Cave's Quarterly

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Trade tensions intensify while central bankers ease

A 'Brextension', the US vs China trade standoff, tensions in the Middle East and central bankers once again pulling on monetary 'easing' levers have been the more significant influences moving markets over this second quarter. Whilst trading has been volatile at times, the general trend has been upwards, as global equity markets have continued to march on, with the S&P500 trading back at the previous highs of last September and the FTSE100 not all that far behind despite the Brexit 'cloud' still looming large.

Theresa May's withdrawal agreement was overwhelmingly voted down by parliament on three separate occasions, the last of which was on 29th March (the day we were supposed to officially leave the EU). With her position effectively rendered untenable, she announced on 7th June that she would step down as prime minister and, as a result, fired the starting gun for a Tory leadership contest, which will conclude on 27th July as we find out whether Jeremy Hunt or Boris Johnson will become our new prime minister. Johnson is the bookmakers' current frontrunner and appears open to a hard Brexit, leaving the EU without a deal if necessary. Current parliamentary arithmetic would, though, suggest this is not possible and would require him to win his own mandate via a general election; an endeavour he, or any other potential Tory leader, may not wish to risk given the party's weakened position.

Failure to meet the March deadline saw EU leaders and the UK agree to delay Brexit until 31st October, resulting in the UK partaking in the European elections. Voters who would have previously supported Conservatives or Labour, defected to Nigel Farage's newly formed Brexit Party, which won over 31% of the votes on their 'Brexit means Brexit' message, and the Liberal Democrats, who won over 20% campaigning for a second referendum. The two main political parties are discovering that occupying the centre ground is becoming increasingly unpopular as the issue of Brexit continues to split the nation.

Despite being widely shunned by global investors, those who have remained invested in the UK have, so far, been rewarded as domestic equity markets have moved higher; both the FTSE100 and FTSE250 stand roughly 10% higher than at the start of the year.

Over half of European government bonds now offer negative interest rates (meaning investors are happy to lend money for a guaranteed loss!); a clear sign that global bond markets are concerned over the economic outlook for the single currency bloc. The most immediate risk is the UK, the world's fifth largest economy, crashing out of the union without a deal on 31st October. A perhaps more serious, albeit less imminent, menace is the potential for a new Italian sovereign debt crisis that could threaten the euro's survival, as its populist government continues along a reckless policy path at a time the country is already lumbered with Europe's second highest ratio of public debt-to-GDP, behind only Greece. At around ten times the size of Greece's economy, Italy would be far more difficult to save in the event of a default. Trump's threat to slap a 25% import tariff on European automobiles, were it to materialise, could be the final straw that pushes the export dependent German economy into recession. Given these risks, the ECB is expected to remain accommodative throughout 2019.

Trump's claims unfounded?

The IMF's Christine Lagarde warned that the US-China tariffs could reduce global gross domestic product by 0.5% in 2020, which would amount to a loss of roughly $455bn; a loss not just confined to the two countries involved. However, studies so far would suggest that, despite Trump's claims the US is collecting "billions of dollars" from tariffs, a combination of economics researchers from Harvard University, University of Chicago and the Federal Reserve Bank of Boston found a "nearly complete pass through of tariffs" to America, or in other words, little cost is falling on Chinese manufacturers and it is the US consumer that is bearing the initial brunt. To use washing machines as an example (one of the first products targeted by the Trump administration), in the immediate few months after implementation of the new levies, prices on both imported and domestically produced washers have jumped by 12%.

Longer term, it is generally predicted that China will fare worse from trade tariffs, as the consumer driven American economy is on a firmer footing and China may have more to lose because of its larger reliance on exports. Oxford Economics expects Chinese GDP growth to fall by 1.3% in 2020, should the US implement tariffs on all Chinese imports as threatened. While Chinese officials would not welcome a prolonged trade war, analysts believe the Communist party's control over everything from the renminbi's dollar exchange rate to the state-denominated banking system will help the country prevail. China's attitude to diplomacy is also hardening, as one semi-official social media account used to channel Beijing's anger posted "We do not want to fight but are not afraid of one to safeguard national dignity and our core interests." For those investors courageous enough, Chinese equity markets have rewarded irrespective of lingering trade war concerns; the SSE Composite Index has climbed 21% since the turn of the year.

US policymakers turn dovish

The Federal Reserve held interest rates steady in June, though shifted towards a more dovish stance and pointed to possible interest rate cuts in the future, citing rising 'uncertainties' about the economic outlook whilst downgrading its assessment of the health of the US economy. US government bond prices rallied on the expectation that the Fed will ease monetary policy later this year and the stockmarket cheered the more dovish tones as the S&P500 added 3.8% over the quarter.

