THE DRIVE YOU DEMAND

THE END OF THE US-CHINA TRADE WAR...

Spotlight

August 2019 | Global Investment Committee

UNION BANCAIRE PRIVÉE

Key points

- *The 'trade war' between the US and China is likely to be nearing an end as both the US and China exhaust available imports on which they can levy new tariffs.*
- *Instead, investors should expect the end of the 'trade war' to reveal more clearly the broader US-China competition for global dominance where it may spread to other, more problematic landscapes.*
- *Indeed, China's initial retaliatory move to weaken its currency appears to be only a 'warning shot' as they fall short of fully offsetting the August 1 US tariffs for Chinese exporters.*
- *The August 19th deadline for the US to roll over waivers on its ban on American companies supplying Huawei Technologies looms as a potential trigger to the next stage of the hegemonic struggle.*
- *Despite the 6-7% declines in China equity indices in August, valuations still fall short of pricing the economic risks ahead for the Chinese economy as well as the increased geopolitical risk that the new stage of the US-China struggle portends.*
- *We remain cautiously positioned in portfolios having rotated China equity holdings towards 'asymmetric' exposure in early July.*

The trade war ends and a hegemonic struggle begins

US President Donald Trump's August 1 announcement that the US would impose 10% tariffs on the remaining US$300 billion in US imports of Chinese goods signals that the 'trade war' that began in earnest in early-2018 is nearing its final stage.

The August 1 tariffs will leave substantially all US imports of Chinese goods subject to tariffs leaving limited capability for the US to escalate meaningfully using the tariff tools applied to date. Indeed, in retaliation for American tariffs, China has already levied tariffs on substantially all imports from the United States.

With both nations having substantially exhausted the opportunity set of goods subject to increased tariffs, the trade/tariff-phase of a broader struggle for dominance in the world appears virtually complete. However, this does not suggest that tensions are set to ease meaningfully between the two largest economies in the world.

Rather, it indicates that the conflict which has to date manifested itself on the tariff front will now shift to increasingly non-tariff related, though still dangerous battlefields in the months ahead should both parties seek to escalate the conflict further.

Currency measures now actively in play

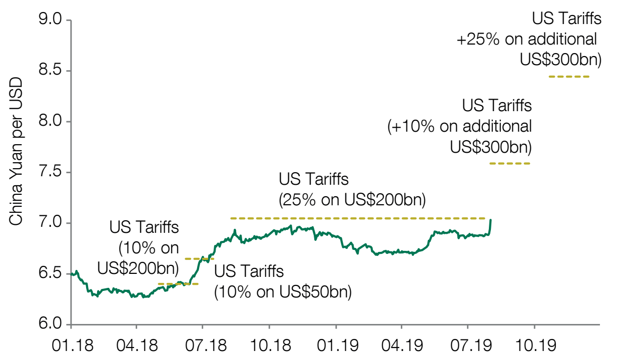
While the US retains modest capability to raise tariffs further, China must instead turn increasingly to non-trade and non-tariff tools. Indeed, China's initial response to the Trump announcement encompassed both measures – engineering a weakening of the Chinese yuan as well as ending the purchase of US agricultural products by Chinese firms.

Though China rejects US claims that it is 'manipulating' its currency, the US dollar axis of yuan exchange rates has been bearing the brunt of the weakening. Whereas the yuan has weakened by nearly 12% against the US dollar since the first US tariffs were announced in April, 2018, the yuan exchange rate versus the euro is only 1% weaker.

Indeed, not coincidently, the yuan exchange rate 'adjustments' have been roughly consistent with what is required to offset the impact on Chinese exporters were they to fully absorb the additional tariff costs via price adjustments.

Despite the weakening to beyond the politically sensitive seven yuan per US dollar following the August 1 tariff announcement, the Chinese currency remains well short of the 7.50 per US dollar that would fully offset the announced tariffs. This suggests that the recent move in the currency is but a warning shot from China, looking to demonstrate the potential consequences, should the full tariffs be implemented (See chart).

China FX policy – fully offsetting tariff impacts



*dotted lines represent USDCNY FX rates that would largely offset US tariffs announced

Sources: Bloomberg Finance L.P. and UBP

So, with retaliatory tariff tools no longer available, currency weakness represents both an expedient method to respond to the current and future US tariff escalations as well as a way to cushion its impact upon Chinese exporters. With limited risk of imported inflation consequences and having tightened capital controls significantly in recent years following China's currency 2015 devaluation, the currency is a credible policy tool for mainland policymakers.

'National security' measures on the horizon

While the US may stay focused on increasing tariffs from their current 10% (on the remaining US$300 billion in Chinese exports to the US) to 25% as imposed on China's original US$200 billion in shipments to the US, on August 19, the Americans must choose whether to extend the waivers (granted in May, 2019) to the US Presidential Executive Order that, in effect, restricts American companies from transacting with Chinese telecom and technology firms and in particular, telecom operator, Huawei Technologies.

While China, via Huawei, leads the world in the rollout of 5G technologies, it remains heavily reliant on non-Chinese component suppliers (See table). The US restrictions therefore present a clear and present danger to China's 5G dominance.

