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Markets are yet to fully discount growing political uncertainty

- **US and China tensions have escalated as Beijing passed a new law to increase control over Hong Kong ahead of its September legislative elections.**
- **The US is expected to report record unemployment on Friday, unhelpful to President Trump before the presidential elections in November.**
- **Investors take comfort in the fact that President Donald Trump has not called off the preliminary trade agreement with China.**
- **The trade agreement comes up for a review in October and China is unlikely to be able to meet all of the US demands.**
- **A series of upcoming politically-charged events and a weak US economy suggest risk asset valuations could soon be challenged.**
- **The FAB AAC remains underweight in global equities and overweight gold.**

President Donald Trump is tip-toeing along a fine line. On Friday, he suggested in a press conference that he was not going to abandon the preliminary trade agreement signed with China in January. However, he also said that the US was pulling out of the World Health Organization, claiming that China had too much influence on the institution.

The President said that the US would act forcefully against China's decision to impose stricter rules in Hong Kong to curb protests and press stories questioning Beijing's control over the territory. Still, did not detail what measures would be taken.

The press conference, however, had a much more local tone as neighbourhoods were set ablaze in Minnesota after an incident that triggered riots. The images on TV of Minnesota were reminiscent of the Los Angeles riots in 1992. And the political situation President Trump now faces is not too different from what President George H. Bush faced in 1992. Then, President Bush was attempting reelection amid a wave of dissatisfaction.

While he had successfully rebuffed Saddam Hussein's attack on Kuwait, the US was in a recession by the time the polls were open, one that some historians say may have played a part in the viciousness of the Los Angeles riots. This time, the economic downturn is even worse, and it is the poorest people in the US who are losing their jobs.

This week non-farm payrolls are expected to show that the lockdown eliminated 27 million jobs in the past two months, more than the US economy had created in the past decade. Unemployment is expected to rise to 19.6%, the highest since the Bureau of Labor Statistics began to publish the survey.

The US is expected to show its worst quarterly contraction since 1958 at the end of June

Some of these job losses will prove to be temporary. The last employment situation survey of the Bureau of Labor Statistics indicated that 18.1 million of the 23.1 million out of work identified themselves as being in a temporary layoff situation. If all these people come back from their furloughs, unemployment would drop back to about 4%. However, it is highly unlikely that these jobs will all return. In fact, James Bullard, the President of the St. Louis Fed, predicted that the unemployment rate is likely to end the year near 10%.

Blacks and Latinos, the poorest ethnicities, were hit hardest. The unemployment among African-Americans rose to 16.7% in April, from 5.8% in February. Overall, 51.2% of all blacks are not working. Employment data for May, due on Friday, is likely to show that this specific portion of the population has seen unemployment rise even further to an all-time high. It is also likely to show that many of these are unlikely to be re-hired.

Unfortunately for President Trump, the same issue also afflicts poorer white Americans, his main support base, many of whom work in services jobs as drivers and waiters, and who may not get their jobs back. Even those in steadier jobs such as those in manufacturing are losing their livelihood. All of this, plus the social unrest, coming in an election year is a bad omen for the prospects of reelection for President Trump. For the market, the key thing that matters is a potential tax increase if a Democrat is elected President in November, especially if the party takes control of the Senate, which would allow the new incumbent to adjust the tax laws.

Seeing that prospect, President Trump is shifting the attention back to his tough stance against China, one of his campaign promises in 2016 which he delivered. Hence, while the rhetoric the President expressed on Friday was mild enough to leave investors hopeful that there will be no further escalation of the US spat with China, there is every reason to believe that the tone is only going to get more heated.

Meanwhile, China faces a separate and tough political situation regarding Hong Kong. Xi Jinping, the Chairman of the Communist Party, faced a conundrum last year as he saw protests in Hong Kong increasingly defy Beijing's control. The protests died due to the social distancing measures required by the Covid-19 pandemic but they reemerged last week as the National People's Congress passed Article 23, a bill that will change Hong Kong's Basic Law to allow the prosecution and extradition of people who express animosity against China.

