



May 2019 | Macro Insights

Market Update: Trade Tensions versus Policy Puts

Overview

An escalation in US-China trade tensions has weighed on investor sentiment and risk asset performance, including emerging market (EM) assets and corporate credit, though fixed income markets have generally fared better than equity markets during the recent bout of market weakness. Meanwhile, perceived safe-haven currencies have appreciated and core sovereign bond yields have fallen. In our recent Q&A on The Outlook for Global Growth and Fixed Income we listed an improving trade backdrop as one of three factors that had evolved in ways that led us to believe global growth will stabilize for the rest of 2019. This assessment has clearly shifted. However, the other two factors—a patient US Federal Reserve (Fed) and policy easing in China—remain in place.

Against a backdrop of heightened trade tensions we have scaled back overweight exposure to EM currencies and EM debt. That said, given policy support—or “policy puts” whereby policymaker actions support market liquidity thereby creating put protection on asset prices—and our expectation for the cycle to continue, we maintain exposure to spread sectors and we continue to identify relative value opportunities in macro markets.

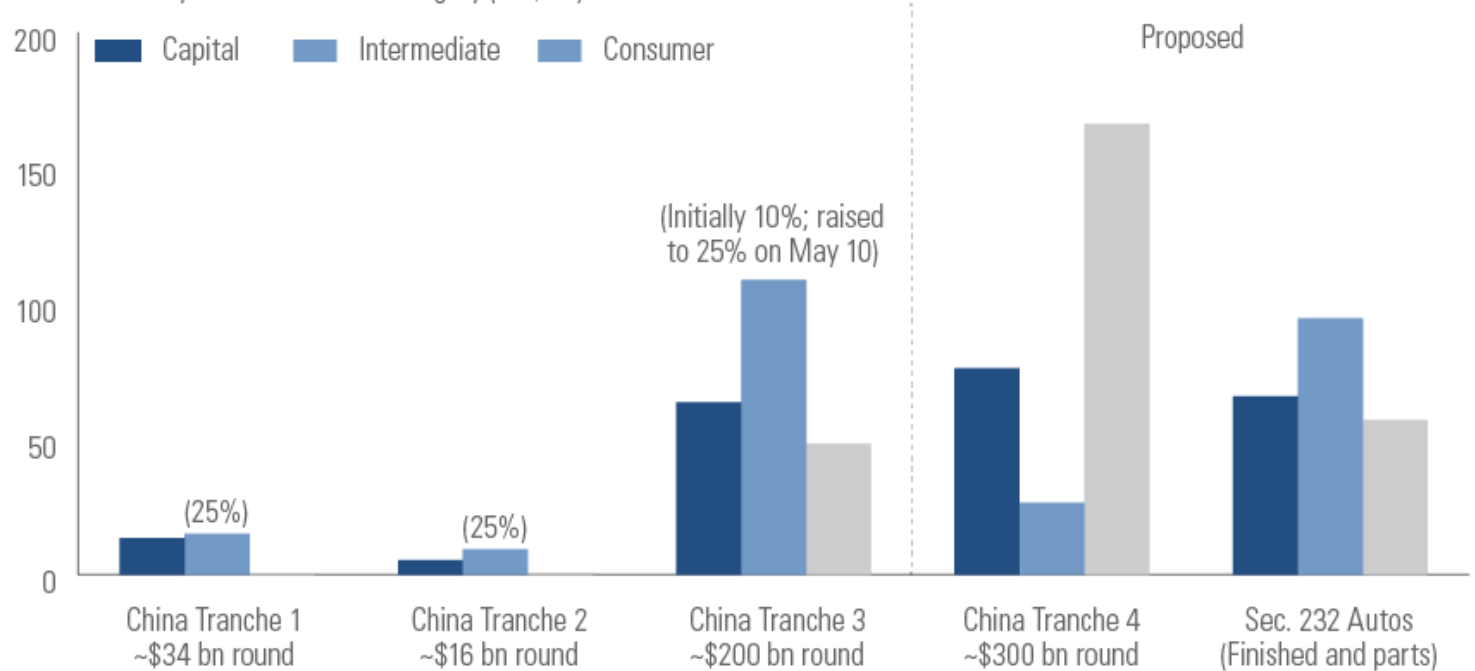
Trade Tensions

Recent Escalation

On May 10, the US raised the tariff rate on \$200bn of imports from China from 10% to 25%. US President Donald Trump has also indicated that tariffs will be applied to remaining goods imported from China which amount to roughly \$300bn in value. In response, on May 13, China announced it will raise tariffs on \$60bn of imports from the US from June 1. These events mark an abrupt escalation in US-China trade tensions after a period of relative calm since the fourth quarter of 2018 (see Appendix I).

