



MARKET NEWS

7 AUGUST 2019

AFTER THE
MARKET FALL,
IT IS NOT YET
TIME FOR A
REPOSITIONING

► In the last 6 trading sessions, equity markets have fallen sharply and yields on core government bonds have plunged.



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A recall of the events over the last few days:

- As early as 26 July, downward pressure on sterling accentuated as the risk of **hard Brexit** increased after hard-liner anti-EU conservatives assumed power in London.
- On 31 July, **the Fed cut rates by the expected 25bp** but the accompanying communique presented the move more as insurance against mounting uncertainties than the start of a potentially bigger move towards a monetary easing cycle. The Fed's stance is changing from being proactive to reactive, a significant shift in our view.

Based on what has been observed above, we decided on 01 August to cut European equity weightings and go into cash.

- Late on 01 August, Donald Trump tweeted that he was introducing a **10% tariff on \$300bn-worth of Chinese imports**.
- On 05 August, **the renminbi moved above the watershed 7 mark against the US dollar**, a drop of 2% in two trading sessions (figures as of 06/08/2019). Beijing also let it be known that it was halting purchases of US crops. The US Treasury Department then accused China of currency manipulation. (In fact, China's central bank had reduced or stopped currency market intervention to keep the renminbi from depreciating).

Unquestionably, the big sell-off in risk assets was triggered by fresh US-China tensions with an initial knock-on effect on currency markets.

Analysis

Incomprehension between the US and China has deepened. China seems to have underestimated the broad political consensus between Republicans and Democrats over Beijing's profoundly unbalanced and unfair use of commercial rules and its lack of respect for intellectual property. And it is likely that the US has not properly factored in the assault on Chinese sovereignty that some of its claims reflect. The bad news is that some potentially dangerous stages in the US-China escalation have been crossed. The good news is that neither country has a fundamental interest in a conflict and that, after such a show of determination from each sides, there is likely no desire to go beyond the point of no-return. At this stage, it is very difficult to know how US-China relations will go from here.



KEY POINTS

The Fed's stance is changing from being proactive to reactive

Fresh US-China tensions have an initial knock-on effect on currency market

We remain underweight European Equities and favor cash instead

We should, however, note that there are an increasing number of potential friction points:

- ▶ **China's retaliation is probably and intentionally targeting the US President.** Beijing knew that a falling renminbi would trigger a financial market upheaval, an area that Donald Trump holds dear. Similarly, restrictions on US crops would hit pro-Trump supporters in Republican strongholds, a sensitive area as he has already started his re-election campaign. All this could just as easily make Donald Trump compromise or, on the contrary, lead him to raise the stakes.
- ▶ **Currency war risk?** Both the US President and the US Treasury have an ambiguous stance on the US dollar; it can therefore be used as an instrument. Markets would react strongly to any developments. In August 2015, the renminbi depreciated by 3%, triggering a market correction and then investors heaved a sigh of relief when the February 2016 Shanghai agreement ended the currency dispute. With today's economic slowdown and chronically weak inflation, any attempt by a government to get its currency lower would be seen as trying to export its own deflationary risk, disrupting investors' bearings in the process.
- ▶ **Missile crisis risk?** - the US has withdrawn from the Intermediate-Range Nuclear Forces Treaty and is now looking to install medium-range missiles in Asia. China's Foreign Ministry reacted by saying *"China will not sit idly by and will be obliged to take retaliatory measures if the US were to roll out missiles in this region."*

- ▶ According to the FT, the US is closely watching Chinese cargo movements as **some ships are suspected of transporting Iranian oil to China.**
- ▶ Lastly, **widespread demonstrations and strikes in Hong Kong** have resulted in open threats from Beijing as it tries to signal the end of the party. What would be the international repercussions if the Chinese intervened directly? Significantly, Western governments have been remarkably quiet about the incidents.

Conclusion

Any market fall is potentially a chance to adjust our positioning, especially for us as (i) our asset allocation is still generally conservative and (ii) the US and China are still proving resilient even if the global economy is clearly slowing. However, mounting geopolitical tensions, especially with the US presidential election campaign in the starting blocks, is bad for visibility. And any repercussions if one side were to raise the stakes could have concrete effects. This market fall in itself is not enough to argue that this uncertainty has been discounted, all the more so in that it is moving erratically in real time. Nevertheless, strong underperformance from emerging country equities shows that some indices are back in value territory although the short term picture remains uncertain. **After recently cutting risk in portfolios, we are leaving our asset allocation unchanged and continuing to watch the situation closely.**

Written on 07/08/2019. This document is for information only.

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Société anonyme governed by an executive board
and a supervisory board with capital of €11,033,769
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