Goldman Sachs Asset Management

May 2019 | Macro Insights

Market Update: Trade Tensions versus Policy Puts

Overview

An escalation in US-China trade tensions has weighed on investor sentiment and risk asset performance, including emerging market (EM) assets and corporate credit, though fixed income markets have generally fared better than equity markets during the recent bout of market weakness. Meanwhile, perceived safe-haven currencies have appreciated and core sovereign bond yields have fallen. In our recent Q&A on The Outlook for Global Growth and Fixed Income we listed an improving trade backdrop as one of three factors that had evolved in ways that led us to believe global growth will stabilize for the rest of 2019. This assessment has clearly shifted. However, the other two factors—a patient US Federal Reserve (Fed) and policy easing in China—remain in place.

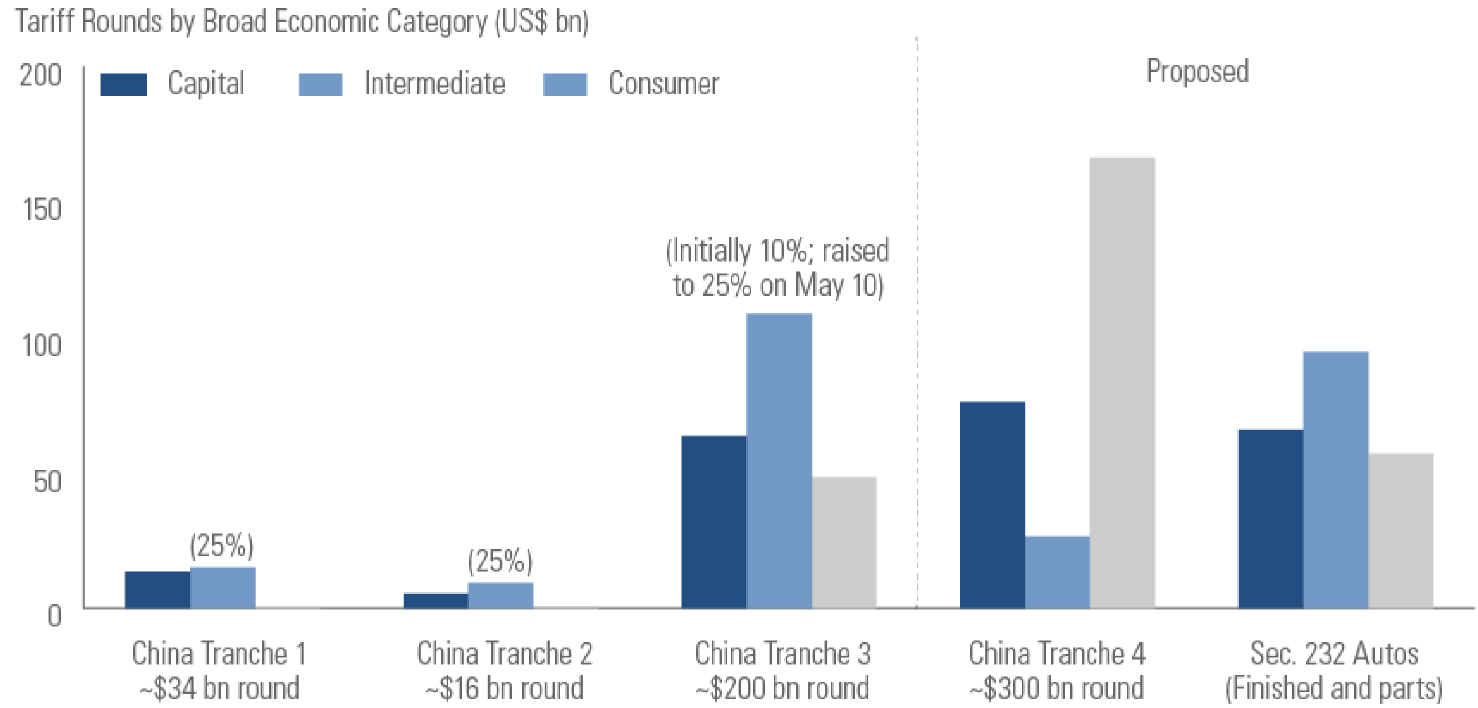
Against a backdrop of heightened trade tensions we have scaled back overweight exposure to EM currencies and EM debt. That said, given policy support —or “policy puts” whereby policymaker actions support market liquidity thereby creating put protection on asset prices—and our expectation for the cycle to continue, we maintain exposure to spread sectors and we continue to identify relative value opportunities in macro markets.

