THOUGHTS ON THE LATEST TRADE WAR FLARE-UP

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After an early summer reprieve in the trade war between the United States and China, President Donald Trump imposed another round of tariffs on Chinese goods, targeting $300 billion in imports at a 10% rate. China retaliated by directing state buyers to cease purchases of U.S. agricultural products and by allowing the country's currency, the yuan, to breach the psychologically important level of 7.00 against the U.S. dollar. The U.S. Treasury Department then retaliated by labeling China a "currency manipulator", a designation which can be used to impose further sanctions on China, such as more and steeper tariffs. All in all, this is a significant escalation in the protracted trade war between the two countries.

The first response to this escalation likely will come from the Federal Reserve. The recent July 31st Federal Open Market Committee disappointed investors, who had been looking for a more aggressive easing stance on the Fed's part. While the central bank did cut rates by 25 bps, communications from Fed Chair Jerome Powell appeared out of tune with market expectations, especially when he mentioned that the rate cut was a "mid-cycle adjustment to policy" and not the beginning of an easing cycle. President Trump has made no secret of his desire for lower rates, leading some to interpret the recent escalation with China as a way of pushing the Fed into more easing. Either way, we think that the fall in growth and inflation expectations which resulted from the recent trade flare-up will push the Fed to do more in the near term, both on the communications and on the policy fronts. In our recent economic outlook, we mentioned a high probability of interest rate cuts heading into 2020. The recent trade events have increased this probability even further, in our view.

On the Chinese side, policy makers appear to have adopted a less conciliatory approach in dealing with U.S. demands over the last few months. However, we would be careful in reading too much into the recent yuan move. Tariffs impose a cost on the global economy and the global trading system, while currency moves can help to cushion the blow. In this context, the yuan's recent depreciation is a natural adjustment to the new information about higher tariffs. In general, given the current context, we view the currencies of export-oriented, trade-dependent countries or areas as most vulnerable to the imposition of higher tariffs. This is the case, for example, of the euro or the Korean won.

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What can investors do to protect their portfolios against short-term flare-ups in volatility such as the most recent one caused by the trade war? We think the first line of defense resides in building robust fixed income allocations that have sufficient duration to withstand equity market drawdowns. This is something the Multi-Asset Strategies Team did in the second quarter of this year, by adding to our fixed income position in anticipation of disinflationary trends and rate cuts by central banks. Long-term government bonds are continuing to represent the best diversifier of equity risk and having exposure to the asset class remains a strong protection against volatility spikes. Another way in which investors can protect portfolios is to have exposure to foreign currencies and foreign assets, which can help to diversify the cyclicality that is inherent to the Canadian dollar.

For now, we see the latest round of tariffs as a negative for global growth, but not yet one which will topple the United States economy, which has proven to be more resilient than other more export-oriented regions (such as the Eurozone and Asia, where slowdowns had already taken hold well before the tariff announcement). We expect that increased central bank support will help soften the impact of the higher tariffs. We are monitoring these events very closely, continually evaluating any impact to our growth expectations and to our asset class return expectations.

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