AquilaFlash

The Fed cuts its key policy interest rate by 25 basis points. US-China trade tensions ratchet up.

Last week provided a lot of news for markets to digest but investors found little to cheer. While the Fed reduced its key US interest rate by 25 basis points as expected, investors were disturbed by the way this decision was presented. US-China trade hostilities intensified as President Trump announced fresh tariffs.

Fed cuts rate by a quarter point
On Wednesday and as expected, the US Federal Reserve cut its key policy interest rate range by 25 basis points to 2% to 2.25%. Also, the program to reduce the Fed's massive portfolio of securities will end in August, two months earlier than previously scheduled. The interest rate cut decision was not unanimous. Two FOMC members voted to keep interest rates unchanged.

While financial markets initially reacted with calm to the announcement of an interest rate cut and its characterization by Fed Chairman Powell as an "insurance against global downside risks," other comments from the Chairman were not well received. Markets swooned when he suggested that the rate cut was just a mid-cycle adjustment and not the first in a series of cuts. The Dow promptly lost over 400 points, though it retraced a good bit of this decline before the close. Unsurprisingly, the Fed's performance drew a critical tweet from President Trump. "What the Market wanted to hear…. was that this was the beginning of a lengthy and aggressive rate-cutting cycle that would keep pace with China, the European Union and other countries around the world. As usual, Powell let us down…" Trading on July 31 suggests Mr. Trump was right in his assessment of what the market had anticipated.

Further escalation of the US-China trade conflict
The next day (August 1) the US President tweeted that, given China's failure to follow through on greatly increasing its imports of US farm goods and on cutting the flow of fentanyl to America, he would institute a "small" 10% tariff on a further $300bn of Chinese imports as of September 1. These new tariffs would be in addition to the $250bn worth of Chinese imports already attracting a 25% tariff. While most companies should be able to cope with the new 10% duty, there is always a risk it could be increased to 25%. The trade dispute is clearly already weighing on business investment. Later in his tweet, Donald Trump confirmed he is looking forward to further talks with China and is confident "the future between our two countries will be a very bright one". For the time being, investors aren't sharing his optimism.

The Dow Jones lost another 500 points on the Trump tariff announcement and is now nearly 4% below its 2019 high. Even more striking has been the behavior of bond markets. Since July 31 the yield on the 10-year US Treasury has fallen from around 2% to around 1.75%. This reflects a sharp change in interest rate expectations. More than 70% of economists polled expect another 25 basis point rate cut at the September FOMC meeting (Source: Bloomberg). With his new trade war initiative, President Trump has managed to significantly raise pressure on the Fed to stimulate the economy.

US labor market remains solid
Non-farm payrolls increased by 164'000 in July relative to the June figure which was revised downwards. This resulted in an unemployment rate of 3.7%. July data

show average hourly wages rising at a 3.2% annual rate, indicating a slight rise in wage inflation.

Focus will now shift back to the macro numbers and company results

Whereas markets last week were hostage to the Fed and President Trump, this week they are likely to adjust their focus back to economic data and the current corporate earnings season. Following disappointing activity data (GDP from France and Sweden, industrial output for Japan), we should get some data in the coming days showing how other European economies are performing. We expect, however, that the Purchasing Managers' indices for the service sectors to remain above 50, indicating continuing expansion.

Technically, stock markets look vulnerable. The German DAX is currently trading below its 100-day average, with the next support around 11'640 points. In the US, the picture looks a little better, but the support at 2'970 for the S&P 500 has now been broken. We think that US stocks could establish some sort of bottom for the S&P 500 around the 2870 mark. If this support does not hold the way is open for further declines. Seasonal factors suggest caution as August is traditionally one of the weakest months in the calendar for stock markets.

We started taking profits in equities a few weeks ago and are currently slightly underweight in equities as an asset class. For the time being we are staying cautious. But if markets continue to weaken, tactical buying opportunities may soon develop.

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