

Safe haven status of the USD starting to crumble under the weight of Trump's trade wars

Posted on May 28, 2019

US equities couldn't muster an end of month consolidation. They attempted to stabilise on Thursday but closed near their lows on Friday. The weight of the news was too much – Trump expanding tariffs threats to one of its biggest and most integrated trading partners, Mexico, and trade relations hardened between China and the US. Trump plans to convince the UK to avoid Huawei, China started its own "Entity" list to potential ban US companies, and it is preparing to halt rare earth mineral exports to the US. Optimists are giving up on a global economic recovery, and Chinese PMI data confirm its manufacturing sector is struggling already from the trade war. The tide may be turning against the USD as the market prices in significant Fed rate cuts, its yields fall sharply, and its equity market leads recent falls. The USA is starting to look like one of the biggest potential losers in a trade war. Its economic data are not revealing many problems yet, but this only suggests it has further to fall. The market is likely to dismiss stronger US economic data and panic at the first sign of weakness (raising risks around the ISM and payrolls reports next week).

Trump's tariff threats broaden

US asset markets already struggling with the US-China trade dispute were knocked over by the Trump tariff announcements against Mexico; one of the big three US trading partners. Mexico accounted for more goods imports than any other country to the USA in the first quarter, and it is part of a highly integrated supply chain; particularly in the auto sector.

Statement from the President:

"To address the emergency at the Southern Border, I am invoking the authorities granted to me by the International Emergency Economic Powers Act. Accordingly, starting on June 10, 2019, the United States will impose a 5 percent Tariff on all goods imported from Mexico. If the illegal migration crisis is alleviated through effective actions taken by Mexico, to be determined in our sole discretion and judgment, the Tariffs will be removed. If the crisis persists, however, the Tariffs will be raised to 10 percent on July 1, 2019. Similarly, if Mexico still has not taken action to dramatically reduce or eliminate the number of illegal aliens crossing its territory into the United States, Tariffs will be increased to 15 percent on August 1, 2019, to 20 percent on September 1, 2019, and to 25 percent on October 1, 2019. Tariffs will permanently remain at the 25 percent level unless and until Mexico substantially stops the illegal inflow of aliens coming through its territory."

[Statement from the President Regarding Emergency Measures to Address the Border Crisis; 30 May - WhiteHouse.com](#)

It remains to be seen if the US will go through with its threat of tariffs against Mexico, and how Mexico will respond. They are intended to pressure Mexico to stop people crossing the border. This is a major political issue for US President Trump, so it's a threat that must be taken seriously.

However, it is possible that after meeting with Trump, the Mexican government will convince it to hold off from raising tariffs while it works harder to control the movement of people across Mexico into the USA.

The US administration has stressed that the Mexico tariff threat is separate from the USMCA trade deal that was negotiated last year to replace NAFTA. On Thursday, ahead of the Mexico tariff announcement, the US administration signalled that it was stepping up efforts to get USMCA passed by the US Congress over the summer

[Pence Says Administration Seeks New Nafta's Approval This Summer; 30 May - WSJ.com](#)

The Mexican PM Andres Manuel Lopes Obrador (AMLO) has taken a measured approach to the tariff threat, calling for dialogue with the US administration, and continuing to push USMCA through the Mexican Senate. The Mexican Foreign Minister is expected to travel to Washington to discuss the matter.

[Mexico Continues Trade Pact Process Despite Trump Tariff Threat; 31 May - WSJ.com](#)

As such, the tariff threat may not derail USMCA or long term trade relations. Nevertheless, it will be hard for the US Congress or government in Mexico to separate the two issues and pass the trade pact legislation.

Furthermore, the fact that Trump has reached for the tariff lever so frequently, threatened tariffs against a range of trading partners, and is now using the tariff threat for a non-trade or economic related policy issue is raising overall economic uncertainty.

US-China trade risks also increased

The Mexico tariff news was shocking, but perhaps just as bad for the global markets outlook were signs of hardening barriers in China and the US in their trade dispute.

At the same time that the Mexico news developed, the press reported that US President Trump is expected to pressure the UK government to ban Huawei from supplying product to its 5G network during his visit to the UK next week.

This is probably not that surprising but suggests that the US is stepping up efforts more broadly to pressure all Western nations and its traditional allies to limit its dealings with Chinese technology companies.

[Trump, U.K.'s May to Discuss Huawei as U.S. Urges Ban From 5G Networks; 30 May - Bloomberg.com](#)

There are increasing signs that China is stepping up its plans to retaliate against US tariffs and Huawei attacks with direct action against US companies and restricting exports of rare earth metals to the USA.

Bloomberg reports that “people familiar with the matter” say that the Chinese government has prepared steps to ban exports of rare earth minerals to the US used in the production of a wide range of manufactured high tech machinery, autos and a range of consumer goods.

China is a dominant global supplier of various rare earth metals, and restricting exports to the US could cause significant disruption to US manufacturing activity.

In what appears to be a counter to the US Administration adding Huawei to its so-called “[Entity List](#)”, China is reported to be establishing an “Unreliable Entities List”. The Chinese state-controlled media, citing Ministry of Commerce spokesperson Gao Feng, reported that the government will set up a list of foreign enterprises, organizations and individuals that don’t obey market rules, violate contracts and block supply for non-commercial reasons or severely damage the legitimate interest of Chinese companies.

[China Steps Up Trade War and Plans Blacklist of U.S. Firms; 31 May - NYTimes.com](#)

It isn’t clear what US companies might be added to the China list. Semiconductor companies that refuse to supply Huawei because it is on the US Entity list, may be limited in supplying other companies in China. This may hurt Chinese companies as well. The US and China so-called entity lists seem to inflict pain in both countries.

The lists limit trade across the high tech sector, something the US administration appears to be seeking in any case - to hamper the transfer of technology to China and reduce the competitive pressure it is feeling from China in this strategic industry.

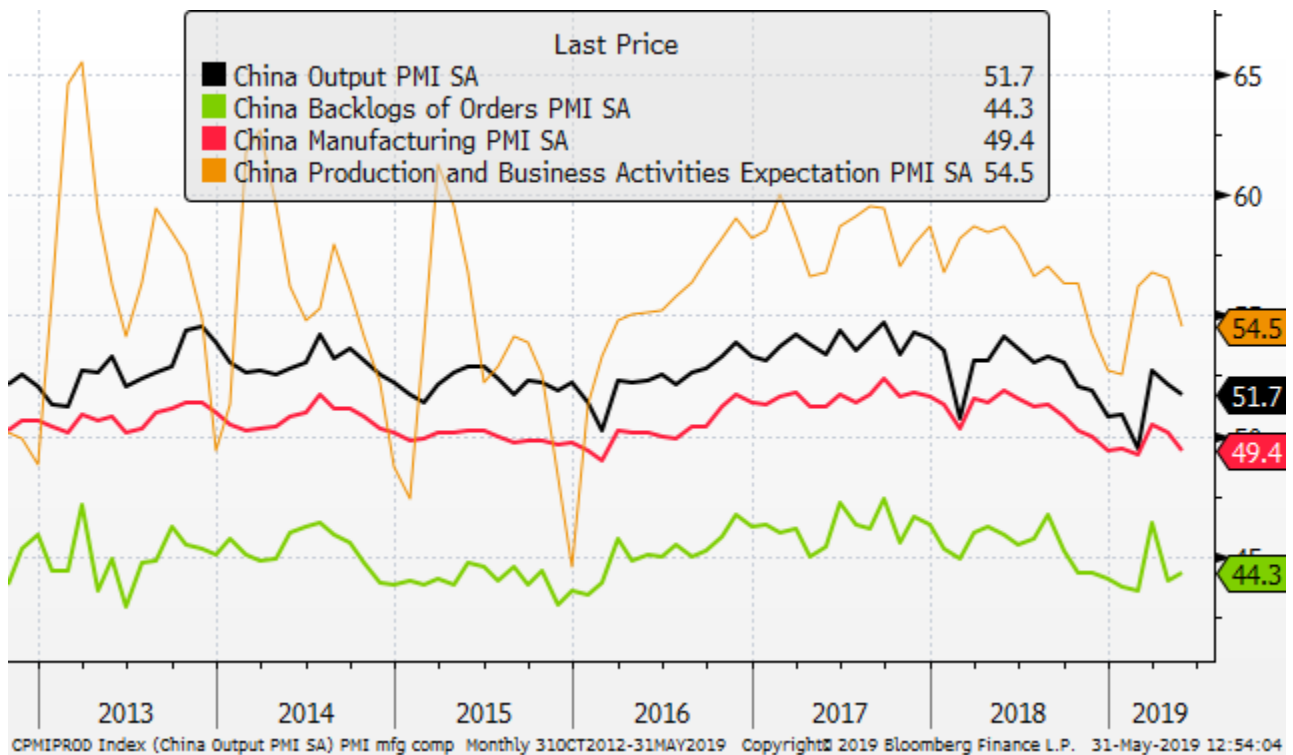
These measures appear to make it harder for the two sides to negotiate a trade deal, and would limit the effectiveness of a trade deal if the two sides are still directly restricting trade in the high tech sector.

