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In this week's *Highlights,* Ryan Grabinski talks about the impact U.S.-China trade relations are having on the markets and economy.

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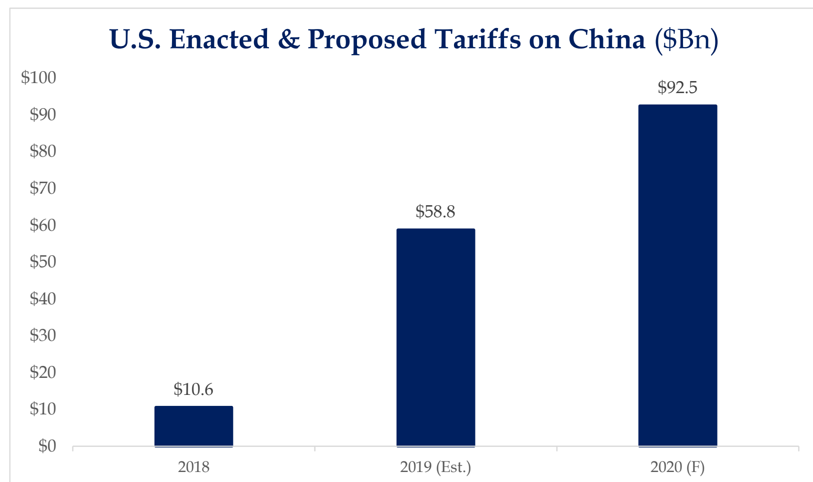
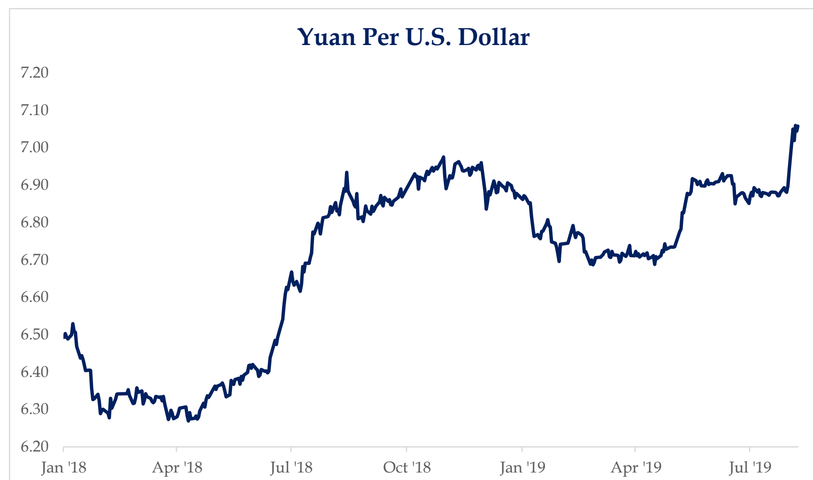
U.S./CHINA TRADE RELATIONS MOVING IN THE WRONG DIRECTION

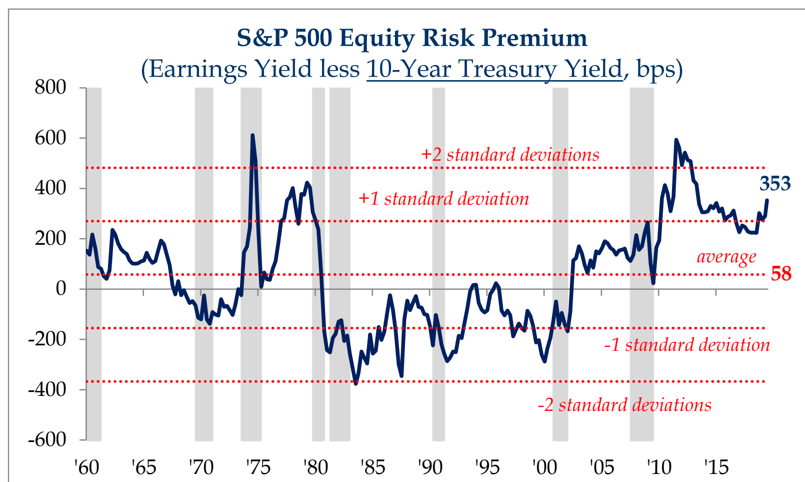
Following a bare minimum rate cut from the Fed last week, President Trump announced that the U.S. would proceed with a 10% tariff on the remaining $300bn billion in goods from China effective September 1st. Up until this point, consumers were spared from the trade dispute but that will change with this latest round. The tariffs on China's goods would be a large tax increase, which is digestible when growth is robust but should the state of the economy weaken it becomes problematic.

