

# Mitch on the Markets

## Chinese Trade Breakthrough Could Spark Market



By Mitch Zacks  
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Apple, Inc. stunned Wall Street last week when the company issued a rare cut to its revenue forecast for the upcoming quarter – the first time it has slashed expectations in more than 15 years. Markets don't like downward earnings revisions, and no exception was made for Apple. The stock fell some -10% in the following day's trading session.

In a statement, Apple essentially blamed most of its revenue revision on sluggish iPhone sales in "Greater China," which made many market watchers' heads spin. Many were already fearful of the impact of an ongoing trade war between China and the U.S., and Apple's news seemingly moved investors to posture for the worst-case scenario: no trade deal with China, increased probability of a global recession.<sup>1</sup>

To be fair, data across the board does suggest weakening (but not outright contractionary) economic fundamentals in China. Walking through these Chinese

economic data points one by one is not necessarily a reassuring exercise:

- Retail sales growth fell to its lowest level in 15 years at the end of last year
- Property sales remain in a rut, and the long-time housing bubble concern remains at the forefront
- Auto sales experienced their worst decline in nearly 7 years, putting China – the world's largest auto market – on pace for its first annual sales drop since 1990
- Chinese industrial companies experienced double-digit profit growth in 2017, but saw 2017 deliver negative earnings growth for the first time in 3 years
- China's manufacturing PMI readings actually contracted in December, which was the first time that's happened in two years.<sup>2</sup>

At face value, the data doesn't look great. But here's the kicker: *For all this slowing in economic data readings, economists still expect China's economy to grow 6.4% in the fourth quarter.* This growth rate marks a deceleration from Q3, but it's less alarming when you consider that Q3's growth rate was

6.5%. In my view, investors are too often erroneously conflating “slowing” growth with negative growth. They are not the same thing.<sup>3</sup>

My take from 30,000 feet is this: We’re seeing quite a bit of worst-case, negative growth scenarios being priced-into stocks, which to me opens the door for a positive surprise. And markets like positive surprises.

### **Eyeing Trade Talks**

One area where I think we could be poised for a positive surprise is in trade. U.S. trade representatives, led by Robert Lighthizer, arrived in Beijing last week to push strongly for negotiations. On the table are issues over Chinese tariffs, the forced transfer of technology from American businesses doing business in China, and Chinese state subsidies to companies which create unfair competition. Lighthizer’s primary focus is on these structural trade issues.

On the other hand, because of President Trump’s fixation on trade deficits, Treasury Secretary Steve Mnuchin has a different goal of getting concessions from China to purchase more American goods, such as agriculture products and use of U.S. banking, brokerage, and insurance products and services. Lighthizer and Mnuchin’s goals are not necessarily in conflict, but they’re also not necessarily a unified front. It will be interesting to see how China works both lanes of demands.<sup>4</sup>

To date, we’ve already seen some signs of small victories and Chinese concession. China recently removed punitive tariffs on US-made cars and auto parts, and they also upped purchases of American soybeans. Also, just last week, China agreed to approve the import of five new varieties of GMO (genetically modified) crop seeds, which the U.S. – the world’s largest producer of GMO crops – has been working to achieve for years.<sup>5</sup>

These small breakthroughs, along with encouraging rhetoric from both sides, have arguably offered the equity market a glimmer of hope that a breakthrough is near. At this stage, with economic and political pressure mounting on both sides of the table, there’s a strong case that both countries are eager to arrive at a deal. Time will tell, but we see a positive surprise on the horizon.

### **Bottom Line for Investors**

For Apple, the revenue issues may run a bit deeper than just a simple, linear connection between a slowing China and slowing sales. Global iPhone sales have been stagnant, and Apple’s share of the Chinese smartphone market has been troublingly falling – from 12.5% in 2015 down to 7.8% in Q3 2018. These company-specific revenue trends matter, but they are also not perfect indicators of the broader macroeconomic trends.<sup>6</sup>

What the market wants today, in my view, is some kind of deal and de-

escalation between the world's biggest and second biggest economies. If that 'fear' fades, which I think it will, the market should respond positively.

#### About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

- <sup>1</sup> The Wall Street Journal, January 2, 2019. [https://www.wsj.com/articles/apple-revises-guidance-sees-lower-revenue-in-fiscal-1st-quarter-11546465050?mod=hp\\_lead\\_pos1](https://www.wsj.com/articles/apple-revises-guidance-sees-lower-revenue-in-fiscal-1st-quarter-11546465050?mod=hp_lead_pos1)
- <sup>2</sup> The Wall Street Journal, January 2, 2019. <https://www.wsj.com/articles/chinas-economic-downturn-takes-the-shine-off-its-resilient-consumers-11546513717>
- <sup>3</sup> The Wall Street Journal, January 2, 2019. <https://www.wsj.com/articles/chinas-economic-downturn-takes-the-shine-off-its-resilient-consumers-11546513717>
- <sup>4</sup> The Wall Street Journal, January 8, 2019. <https://www.wsj.com/articles/u-s-china-negotiators-narrow-differences-on-trade-11546959523>
- <sup>5</sup> The Wall Street Journal, January 8, 2019. <https://www.wsj.com/articles/u-s-china-negotiators-narrow-differences-on-trade-11546959523>
- <sup>6</sup> The Wall Street Journal, January 2, 2019. [https://www.wsj.com/articles/apple-revises-guidance-sees-lower-revenue-in-fiscal-1st-quarter-11546465050?mod=hp\\_lead\\_pos1](https://www.wsj.com/articles/apple-revises-guidance-sees-lower-revenue-in-fiscal-1st-quarter-11546465050?mod=hp_lead_pos1)

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