Chinese PMI consistent with the weaker global trend

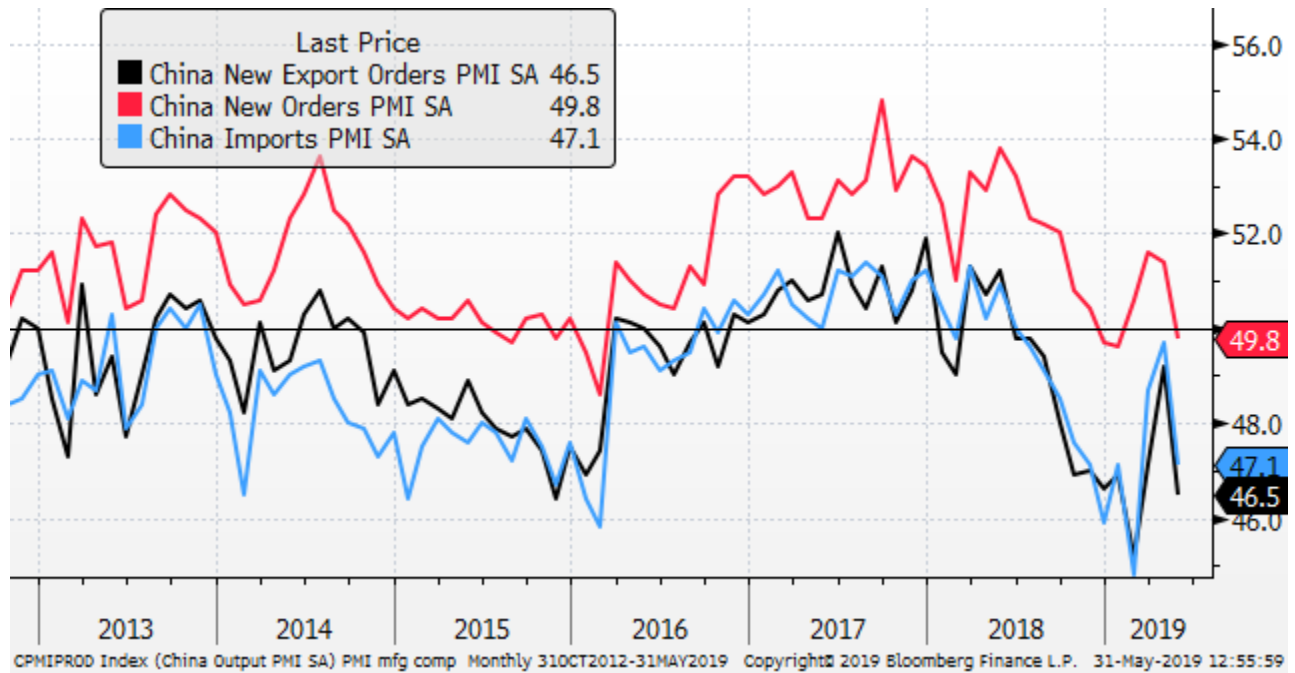
It is not just the case that the recent increase in US tariffs on China and Huawei ban will weaken global trade and manufacturing, the trade tensions since last year already appear to have undermined activity.

Global manufacturing PMI data released for the US, Eurozone and Japan for May have been weak. The China government PMI slipped back below 50 in May, reported on Thursday.

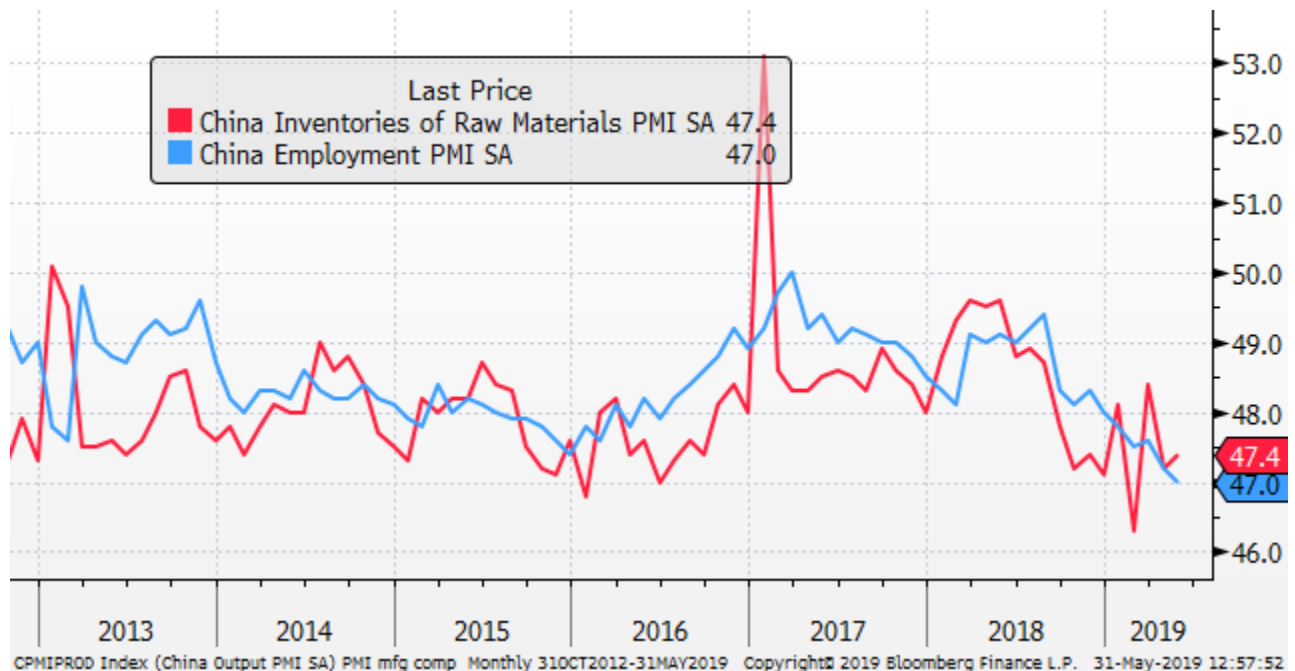
China PMI manufacturing fell to 49.4 in May, reversing its modest recovery in March, to be around its lows since early 2016