EXHIBIT 1: CHINA-SPECIFIC TARIFFS ENACTED BY THE US

Tariff Rounds by Broad Economic Category (US\$ bn)



Source: Goldman Sachs Global Investment Research. As of May 15, 2019. Tariff rate denoted in brackets.

Macro Impacts¹

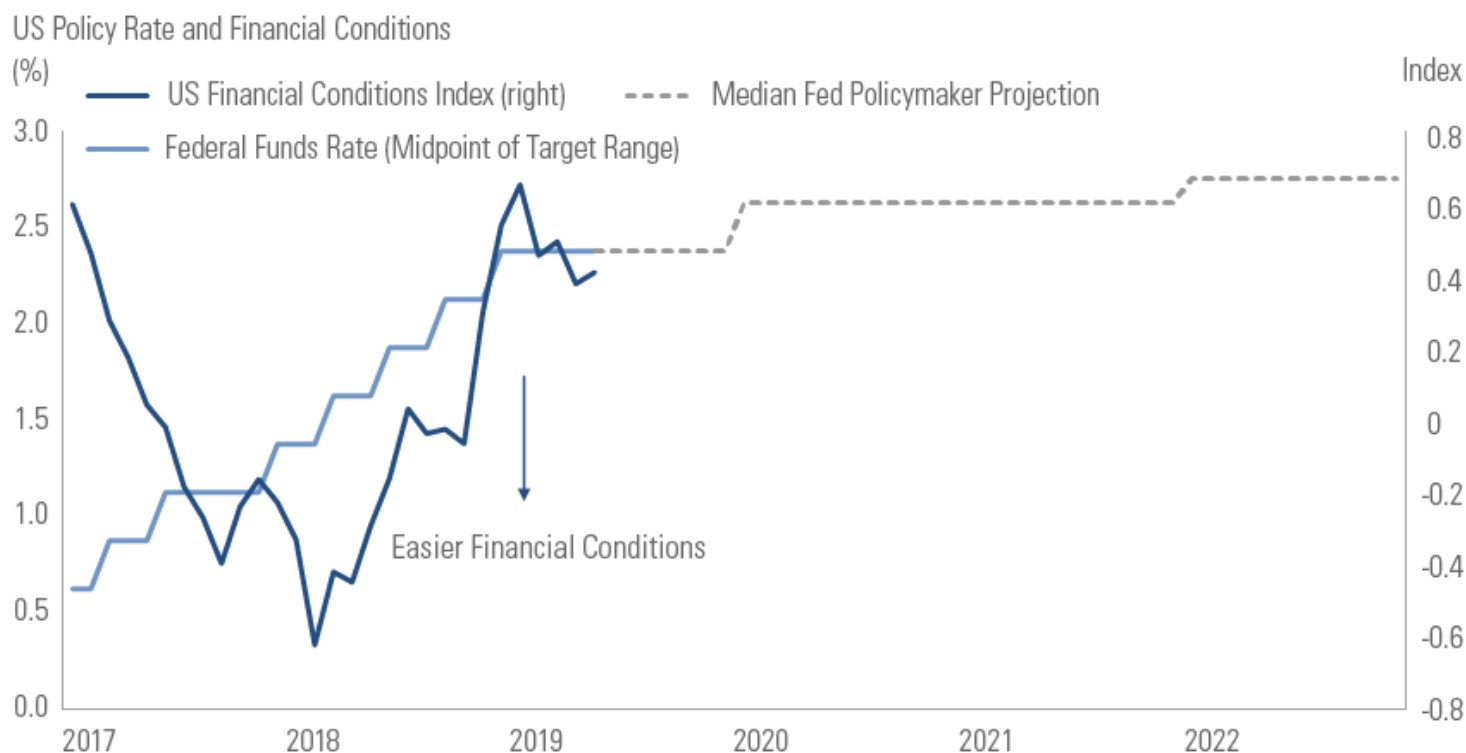
- Chinese Growth Outlook: Full Circle
 - We recently revised higher our 2019 China growth forecast from 6.3% to 6.5% in light of stronger-than-expected first quarter GDP growth and on raised prospects of a US-China trade deal.
 - Given the recent deterioration in US-China trade relations, we have lowered our forecast to 6.2%. This downward revision reflects our estimate of the direct impact on Chinese growth from lower exports to the US (following the tariff step-up) and indirect impacts (such as lower business sentiment and activity) somewhat offset by measures taken by Chinese policymakers to stabilize growth.
- US Inflation and Monetary Policy Implications: Limited
 - In the absence of a material growth shock, we forecast US core PCE inflation—the Fed’s preferred measure—to rise 1.8% in 2019; slightly below the central bank’s target. The 25% tariff on \$200bn of imports from China could add around 10-15bps to our core PCE inflation forecast over the next year. Tariffs on remaining imports from China could see this boost rise to 40bps.
 - In our view, a temporary upward inflationary impulse from a higher tariff rate will have limited implications for Fed policy and for now, we continue to expect US monetary policy to remain unchanged in 2019. We think the Fed will prioritize a continuation of the US expansion—which is set to become the longest on record if growth continues through June—rather than react to a temporary inflation overshoot.