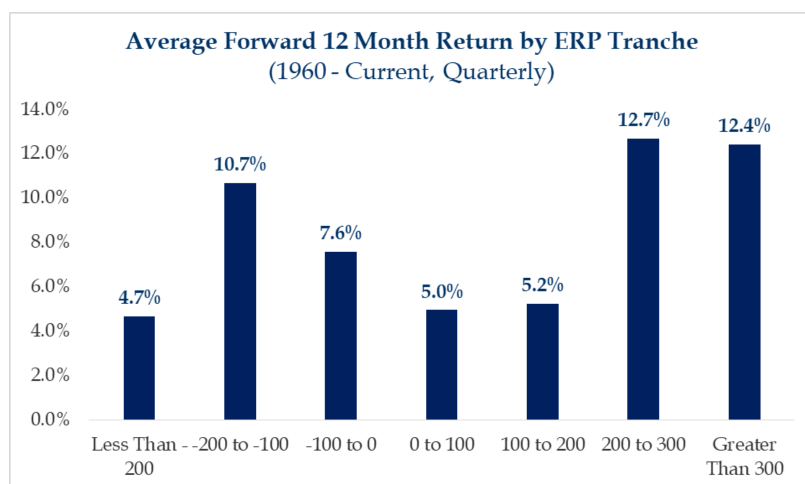


China's response to the President's tariff threat was to allow the Yuan to weaken and asking state-owned companies to suspend imports of U.S. agricultural products. The Yuan has weakened versus the dollar from roughly 6.25 in April 2018 to over 7.00 today.



The markets reacted swiftly with equities tumbling and bonds rallying as the flight to safety trade took over. With earnings hanging in for now, the equity risk premium spiked. History shows that when the ERP is near levels seen today the forward 12-month returns are double digits.





However, not all is well and the odds of a recession are on the rise. The back-and-forth during this past week between the US/CN leads us to believe it may be difficult to reach a deal before the next U.S. election in 2020. China does not have the same political urgency, and is unlikely to back down quickly. The continued protests in Hong Kong suggest China's leadership will need to project a tough image. Remaining trade issues such as intellectual-property protection are complex. China also wants existing tariffs removed, which simply does not fit with the current U.S. administration's strategy. As global growth continues to trend downward and central banks appear to be starting a rate cutting cycle, in a world of already low/negative rates, the odds are not zero that we see negative rates in the U.S. during the next recession.

This begs the question what should you own or look to buy? As it stands now, it's probably too late to overweight defensive sectors with a 10-year Treasury yield of 1.70% and perhaps a bit too early to leg into cyclical sectors like Financials and Industrials without greater clarity on global growth. Financials and Industrials had started to outperform in July only to be drawn asunder by the new concerns about trade and a race to the bottom for global long-term interest rates. From a valuation perspective, Financials are undoubtedly cheap with a PEG ratio of 1.3x and the defensive sectors like Utilities and Consumer Staples are undoubtedly expensive with PEG ratios of 3.4x and 2.9x respectively. Still, in a TINA market, assets with yield and with growth become extraordinarily expensive. Some stabilization of Fed policy and long-term interest rates are likely natural prerequisites for a resumption of cyclical sectors outperforming. Strategas' "New Sovereign" basket of stocks can be seen as proxies for sovereign debt has outperformed as the amount of negative yielding government debt has surged.

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