The export component of the Chinese PMI (46.5) reversed its gains in March/April to be around its lows since 2015



The employment component of the manufacturing PMI fell to a low since 2008 of 47.0



Only a month ago, investors were running with a narrative that a thaw in trade tensions and multi-pronged Chinese policy easing would revive global growth later in the year, perhaps in the second

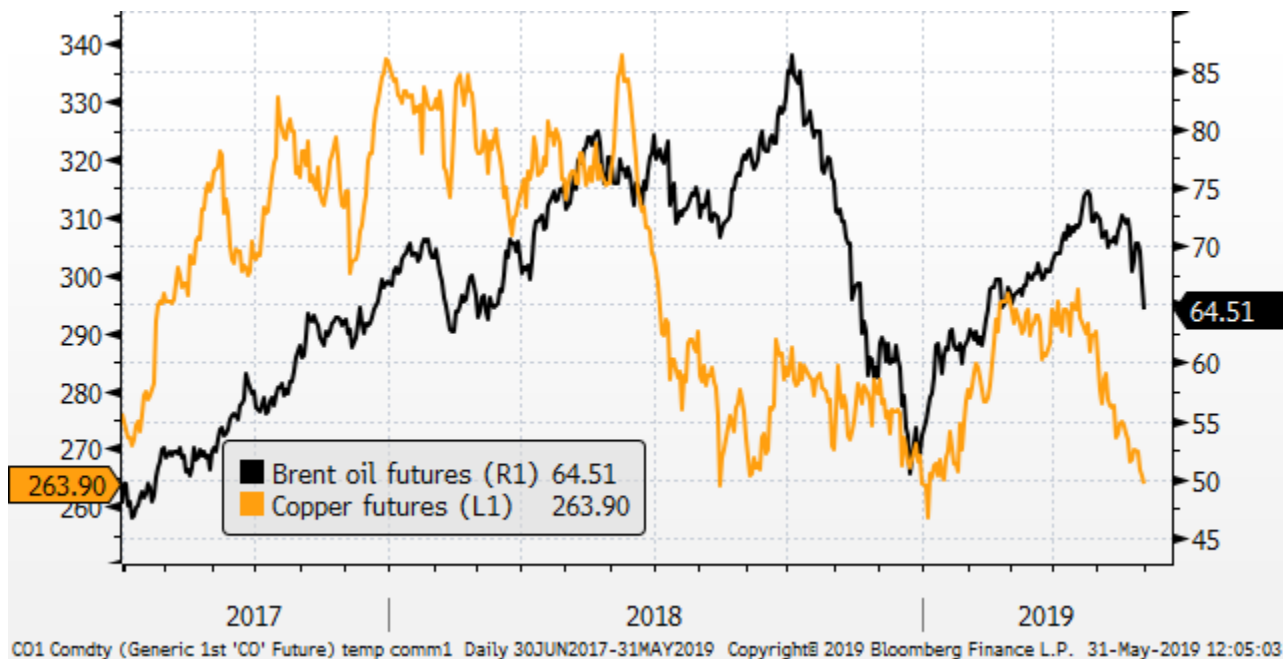
quarter, but certainly in the second half of the year. It saw some green shoots in Chinese economic data in March.

However, that rebound proved to be a false dawn; it was not backed up by any significant improvement in any of China's key trading partners, including Europe, Japan, Korea or Taiwan.

Now trade tensions and global business uncertainty have deteriorated, the market is coming to see a high risk of further weakening in the global economy for the foreseeable future.

Weakening global investor confidence is being manifest in a wide range of asset classes, including weaker equities, weaker bond yields, inverted yield curves, weaker inflation expectations, weaker industrial commodity prices, and a deep slide in semiconductor equity prices.

Industrial commodity prices – copper and oil have been closely correlated with swings in the equity market over the last six months; Their recent slide to new lows in a recent downtrend over the last month suggest that global industrial activity has and is expected to decline



US Semiconductor equities might be considered the canary in the trade war coal-mine. They deteriorated late last year, leading falls in the overall equity market as trade tensions increased. They rebounded in the first four months of this year as trade tensions eased, and have fallen rapidly in the last month as trade tensions increased again. Semiconductors have attributes as an industrial commodity, and there recent sharp fall may be further evidence of weak global growth expectations



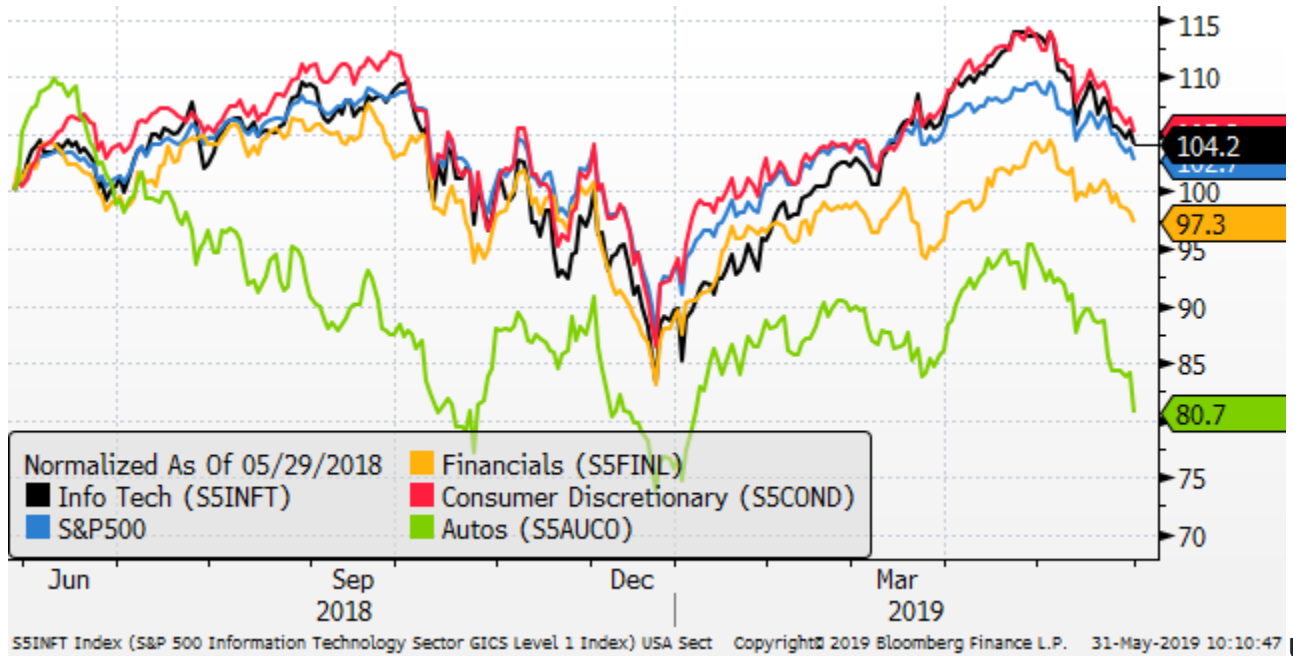
USD losing steam

Weakness in the equity market may be contained by falling US yields, on increasing expectations that the Fed may ease policy, but the outlook for US assets looks very challenging. The trade wars are likely to undermine business confidence and broader economic and consumer confidence in the USA.

