Who wins in a trade war?

Key highlights:
- Trade talks dominate news headlines on a daily basis, yet nothing substantive seems to be happening to bridge the gap between the U.S. and China.
- Bond markets have rallied, while stocks have traded down.
- Investors seem to think that a resolution lies over the horizon.
- Utilities, Real Estate and Information Technology offer some attractive opportunities.

Heading into the summer, trade tensions with China have been dominating news headlines, with both the U.S. and China ratcheting up their rhetoric and leveling trading sanctions against one another. Despite this still-unfolding drama in which most sectors of the U.S. economy have been negatively impacted (see Exhibit 1), many investors remain complacent, seemingly embracing the idea that the U.S. and China will come to an eventual agreement later this year, while no real blueprint has been produced to show exactly how that result will be reached.

Exhibit 1: Few sectors spared from the trade fallout
Performance, month to date (as of 5/23/19)


Potential impact on U.S. economy

What might happen if the two countries fail to reach an agreement by year’s end? To begin with, economic growth for both would likely fall, given the expected drop in trade between the U.S. and China. In addition, inflation could rise due to higher prices because of tariffs. This would likely lead to a significant impact on consumer confidence, which is a key statistic when analyzing expected buyer behavior. Lower confidence would suggest consumers could hold off their upcoming purchases, thus slowing the economic cycle. Risk-off sentiment would increase as stock prices tumbled, while conversely, risk-free assets such as U.S. Treasurys would become more attractive given their perceived safety. The U.S. dollar, which has been strengthening this year (see Exhibit 2), would continue, in our opinion, its upward trend.
Potential Federal Reserve reaction

At this time, as shown in Exhibit 3, the market is pricing in a cut in the federal funds rate before year end as the futures contacts show yields less than the current 2.50% fed funds target. This expectation may also be the reason why financial markets have reacted relatively well during the recent trade talks between the U.S. and China. At the moment, the Federal Reserve (Fed) is in a pause mode, but many clearly expect a rate decrease which has resurrected the so-called “Fed put”, the belief the central bank will always help the U.S. economy by lowering interest rates and encouraging risk-taking behavior by investors.

Exhibit 3: Fed futures showing a cut in interest rates
Rates on federal funds futures contracts

What about fixed income?

The U.S. bond market, when compared to equities, has rallied in reaction to the talks surrounding trade issues. Yields have fallen over the month of May, particularly on high quality U.S. Treasury securities (see Exhibit 4). Riskier bond markets, such as high yield bonds, have underperformed as spreads have widened. We would point out that if a trade resolution was reached between the U.S. and China, it is likely that interest rates would rise as risk-on sentiment would probably find more support in the market.

Exhibit 4: Falling bond yields
Benchmark 10-year U.S. Treasury yield

![Graph showing falling bond yields.](image)

Potential impact on world markets

As shown in Exhibit 5, most global equities have seen negative performance during May. Emerging markets stocks, including China, have been particularly hurt during 2019. It is useful to note that the U.S. has not been spared as the S&P 500 Index has also experienced a downturn in its performance for the month. This suggests that no one truly wins a trade war so we remain hopeful that an accommodation can be found for both sides in the ongoing negotiations.

Exhibit 5: Major stock indexes struggled in May, but U.S. fared better than most
Month to date performance

![Bar chart showing month to date performance.](image)

Source: U.S. Department of the Treasury, 5/22/19.

What does this mean to investors?

Will there be a resolution by December? The short answer is we aren’t sure. It has become abundantly clear that President Trump considers trade to be a major issue for his 2020 reelection campaign and wants to portray the U.S. as being a tough negotiator. This equates to extracting key concessions from China, which equally wants to present itself in the strongest possible terms on the world stage. With an outcome still not visible on the horizon, we would be defensive in the equity market. Defensive sectors such as Utilities and Real Estate offer a potential safe haven. Additionally, we favor buying Information Technology stocks opportunistically at depressed levels. Finally, it is important to maintain a balanced portfolio – stocks, bonds, and cash – during these periods of heightened uncertainty.