



What Jitters Over Trade Indicate About Markets

The potential for further volatility emphasizes the need for selectivity.

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KEY INSIGHTS

- The recent spike in volatility amid rising concerns over U.S.-China trade relations indicated that the medium-term fate of markets will be heavily influenced by how the dispute is resolved.
- A deterioration in relations between the two countries is likely to lead to further bouts of volatility—and possibly a more serious downturn.
- “Timing” the market in this environment will be very difficult. Selectivity is more likely to deliver durable returns during difficult periods.

The recent bout of market agitation over fears of an escalating trade war provided a stark reminder of just how influential US-China relations are on the global economy. While support remains in place from continued positive corporate earnings growth and accommodative central banks, any worsening of the trade dispute could bring further bouts of turbulence, possibly leading to a more sustained correction. Attempting to time the markets in this environment will be very risky, meaning that investors will likely need to be highly selective if they are to successfully navigate the difficult period ahead.

U.S.-China Trade Tensions Blow Up Again

What a difference a few days can make. For much of the first half of this year, investors seemed assured that slowing global growth would be mitigated by accommodative monetary policies from the U.S., Europe, and emerging

markets. While trade tensions ebbed and flowed, the markets chose to believe that common sense would prevail and that a “muddle through” scenario would play out. Rising asset prices reflected this view.

That all changed at the beginning of August when U.S. President Donald Trump announced new tariffs and China swiftly responded by allowing the renminbi to depreciate, prompting accusations of currency manipulation from the U.S. The sudden deterioration in relations between the two countries caused markets to sell off dramatically before stabilizing partially after Beijing stepped in to steady the currency. Any complacency over the U.S.-China trade dispute was wiped out in a matter of days.

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“...selectivity is key to tuning out short-term noise...”

“Given the pace at which things change in trade negotiations, it is likely markets will continue to react to headlines and tweets for a while,” says Andrew McCormick, head of Fixed Income. “We are no longer pricing in a rosy scenario.”

The depth and complexity of the U.S.-China trade dispute means that it is very difficult to predict how negotiations will progress from here. “There have always been two issues,” says Fixed Income Sovereign Analyst Chris Kushlis. “First, the narrow trade issue, and second, the longer-term, geo-strategic rivalry—and it has been very hard to keep those on separate tracks. For a while, it seemed as if it might be possible to craft a narrow trade deal with limited substance, but even that now seems unlikely.”

What President Trump does from here will likely depend on what he believes will best enable him to get reelected as president next year, Kushlis believes. “What serves President Trump better: striking a trade deal or positioning himself as a ‘trade warrior’ and hoping that Fed interest rate cuts bail him out?” he says. “The Chinese are likely to dig in—they will not want to reward any pressure tactics from Trump. Overall, this is not good for anybody. There are no winners—just relative losers.”

Lack of Consensus on Strength of Global Economy

The potential impact of a worsening U.S.-China trade dispute on markets depends largely on the underlying strength of the global economy. Here, views differ, reflecting the strength of

T. Rowe Price’s diversity of thought among its investment professionals.

Head of Global Multi-Asset Sebastien Page acknowledges that there are concerns that the current extended cycle is fragile, but he says he does not believe the conditions are in place for a severe downturn. “We recognize the fragility of an aging cycle,” he says, “but we don’t see major speculative imbalances that could trigger a crisis.”

Charles Shriver, co-head of the T. Rowe Price Asset Allocation Committee, agrees. He argues that while continued volatility can be expected, conditions remain supportive. “The monetary policy environment is supportive, with the recent Fed rate cut and the likelihood of further action to offset weak growth, trade uncertainty, and tighter financial conditions,” Shriver says.

Other portfolio managers, particularly those in fixed income, are more cautious. Quentin Fitzsimmons, senior portfolio manager in the Fixed Income Division, believes that a breakdown in talks could push a fragile global economy over the edge. “I believe that the current situation has the ingredients of a full-blown international crisis,” he says. “There is a confluence of factors—U.S. politics, Chinese politics, the global economic cycle, the rise of populism, and the impact of technological change on key industries. All of these have been around for a while, but they seem to be coming to a head at the same time.”

“I see parallels with 2007, just before the global financial crisis struck.”

Maintaining a Long-Term Strategic Approach

When uncertainty is elevated, timing the markets—always a risky endeavor—becomes virtually impossible. At T. Rowe Price, we believe that selectivity is key to tuning out short-term noise in favor of durable, consistent returns. Our portfolio managers average 22 years in the industry and 17 years with T. Rowe Price, so they've weathered all kinds of markets. We've learned that volatile periods are often the time to buy good businesses at attractive valuations.

Against that backdrop, here are some notable trends we're observing:

Health Care

“Concerns over a possible “Medicare for All” system and drug price regulation have weighed down many health care shares. Yet, shares in many of the most innovative companies have performed well in recent months. Drug innovation appears to be accelerating—in our eyes, companies producing leading-edge therapeutics and medical devices offer some of the market's most attractive growth areas.

—Ziad Bakri,
Portfolio Manager,
Health Sciences Equity

European Corporate Bonds

“We currently see opportunities in eurozone corporate debt as the European Central Bank (ECB) could restart quantitative easing involving corporate bond purchases. The positive technical conditions generated by the ECB's potential return to the market more than offset the negative drag from weak fundamentals.

—Steven Boothe,
Head of Investment-Grade Credit

Secular Disruption

“The secular forces powering the technology sector are robust and here to stay. The pace of innovation remains breathless. The expansion of media platforms, the rise of artificial intelligence and machine learning, and the potential of the cloud remain powerful forces at many different levels. However, investors should approach technology less as a standalone sector, but in a more diverse way.

—Scott Berg,
Portfolio Manager,
Global Growth Equity

Global Equities: Growth Cyclical

“Global investors are afraid and have crowded into stocks with low earnings volatility. High-quality, long-term growth assets with cyclical and perceived “risky” characteristics are priced for fear. Yet, to us, the world still looks much more like a “slow growth” and “low inflation” environment than a global crisis. If rates stay low while modestly positive growth persists, stocks should trade at higher multiples based on the equity risk premium—it is just math.

—David Eiswert,
Portfolio Manager,
Global Focused Growth Equity

Emerging Markets

“We believe investors need to cast aside any preconceptions of emerging markets (EM) being a single investment opportunity and take the time to look at individual EM regions and sectors to find attractive investments. A number of EM economies boast a growing middle class that is underpinning domestic demand. Consequently, EM is no longer just an export-driven investment reliant on developed markets, or even Chinese, economic growth. EM credit is on a strong footing. Corporate fundamentals remain favorable despite a difficult 2018. Growth concerns in key global markets could also become tailwinds as central banks appear to be shifting to more accommodative policies.

—Ernest Yeung,
Portfolio Manager,
Emerging Markets Value Equity

—Ben Robins,
Portfolio Specialist,
Emerging Markets Bond

WHAT WE'RE WATCHING NEXT

The unpredictable nature of the U.S.-China trade dispute means that it is difficult to predict when the next developments will occur, but we will be monitoring this situation very closely for the foreseeable future. U.S. President Donald Trump's next move should tell us something about his long-term objective: Will he tone down the rhetoric and focus on trying to strike a deal with the Chinese (in which case, the economic cycle may be extended further)? Or will he dial up the pressure in a bid to position himself as defender of the U.S. economy ahead of next year's presidential election (in which case, brace yourself for further volatility)?

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