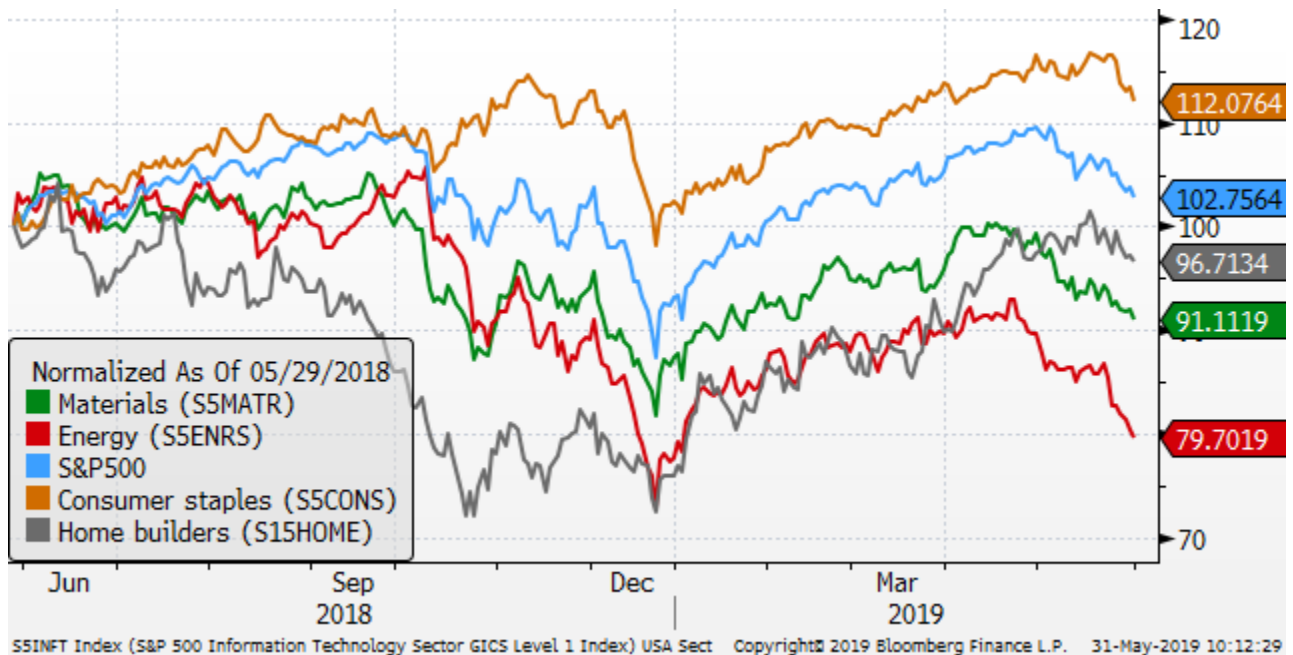
The US is at the centre of these disputes, and while trade is a relatively small component of its overall GDP compared to many of its trading partners, the direct economic impacts, via retaliatory action from China and potentially Mexico, may be relatively large. As such, it is becoming harder to view US assets as a safe haven.

In the last week, the impact on US equities and yields has been larger than most other countries, and this may be starting to turn the strength in the USD.

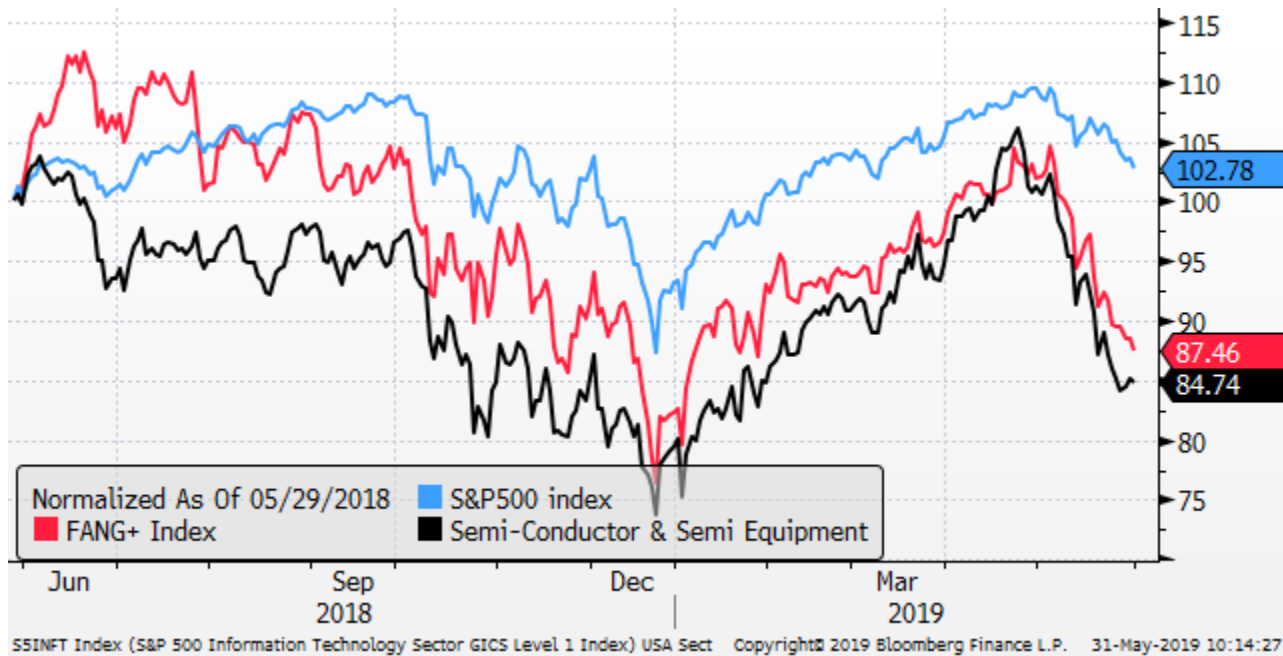
US equity sectors – auto sector falls sharply, tech and consumer discretionary leading falls over the last month



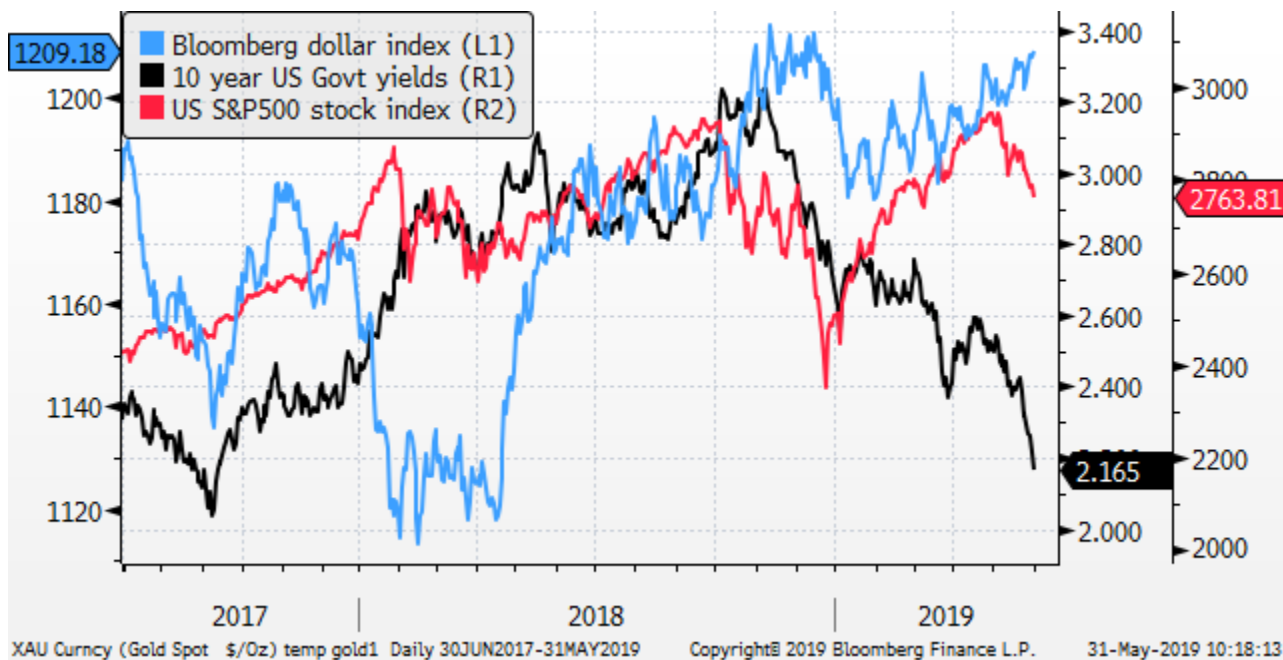
equity sectors – broad-based weakness in the last week, including interest rate sensitive sectors (Consumer staples and home builders); energy sector falls sharply as oil prices fall