Trade Tensions

Recent Escalation

On May 10, the US raised the tariff rate on $200bn of imports from China from 10% to 25%. US President Donald Trump has also indicated that tariffs will be applied to remaining goods imported from China which amount to roughly $300bn in value. In response, on May 13, China announced it will raise tariffs on $60bn of imports from the US from June 1. These events mark an abrupt escalation in US-China trade tensions after a period of relative calm since the fourth quarter of 2018 (see Appendix I).

EXHIBIT 1: CHINA-SPECIFIC TARIFFS ENACTED BY THE US



Source: Goldman Sachs Global Investment Research. As of May 15, 2019. Tariff rate denoted in brackets.

Macro Impacts[1]

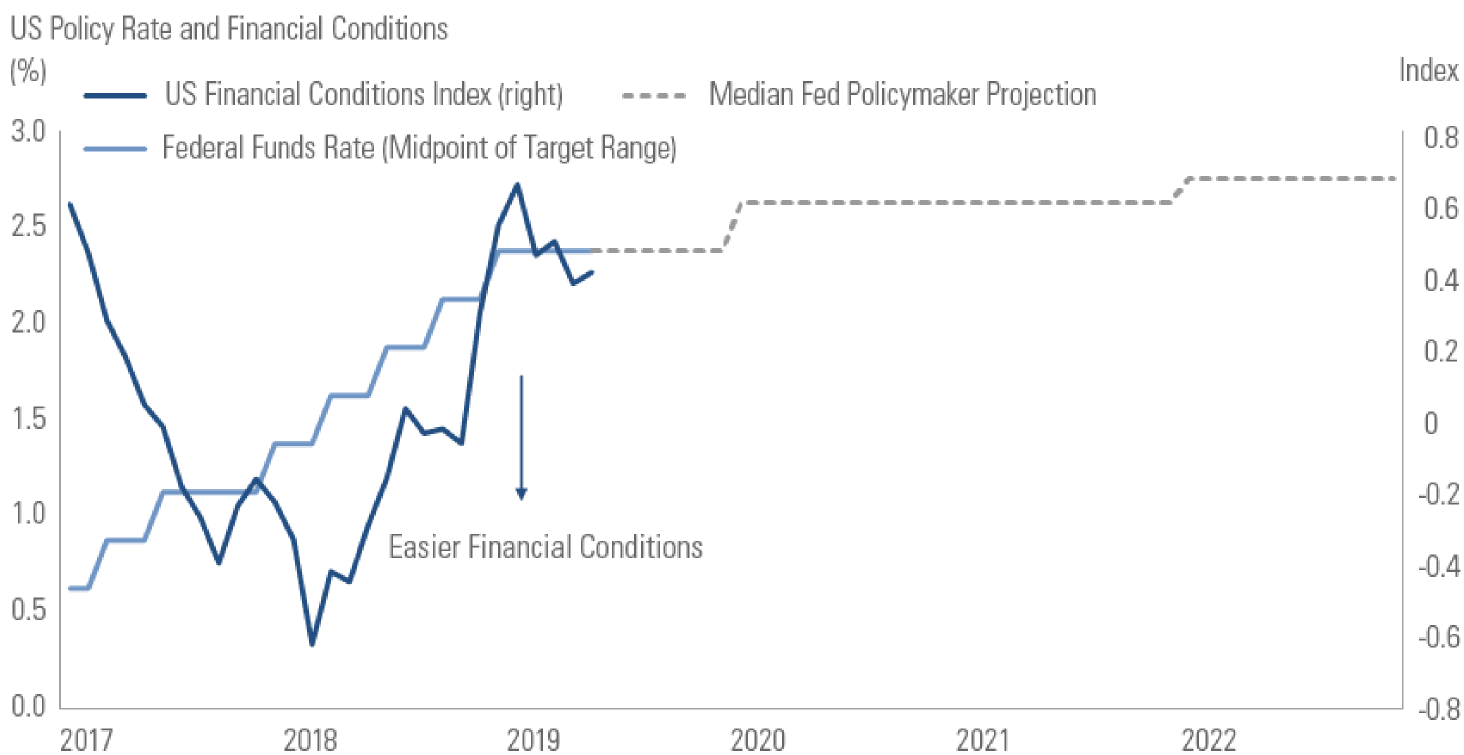
- Chinese Growth Outlook: Full Circle
  - We recently revised higher our 2019 China growth forecast from 6.3% to 6.5% in light of stronger-than-expected first quarter GDP growth and on raised prospects of a US-China trade deal.
  - Given the recent deterioration in US-China trade relations, we have lowered our forecast to 6.2%. This downward revision reflects our estimate of the direct impact on Chinese growth from lower exports to the US (following the tariff step-up) and indirect impacts (such as lower business sentiment and activity) somewhat offset by measures taken by Chinese policymakers to stabilize growth.
- US Inflation and Monetary Policy Implications: Limited
  - In the absence of a material growth shock, we forecast US core PCE inflation—the Fed's preferred measure—to rise 1.8% in 2019; slightly below the central bank's target. The 25% tariff on $200bn of imports from China could add around 10-15bps to our core PCE inflation forecast over the next year. Tariffs on remaining imports from China could see this boost rise to 40bps.
  - In our view, a temporary upward inflationary impulse from a higher tariff rate will have limited implications for Fed policy and for now, we continue to expect US monetary policy to remain unchanged in 2019. We think the Fed will prioritize a continuation of the US expansion—which is set to become the longest on record if growth continues through June—rather than react to a temporary inflation overshoot.