Policy Puts

As noted above, two of the three developments we highlighted in our recent Q&A as being supportive for global growth and markets remain in place; a patient Fed and policy easing in China.

In our view, factors guiding **US monetary policy** are broadly balanced and therefore consistent with unchanged near-term policy. From a hawkish perspective, the labor market is tight, with solid monthly job gains and a multi-decade low unemployment rate. Moreover, several measures of wage growth are trending upwards. The non-financial sector is less indebted and therefore more resilient to monetary policy normalization than in prior cycles. From a dovish standpoint, supply-side improvements such as raised labor force participation and productivity growth may limit further upward wage inflation pressures and unit labor costs—which tend to have a closer relationship with broader prices—remain subdued. In addition, policymakers have highlighted that some measures of inflation expectations are low and there are signs of slowing activity in cyclical sectors. Overlaying these macro considerations is a potential change in policy framework at the Fed, with policymakers potentially growing more tolerant of periods of inflation above its 2% target.

EXHIBIT 2: US FINANCIAL CONDITIONS HAVE EASED FOLLOWING THE FEDS PATIENT PIVOT



Source: GSAM, Macrobond. As of May 15, 2019.

In contrast, we think there is a clearer case for continued **policy easing in China**. Growth is moderating due to the economy's evolution from being investment-led to consumption-driven. This moderation is reinforced by hawkish US trade actions. As noted previously, the policy response in China is smaller in magnitude relative to prior installments of support and will also likely take longer to impact growth relative to when the economy was less levered. However, first quarter activity data pointed to some

signs of policy measures taking hold and we expect supportive policies—including issuance of special local government bonds for infrastructure investment—to gain traction in response to recent trade events.

Fixed Income Investment Implications

Beyond a recalibration of EM asset exposures, our key fixed income investment views—some of which are listed below—are broadly unchanged. We maintain exposure to spread sectors and continue to identify relative value opportunities in macro markets.