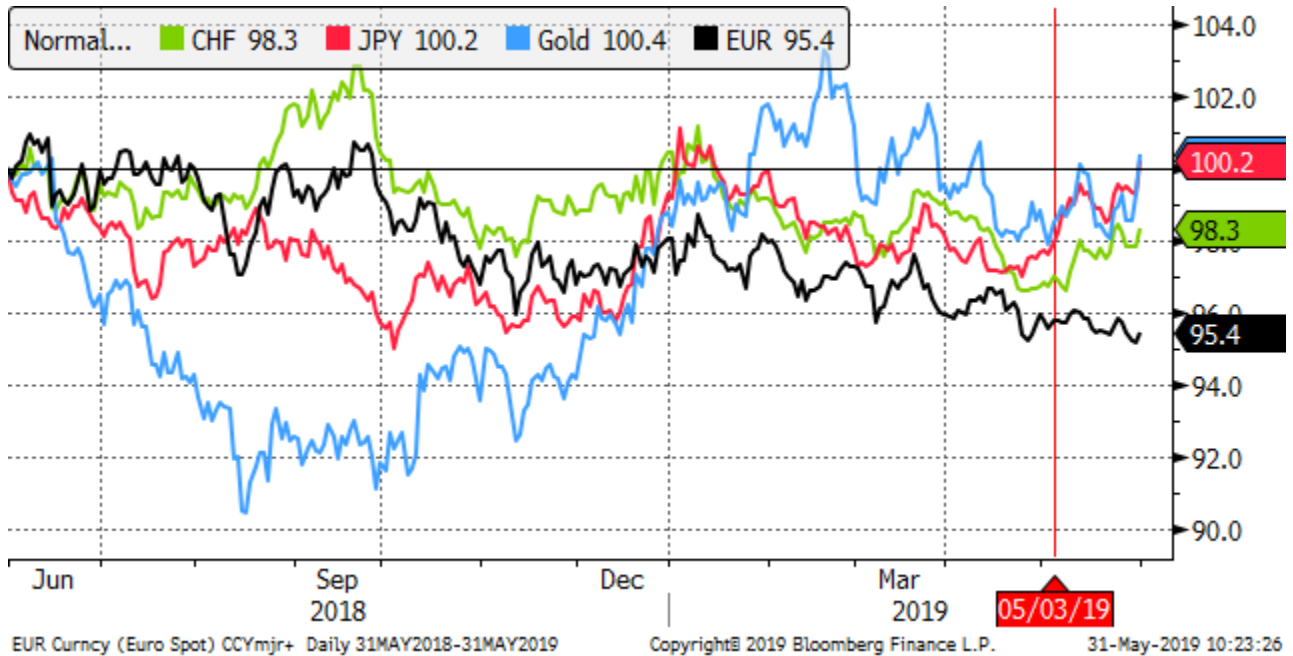
The FANG+ index that includes the big US and China tech companies and US Semiconductor equities have led falls responding in particular to the US-China trade dispute



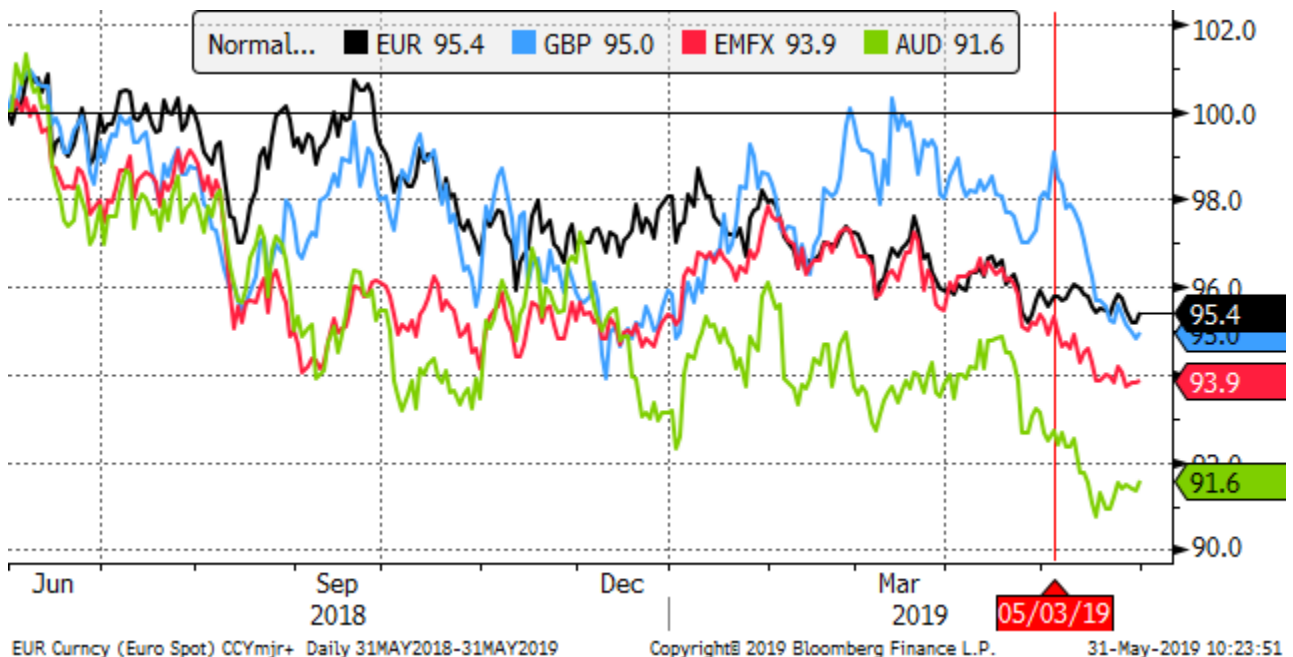
US 10-year bond yields fall sharply to lows since 2017 as Fed shifts bias from tightening to neutral to a hint of easing over the last six months. Yields accelerate lower as the US-China trade dispute deteriorates in the last month. The USD has been resilient to yield falls to date.



