STATE STREET GLOBAL ADVISORS

State Street Multi-Asset Funds

War (What is it good for)

- PBOC has been manipulating its currency for years – but actually in the US's favour.
- Expect CNY to stay over 7 and head even higher.
- Trade war and tariff uncertainty to continue.

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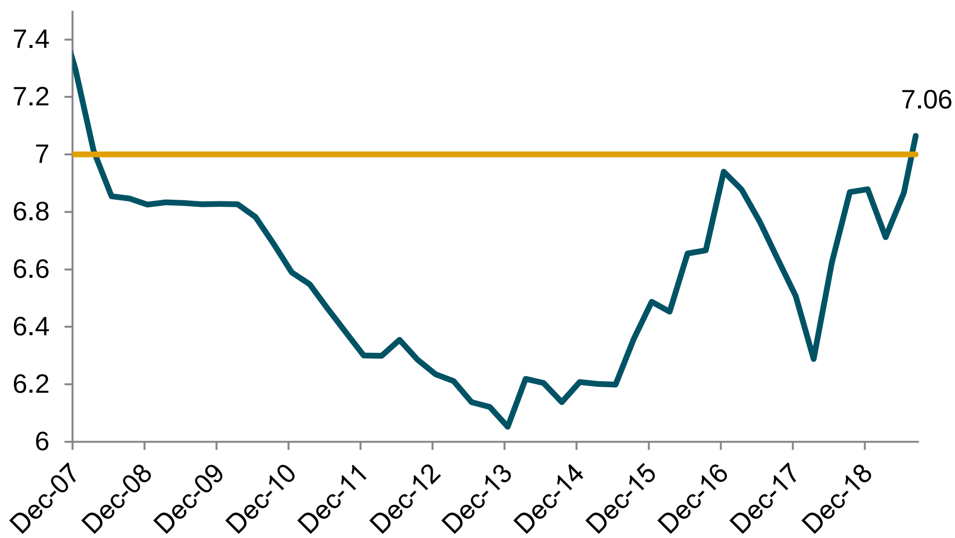
First there were trade wars and now we have currency wars, but as Edwin Starr sang, what is it good for?

In that latest tête-à-tête between the US and China, President Trump not unsurprisingly threatened more tariffs on China with talk of 10% tariffs on USD 300bn of Chinese imports. While a reaction from China was expected, China's next move to weaponize its currency and let it trade above 7 CNY to the USD was not.

This resulted in the US instantly accusing China of being a "currency manipulator" and an escalation of the trade wars.

Even more alarming was the open admission of what had taken place with the People's Bank of China (PBOC) releasing a statement in which it said the slump in the yuan was driven by "unilateralism and trade protectionism measures and the imposition of tariff increases on China". With the CNY strengthening against USD, China made its exports a little less expensive with the aim of partly offsetting the tariffs.

Figure 1. **Yuan break 7 for the first time since 2008: CNY per USD.** 1 December 2007 to 1 August 2019.



Source: SSGA, Bloomberg. As at 1 August 2019. Past performance is not a reliable indicator of future performance.

So what does this latest escalation mean?

Well firstly, China is a currency manipulator, but not how the US administration is claiming. In the past, they have been intervening directly and via capital controls to prevent the currency from weakening by buying large amounts of the yuan, and potentially keeping the yuan artificially high. They didn't do that this time, but they knew what they were doing, which was to engineer the price of their currency in their favour, this time round by not intervening, so while not necessarily manipulating their currency this time round, they have certainly entered into a currency war with the US.

The impact could see further headwinds for global growth as the trade spat between the two countries continues. The global fallout is already being seen with a number of central banks already cutting their domestic cash rates with slowing global growth from trade wars commonly cited as the main concern. Some of those countries could follow suite in weakening their currency, but given currency is a relative game, someone will lose out. At the moment that looks like the US, with Trump already accusing the Federal Reserve of being responsible for the current relative strength in USD by not cutting rates sufficiently (he was looking for 50bps not the 25bps the Fed delivered). A greater rate cut in theory would boost the economy, reduce the carry and attractiveness of the USD and ensure that US exports remained competitive.

So what happens next?

In the past, when one country accused another of being a currency manipulator, they would usually then enter into trade negotiations. This time round things have happened backwards so that doesn't leave many options. Treasury Secretary Steven Mnuchin is expected to go to the IMF but as the IMF had previously said China was not manipulating its currency, there could be little support down that avenue.

Potentially the US could start intervening directly although that might be the pot calling the kettle black. Otherwise they could adopt capital controls as China has done in the past or use monetary policy – although options there are looking limited.

Whatever happens next, the likelihood is that CNY will continue to weaken a bit further, and the probability of a full 25% tariff on everything is much higher than before. The risk to the global growth outlook has increased and could lead to higher inflation and huge volatility in foreign exchange markets that investors should be prepared to weather.

Portfolio positioning and performance[1]

July saw global markets post positive returns again with markets continuing to price in an optimistic outlook although this was tempered somewhat as Trump threatened China with more tariffs at the end of the month. We also saw the US Federal Reserve cut interest rates in July as expected although the accompanying press conference tempered expectations that this was the start of an extended cutting cycle stating that the cut was only a “mid-cycle” policy adjustment. Nevertheless global markets were positive over the month continuing their excellent run in 2019. In the US, we saw positive returns in July with the market (MSCI US Net total return local) up 1.4% and is up a strong 19.8% year to date. Other major markets were also positive in July with Europe (MSCI Europe Net total return local) and Japan (MSCI Japan Net total return local) up 0.7% and 0.9% respectively. Emerging markets (MSCI EM Index Net total return local) was an exception posting a negative return, down -1.0% in July. In local equity markets we saw the seventh positive month in a row with the S&P/ASX 200 Index delivering a 2.9% return for July with the index now up a very strong 23.2% year to date. Local based fixed income returns again saw positive returns in July with Australian government bonds up for the month after negative yield moves with the markets continuing to reprice the direction of interest rates moving forward. Our investments in Emerging markets bonds (SPDR Barclays Emerging Markets Local Bond ETF) was also positive for the month and is positive since the start of the year. Looking into our average positioning across the portfolio for the month of July, the Growth assets allocations have been approximately 70% for the State Street Multi-Asset Builder Fund. Our exposure preferences in July were again an overweight in global equities relative to fixed income. Performance wise, with positive results seen across growth assets, the funds delivered positive returns for the month of July.

[1] Bloomberg Finance, L.P. SSGA. As at 31 July 2019. Past performance is not a reliable indicator of future performance. This information should not be considered a recommendation to buy or sell any security or sector shown. It is not known whether the securities or sectors shown will be profitable in the future. Characteristics are as of the date indicated, subject to change, and should not be relied upon as current thereafter. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income.

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