Je ne regret rien

- **The US President only regrets not putting up tariffs earlier and higher**
- **Further escalation of trade wars leaves equities and bond yields lower**
- **Watch for a policymaker supportive reaction… more interest rate and potential tax cuts in the offing**
- **Duration still favoured in bond markets**
- **Currency wars could be the next policy weapon**
- **Precious metals the clear asset class winner**

Just for a moment, there was good news from the G7 meeting in Biarritz, France. News wires reported that Donald Trump was regretting his trade wars. Sadly, the President only regrets not raising tariffs quicker still higher! Hence, the financial markets face a challenging week discounting another escalation of geopolitical strife.

Late last week the US raised duties on $250 billion of Chinese products to 30% from 25% from Oct 1. Also, the US government set tariffs on a further $300 billion of Chinese goods, to take effect on Sept 1 at 15% instead of the previously announced 10%.

In his usual bluster, the President says the Chinese are paying the extra duties when it just is not the case. Duties are payable in the US by US importing companies. Also, a good measure of the imports from China are US products manufactured in China. As we mentioned in a previous weekly, US fisherman catch their fish and send it to China for processing. The fish arrives back in the ports of the US as a Chinese product subject to these ever-higher tariffs.

The US move comes days after China's response to the US's previous imposition of tariffs. The retaliation by the Chinese took the form of new duties on top of existing rates taking effect on Sept 1 and Dec 15.

For sure, there are some winners from the current trade wars. Vietnam, Chile, Malaysia and Argentina have seen benefits. Vietnam is replacing China in some product supply. The latter three are winning from higher imports from China. However, the stepping-up of tariffs can only do more damage to confidence and activity in the global economy.

As always when making a call on asset markets against the backdrop of trade wars, you have to watch for possible policy responses. Fed Chairman Jerome Powell speaking at last week's Jackson Hole meetings for central banks highlighted that it is difficult for central banks to set policies for trade wars. Powell commented "while monetary policy is a powerful tool that works to support consumer spending, business investment, and public confidence, it cannot provide a settled rulebook for international trade." The market continues to take the view that the Fed will be forced to respond with lower rates in the coming months.

Mr Powell also referred to the Fed's work on an expansion of the central bank's tool kit so that the Fed could hit its inflation target in the future. One starts to sense that the Fed will be looking at the Bank of Japan's playbook of the past decades. The Bank of Japan, for example, currently owns 80% of the Japanese equity ETF market and 5% of the overall equity market.

Of course, President Trump has his own ideas about the right policies for the US economy. At one stage last week he raised the prospect of a possible payroll tax cut. His logic will be that the last time he cut taxes, the economy hit a 3% growth rate, employment growth picked up, and the stock market put in a stonking performance. At least the cutting of payroll taxes benefits the less well off in the first instance. However, he may have forgotten that payroll taxes fund medicare, pension and social benefits.

In the markets, the lower bounds of government bond yields are being tested again, and equities are under pressure. At one point last week commentators were speculating that the bond market rally was over for the moment. The limited demand for the German 30-year bond auction at a rate of –11bps suggested that investor appetite for bonds paying ever-lower yields had met its limit. However, as trade tensions escalated at the end of the week, market participants may be regretting their decision not to buy. The US 10-year bond yield which at one stage during the week has hit a high of 1.66% was back down at 1.54% by Friday's close and has opened Monday morning at 1.47%. German 30-year bunds that hit a yield low of -31bps ended the week at -17bps, could see a retest of the yield lows in the coming days.

What are the implications for fixed income portfolio positioning? Apart from the obvious avoidance of financials, we think duration exposure remains a must for investors. Even after the surge in bond returns, and despite the shorter-term risk of some corrections, the longer-term trend globally is for lower rates. The idea is to remain exposed to assets that will benefit from this trend.

In the context of the G7, US rates are borderline high yield. In Germany's case, we expect a future extension of ECB support to keep yields in negative territory. However, with other countries in Europe issuing bonds at yields slightly less negative than in Germany, may see more immediate support. The message from both the ECB and Fed is clear: rates are headed lower. If that is the case, further curve inversion will be challenging to sustain. It does not rule out sustained declines in the long end of curves either. However, it does appear to imply that investors will have to cope with even lower and more deeply negative rates in the future.

The implications of a rate structure of this shape are already being felt in some areas. For example, the market has taken a pretty dim view of European banks, valuation-wise. It is not clear how banks can grow profitability in the context of extremely compressed margins. There are expectations that the ECB will step up with some measures to offer relief, but the gloom has not lifted from banks yet.

Finally, a focus on income is essential, with one caveat: don't mistake yield for return. Developments in Argentina should be a timely reminder to investors that no amount of yield will compensate for a permanent loss of capital. So, scour the credit universe for good opportunities with a focus on quality rather than outright yield. We sense that it is possible to build portfolios that will reliably pay around 5% per annum (in USD) without taking silly levels of risk. There are enough solid credit exposures available globally in high yield, emerging markets and even high-grade bonds.

Singapore's AAA paper becomes increasingly attractive in the environment of near zero yields in many parts of the government bond markets. Singapore will sell a reopened July 2029 government debt worth US$2.9 billion (S$4 billion) on Wednesday (Aug 28), the second-largest amount on record for 10-year tenors. The current ten-year government bond yield is at 1.799%.

The markets fear that trade wars spill over in currency wars. The US President is hinting at a policy shift to weaken the dollar The US has already labelled China a currency manipulator (although without too much foundation). Tellingly the dollar index fell last Friday by 0.56%. The President has also instructed the Treasury to put more countries on the watch list for currency manipulators; the list includes countries such as Ireland, Singapore, Germany and Malaysia. The fact that the US needs the rest of the world to buy its debt to fund its largesse of overspending and nonsense tax cuts is of course forgotten.

Precious metals remain the asset class of choice through the noise and stress in markets and the global economy. Gold ended the week at a six-year high ($1537) after drifting briefly below $1500 during the week. gold is up 8% so far this month. Silver has performed strongly since May. The upside looks still quite substantial given the poor performance of silver relative to gold since 2016.

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