MARKET COMMENTARY

INVESTMENT STRATEGY GROUP
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Can Escalating Trade Tensions Lead to a Recession?

Backdrop

August has been quite a turbulent month for markets as trade tensions between the U.S. and China have escalated dramatically, ratcheting up tariffs on each other's exports. China has allowed its currency to depreciate, which helps to offset the additional tariff costs. The U.S. consequently labeled China a currency manipulator. As of this writing, the President has "ordered" U.S. businesses to move their operations out of China. Investors have responded in typical flight to safety fashion: stocks have sold off, bond yields have fallen, and gold prices have risen dramatically.

The decline in bond yields has been particularly concerning to markets because there were instances where the yield curve briefly inverted, potentially indicating recession. Specifically, the yield on the shorter-term two-year bond was higher than the yield on the longer-dated 10-year Treasury; typically, longer maturities have higher yields.

Is the yield curve inversion signaling a recession this time? Although it has a good historical track record of leading recessions, we cannot say for sure. It usually leads by approximately two years, and many things can happen within that time. Also consider that on average, stocks have positive returns one year after we see an inversion. Dangerous yield curve inversions are usually associated with rising rates, not falling rates like we have now. Additionally, the primary driver of the U.S. economy, the consumer, is still healthy and spending. In the end, it's difficult to predict a recession until it actually occurs because economic data is revised later, revealing what went wrong after the fact.

Still, in an uncertain environment, the Fed doesn't want the blame for contributing to a slowdown. It's done an about-face from its tightening posture last year and is now communicating that it will do whatever it can to bolster the economy, which is the reason they cut rates in July (the first time in over 10 years). But the Fed is not able to unilaterally keep the U.S. out of recession. They are aware of this and have rightly pointed to increased trade tensions as an important development to abate in order to help keep the economy moving.

They are also aware that the strong U.S. dollar has only aggravated the slowing global economy because of its position as the primary currency for global commerce and safe haven status. International investors have been attracted to the higher yields within the U.S., which strengthens the dollar, tightens global financial conditions, and slows global growth. Therefore, the Fed may have no choice but to continue to loosen monetary policy in hopes that it will help weaken the U.S. dollar and loosen financial conditions abroad.

The economic situation and the trade war are tenuous and changing rapidly. Although we cannot know how this will ultimately conclude, we believe that trade wars are not good for economies or markets. Globalization has been a strong stimulant to the global economy and the financial markets the last several decades. If we were to suddenly reverse course and embark down the path of restricting more trade, that would most certainly be bad for economies and markets.

What does this mean for you?

So much has transpired over the last month. Yet, in our view, nothing has materially changed. These are reciprocal expressions of the larger underlying geopolitical U.S.-China tensions that have to play out.

We do not advocate that you move money out of the markets ahead of a potential recession because no one knows how this will turn out. Many have incorrectly been anticipating a major market pullback since 2015.

Instead, we believe it's important for you to first make sure there are assets set aside in less volatile, shorter-term investments (such as bonds) for near-term cash flow needs. This frees up money that is not needed for a longer time frame to be invested in longer duration assets, which still make sense. Stocks, although more volatile, still look more attractive than bonds with low or negative yields for longer horizons. When sell-offs do occur, you can then look for opportunities within the context of your financial plan to add to asset classes that have gotten cheaper. This way, you can be prepared and don't have to fear a market disruption.

Also, we believe you should stay focused on being diversified because this present environment is complicated; not only are economic forces at play, but policymakers are actively engaged in moving market prices as well. What we are seeing is not an investor-driven market, and because of this, the range of potential outcomes is very wide. While it is possible that the U.S. could move into a recession, there are no obvious global excesses set to exacerbate a downturn in markets, like we saw in 2008. This suggests that investors with longer time frames are likely to do well to ride out the volatility.

If you have questions regarding your financial plan or would like to speak to one of our investment strategists, please contact your advisor.