China depends on global technology components…

	US	OTHER	CHINA
COMPONENTS			
CPU/GPU	Intel; Nvidia; AMD	ARM	
Mobile SoC	Apple; Qualcomm	ARM; Samsung	HiSilicon
RF Semi	Skyworks; Qorvo; Avago	Murarta	
Analog Semi	Texas Inst; Analog Devices; Maxim	SST Micro; Infineon, NXP	
Memory/Storage	Micron, Western Digital; Seagate	Samsung; Hynix; Toshiba	YMTC / Jinhua
Foundry		Taiwan Semi; Samsung; United Micro	SMIC
Semi Capital Goods	Appleied Materials; Lam Res; KLA	ASML; Tokyo Electron	
EDA tools	Cadence; Synopsys	Mentor (Siemens)	
Display		Samsung; LG; JDI	BOE

*Red shading indicates key gaps in local value chains
Source: Fidelity International

Should the US restrictions come into force, China has conveniently used the period since the May, 2019 tariff hike to outline its own potential retaliatory toolkit.

China has prepared a list of 'unreliable' entities which 'boycott or cut off supplies to Chinese companies for non-commercial purposes and cause serious damage to Chinese companies'. This is comparable to a list compiled by the US severely restricting firms' ability to do business in the US.

Similarly, press reports suggest that China has prepared draft cybersecurity legislation that would require a national security assessment associated with the risk of using foreign supplied technology in China, likely targeting US suppliers and seeking to force companies to substitute in favour of domestic Chinese producers (See table).

…but it can be independent in software, devices, and infrastructure

	US	OTHER	CHINA
SOFTWARE			
E-Commerce	Google; Facebook; Amazon; Paypal, etc.		Alibaba; Tencent; etc.
Search	Google		Baidu
Gaming	EA; Activision; Microsoft		Netease
Enterprise Applications	Oracle; Microsoft, Salesforce; Adobe		Kingdee
Infrastructure Software	VMWare; Microsoft		
DEVICES			
Smartphone/ Tablets	Apple; Qualcomm	Samsung	Huawei; Xiomi; Oppo/Vivo
PCs	HP; Dell		Lenovo
INFRASTRUCTURE			
Servers	HP; Dell; Hyperscle		Lenovo
Storage	Dell; NetApp; HPE		
Switching/Routing	Cisco; Juniper; Arista		Huawei; H3C
Base Stations		Nokia; Ericsson; Samsung	Huawei; ZTE

*Red shading indicates key gaps in local value chains
Source: Fidelity International

Another potential 'national security' tool in China's retaliatory arsenal may be re-starting its purchases of Iranian crude oil (ended with the re-instatement of US sanctions on Iran). Such a move would potentially escalate and broaden the scope of the US–China conflict meaningfully, given the on-going US–Iran confrontation, and risk direct sanctions by the US against Chinese state-owned companies.

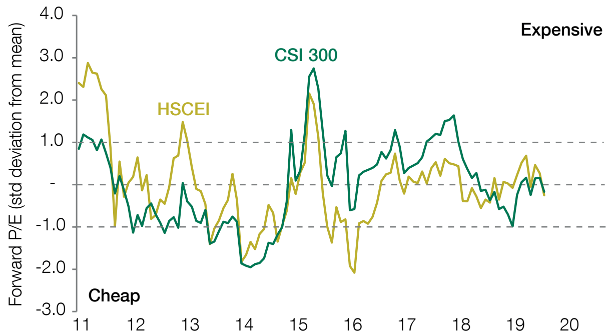
Should the US refrain from moves against Huawei, China may similarly avoid a pivot to 'national security' measures and instead choose more limited retaliatory tools, such as limiting exports of rare earth metals. While these metals are a critical input to the technology supply chain, Japan demonstrated in 2010 (when China cut off supply in a dispute) that recycling and stockpiling can be significant interim measures until mine and processing supply (shutdown due to environmental concerns) can come back on stream.

Staying asymmetric until valuations re-price cyclical risk

In China, we used the early part of summer to begin rotating positions towards asymmetric positioning – allowing portfolios to participate in upside potential in markets while establishing protection against downside risks – as geopolitical risks remained concerning.

Indeed, even with the 6-7% declines, China equities still sit only modestly below 10-year average valuations despite the risks to earnings that have emerged with the more uncertain geopolitical backdrop.

China Equities: Valuations not pricing cyclical risks



Sources: Bloomberg Finance L.P. and UBP

Though the mainland has the capability to deploy significant stimulus to drive growth should it choose, policymakers to date have instead sought to use targeted stimulus strategies to stabilise growth in the face of trade headwinds while concurrently restructuring and reforming segments of the economy as seen in the banking system this summer.

Therefore without a re-pricing of valuations to better reflect the uncertain growth and geopolitical outlooks, we believe our 'asymmetric' approach, via select long-short China-focused hedge funds as well as partially capital protected structured exposure allows us to participate should China choose to deploy more significant stimulus than expected while limiting exposure should growth and/or geopolitical concerns crystallise in the months ahead.

From a stock-selection perspective for China-focused investors, we see relative 'safe harbours' among education leaders, healthcare, and telecommunications companies in China.

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