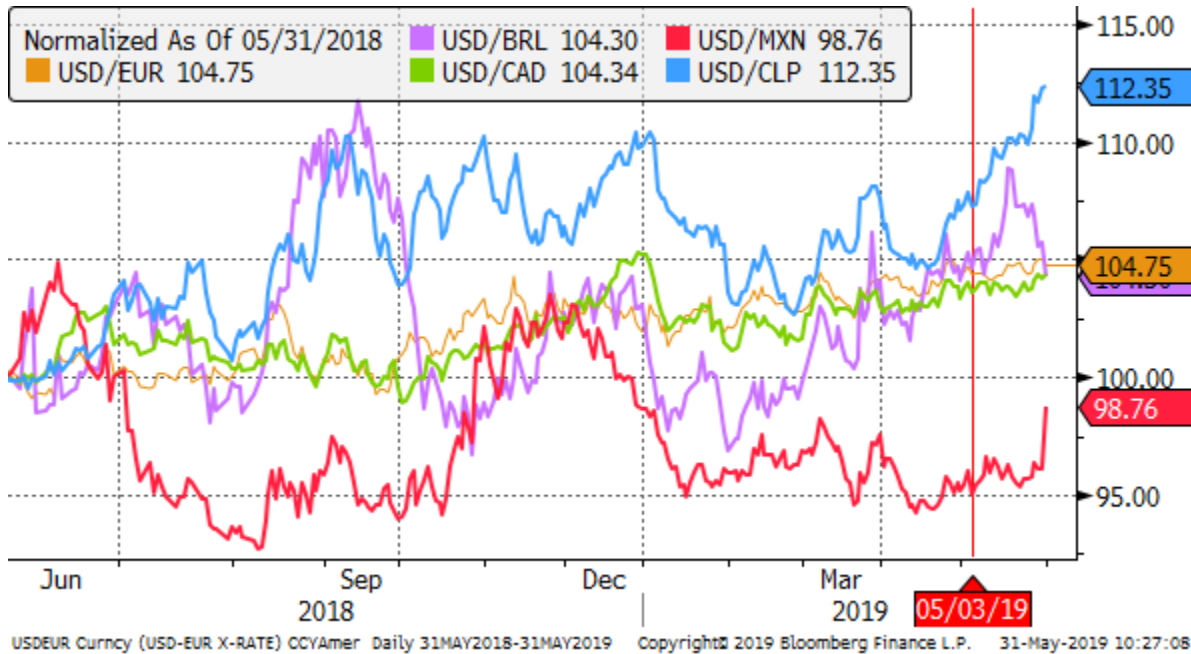
Safe haven currencies, JPY, CHF and gold, have strengthened against the USD over the last month as trade tensions have increased



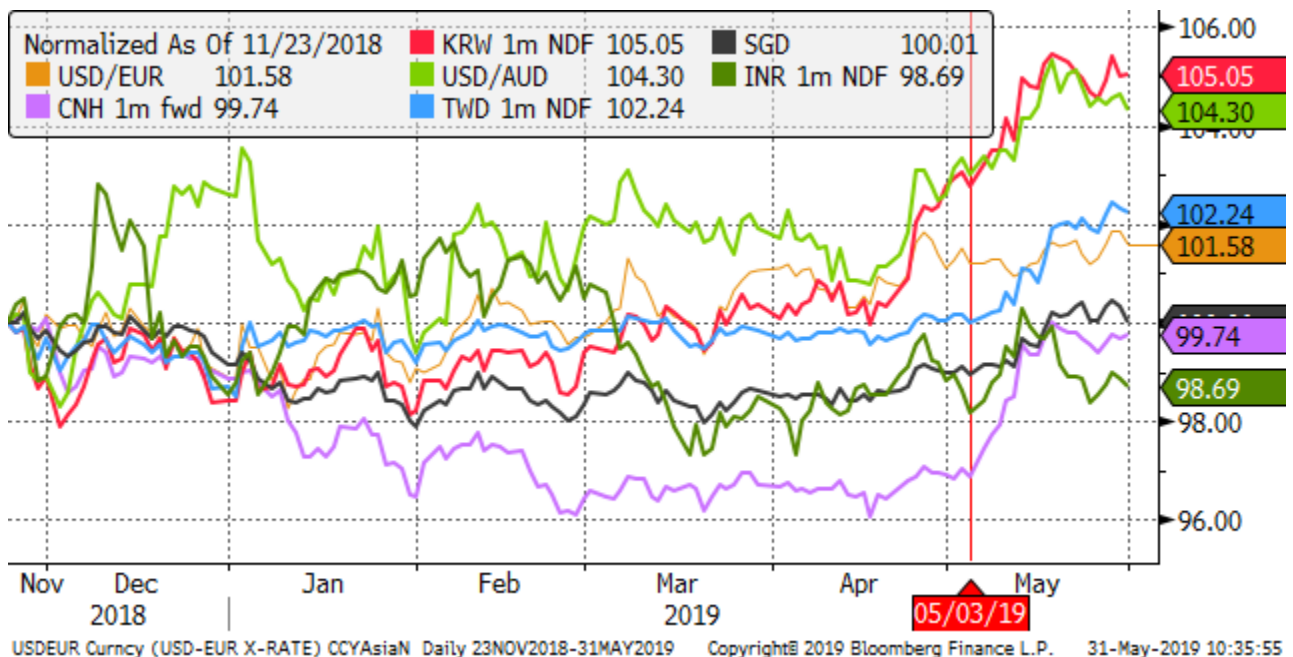
EM currencies, AUD and EUR fell initially as the US-China trade tensions increased, but they have been mixed in recent weeks. GBP remains weaker on increasing political/Brexit chaos



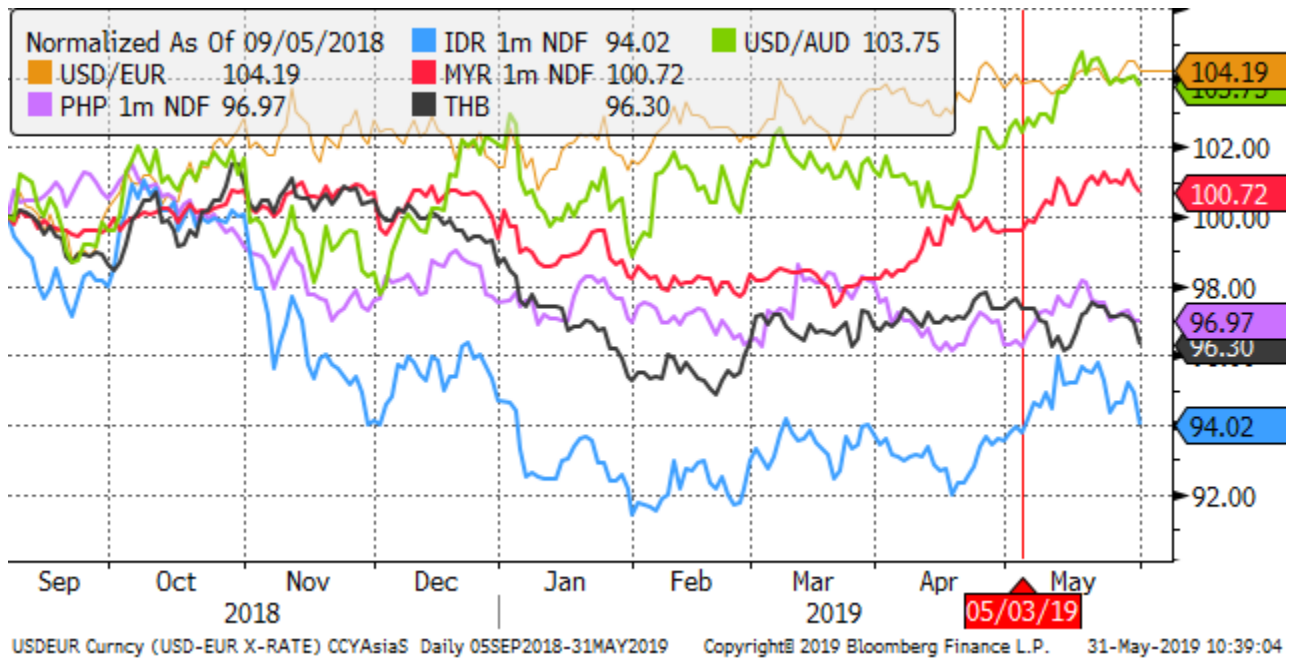
Copper producer Chile's currency is weaker, MXN has dropped sharply on tariff news, BRL has rebounded in recent weeks on positive political developments



