

Cliffhanger

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While optimism had been growing that the U.S. and China were nearing the final stages of a trade deal, market uncertainty moved sharply higher following President Trump’s Sunday tweet that threatened to raise tariffs from the existing 10% to 25% on \$200 billion worth of Chinese goods at 12:01 AM (May 10) and potentially add tariffs to an additional \$325 billion dollars of Chinese imports at 25%. In total, that amounts to the potential of \$575 billion in Chinese imports being taxed at 25% (~\$144 billion or 0.7% of U.S. GDP). As a result, the potential parameters of what constitutes a “deal” have expanded, with increased downside risk. The table below illustrates the current tariffs in place (gray), with a reduction in tariffs in green and an increase in tariffs in red. The simplest way to interpret this chart is that a reduction of overall tariffs could lead to upside pressure in the equity market and an increase in tariffs could lead to further downside pressure. The timing and enforcement of these tariffs will similarly play a role in the market response.

Will a deal be struck? We remain optimistic a deal will be struck. We disagree with many market pundits that believe better economic conditions in both the U.S. and China have emboldened each side to be more aggressive in negotiating. To the contrary, the current “indefinite” postponement of the tariffs and apparent progress in the trade discussions has helped sentiment and led to better economic and equity market performance. Increased tariffs and trade war rhetoric could cause that economic momentum to be short-lived, with both sides incurring at least short-term negative repercussions. Thus, a negative response to increased tariffs could force both sides back to the negotiating table. With President Trump having such favorable polling on his handling of the U.S. economy (56% approval rate), it is unlikely that he would want to jeopardize the momentum of the economy and dampen his prospects for re-election.

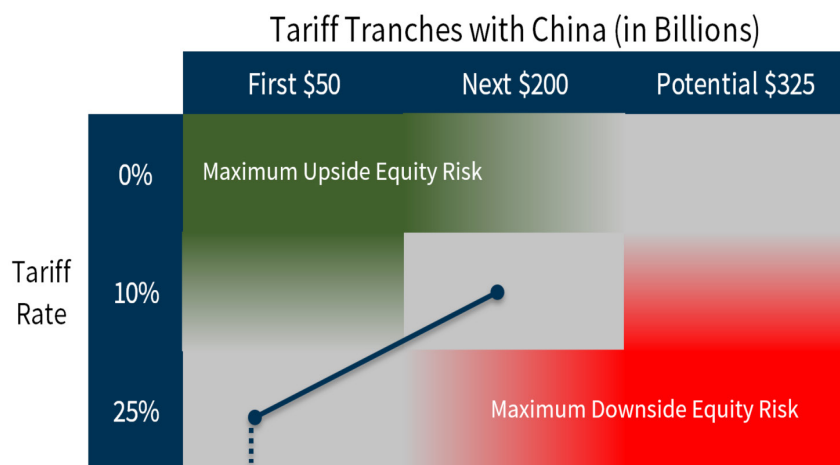
However, no one knows what the timing could be or what the framework of a deal would look like. Therein lies the “cliffhanger” for the market.

What could a deal look like? Our instincts tell us that a deal will ultimately be consummated. The new threat of an additional \$325 billion dollars is unlikely. It would be difficult to implement as that would essentially include all Chinese imports, with no exceptions. If the current rate on the \$200 billion goes to 25% (from 10%), it will likely be for a limited amount of time as both sides continue to talk. In the end, it is our belief that President Trump wants to engineer a deal that ultimately lowers tariffs from current levels to show he has effectively made a deal. Not all tariffs will be removed as the President needs an enforcement mechanism in place and is likely to use them as a tool to reference in his re-election bid. A deal should provide a catalyst to push global equities higher, especially emerging markets (EM) equities, and would be supportive of more cyclical and internationally-exposed sectors such as industrials and info tech.

What is the downside risk? If both sides walk away from the table and the 25% tariff (from 10%) goes into effect, it will likely lead to further downside for global equities, with EM equities (especially China) getting hurt the most. However, while we see a modest pullback, we do not expect a redux of the ~20% decline experienced in late 2018 for U.S. equities, as a number of key risks have been removed from the market since then. First, interest rates (10-year Treasury yield) have declined significantly, and are down ~75 bps from the September high. Second, the Fed has moved to the sideline as the market is now pricing in a 66% chance of a rate cut in 2019 relative to the expected one to two 2019 interest rate hikes expected last September. Lastly, U.S. recessionary concerns have abated as fundamentals remain solid (e.g., employment, retail sales, earnings growth) and have arguably improved over recent months.

The Dynamics of the Deal

Gray shading denotes the existing tariffs, upside (green) and downside (red) represent the potential equity market impact given the outcome (or lack thereof) of a deal.



Current Tariffs in Place (25% on \$50 Billion, 10% on \$200 Billion)

Source: FactSet, Raymond James Investment Strategy

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