Basis Points

Weekly Market Commentary

Basis Points – August 6, 2019

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Above the Fold

Trade Reversal, Selling Pressure Increases – Once investors had a chance to digest the Federal Reserve's (Fed) first rate cut in more than a decade, the light selling that followed the Fed announcement had initially reversed, sending futures higher. But that bullishness quickly disappeared after President Trump unexpectedly announced that additional tariffs of 10% would be levied on the remaining $300 billion worth of goods imported from China on Sept. 1. The goal was likely to motivate the Chinese to act quickly as the communist nation has been reportedly dragging its feet in negotiations. The move took investors by surprise as most believed progress was being made, triggering the initial selloff that drove the S&P 500 down 3.1% last week.

From there, the selling deepened into the weekend as China announced it was halting U.S. agricultural purchases, adding pressure to commodity prices as well. Over the weekend, China took things a step further by devaluing its currency, the Yuan, to levels not seen in 10 years. By devaluing its currency, China can effectively soften the effects of tariffs. Investors are now concerned that this quid pro quo volley could lead to even higher tariffs or even a currency war where Americans' purchasing power could be compromised.

While chances of the latter are low, the tone of the ongoing negotiations between the two largest economies has certainly shifted from last week, and that is sending stocks lower *for now*. China does have an advantage when it comes to currency manipulation given the structure of its government and its experience. China has also been very public about why it was taking these actions, blaming rising tariffs and trade protectionism, further escalating fears of a prolonged trade war.

Here in the states, Friday's BLS (Bureau of Labor Statistics) employment data showed 164,000 jobs were added last month, lower than expectations. The BLS also revised May and June data lower by 41,000 jobs in aggregate, and the non-manufacturing index for

July from the Institute of Supply Management also missed consensus expectations. While these data may offer the Fed increased impetus to continue cutting interest rates, a trade deal with China seems to be a much more important factor at the moment. It was this growing uncertainty for a favorable deal that continues to feed the selloff, leading to a roughly 3% drop in the S&P 500 on Monday, the biggest drop since December 2018.

The good news is that sharp selloffs can often present opportunities as large swaths of stocks are dragged through the mud, some unnecessarily. And even though this selloff might seem dramatic, it's perfectly within the realm of normal for the markets, which are still not far off from all-time highs.

What's Ahead

This week is light on economic data, but still heavy on earnings. With an earnings season that's been good, but not great, investors will be looking for better than expected guidance from executives, which may be hard to come by without a trade solution.

Three Things

1. *Huawei Soaring (In China)* – Even though the Chinese telecommunications giant was blacklisted in the U.S., the world's No. 2 smartphone maker is experiencing a second-quarter boom in China as a patriotic buying spree is offsetting weakness in other countries. All of Huawei's competitors saw declines in the same period.
2. *HSBC Cuts Deep* – After ousting CEO John Flint, HSBC executives are planning more cuts. Finance Director Ewen Stevenson said that up to 2% of the company's 237,685 employees could lose their jobs. The cuts will target senior roles, and the company expects severance packages to cost between $650 and $700 million this year, but expects to save that much on an annual basis moving forward.
3. *Crude and Copper Suffer* – Suffering their biggest one-day drop in four and a half years, crude prices sank nearly 8% on Thursday after the President announced additional tariffs on China. Industrial metal copper, often used as a proxy for global economic health, also saw a near 3% drop on Friday alone, and nearly 4% for the week.

Did You Know?

The ABC’s of Currency Manipulation

Currency manipulation typically occurs when a central bank or government buys or sells foreign currency in exchange for its own. For a country like China, who is a massive exporter, it logically wants to cheapen its currency (within reason) to keep its goods attractive to buyers around the world (especially the U.S.). If China reduces the value of the Yuan compared to the USD (U.S. dollar), it will mean that local Chinese companies will receive more Yuan for items exported.

Since the Yuan is considered an official reserve currency by the IMF (International Monetary Fund), along with the USD, Euro, Yen and British Pound, it shouldn’t be as easy to manipulate, but the PBOC (People’s Bank of China) does have the ability to adjust the Yuan’s value against the USD with something called the reference rate. The reference rate essentially means the PBOC guarantees it will pay “X” amount for each dollar. Today, the reference rate is near 7.04, or 7.04 Yuan for every $1 USD — a near 11-year low for the Yuan.

China is able to make adjustments in the reference rate using the purchase and sale of U.S. Treasuries. And since it pegs value to the price of the USD, the USD value also has a direct influence on the Yuan.

This all may sound confusing, but the most important takeaway here is that the PBOC selected the USD to peg its currency to, and through its mechanisms can directly adjust just how strong or weak its currency is in relation to the USD, even though Mexico is now China’s largest trading partner.