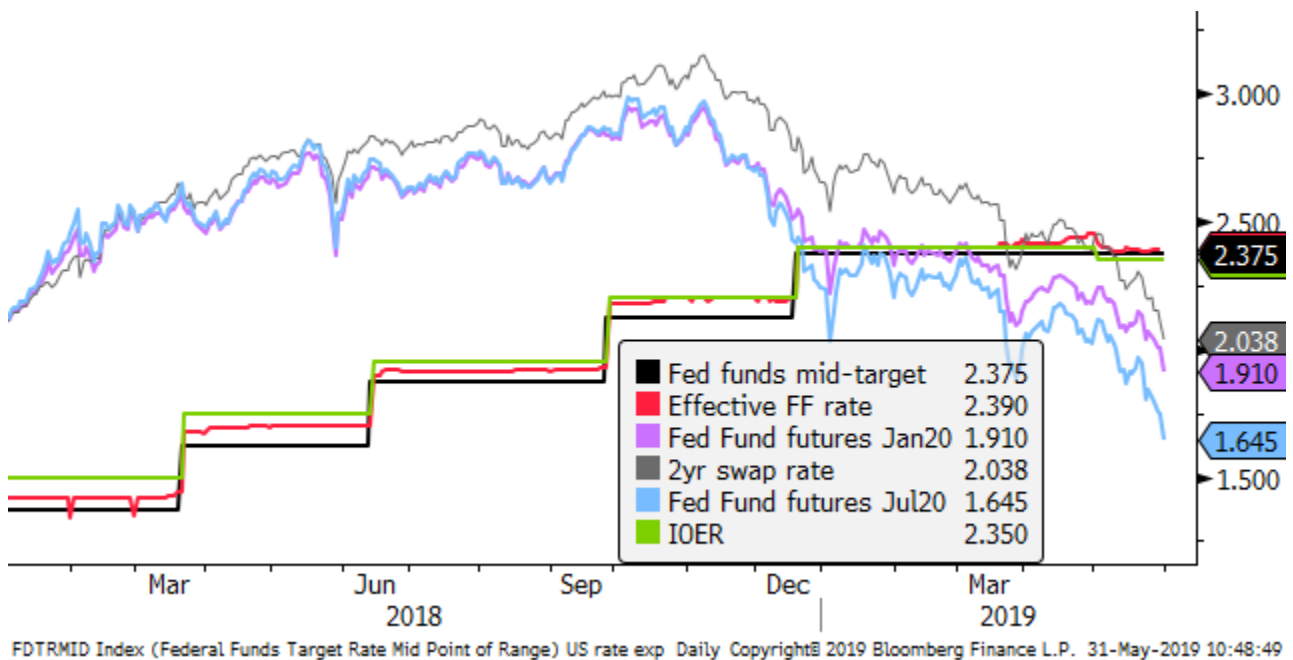
CNY has stabilized in recent weeks, KRW and TWD remain near lows but more stable. INR has strengthened on Modi's election win. AUD also supported by the LNC election win



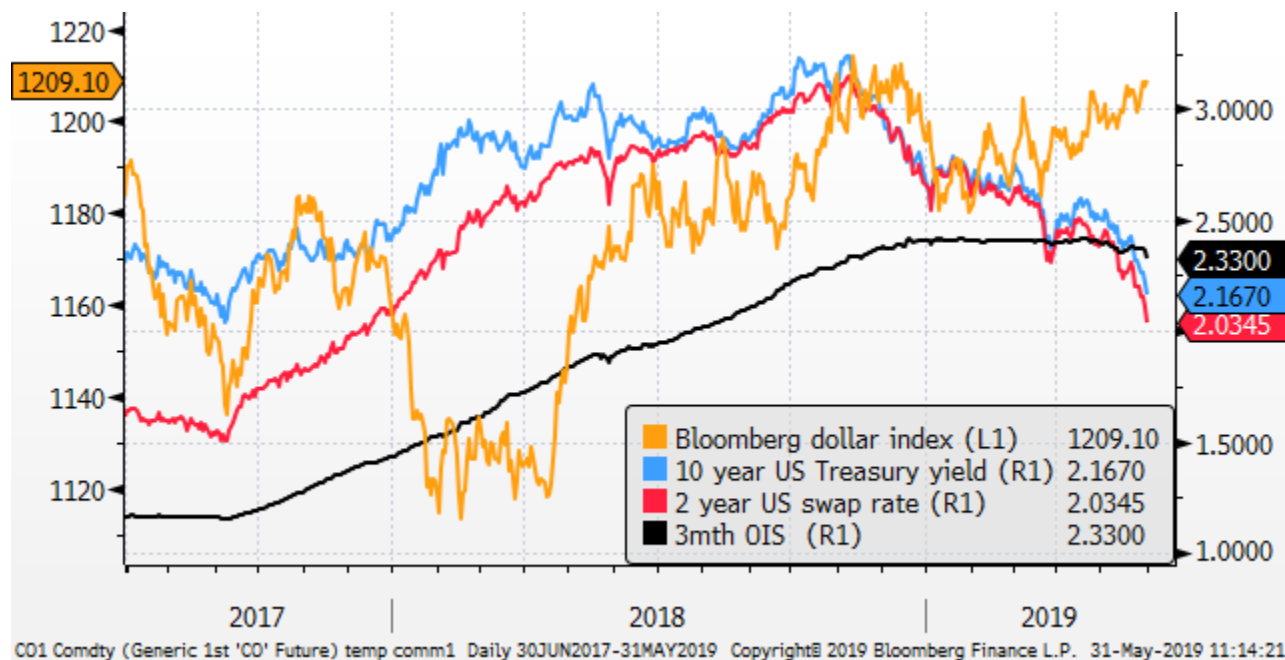
Solid performance in recent weeks by IDR, PHP, THB – signs that the USD is not necessarily the beneficiary from trade wars it starts



Fed rate expectations -48bp by year end, -74bp by mid-2020. Rate cut expectations are very large considering the Fed has essentially no bias. Although Fed's Clarida acknowledged a capacity to ease rates if global conditions weakened or low inflation persisted.



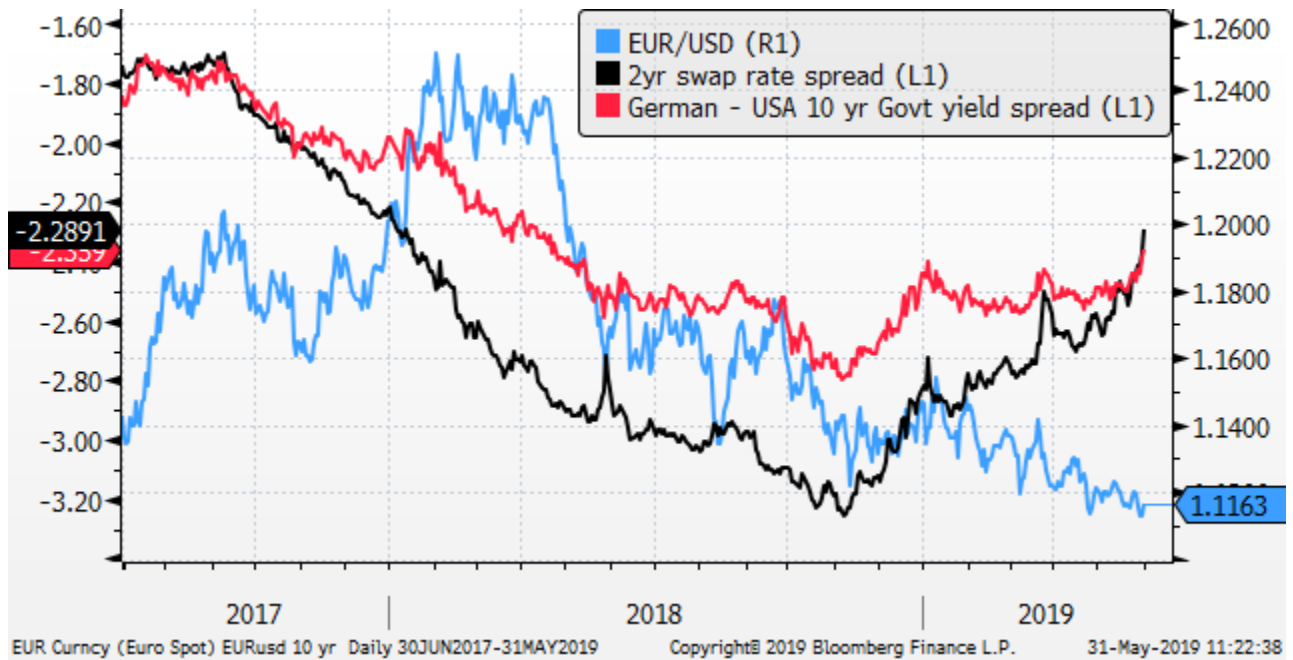
USA 10 and 2 yr yields fall below cash rate expectations over three months – curve inversion points to risks of weaker US economic growth and expectations that the Fed will cut rates relatively soon