Policy Puts

As noted above, two of the three developments we highlighted in our recent Q&A as being supportive for global growth and markets remain in place; a patient Fed and policy easing in China.

In our view, factors guiding **US monetary policy** are broadly balanced and therefore consistent with unchanged near-term policy. From a hawkish perspective, the labor market is tight, with solid monthly job gains and a multi-decade low unemployment rate. Moreover, several measures of wage growth are trending upwards. The non-financial sector is less indebted and therefore more resilient to monetary policy normalization than in prior cycles. From a dovish standpoint, supply-side improvements such as raised labor force participation and productivity growth may limit further upward wage inflation pressures and unit labor costs—which tend to have a closer relationship with broader prices—remain subdued. In addition, policymakers have highlighted that some measures of inflation expectations are low and there are signs of slowing activity in cyclical sectors. Overlaying these macro considerations is a potential change in policy framework at the Fed, with policymakers potentially growing more tolerant of periods of inflation above its 2% target.

EXHIBIT 2: US FINANCIAL CONDITIONS HAVE EASED FOLLOWING THE FEDS PATIENT PIVOT



Source: GSAM, Macrobond. As of May 15, 2019.

In contrast, we think there is a clearer case for continued **policy easing in China**. Growth is moderating due to the economy's evolution from being investment-led to consumption-driven. This moderation is reinforced by hawkish US trade actions. As noted previously, the policy response in China is smaller in magnitude relative to prior installments of support and will also likely take longer to impact growth relative to when the economy was less levered. However, first quarter activity data pointed to some signs of policy measures taking hold and we expect supportive policies—including issuance of special local government bonds for infrastructure investment—to gain traction in response to recent trade events.

Fixed Income Investment Implications

Beyond a recalibration of EM asset exposures, our key fixed income investment views—some of which are listed below—are broadly unchanged. We maintain exposure to spread sectors and continue to identify relative value opportunities in macro markets.

