

Morgan Stanley

INVESTMENT MANAGEMENT

U.S.-China Tensions: Not a Widespread Risk...Yet

FIXED INCOME | GLOBAL FIXED INCOME TEAM | MARKET PULSE | May 6, 2019

On Thursday, May 2 a story from China's Global Times leaked that U.S.-China talks hit an impasse. The market reacted negatively that day, but the following day, strong nonfarm payroll numbers turned the market in a more positive direction.

The timeline matters. Three days following the May 2 story leak, President Trump tweeted that tariffs may rise from 10%-25% on \$200 billion of goods. This implies that Trump is trying to control the narrative and get ahead of the story.

What's at stake for China? Morgan Stanley economists believe this could shave 0.3% from China's gross domestic product (GDP), putting China on the threshold of falling below 6% growth, something President Xi Jinping expressly wants to avoid. As a result, China is likely to add more stimulus, as they have already announced cuts to reserve requirement ratio—could do a lot more.

Global market impact is still idiosyncratic and NOT YET a systemic event.

Risk premia has risen marginally. U.S. equity prices have declined and U.S. Treasury bond yields have decreased by 2-4 basis points (bps).¹ The U.S. dollar has marginally appreciated. Emerging market debt spreads have widened by 5 bps to 365 bps.² U.S. investment grade spread have widened by 2-4 bps, with a 112 bps option adjusted spread (OAS) that is still near tights of the year.³ U.S. high yield spread widened by 5 bps, with a 360 bps OAS that is still near tights of the year.⁴

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¹ Bloomberg Barclays. Data from May 2, 2019 to May 6, 2019.

² JP Morgan Emerging Markets Bond Index (EMBI) Global Index. Data from May 2, 2019 to May 6, 2019.

³ Bloomberg Barclays U.S. Corporate Index. Data from May 2, 2019 to May 6, 2019.

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What are we watching? We are keeping an eye on the U.S. dollar, as a stronger dollar would signal heightened tensions, outflows from riskier assets and further escalation in U.S.-China tensions.

What are we doing as fixed income investors? We are staying the course. At this point the market reaction has been minor. However, it is important to note that China stimulus and stability is critical to world growth for remainder of 2019. **If U.S.-China talks break down, risk premia will rise and global growth will be unlikely to recover further in 2019.**

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⁴ Bloomberg Barclays U.S. Corporate High Yield Index. Data from May 2, 2019 to May 6, 2019.

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