# ARE MARKETS PRICING IN A "TRUMP PUT"?

**May 14, 2019**

On Sunday May 5th, President Trump announced on Twitter that trade talks between the US and China had stalled because China had tried to renegotiate already agreed-upon portions of the trade deal between the two countries. As a result, the US increased tariffs on $200Bn of Chinese goods from 10 to 25 percent the following Friday morning, with tariffs on the remaining $325Bn worth of Chinese goods also potentially coming into effect in the coming months.

The setback in the ongoing talks has resulted in an apparent escalation of trade tensions between the two countries, with China already preparing retaliatory tariffs in response to Friday's tariff increases. Moody's Analytics has modeled that in what is still an unlikely "worst-case" scenario – i.e., an all-out trade war between the two nations – US GDP could potentially be reduced by up to 1.8%, hitting the financial results of American companies that either import Chinese goods or have large customer bases in China, and putting an end to the historic downward trend in unemployment.

In the six trading days following the President's Twitter announcement, the S&P 500 was down 4.3% from its closing price the previous Friday, though context is important here, as even with this recent decline, the U.S. stock market is still up 12.3% year-to-date. The consensus before the weekend Tweetstorm had been that an agreement between the nations was all but a done deal and this view had largely been priced into markets. Some analysts now fear a protracted trade war is possible or that at the very least any deal is likely weeks or months away at best. Given how optimistic the consensus view had become and the potential consequences of an extended trade war, some analysts are beginning to wonder: "Why haven't markets reacted more?" With a deal looking – at least on the surface – a lot less likely, markets have largely taken it in stride, only giving up about a month's worth of gains.

One theory is the market's belief in a "Trump Put". Since his election, the President has made it a habit to lead with hardline posturing to satisfy his voter base, and then soften his position in the 11th hour if the market begins to react negatively. This cycle of sensitivity to economic feedback has created a sense in the markets that after his initial posturing he will back away if the markets or the economy give him a strong enough rap on the knuckles. In the other direction, when the economy has shown signs of weakness, Trump has seemed more than willing to engage in stimulative politics. In 2018, with the markets showing signs of weakness and recession risk rising, constructive negotiations between the US and China emerged, along with a some strongly worded "suggestions" that the Fed relax their interest rate trajectory, and markets responded accordingly, with the S&P 500 up almost 19% in 2019 before this latest dustup.

If markets are getting used to and begin to anticipate this dynamic, it could ultimately backfire if they begin pricing in Trump's actions before he takes them. If the President really is using feedback from the markets as a signal to moderate his positions, and the markets are underrating the potential of a trade war because they expect Trump to edge up to the brink then back away as he has before, they may inadvertently not signal hard enough for him to get the hint that it's time to back off. With the economy and the financial markets looking strong, he may be emboldened to continue to play hardball with China in an attempt to keep a key campaign promise, and if the markets really have been mispricing this risk we might be in for a bumpy ride.

Another theory, however, is that the market is looking beyond the day-to-day headlines and taking a longer-term view. As of Wednesday, Moody's Analytics has the base-case trade scenario only shaving a few tenths of a percent off US GDP in the next 12 months, and in industries not affected by the tariffs the fundamental economic picture has not changed much since the talks hit their rough patch. This extension of the timeline for a deal may increase near-term stock market volatility in the US and abroad as markets recalibrate their expectations, but Treasury Secretary Steven Mnuchin described last Friday's trade talks as "constructive", and the administration has said they will continue to negotiate in pursuit of a deal, softening the harsher rhetoric from earlier in the week. Our fundamental outlook is that the economy continues to be strong, and that even if a deal is not right around the corner, we believe the two countries will eventually some to terms. Until a deal is ultimately hammered out, being a long-term investor and staying diversified is the best way to insulate from the day-to-day effects the news cycle can sometimes have on the markets.