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MAKING SENSE OF *THIS* WORLD

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Trump's Threat Of New Tariffs On China Increases The Risk Of A Global Recession

At the end of last week, US President Donald Trump threatened to impose a 10% tariff on the remaining USD 300bn of imports from China beginning on September 1st, if by that date an agreement is not reached between the Chinese and US governments. After the small level of hope generated from the "positive" meeting between Trump and Chinese President Xi Jinping at the G20 meeting in Osaka, this turn of events makes the possibility of a comprehensive trade deal between the US and China being reached soon even slimmer than it had previously been. In the days preceding this latest of Trump's threats, he had warned markets and the general public that China's tactics might have been to wait until November 2020 before signing any agreement, in the hope that by January 2021 they could deal with a more conciliatory, Democratic president.

Unfortunately, events are unfolding in line with our view that a controlled escalation between the two countries is more likely than a full-fledged deal being reached, and that at best the US and China can only agree on temporary truces during what may prove to be a long-term technological and geo-strategic new cold war— or Cold War 2, as we labelled it in early May. A comprehensive and long-lasting agreement is hard to envision, even if Trump were to win re-election in 2020. At most, a more prolonged truce between China and the US could be agreed upon, but such a truce would remain fragile and subject to interpretation and controversy.

Needless to say, the market did not respond well to the latest turn of events. Equity market sold off massively throughout the world, reinforcing a move that was already taking place as a result of the disappointment that followed the Fed rate cut on Wednesday 31 July. Long-term sovereign bond yields in US, UK, Europe and Japan collapsed. In those jurisdictions where the market could expect more rate cuts from central banks, sovereign yield curves steepened. Elsewhere, they continued to flatten. Even in the US, where the Fed has 225bps of easing space available, the 2y US Treasury yield closed the week down by 16bps, while the 10y yield fell by 24bps on the weekly basis. The net result has been a re-flattening of the yield curve, after the marginal steepening that had occurred in anticipation of the Fed's rate cut.

In the past, a flattening of the yield curve has been associated with upcoming recessions. In our analysis, we have argued that with the long end of the US yield curve being anchored by low yields in Germany and Japan, this correlation between the curve and recession probabilities has diminished. Nevertheless the latest developments do not bode well for the US or the global economy. To begin with, it would be delusional to think that lower policy rates by the Fed could compensate higher tariffs, which risk having a disproportionate and non-linear effect on the economy. Second, in addition to the ongoing trade and tech war there are also unabated tensions with Iran, which have recently escalated with the seizure by Tehran of a UK super-tanker. This stand-off is likely to be prolonged; the Iranian government might wait for the end of Trump's presidency before re-opening the diplomatic channels of communication, in the hope of dealing with a less confrontational US president. Finally, as the global manufacturing recession continues, the global economy might be on the cusp of a downturn which looser monetary policy alone might be insufficient to avert.

Our Recent Publications

- Flash Preview: RBNZ to Cut Rates in August, *by Brunello Rosa and Francesca Panelli, 2 August 2019*
- Review: A Cautious BOJ Stays Put, But Signals Readiness To Ease If Economic Conditions Worsen, *by Brunello Rosa and Francesca Panelli, 30 July 2019*
- Federal Reserve Review: Fed Unwillingly Delivers A Relatively Hawkish Rate Cut, *by Brunello Rosa, 31 July 2019*
- Flash Review: BOE Leaves Policy Stance Unchanged And Awaits Brexit Outcome, *by Brunello Rosa, 1 August 2019*
- Preview: Fed to Cut Rates by 25bps in July and Signal Another 25bps Cut In September, *by N. Roubini, Brunello Rosa and Alex Waters, 29 July 2019*
- **Geopolitical Corner:** A Revolutionary Premiership: Boris Johnson and the Anglosphere, *By John C. Hulsman, 30 July 2019*

Looking Ahead

The Week Ahead: Growth Likely To Slow Down In Japan And The UK

In the EZ, German factory orders and industrial production are expected to improve, yet to remain in negative territories (Factory orders June, c: -7.0% y-o-y; p: -8.6; Industrial production June, c: -1.8% y-o-y; p: -3.7).

In Japan and the UK, Q2 growth is expected to have slowed down (Japan GDP, c: 1.7% y-o-y; p: 2.2; UK GDP, c: 1.4% y-o-y; p: 1.8).

