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ASIA MACRO STRATEGY

China-US Trade Deal: Positive in the Near Term

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On October 11, China and the US have agreed to work towards a partial trade deal. US President Donald Trump called it 'Phase One', with subsequent phases to deal with broader and fundamental issues.

With a renewed trade truce and as negotiations are back on track, there may be a near-term positive momentum trade on equities in the run-up to Phase One. Beyond that, however, the road may be bumpy again as both parties touch on tough issues to address the remaining large gaps.

What Was Agreed and Missed Out

In a nutshell, what has agreed in this latest meeting was pretty minimal – China will step up purchase of US soybean and pork, while US will stay put on the existing 25% tariff on $250bn of Chinese imports.

However, the scheduled 15% tariff on $156bn of Chinese imports on 15 December remains on the table, and whether Huawei will get a waiver extension on the 19 November deadline remains a separate issue excluded from the trade talks.

Positive on Phase One

There are three main areas of discussion and Trump hopes to sign a partial trade deal with Chinese President Xi Jinping at the APEC meeting in mid-November. They include opening up China's financial services, protecting US firms' intellectual property right (IPR) in China and agreeing on a currency pact similar to that signed in the US-Mexico-Canada trade agreement.

In our view, these three issues are not tough for China to make sufficient concessions around. Financial services reform is well underway in China and allowing increased foreign participation into domestic financial sectors (futures trading, brokerages, asset management, insurance, etc.) pose limited threat to local players since foreign market shares are basically negligible.

From what we have learned, the Phase One discussion on IPR centred on copyright and trademark issues excluding the tougher and sensitive topics of cyber- and information security as well as cross-border data flows.

The currency pact discussion is essentially a return to what was already negotiated in February before trade talks broke down. It seems to be more about adopting a market-oriented exchange rate and increasing foreign exchange operational transparency. There is no demand for a renminbi (RMB) appreciation path mirroring Japan's Plaza Accord in 1985. Again, this seems something the PBOC should get around reasonably well given its increasingly open operation in daily fixing and the 'counter-cyclical' framework to signal RMB direction.

Bumpy Road in Phase Two and Beyond

Beyond Phase One, discussions on the core issues are more difficult to compromise.

Huge differences between Beijing and Washington caused the breakdown in trade talks in early May. They include China's demand for the rollback of exiting tariffs (especially non-tech items), US market access into China, forced technology transfers, China's state subsidies, Huawei and China's 5G development as well as a credible (but acceptable to China) enforcement system to check China's reform progress on any trade deal.

The looming issue is that US' isolation policy of China has branched out to broader areas which have bipartisan support.

Xinjiang's human right issue is now included in the US' backlisting of Chinese surveillance equipment producers and banning of some official travel visa. There are also reports on the US considering measures to constrain China's capital flows - delisting of American Depositary Receipts (ADRs) in US markets, removing Chinese assets in US pension funds' investment, and excluding Chinese assets in global indices.

There may be a possible US' passage of Hong Kong's Human Rights and Democracy Act and removal of the US-Hong Kong Policy Act (removing Hong Kong's special trading status as an autonomous region in China) which will play against China's economic development.

Market Outlook

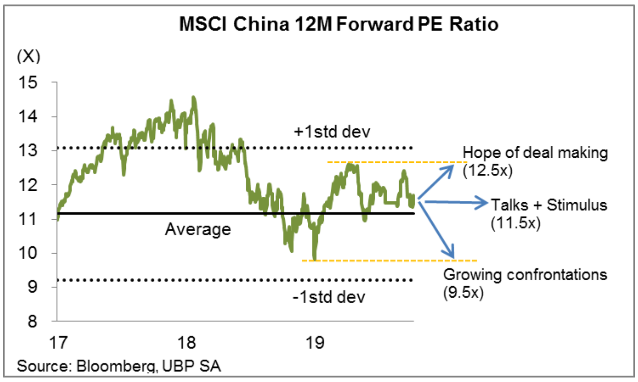
It looks like that Trump has learned the lesson of being more pragmatic and is taking a step-by-step approach to China rather than aiming to overthrow the Chinese system in one goal.

China has stayed tough and is playing the long game as Trump's re-election pressure builds. One best-case scenario (though still low probability), in our view, is that Trump may accept a half-measured 'deal' and rush to claim victory for his re-election campaigns.

The trade truce will provide some support to investors and consumer sentiments. However, it is insufficient to meaningfully revive corporate earnings, capital expenditure plans, consumer spending, and China's growth, given lingering uncertainty on those core trade and market access issues as well as the current structural slowdown of the Chinese economy.

That said, we are constructive in the near-term and see positive momentum for China and Hong Kong equities from here to the signing of Phase One.

The April/early May levels - where investors were optimistic about an interim trade deal – remain our upside reference for both markets. For any overshooting on the upside multiples and, in the absence of any breakthrough in negotiations in the phase two, caution is needed from the risk and reward perspectives.



Specifically, we expect the Hang Seng Index (HSI) to re-tests 28,500 to 29,500 level (forward price/earnings or P/E to 11.7x from current 10.7x) – assuming the drag from Hong Kong protests to stay constant. MSCI China will enjoy another an 8-10% upside as forward P/E trades up to 12.5x to 13.0x (from 11.7x) with continued rollout of policy stimulus.

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