Will Trade War Lead to More Market Volatility?

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Authored by Brad McMillan, CFA®, CAIA, MAI

On July 26, 2019, the S&P 500 peaked-but it has since dropped by almost 6 percent (as of August 3). To be sure, such a large and fast drop has rattled investors. So, what's behind this sudden pullback--and is it likely to continue?

Spotlight on Trade War

The drop was triggered by a renewal of the trade conflict between the U.S. and China. The U.S. ratcheted up the conflict by threatening to impose a new range of tariffs of 10 percent on $300 billion of imports from China. China retaliated by canceling orders of U.S. agricultural goods and allowing the exchange rate for its currency to drop below 7 against the U.S. dollar for the first time ever. The market had largely grown used to U.S. threats, but the Chinese retaliation is a new element that has threatened to take what had been a cold trade war into the hot zone. Such a hot trade war would meaningfully threaten corporate earnings by causing lower sales and higher costs around the world.

Given this, the cause of the pullback is clear: corporate earnings will be threatened, and as stock prices depend crucially on those earnings, prices have pulled back. With sales to China potentially down, and with costs rising as companies relocate their supply chains to more expensive areas, a 6 percent drop in earnings is certainly possible. In that sense, the size of the pullback makes sense, as it reflects a reasonable estimate of the potential earnings damage. The speed of the pullback also makes sense, in that the causes--U.S. policy and Chinese reaction--took place over a period of days, just as the pullback did.

Looking at the recent pullback this way, we can see it not as some bolt out of the blue, but as a rational reaction to changes in policy and the subsequent economic impact. With this understanding, we can also draw some conclusions about what likely comes next.

Is the Market Reaction Rational?

First, markets are indeed reacting rationally. There is a clear connection between what is happening in the news, what it means for corporate earnings, and what happens to stock prices. Markets are reacting as they should.

Second, we may see more volatility. As the U.S. and China duel back and forth on policy, the markets will keep responding to that new information. If earnings look likely to get hit, we could see more of a decline. On the flip side, markets are also likely to respond if policy looks to be less damaging. If, for instance, the U.S. and China cut a deal, or even agree to keep talking, we could see a recovery. This recent drop is not necessarily the start of a larger decline but a response to circumstances--which could go either way.

What's Next?

The good news is that a deal should be reachable. The U.S. made its point with the tariff announcement, while the Chinese have now made theirs, with the agricultural order suspension and currency manipulation. These are likely both negotiating tactics, rather than a determination to start a trade war. We have seen this kind of back-and-forth before, although at a lower volume, and the result has been a deal. An agreement remains the most probable result this time, in which case we could see a recovery in both expectations and stock prices.

The real risk here is that if the confrontation continues, it will increasingly affect both business and consumer confidence. Business confidence has already pulled back, although it remains expansionary. But consumer confidence remains strong. The U.S. economy largely depends on internal demand. So, a pullback in consumer confidence is what could ultimately cause a deeper and longer decline in financial markets. This scenario, however, would take time. And unlike the stock reaction, it would not be immediate.

Pay Attention, Do Not Panic

We therefore need to pay attention to how the situation evolves, but now is not a time to panic. So far, we are seeing a rational reaction by markets to a change in circumstances; moreover, it is one we have seen before. Chances are that a deal will be reached and conditions will normalize.

Even if they do not, the fact is that the U.S. economy remains solid--and that will not change overnight. With hiring still strong, with consumers confident and spending, and with the recent rate cut by the Federal Reserve providing a tailwind, there is a considerable amount of cushion for financial markets to help them weather the policy-related turbulence around the trade war. Any decline will likely be gradual, and we will have time to respond.

My staff and I deeply appreciate the continuing opportunity to work with you. Please let me know if you have any questions or requests. Thank you.

Sincerely,

Paul S. Bonapart, JD, RFC, AIF®, President
Financial Security Planning Services, Inc.
520 Tamalpais Dr, Suites 103 & 104
Corte Madera, CA 94925
(415) 927-2555
www.FinancialSecurityPlanning.com
CA Insurance License No. 0808412

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- Authored by Brad McMillan, CFA®, CAIA, MAI, managing principal, chief investment officer, at Commonwealth Financial Network®.

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