The new law will be tested this week with the anniversary of the Tiananmen Square protests. Every year, Hong Kongers hold vigils around this time to defy China and last year's protests strengthened around this time. Depending on how China reacts to these protests, the US could escalate its threats against the country.

From a political perspective, though, it seems like Beijing also felt the need to add some safeguards to its hold on the autonomous region ahead of key legislative elections in September. In the last Hong Kong polls, opposition lawmakers gained ground and China is probably trying to avoid another uncomfortable situation.

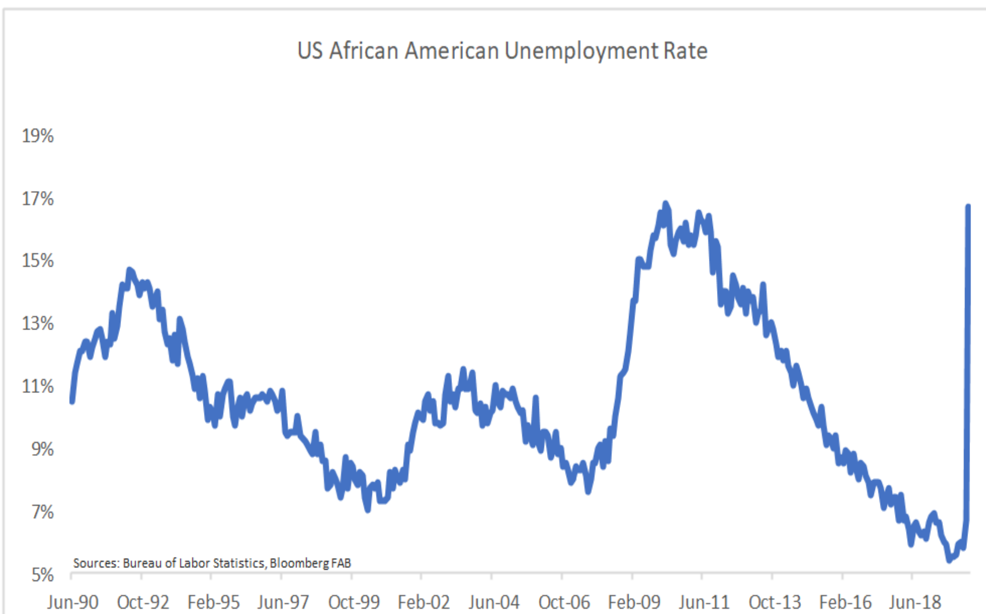
The new law and the impending elections, however, set the stage for a series of events that could unsettle markets. In fact, while risk assets are rallying right now on optimism about the restart after the great lockdown, there is much uncertainty and potential flashpoints ahead. Strictly from the point of view of the relationship between the US and China there are three major milestones ahead to watch.

As previously, stated, this week's potential rise in protests in Hong Kong is the first one. Then, the run-up to the September legislative elections in the city is another. In October, the US is set to review its preliminary trade agreement with China, signed in January, and given the economic situation of China and the state of the relationship between the two countries there is a significant probability that the agreement could be suspended. All of that culminates with the US Presidential election in November.

If these uncertainties were not enough, many risk assets are exhibiting valuations that are consistent with a high growth environment, exactly the opposite of what the world is going through right now.

Amid such a background, the FAB Asset Allocation Committee met on Thursday and decided to maintain its underweight position in equities and its overweight in high quality bonds and gold. While the members agreed that a wall of cash being thrown into the system by central banks and governments is likely to support risk asset prices, they also agreed that the depth of the economic slowdown and the growing political uncertainties are likely not fully priced in. The members therefore agreed to leave the underweight tactical position in global equities in place.

