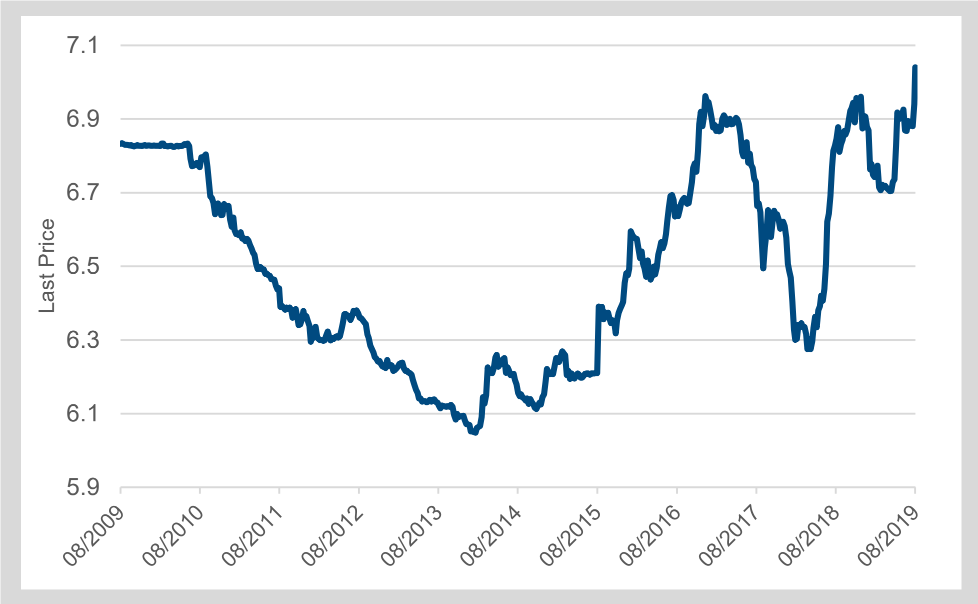
The Trade War shifts up a gear, we dab on the brakes

China's decision to allow the Yuan / Renminbi to depreciate, both to its lowest value versus the US Dollar since the global financial crisis, and through the psychologically and symbolically significant CNY / USD 7.00 level represents a significant development in the Sino-US trade war. At the same time, China's Commerce Ministry has also said that purchases of US agricultural goods have ceased and it may apply tariffs on farm products. This comes in response to an announcement by President Trump (via Twitter, of course) that the US will impose a tariff of 10% on another $300 billion of Chinese goods from September 1st that was also accompanied by the threat of further action if the Beijing government failed to resume trade negotiations quickly enough.

In a separate, but equally significant, development, the US Treasury has branded China a "currency manipulator", thereby aligning itself with frequent past complaints from the Oval Office and opening up the possibility of further sanctions on the US's part.

CNY/USD FX Rate



Source: Bloomberg

Reacting to both the unexpected timing of these events (recent exchanges between the two sides had taken on an encouraging conciliatory tone), and the fact that they appear to represent a meaningful escalation in the trade war's terms of engagement, markets have gone into "risk-off" mode.

In equity markets, at the time of writing (Tuesday 6th August, lunchtime) the MSCI World Index is down a little over 4% in US Dollar terms in the period since the President's latest "t-bomb", with volatility indicators spiking to an eight-month high. Concurrently, the ten-year US Treasury's yield has fallen by 24 basis points, reflecting the increased odds of a further interest rate cut at the Federal Reserve's September meeting, which futures prices are currently suggesting is pretty much a certainty. So far so predictable. Perhaps less so, however, has been the decline in the Dollar over this time: the currency's status as a safe haven has been trumped (pun intended) by the prospect of lower returns from US-denominated "risk-free" assets, with the Japanese Yen being the major beneficiary. Meanwhile, Gold has also risen to new highs.

In contrast to the sensationalist coverage in some parts of the media that has accompanied these moves (markets have "plummeted"!!!), it's probably fair to say that, given the likely consequences for global growth and the possibility of Sino-US relations deteriorating further, they represent a proportionate, even measured, response by investors that is arguably out of character when compared with more recent market behaviour (Q4 of last year, for example).

For our part, although we don't necessarily believe at this point that it's anywhere close to a racing certainty, there's no question that the probability of a global recession has increased. Factoring in the possibility of a policy error and/or a negative geopolitical event (neither of which, we would stress, are any greater than before), we have concluded that it is prudent to reduce our "house view" tactical risk score in recognition that, from an economic perspective in the shorter term, the world is now a marginally riskier place.

For our portfolio models, that means we have reduced equity exposure at the margin in favour of additional cash. At an individual fund level, meanwhile, some of our managers have also de-risked to a degree, either by increasing duration and/or reducing credit exposure within bond funds, adding to short exposure within long/short equity mandates, or raising cash on the long-only equity side.

Shaun McDade

Joint Managing Director (Guernsey) & Head of Portfolio Management (International)

www.mitonoptimal.com