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04
2019

Featured G

When Elephants Fight, the Mice Get Squashed

Jack P. McIntyre, CFA |

The topic of U.S.-China trade tensions has been at the forefront of almost every conversation I've had over the last two weeks with clients in Australia and New Zealand. It makes sense. That part of the world is on the front lines of world trade. During those discussions, I heard a line that makes a lot of sense: when the elephants fight, the mice get squashed. In this analogy, the U.S. and China are the elephants and the rest of the global economy is the mice. At the beginning of the year, I blogged about the possible trinity, where risk assets needed three catalysts to perform well in 2019:

1. **The rest of the world needs to experience more stable growth relative to the U.S. economy.**
2. **China needs to do more stimulate its economy.**
3. **The U.S. and China need to continue making progress on trade.**

The world isn't overly complicated right now. China is the driving force behind all three of these catalysts, and we are finally starting to see some constructive developments regarding the third item. The Trump Administration very recently ended their threat to impose higher tariffs on $200 billion of Chinese goods on March 1, demonstrating a willingness to broker an agreement with China. The president's retreat from a hardline approach underscores the fact that the U.S. isn't an economic island. The U.S. is exposed to global developments, though nowhere to the same degree that the European and Japanese economies are. So when the global economy slows, the U.S. economy will eventually slow as well—and we'll see the global slowdown in 2018 start to register in the domestic economy this year. It seems as though Federal Reserve (Fed) Chairman Jerome Powell understands the risk to U.S. growth could come from a slowdown abroad.

The uncertainty over the outcome of the trade dispute has been a drag on business confidence, with companies pulling back on longer-term investment both in the U.S. and China. A trade deal could salvage global and domestic economic growth by igniting another wave of capital expenditures. U.S. Trade Representative Robert Lighthizer recently testified before Congress, citing that "real progress" has been made toward a trade deal but "much remains to be done." We agree much needs to be done, but it's a good sign that Trump has reined in some of the biggest trade hawks in his administration, including Lighthizer. Keep in mind that Trump's signature move is to weaponize uncertainty, so we may see some short-term volatility before a deal is announced. President Donald Trump is in 2020 reelection campaign mode so his negotiating style may be on hold for a while as he resumes weaponizing uncertainty. Bottom line: he needs to show wins economically, financial market wise, and on the trade front.

In spite of the anticipated periodic volatility, emerging market valuations remain compelling. Of course emerging market economies are the "mice" that could get squashed in this trade dispute, but there is significant upside potential if a trade deal is brokered, Chinese officials continue to stimulate the economy, and the dollar cyclically weakens. Our view is that emerging market assets, based on 2018's weak performance, have reflected the "mice losing" scenario. However, the risks to this constructive outlook are the usual suspects: deterioration in the trade talks or if the Fed betrays its patient rhetoric, defies market expectations, and tightens again. We don't think a hard Brexit could derail the global economy and our emerging market outlook.

Continental Europe and the U.K. are not determinants of global growth. So any impasse in the Brexit negotiations will hurt the regional economies. It appears that the no-deal Brexit is increasingly become a smaller fat tail event. However, a stalemate in the U.S.-China negotiations will certainly worsen Europe's already anemic growth. The U.S.-China trade war has global consequences. We need to see real progress on trade that goes beyond rhetoric. The elephants have to stop fighting.

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