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NO ONE HAS WON THE TRADE WAR...YET

Spotlight | Global Investment Committee

UNION BANCAIRE PRIVÉE

Key points

- *It is too early for either China or the United States to claim victory following the 'Phase 1' agreement announced last week.*
- *The ongoing 5G debate in Germany may hold the key for the US credibly to claim victory towards achieving strategic objectives in the continuing hegemonic struggle with China.*
- *In contrast, China must continue to accelerate its domestic financial sector reforms and development to solidify its standing vis-à-vis the United States.*
- *For investors, cyclical relief in the global economy appears well priced. However, a more meaningful local recovery in China should accelerate opportunities in its domestic transformation via technology, healthcare, insurance and on-shore A-share equities.*

The Phase 1 agreement between the US and China should provide cover for the Trump administration to begin an uneasy pause in the 18-month Sino-American trade conflict. However, even though the reported agreement looks like the deal the US had on the table in the early days of negotiations - American tariff concessions in exchange for the purchase of agricultural products - it is still too early for either China OR the United States to claim victory.

Germany now holds a key to an American 'victory'

With this agreement, US negotiators have achieved a tactical pause in the broader conflict, providing political cover for the American President as he enters his campaign for re-election.

Beyond this, the US Trade Representative, Robert Lighthizer asserts that the US has in fact made strategic progress with promises made by China on "...structural reforms...in the areas of intellectual property, technology transfer, agriculture, financial services, and currency and foreign exchange" as well as a dispute resolution system that enables a snap-back of the tariffs imposed.

While this may be the case, investors should look beyond the narrow scope of this agreement to make a better assessment of actual progress towards US strategic objectives over the past 18 months vis-a-vis China.

In particular, an intra-coalition debate is now underway pitting German Chancellor Angela Merkel against both ruling coalition CDU and SPD members on the banning of Huawei from German 5G networks in favour of European alternatives - Nokia and/or Ericsson. Undoubtedly at American urging, the previous bilateral US-China conflict over 5G has spilled over into a multilateral debate where Europe could tilt the developed market playing field for 5G away from China.

As a result, the combination of China's compliance on its 'soft' concessions in the 'phase 1' trade agreement plus progress towards containing the reach of China's 5G ambitions in the months ahead will allow investors and geopolitical observers to have a clearer view of US progress towards its strategic goals. A German and broader European tilt towards supporting European champions in the battle over 5G dominance would allow the US to claim a measure of 'victory' in this ongoing hegemonic struggle.

'Victory' is within China's reach...via accelerating financial system reforms

From China's perspective, it too has achieved tactical benefits, with tariff concessions providing political and economic relief at home.

Beyond this, China should recognise that the trade war has served as the impetus to accelerate a broader domestic economic reform agenda leaving strategic progress well within China's reach following this initial battle in the wider US-China contest.

As a result, unlike in mid-2018, China should not forgo the opportunity this détente affords it - to buy additional time in its continuing clash with the world's largest economy. Instead, China should press on with its efforts, begun in the face of an apparent US hardline stance in the spring of 2019, to accelerate the restructuring/reform of its domestic financial system. At the same time, it should seek to secure its access to global capital flows until its financial system can be put on a sounder footing.

Nearly seven months into this effort, the restructuring process has made progress but is not yet complete. Until it is, China will remain susceptible to America's ultimate yet unused weapon namely access to the US dollar.

Indeed, the window for continuing this effort remains open as US President Donald Trump is currently constrained by his domestic electoral calendar, at least until November, 2020. However, should the 45th American President extend his term through to 2024, the constraints that have prevented him from continuing the aggressive trade war pursued over the past 18 months could fade quickly once election results are confirmed.

So, for China to claim its measure of 'victory' in the still early days of what could turn out to be an extended struggle with its American adversary, it will need more durably to establish a functioning domestic financial system (with the help of American banks following the phase 1 agreement), deepen its domestic capital markets, and ultimately dramatically reduce its reliance on the US dollar to fund its economy.

Cyclical relief is well priced, capital spending recovery is not

For investors, cyclical relief from the phase 1 agreement trade agreement appears well priced given the fourth quarter rally in risk assets. Should trade uncertainty allow for a restarting of long-delayed capital spending moving through 2020, yet another economic headwind may fade and provide further impetus to the inflection in mini-cycles in the US as well as the Chinese economies. Such an outcome will provide global support from the world's two largest economic engines.

For China, while this will allow it to continue to press forward with domestic financial system reform, it also allows an acceleration of its domestic transformation. This provides investors an opportunity to align themselves with domestic policy makers via technology, healthcare, insurance, and onshore A-share equities to position for US-China détente in 2020.

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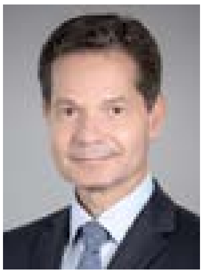

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