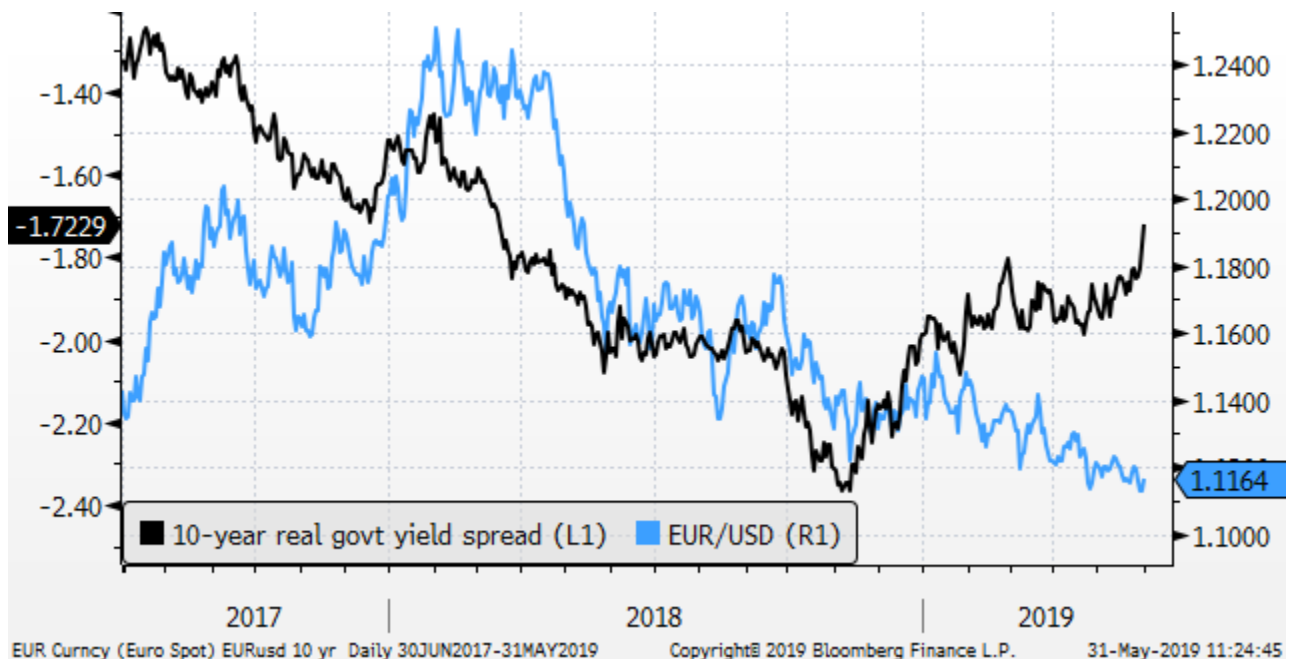
Decomposing US 10 year government yields – real yield at a low since 2017, inflation compensation returns to its low in December, around the lows since 2017. The term premium at a new record low



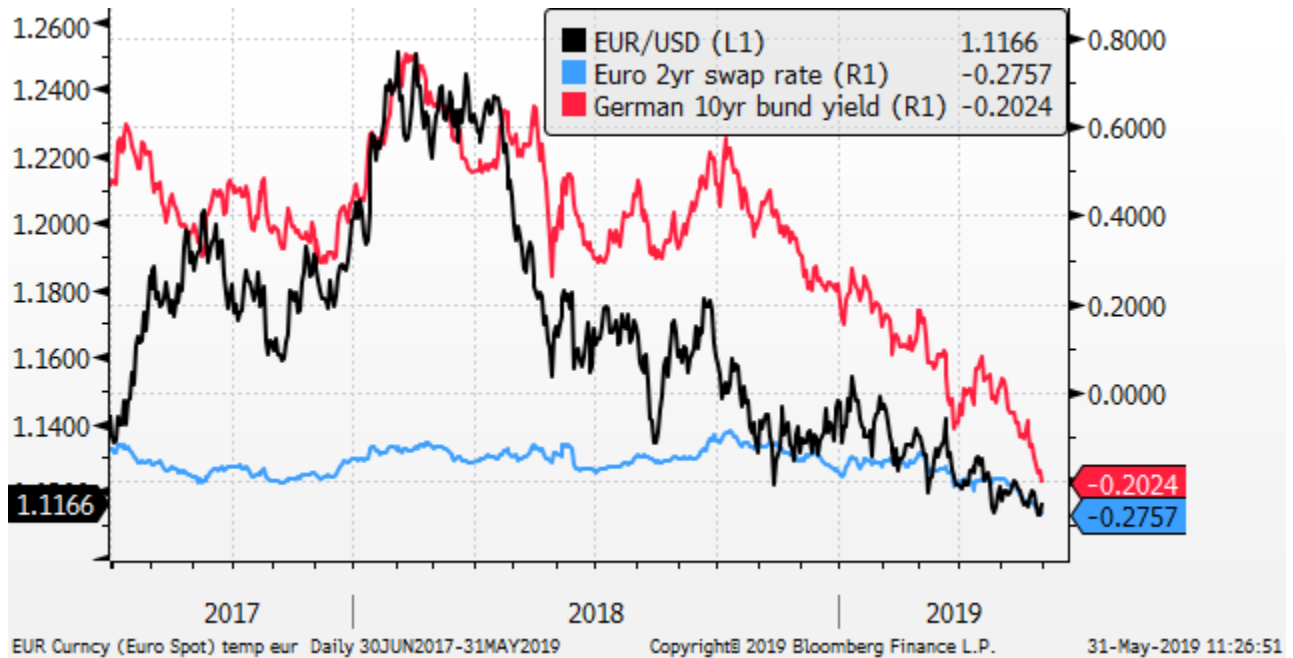
EUR/USD yield spreads have risen (disadvantage narrowed) significantly over the last six months and may support the EUR, especially if risk aversion discourages the use of EUR as a funding currency in carry trades



The rise in the real 10-year spread also points to upside risk for the EUR



EUR/USD has been more correlated with falling German yields in the last six months. This may have reflected a search for yield in a falling yield environment and diminishing credit spreads in the first four months of this year. However, if risk appetite is weaker, selling pressure in EUR related to carry trades should decrease and potentially reverse



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Greg Gibbs,
 Founder, Analyst and PM
 Amplifying Global FX Capital Pty Ltd