After months of positive news flow, trade tensions between the US and China escalated once again in May. Trump's attitude had softened when he agreed to push back the March deadline for increasing tariffs on $200bn of Chinese exports, which signalled progress seemingly being made. However, tensions subsequently escalated, and tariffs were ratcheted up to 25%, as he accused China of attempting to renege on a trade deal and blacklisted Huawei from trading with US firms without government approval. Against this backdrop, global equity markets dipped and, although a tentative truce between Trump and Xi Jinping was announced at the end of June putting a halt on further tariffs for now, investor concern could persist through to the 2020 US presidential elections should confirmation of a full 'ceasefire' fail to be reached.

For emerging market assets, a dovish turn at the Federal Reserve and the ECB is generally considered a boon as it compels investors into riskier markets in search of higher returns. Accordingly, June saw emerging market equities post their best monthly performance since January (MSCI EM Index +5.7%), although risk appetite was kept in check by doubts over progress in the US-China trade war. Hopes of further stock market progress are very much pinned on reaching a resolution, as the implementation of additional tariffs could result in the emerging market rally collapsing.

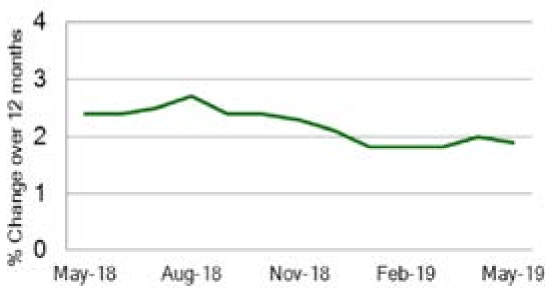
Japanese markets waver

First quarter Japanese GDP growth was upgraded to an annualised 2.2% thanks to an upswing in capital expenditure in the non-manufacturing sector, though concerns over sluggish personal consumption continues to linger. The Japanese government maintains that the economy is recovering moderately despite the uncertain global outlook, and that it will go ahead with the planned hike of consumption tax in October from 8% to 10%. Unemployment in the region held steady at 2.4% in May, although the country's job-to-applicant ratio fell, suggesting the labour market could slacken in the coming months, potentially keeping a lid on wage growth thus making it even harder for the Bank of Japan to reach its elusive 2% target rate of inflation. Japan's stock market is Asia's second-worst performer after South Korea, with the Nikkei up only 6% year-to-date, suffering from the impact of slower global trade and sluggish demand. Investors continue to pull money from the region worried that constraints on further economic stimulus make the country more vulnerable than others directly in the firing line of the Sino-US trade war.

Our assessment of markets remains unchanged, as we move into the second half of 2019 with a cautiously optimistic approach. We expect the trade war rhetoric will eventually dampen down, the UK will leave the European Union with a deal in place, thus, likely avoiding a general election and the risk of a hard-left Corbyn-led Labour government, and that central banks will remain committed to supporting economic growth and asset prices through further loosening of both monetary and fiscal policy. The portfolios we manage, however, are positioned in a diversified manner to protect investors should matters play out in a less favourable fashion and our confidence in generating attractive returns over the medium-to-long term endures.

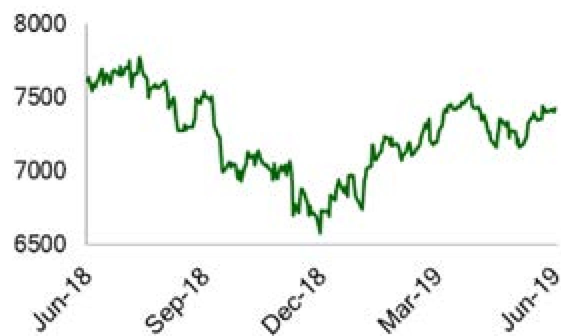
A year in numbers

Consumer Prices Index (CPI)

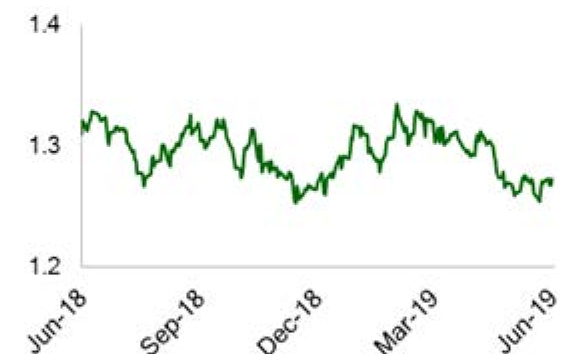


GBP/EUR Exchange Rate

FTSE 100 Index



GBP/USD Exchange Rate



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