- We have scaled back overweight exposure to **EM currencies** and **EM debt** until we gain clarity on the direction of travel for both US-China trade relations and global growth, with the two being interconnected.
- Following strong early-2019 performance, we have scaled back overweight exposure to **US corporate credit**. That said, we continue to identify attractive “carry and roll” opportunities arising from steepness at certain portions of US credit curves. More specifically, we favor the intermediate portion of the BBB-rated US credit curve.
- We also find select opportunities arising from market dynamics and dislocations, such as performance dispersion between **US high yield** bonds from small and large issues. Dispersion has arisen due to the nature of retail fund demand which is largely channeled through ETFs, for which bonds from only large issues tend to be eligible.
- Among developed market currencies, we remain neutral the **US dollar**. In our view the dollar’s perceived safe-haven status and its high-yield (relative to other advanced economies) is counterbalanced by a patient Fed outlook and concerns around US fiscal and current account deficits.
- We also continue to identify attractive **macro relative value** opportunities. Our overweight exposure to core European rates versus rates from other advanced economies has benefited from the European Central Bank’s elongated forward guidance, which confirms unchanged policy rates through to 2020. Additionally, growing opposition to globalization may further undermine sentiment in the Euro area; this could reinforce the growth moderation currently underway and further support our relative value positioning.
- Elsewhere in macro markets, we are positioned for tighter financial conditions in Canada relative to the US. We think the bar for rate hikes in Canada is lower than in the US. We implemented this position ahead of an escalation in US-China trade tensions and therefore gained from the subsequent rally in US rates.

APPENDIX I - US-CHINA TRADE WAR TIMELINE OF KEY EVENTS

Phase	Date	US	China
Escalation	**Tranche 1**		
	Jul 6, 2018	**US implements first China-specific tariff; 25% on $34bn**	**China retaliates with a 25% tariff on $34bn**
	Aug 14, 2018		China files a WTO complaint against the US
	Tranche 2		
	Aug 23, 2018	**US implements a 25% tariff on $16bn**	**China retaliates with 25% on $16bn**
	Aug 23, 2018		China files second WTO complaint against the US
	Tranche 3		
	Sep 24, 2018	**US implements a 10% tariff on $200bn**	**China implements tariffs ranging from 5-10% on $60bn**
De-Escalation	Nov 8, 2018	US and China resume trade talks	
	Dec 2, 2018	**US and China agree to a temporary truce** Both agree to refrain from increasing or imposing new tariffs for 30 days (until Mar 1, 2019). China agrees to purchase more US products including agricultural and energy products.	
	Dec 14, 2018	China temporarily lowers additional tariffs on US autos and resumes purchases of US soybeans (which it stopped buying in Jul 2018)	
	Jan 7-Feb 24, 2019	US and China hold several rounds of trade talks in Beijing and Washington	
	Feb 25, 2019	US extends truce relating to a tariff step-up on $200bn from 10% to 25% (no concrete date for the extension is provided).	
	Mar 31, 2019	China extends suspension of additional tariffs on US autos and auto parts	
	Apr 3-May 1, 2019	US and China hold several more rounds of trade talks in Beijing and Washington	
Abrupt Escalation	May 5, 2019	US President Donald Trump threatens to raise tariffs on $200bn from 10% to 25% and to impose tariffs on an additional $325bn of Chinese goods	
	May 10, 2019	**US raises tariff on $200bn from 10% to 25%**	
	May 13, 2019		**China announces it will raise tariffs on $60bn from 5-10% to 10-25%, effective Jun 1, 2019.**

Total Chinese exports to the US subject to tariffs: $250bn
Total US exports to China subject to tariffs: $110bn

Source: GSAM, China Breifing, USTR. As of May 15, 2019.

[1] The economic and market forecasts presented herein are for informational purposes as of the date of this presentation. There can be no assurance that the forecasts will be achieved. Please see additional disclosures at the end of this presentation.

Abbreviations: Gross domestic product (GDP), personal consumption expenditures (PCE), basis points (bps), exchange-traded funds (ETFs).

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