and the global economy in the third quarter. This development is particularly disappointing, given that most of our research had found green shoots of stabilisation and potential recovery in US business investment, global trade, and the global manufacturing recession. Unfortunately, heightened trade tensions nip those positive developments squarely in the bud and necessitate two key changes of view from the macro strategy team.

1. **We've changed our view from expecting a 25 basis points (bps) rate cut from the US Federal Reserve (Fed) in September, followed by an extended pause, to a 50bps cut with the potential for more.** We also believe an intra-meeting cut is possible, although that isn't our base case. To be clear, we don't believe that 50bps of cuts from the Fed will single-handedly salvage business or consumer confidence, but it could buffer some of the decline in market sentiment, arrest this new round of yield curve flattening, and soften the upside pressure on the US dollar. The Fed would welcome all of those.

2. **We believe a neutral risk exposure in the short-term** makes sense, heading into what we expect to be a difficult, volatile, and particularly uncertain August and September. However**,** this doesn't change our moderately constructive 12-month view, as we believe risk assets (credit and equity) are still in an overall uptrend and will be supported by a low rate environment and extended—albeit weak—business cycle. Indeed, our internal conversations in the past two market days (as of 5 August) have questioned when the appropriate time will be to buy this dip—it's almost entirely dependent on the progression of trade tensions and, secondarily, concerns about emerging-market currencies. In the meantime, US Treasuries and global debt can rally further, and there is some mild-to-moderate room left for equities to decline from here.

Why the change of view?

While markets are now accustomed to trade tensions, this newly proposed set of tariffs comes with three characteristics that are causing us much more concern than all past iterations.

1. This set of tariffs affects the US consumer in a more substantial manner who, until now, has offset weakness in business investment. In particular, new tariffs are tipped to hit electronics, apparel, and toys and are therefore likely to hamper consumer confidence, spending, and prices. This effect is unique to this new bucket of goods.

[1] US Department of the Treasury, 5 August 2019.
[2] Bloomberg, as of 5 August 2019.

2. While we feel the USD/CNY crossing 7.00 is more of a psychological level than an economically important development, the move cements two risk-off narratives: a low but rising possibility of a capital outflow crisis from China, and retaliatory measures from China that may further dampen US and global growth activity.

3. Aggressive global yield curve flattening reignites recession probability indexes and increases the chance of a curve-driven recession in 2020. We aren't currently expecting a technical recession in 2020, but the depth of the confidence shock resulting from higher tariffs could bring US growth to 1% in 2020 or slightly below, depending on the magnitude.

Where do we go from here?

Upside scenarios are more limited now than they were six months ago. They are generally more associated with the potential for additional easing than the market currently expects from global central banks (already a tall order) and/or possible large-scale stimulus from China. Clearly, a reversal of the tariff threat would also present an important catalyst. While the above is all possible, we suggest stepping to the sidelines until we have more visibility on growth.

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