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Another step in the trade war escalation

UBS House View - CIO Alert

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Another escalation in the US-China trade war led the S&P 500 to fall 2.6% today. Global equities dropped 2.1%, and yields on all US Treasury maturities fell at least 8 basis points.

News broke early in the day that China would impose additional tariffs on USD 75 billion of American goods. Some of the measures will be implemented 1 September, including an additional 5% tariff on US soybeans and crude oil. Then on 15 December, China will also resume the previously suspended 25% levy on US autos and an additional 10% on certain vehicles. This timing matches the recently announced US tariffs on imports from China.

But this wasn't the catalyst for the market sell-off, as the S&P 500 was flat for the day as of 11 a.m. The sell-off began after a series of tweets from President Donald Trump, in which he said that a US response to China's actions would be coming later in the day. After the market close, the president tweeted that: 1) tariffs would rise from 25% to 30% effective 1 October on the USD 250 billion of goods already subject to levies; and 2) a tariff of 15% rather than 10% will now be levied against the remaining USD 300 not already subject to tariffs (just under half will be effected 1 September, with the remainder implemented on 15 December).

Our base case was for mild escalation in the form of a proportionate retaliation from China before 1 September, which is in line with China's announcement today. The US administration's response late today stretches the boundaries of that base case and moves us closer to our downside scenario of a 25% tariff on all remaining untaxed Chinese exports. We expect China to respond to this latest US action, as they have always done so far. Beijing's response may include restrictions on US aircraft purchases and travel to the US, and US companies being added to the "unreliable entity" list. The good news in all this is that the US economy still looks fairly solid, supported by a healthy consumer.

The market focus today was supposed to be Federal Reserve Chair Jay Powell's speech at the Jackson Hole central bank conference, where investors were hoping for clues about the Fed's likely path of future rate cuts. Instead, the speech broke little new ground and reinforced our view that the Fed will cut rates by enough to get the yield curve out of inversion—at current market pricing, that would require an additional 75 basis points of cuts. The market seemed to agree, as there was a relatively muted response in both stock and bond markets to the speech.

But the speech came before the latest trade escalation threats from President Trump, which may change the Fed's calculus. While acknowledging a favorable baseline growth outlook and inflation moving back up, Powell reinforced the "risk management" case for additional rate cuts in the face of a long list of downside risks. Today's news on tariffs increases the downside risks and may encourage the Fed to act more aggressively.

The risk for the economy and financial markets is that even a more aggressive Fed rate-cutting policy would likely be "too little, too late" in the downside scenario of a 25–30% tariff on all US imports from China. Consequently, we believe trade policy, not monetary policy, is the biggest factor driving the market outlook in the near term.

For now, we expect the US to avoid a recession next year, but the risks are tilted to the downside. Overall, this is an environment that warrants a balanced approach to risk-taking in portfolios. Near-term upside looks limited, but central bank easing provides market support and we can't rule out a pause, or even reversal, of escalating US-China trade tensions. Therefore, in our tactical asset allocation, we recommend US versus international developed market equities, and Treasury Inflation-Protected Securities (TIPS). For more aggressive portfolios, we continue to recommend long-duration Treasuries to help manage downside risk. And for investors who are able to purchase options, we recommend considering a small allocation to a protective put strategy tied to the S&P 500, where appropriate. Within our US equity exposure, we have recommended avoiding those sectors that are more vulnerable to escalating trade tensions and a global slowdown, such as industrials, technology, and energy, in favor of those more closely aligned to the US consumer including consumer staples, consumer discretionary, and communication services.

Best regards,

Mark Haefele, Jason Draho

Appendix

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