- We have scaled back overweight exposure to **EM currencies** and **EM debt** until we gain clarity on the direction of travel for both US-China trade relations and global growth, with the two being interconnected.
- Following strong early-2019 performance, we have scaled back overweight exposure to **US corporate credit**. That said, we continue to identify attractive “carry and roll” opportunities arising from steepness at certain portions of US credit curves. More specifically, we favor the intermediate portion of the BBB-rated US credit curve.
- We also find select opportunities arising from market dynamics and dislocations, such as performance dispersion between **US high yield** bonds from small and large issues. Dispersion has arisen due to the nature of retail fund demand which is largely channeled through ETFs, for which bonds from only large issues tend to be eligible.
- Among developed market currencies, we remain neutral the **US dollar**. In our view the dollar’s perceived safe-haven status and its high-yield (relative to other advanced economies) is counterbalanced by a patient Fed outlook and concerns around US fiscal and current account deficits.
- We also continue to identify attractive **macro relative value** opportunities. Our overweight exposure to core European rates versus rates from other advanced economies has benefited from the European Central Bank’s elongated forward guidance, which confirms unchanged policy rates through to 2020. Additionally, growing opposition to globalization may further undermine sentiment in the Euro area; this could reinforce the growth moderation currently underway and further support our relative value positioning.
- Elsewhere in macro markets, we are positioned for tighter financial conditions in Canada relative to the US. We think the bar for rate hikes in Canada is lower than in the US. We implemented this position ahead of an escalation in US-China trade tensions and therefore gained from the subsequent rally in US rates.

APPENDIX I - US-CHINA TRADE WAR TIMELINE OF KEY EVENTS

Escalation	Tranche 1		
	Jul 6, 2018	US implements first China-specific tariff; 25% on \$34bn	China retaliates with a 25% tariff on \$34bn
	Aug 14, 2018		China files a WTO complaint against the US
	Tranche 2		
	Aug 23, 2018	US implements a 25% tariff on \$16bn	China retaliates with 25% on \$16bn
	Aug 23, 2018		China files second WTO complaint against the US
	Tranche 3		
Sep 24, 2018	US implements a 10% tariff on \$200bn	China implements tariffs ranging from 5-10% on \$60bn	
De-Escalation	Nov 8, 2018	US and China resume trade talks	
	Dec 2, 2018	US and China agree to a temporary truce Both agree to refrain from increasing or imposing new tariffs for 30 days (until Mar 1, 2019). China agrees to purchase more US products including agricultural and energy products.	
	Dec 14, 2018	China temporarily lowers additional tariffs on US autos and resumes purchases of US soybeans (which it stopped buying in Jul 2018)	
	Jan 7-Feb 24, 2019	US and China hold several rounds of trade talks in Beijing and Washington	
	Feb 25, 2019	US extends truce relating to a tariff step-up on \$200bn from 10% to 25% (no concrete date for the extension is provided).	
	Mar 31, 2019	China extends suspension of additional tariffs on US autos and auto parts	
	Apr 3-May 1, 2019	US and China hold several more rounds of trade talks in Beijing and Washington	
Abrupt Escalation	May 5, 2019	US President Donald Trump threatens to raise tariffs on \$200bn from 10% to 25% and to impose tariffs on an additional \$325bn of Chinese goods	
	May 10, 2019	US raises tariff on \$200bn from 10% to 25%	
	May 13, 2019	China announces it will raise tariffs on \$60bn from 5-10% to 10-25%, effective Jun 1, 2019.	

Total Chinese exports to the US subject to tariffs: \$250bn

Total US exports to China subject to tariffs: \$110bn

Source: GSAM, China Briefing, USTR. As of May 15, 2019.

¹ The economic and market forecasts presented herein are for informational purposes as of the date of this presentation. There can be no assurance that the forecasts will be achieved. Please see additional disclosures at the end of this presentation.

Abbreviations: Gross domestic product (GDP), personal consumption expenditures (PCE), basis points (bps), exchange-traded funds (ETFs).

General Disclosures

Views and opinions expressed are for informational purposes only and do not constitute a recommendation by GSAM to buy, sell, or hold any security. Views and opinions are current as of the date of this presentation and may be subject to change, they should not be construed as investment advice.

This information discusses general market activity, industry or sector trends, or other broad-based economic, market or political conditions and should not be construed as research or investment advice. This material has been prepared by GSAM and is not financial research nor a product of Goldman Sachs Global Investment Research (GIR). It was not prepared in compliance with applicable provisions of law designed to promote the independence of financial analysis and is not subject to a prohibition on trading following the distribution of financial research. The views and opinions expressed may differ from those of Goldman Sachs Global Investment Research or other departments or divisions of Goldman Sachs and its affiliates. Investors are urged to consult with their financial advisors before buying or selling any securities. This information may not be current and GSAM has no obligation to provide any updates or changes.