The Quarter Ahead: Geopolitical Tensions Will Remain High

In the US, President Trump announced a 10% tariff on the remainder USD300bn of Chinese imports, to be put in place as of September 1st; the list of goods includes smart-phones, laptop computers, and clothes. An increase in trade tensions is possibly aimed at: *i)* putting pressure on China before the second round of trade negotiations, scheduled for early September in Washington; and *ii)* lead the Fed into stronger easing. ***China*** vowed to retaliate. President Trump's former chief economic adviser stated "the tariff battle can have a dramatic impact on US manufacturing and capital investment". In H1-2019, investment flows between US and China fell by 18%, to lowest level in five years. ***In China,*** the latest tariff threat will add to growth slowdown worries.

In the US, the Fed provided little guidance over additional interest-rate cuts. Chairman Powell: *i)* defined the latest cut as a 'mid-cycle adjustment'; and *ii)* cited risks to global growth – including trade tensions – as "a factor closely watched in interest rate decisions". The markets increased their expectations (96.2%; p: 56) of an additional cut in the Fed's September meeting.

In the EZ, ECB is likely to pass further easing measures, including deeper negative rates and possibly QE; in 2020, the markets are pricing additional 40bps of easing.

In the UK, as PM Boris Johnson pledged to "leave the EU by October 31, with or without a deal", the government announced an additional USD 2.5bn of funding to prepare for a 'no-deal Brexit'–doubling the amount it has set aside this year. Were the UK to leave without an agreement, the GBP/USD could fall to 1.10 - by more than 9%.

In Japan, the government is expected to approve a second round of 'export control measures' against South Korea – ignoring pleas by both Seoul and Washington to avoid an escalation of tensions.

In Iran, the US will renew sanction-waivers for 'civilian nuclear programs', to allow Russia, China and European countries to continue their cooperation with Tehran.

Last Week's Review

Real Economy: Consumption And Inflation Remain Weak

In the US, nonfarm payrolls declined slightly (Nonfarm payroll July, a: 148K; c: 160K; p: 224K), while average hourly earnings rose (average hourly earnings; a: 3.2% y-o-y; c: 3.1; p: 3.1). In July, PMIs fell below-expectations, due to: *i)* stalling demand; *ii)* low customer inventories; and *iii)* a contraction in backlog orders (ISM Manuf. PMI July, a: 51.2; c: 52.0; p: 51.7). The Fed: 1) cut its policy rate (a: 2.25; c: 2.25; p: 2.50) for the first time since the 2008 financial crisis - framing it as 'insurance against downside risks' rather than the start of an easing cycle; and *2)* decided to end its balance sheet adjustment in August. US personal consumption expenditures remained subdued in June (a: 1.4%; c: 1.7%; p: 1.4%).

In the EZ, Q2-GDP remained stagnant at 1.1% (p: 1.2%) and Inflation declined (CPI July, a: 1.1% y-o-y; c: 1.1; p: 1.3).

Policy: The Fed Delivered A 'Mid-Cycle' Rate Cut, While BOE and BOJ Remained On Hold

In the UK, despite increasing concerns over the risk of a hard-Brexit, the BoE kept its policy rate on hold (a: 0.75%; p: 0.75).

In Japan, the BoJ left its policy rate unchanged (a: -0.1%; p: -0.1) and indicated that – were the economic momentum to soften – it would not hesitate to provide stimulus.

Financial Markets: Escalation Of Trade War Drives Risk-Off Sentiment

Market drivers: the sudden escalation in trade tensions drove investors to save haven assets (i.e. DM bonds, USD, and gold).

Stocks: w-o-w, global stocks fell (MSCI ACWI, -3.1%) driven by both DMs (S&P500, -3.1% to 2,932; Eurostoxx, -4.2% to 3,376) and EMs (MSCI EMs, -2.6% to 2,868). Volatility rose (VIX S&P 500, +5.4 points to 17.6, 52w avg.: 16.4; 10y avg.: 17.2).

Bonds: w-o-w, global indices rose (BAML Global bond index, +0.8%).

FX: over the next quarter, global dynamics and a weak outlook for China and Europe will support the USD; w-o-w the USD appreciated (DXY, +0.1%) against a basket of currencies. The GBP fell (GBP/USD, -1.8% to 1.250). EM FX fell (MSCI EMs, 1.2% at 1,628) bar the TRY (USD/TRY, +2.0% to 5.559).