African Americans are the group facing the highest unemployment in the US



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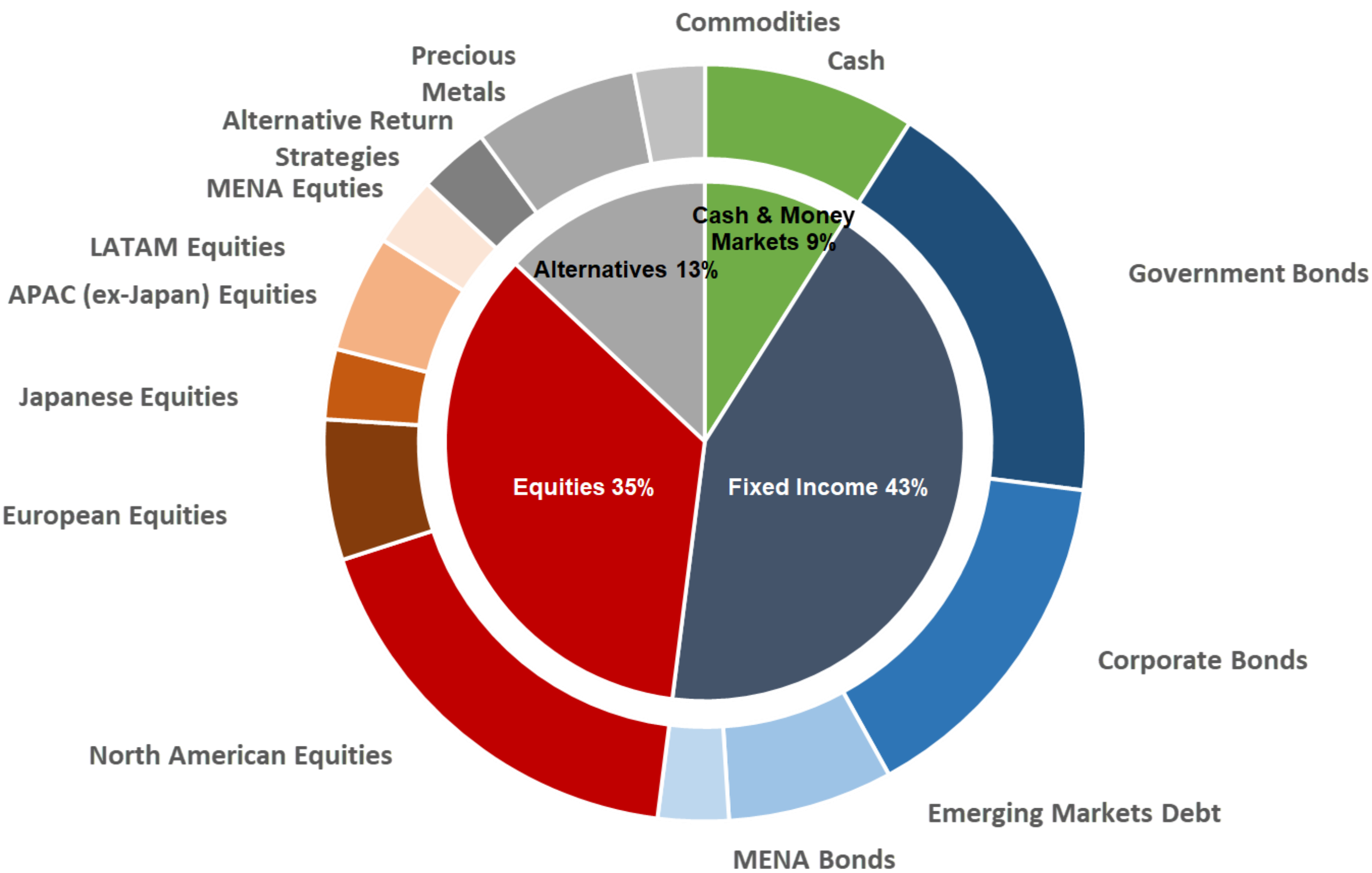
Current Tactical Asset Allocation



Asset Class	Positioning	Detail
Cash	Overweight	After taking profits on some equity positions.
Fixed Income	Overweight	Keeping slightly overweight focused on EM dollar debt and corporate investment grade bonds
Equities	Underweight	After taking profits on part of the US and European equity exposures
Alternatives	Underweight	However, overweight on precious metals specifically

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