This material is provided at your request for informational purposes only. It is not an offer or solicitation to buy or sell any securities.

This material has been prepared by GSAM and is not financial research nor a product of Goldman Sachs Global Investment Research. It was not prepared in compliance with applicable provisions of law designed to promote the independence of financial analysis and is not subject to a prohibition on trading following the distribution of financial research. The views and opinions expressed may differ from the views and opinions expressed by Goldman Sachs Global Investment Research or other departments or divisions of Goldman Sachs and its affiliates. Investors are urged to consult with their financial advisors before buying or selling any securities. This information should not be relied upon in making an investment decision. GSAM has no obligation to provide any updates or changes.

THIS MATERIAL DOES NOT CONSTITUTE AN OFFER OR SOLICITATION IN ANY JURISDICTION WHERE OR TO ANY PERSON TO WHOM IT WOULD BE UNAUTHORIZED OR UNLAWFUL TO DO SO.

Prospective investors should inform themselves as to any applicable legal requirements and taxation and exchange control regulations in the countries of their citizenship, residence or domicile which might be relevant.

This material is provided for informational purposes only and should not be construed as investment advice or an offer or solicitation to buy or sell securities. This material is not intended to be used as a general guide to investing, or as a source of any specific investment recommendations, and makes no implied or express recommendations concerning the manner in which any client's account should or would be handled, as appropriate investment strategies depend upon the client's investment objectives.

United Kingdom and European Economic Area (EEA): In the United Kingdom, this material is a financial promotion and has been approved by Goldman Sachs Asset Management International, which is authorized and regulated in the United Kingdom by the Financial Conduct Authority. Switzerland: For Qualified Investor use only - Not for distribution to general public. This document is provided to you by Goldman Sachs Bank AG, Zürich. Any future contractual relationships will be entered into with affiliates of Goldman Sachs Bank AG, which are domiciled outside of Switzerland. We would like to remind you that foreign (Non-Swiss) legal and regulatory systems may not provide the same level of protection in relation to client confidentiality and data protection as offered to you by Swiss law.

Asia Pacific: Please note that neither Goldman Sachs Asset Management International nor any other entities involved in the Goldman Sachs Asset Management (GSAM) business maintain any licenses, authorizations or registrations in Asia (other than Japan), except that it conducts businesses (subject to applicable local regulations) in and from the following jurisdictions: Hong Kong, Singapore and Malaysia. This material has been issued for use in or from Hong Kong by Goldman Sachs Asset Management (Hong Kong) Limited, in or from Singapore by Goldman Sachs Asset Management (Singapore) Pte. Ltd. (Company Number: 201329851H) and in or from Malaysia by Goldman Sachs (Malaysia) Sdn Berhad (880767W).

Australia: This material is distributed in Australia and New Zealand by Goldman Sachs Asset Management Australia Pty Ltd ABN 41 006 099 681, AFSL 228948 ('GSAMA') and is intended for viewing only by wholesale clients in Australia for the purposes of section 761G of the Corporations Act 2001 (Cth) and to clients who either fall within any or all of the categories of investors set out in section 3(2) or sub-section 5(2CC) of the Securities Act 1978, fall within the definition of a wholesale client for the purposes of the Financial Service Providers (Registration and Dispute Resolution) Act 2008 (FSPA) and the Financial Advisers Act 2008 (FAA), and fall within the definition of a wholesale investor under one of clause 37, clause 39 or clause 40 of Schedule 1 of the Financial Markets Conduct Act 2013 (FMCA) of New Zealand (collectively, a "NZ Wholesale Investor"). GSAMA is not a registered financial service provider under the FSPA. GSAMA does not have a place of business in New Zealand. In New Zealand, this document, and any access to it, is intended only for a person who has first satisfied GSAMA that the person is a NZ Wholesale Investor. This document is intended for viewing only by the intended recipient. This document may not be reproduced or distributed to any person in whole or in part without the prior written consent of GSAMA. This information discusses general market activity, industry or sector trends, or other broad based economic, market or political conditions and should not be construed as research or investment advice. The material provided herein is for informational purposes only. This presentation does not constitute an offer or solicitation to any person in any jurisdiction in which such offer or solicitation is not authorized or to any person to whom it would be unlawful to make such offer or solicitation.