Commodities: Oil prices declined, dragged down by lower global demand (Brent, -2.5% to 61.9 USD/b). Gold rose (1.6% to 1,440 USD/Oz.).

__Farah Aladsani__ contributed to this Viewsletter.

The picture in the front page comes from this website

Abbreviations, Acronyms and Definitions

a	*Actual*	*LN*	*Northern League, Italy*
AKP	*Justice and Development Party, Turkey*	*M5S*	*Five Star Movement, Italy*
ann.	*annualized*	*m-o-m*	*Month-on-month*
ARS	*Argentinian Peso*	*mb*	*Million barrels*
avg.	*Average*	*mb/d*	*Million barrels per day*
bn	*Billion*	*MENA*	*Middle East and North Africa*
BoC	*Bank of Canada*	*MHP*	*Nationalist Movement Party, Turkey*
BoE	*Bank of England*	*mn*	*Million*
BoJ	*Bank of Japan*	*MPC*	*Monetary Policy Committee*
bpd	*Barrels per day*	*NAFTA*	*North-American Free Trade Agreement*
bps	*Basis points*	*NATO*	*North Atlantic Treaty Organization*
BS	*Balance sheet*	*OECD*	*Organization for Economic Cooperation and Development*
c	*Consensus*	*Opec*	*Organization of Petroleum Exporting Countries*
C/A	*Current account*	*p*	*Previous*
CB	*Central bank*	*P2P*	*Peer-to-peer*
CBB	*Central Bank of Bahrain*	*PBoC*	*People's Bank of China*
CBK	*Central Bank of Kuwait*	*PCE*	*Personal Consumption Expenditures*
CBT	*Central Bank of Turkey*	*PE*	*Price to earnings ratio*
CDU	*Christian Democratic Union, Germany*	*PM*	*Prime minister*
CNY	*Chinese Yuan*	*PMI*	*Purchasing managers' index*
CPI	*Consumer Price Index*	*pps*	*Percentage points*
DJIA	*Dow Jones Industrial Average Index*	*pw*	*Previous week*
DJEM	*Dow Jones Emerging Markets Index*	*QCB*	*Qatar Central Bank*
d-o-d	*Day-on-day*	*QAR*	*Qatari Riyal*
DXY	*US Dollar Index*	*QE*	*Quantitative easing*
EC	*European Commission*	*q-o-q*	*Quarter-on-quarter*
ECB	*European Central Bank*	*RE*	*Real estate*
ECJ	*European Court of Justice*	*RBA*	*Reserve Bank of Australia*
EIA	*US Energy Information Agency*	*RRR*	*Reserve Requirement Ratio*
EM	*Emerging Markets*	*RUB*	*Russian Rouble*
EP	*European Parliament*	*SWF*	*Sovereign Wealth Fund*
EPS	*Earnings per share*	*tn*	*Trillion*
EU	*European Union*	*TRY*	*Turkish Lira*
EUR	*Euro*	*UAE*	*United Arab Emirates*
EZ	*Eurozone*	*UK*	*United Kingdom*
Fed	*US Federal Reserve*	*US*	*United States*
FOMC	*US Federal Open Market Committee*	*USD*	*United States Dollar*
FRB	*US Federal Reserve Board*	*USD/b*	*USD per barrel*
FX	*Foreign exchange*	*UST*	*US Treasury bills/bonds*
FY	*Fiscal Year*	*VAT*	*Value added tax*
GCC	*Gulf Cooperation Council*	*VIX*	*Chicago Board Options Exchange Volatility Index*
GBP	*British pound*	*WTI*	*West Texas Intermediate*
GDP	*Gross domestic product*	*WTO*	*World Trade Organisation*
IMF	*International Monetary Fund*	*w*	*Week*
INR	*Indian Rupee*	*w-o-w*	*Week-on-week*
IPO	*Initial public offering*	*y*	*Year*
IRR	*Iranian Rial*	*y-o-y*	*Year-on-year*
JPY	*Japanese yen*	*y-t-d*	*Year-to-date*
k	thousand	*ZAR*	*South African Rand*
KSA	*Kingdom of Saudi Arabia*	*2y; 10y*	*2-year; 10-year*