US-CHINA TRADE WAR: FROM CHECKERS TO CHESS

Spotlight

Global Investment Committee

UBP
UNION BANCAIRE PRIVÉE

Key points

- *The US announcement of 10% tariffs on US$200 billion in additional Chinese exports US was politically shrewd suggesting a shift from tit-for-tat retaliation to a now more strategic confrontation*
- *By imposing 10% tariffs through year-end rather than the expected 25% the Trump administration limits the impact on the US economy ahead of important mid-term elections in November*
- *For investors, the announcement suggests that further escalation of trade tensions is unlikely going into November. However, the risk of rising trade tensions in 2019 seems likely to have increased*
- *We expect Chinese equities to rebound following their summer sell-off. Risk-off trades including 10-year Treasuries should likewise reverse looking ahead.*

US Tariffs signal a shift to a more strategic confrontation

When US President Donald Trump began his trade broadsides in early-2018, many assumed this was a negotiating stance – with Trump simply seeking to extract 'deals' from trading partners to fulfil campaign promises made during his 2016 election run.

With progress towards reshaping the North American Free Trade Agreement (NAFTA), we believe the hardline US stance on trade with China signified by the structure of this latest move highlights a more strategic approach on trade.

The announcement of a second round of tariffs on imports from China earlier this week outlines both the political as well as the strategic objectives being pursued by the Trump administration.

By imposing tariffs of 10% rather than the widely predicted 25% on US$200 billion in Chinese goods bound for the US, the US has ostensibly provided US companies with an opportunity to find alternative suppliers to cushion the potential impact on the domestic economy.

Just as important, by choosing a lower tariff rate until the end of 2018, the US president has signalled a desire to limit the potential near-term impacts, pushing them to after the politically important November Congressional elections.

The move, as constructed, allows Republicans running in November to campaign on 'being tough on China' while minimising the risk of political fallout should consumer prices rise and/or jobs get affected by the policy.

However, looking into 2019, the tariffs on the US$200 billion announced earlier this week are set to rise to 25% at year-end. In addition, President Trump's has threatened to extend tariffs to the full complement of Chinese exports to the US (appx US$500 billion per annum) should China retaliate. The US has also signalled a willingness to re-engage and potential extend (in the absence of concessions from China on its industrial policies) this conflict into 2019 once the politically sensitive November period has passed.

Near-term calm should return to equity markets…

The lower than expected tariff rates initially imposed by the US on Chinese imports suggest relative calm should return to Chinese equity markets following a tumultuous summer. Indeed, the sell-off among China's domestically focused companies has reached a point where they are close to pricing a downturn similar to those seen in China in 2008-09 or 2015 (chart).

HK-listed China equities close to pricing a 'growth' recession

Sources: Bloomberg Finance L.P., UBP

Though investors will probably continue to see deteriorating economic data from China in the months ahead, this data better reflects the de-leveraging focus in place in China in early-2018 ahead of the flare-up in trade tensions over the summer.

Since then, however, China has begun easing monetary policy in particular which should see economic data as well as corporate earnings rebounding moving into 2019, providing some much-needed relief to investors.

Sectorally, this should benefit domestically focused names. We expect Chinese banks to benefit from policy easing with a cyclical rebound in ROE and earnings in early 2019. Over the longer term, however, we favour healthcare, education, IT/internet tech and domestic consumption-driven sectors. These areas will not only be better shielded from direct trade war risk but will also capture 'China's new economy' transformation.

In particular, China's healthcare sector has yet to reach its full potential with medical spending lagging that of developed countries. The sector is set to grow along with China's rising living standards and be particularly boosted by the government's policy of extending coverage and reimbursement of hospital and drug expenses.

The education sector is a likely beneficiary of urbanisation and consumption upgrades. Over the past two decades, discretionary spending on education has grown to 56% of wallet share while staples spending fell to 44% (from 75%). This secular trend will have further room to grow as incomes rise and is set to benefit education services providers.

On technology, we expect that China will become more determined to forge ahead with its home-grown technological development especially if the trade war lingers. Official interest in promoting national winners in the tech segment should particularly favour AI and FinTech developers as part of the national commitment to accelerate the sector's secular growth.

…but watch out for a return of rising US bond yields

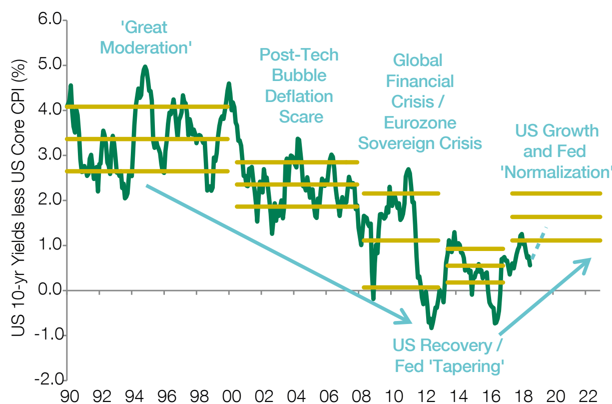
As worries have built surrounding growing trade tensions, investors have sought refuge in 'risk-off' havens, pushing US 10-year Treasury yields lower. We believe this expected pause in trade tensions between the US and China should allow the underlying fundamental economic pressures to reassert themselves.

Indeed, despite the fact that wage inflation in the US has accelerated to the fastest rate since 2008-09 and core inflation has similarly reached 2.4%, US 10-year yields have remained range bound since February.

Should the application of tariffs expand in 2019, the prospect of inflation remaining elevated should grow and, in our view, underpins the continued long-cycle reversal in the downward trend in US bond yields begun with the Federal Reserve's 'tapering' of Quantitative Easing policy back in 2013.

We continue to believe that evolving trade tensions between the US and China combined with a normalisation of US monetary policy should push yields towards 3.5%, or inflation-adjusted yields closer to our target of 1-1.5% moving into year-end.

Normalisation of long-term US interest rates should resume



Sources: Federal Reserve Bank of St. Louis and UBP

In the China fixed income space, China's USD high yield bonds offer better relative value in the aftermath of the sell-off in 1H/2018. The sector should perform well as continued monetary easing reduces immediate credit default concerns.

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September 2018

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