Canada: This presentation has been communicated in Canada by GSAM LP, which is registered as a portfolio manager under securities legislation in all provinces of Canada and as a commodity trading manager under the commodity futures legislation of Ontario and as a derivatives adviser under the derivatives legislation of Quebec. GSAM LP is not registered to provide investment advisory or portfolio management services in respect of exchange-traded futures or options contracts in Manitoba and is not offering to provide such investment advisory or portfolio management services in Manitoba by delivery of this material.

Japan: This material has been issued or approved in Japan for the use of professional investors defined in Article 2 paragraph (31) of the Financial Instruments and Exchange Law by Goldman Sachs Asset Management Co., Ltd.

Brazil: 1. Materials to be sent to clients and TPDs in Brazil must include the following disclaimer: These materials are provided at your request and solely for your information, and in no way constitutes an offer, solicitation, advertisement or advice of, or in relation to, any securities, funds, or products by any of Goldman Sachs affiliates in Brazil or in any jurisdiction in which such activity is unlawful or unauthorized, or to any person to whom it is unlawful or unauthorized. This document has not been delivered for registration to the relevant regulators or financial supervisory bodies in Brazil, such as the Brazilian Securities and Exchange Commission (Comissão de Valores Mobiliários - CVM) nor has its content been reviewed or approved by any such regulators or financial supervisory bodies. The securities, funds, or products described in this document have not been registered with the relevant regulators or financial supervisory bodies in Brazil, such as the CVM, nor have been submitted for approval by any such regulators or financial supervisory bodies. The recipient undertakes to keep these materials as well as the information contained herein as confidential and not to circulate them to any third party. 2. If the material is targeted to clients in Brazil that are pension funds (private or public) and insurance/capitalization companies, then it should additionally contain the following disclaimer: These materials do not address any investment restriction or guideline that the requestor may be subject to in Brazil. Prior to investing in any securities, funds or products described herein, the requestor must review the prospectuses and other applicable documents, and make its own assessment on whether the securities, funds or products are adequate to it in light of the applicable Brazilian laws and regulations, and in light of requestor's own Investment Policy.

Colombia: Esta presentación no tiene el propósito o el efecto de iniciar, directa o indirectamente, la adquisición de un producto a prestación de un servicio por parte de Goldman Sachs Asset Management a residentes colombianos. Los productos y/o servicios de Goldman Sachs Asset Management no podrán ser ofrecidos ni promocionados en Colombia o a residentes Colombianos a menos que dicha oferta y promoción se lleve a cabo en cumplimiento del Decreto 2555 de 2010 y las otras reglas y regulaciones aplicables en materia de promoción de productos y/o servicios financieros y /o del mercado de valores en Colombia o a residentes colombianos. Al recibir esta presentación, y en caso que se decida contactar a Goldman Sachs Asset Management, cada destinatario residente en Colombia reconoce y acepta que ha contactado a Goldman Sachs Asset Management por su propia iniciativa y no como resultado de cualquier promoción o publicidad por parte de Goldman Sachs Asset Management o cualquiera de sus agentes o representantes. Los residentes colombianos reconocen que (1) la recepción de esta presentación no constituye una solicitud de los productos y/o servicios de Goldman Sachs Asset Management, y (2) que no están recibiendo ninguna oferta o promoción directa o indirecta de productos y/o servicios financieros y/o del mercado de valores por parte de Goldman Sachs Asset Management.

Esta presentación es estrictamente privada y confidencial, y no podrá ser reproducida o utilizada para cualquier propósito diferente a la evaluación de una inversión potencial en los productos de Goldman Sachs Asset Management o la contratación de sus servicios por parte del destinatario de esta presentación, no podrá ser proporcionada a una persona diferente del destinatario de esta pr.

Confidentiality

No part of this material may, without GSAM's prior written consent, be (i) copied, photocopied or duplicated in any form, by any means, or (ii) distributed to any person that is not an employee, officer, director, or authorized agent of the recipient.

© 2019 Goldman Sachs. All rights reserved. Date of first use: 15 May 2019.