# Investment Note: Sino-US trade tensions enter a new phase

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After months of apparent progress in bilateral trade talks, the US unexpectedly raised tariffs on US$200 billion of Chinese imports to 25%, effective 10 May 2019, and added a threat to place tariffs on all Chinese imports[1]. The Chinese government responded by announcing 25% tariffs on US$60 billion of US imports from 1 June 2019[2]. The escalation in tensions between the world's two biggest economies has left investors wondering what will come next. In this investment note, Ronald Chan, Chief Investment Officer (CIO) of Asian Equities (ex-Japan), lays out a basic roadmap to help investors understand the possible scenarios that could lead to a resolution of the current dispute.

## Escalating trade tensions

After 11 rounds of bilateral trade talks, the US and China have (re)entered a phase of increasing tensions, shattering the calm that settled over the market when both sides agree to refrain from increasing tariffs and continue negotiation in December 2018. However, developments are still in line with our base case; we believe there will be heightened near-term volatility during the Sino-US trade negotiations, but both sides will ultimately reach an agreement and avert a global trade war.

Having acknowledged the increase in trade tensions, we believe there are several constraints on the US and China further upping the ante in the trade conflict. Importantly, additional tariffs on Chinese goods may hurt the US economy, while China's economy is arguably in a better position than it was a year ago.

- **US Position:** Although the US still operates in a benign inflationary environment, we believe that its position of economic strength has moderated since tariffs were first levied on Chinese goods in June 2018 – GDP growth was 4.2% in the second quarter of 2018 compared with 3.2% in the first quarter of 2019[3]. The next set of tariffs, due to be placed on a US$300 billion of imports, could impact consumers and retailers more than the previous two tranches. We are likely to see an increase in the prices of consumer goods, lower profits for retailers, and a decrease in disposable income.

- **China Position:** By contrast, China arguably is in a relatively advantageous position than it was last year. The economy is holding up well with a GDP growth rate of 6.4% in the first three months of 2019 – the equivalent number for the second quarter of 2018 was only slightly higher at 6.7%[4], and the government has chosen targeted monetary and fiscal

[1] Source: Office of the United States Trade Representative, 10 May 2019.
[2] Source: Ministry of Finance of the People's Republic of China, 13 May 2019.
[3] Source: US Bureau of Economic Analysis, as of 26 April 2019. Real gross domestic product (GDP) increased 3.2 % in the first quarter of 2019, compared with 4.2, 3.4% and 2.2% in the second, third and fourth quarter of 2018 respectively. Excluding food and energy, the PCE price index increased 1.6% in March 2019, compared with 2.0% in June, September and December 2018 respectively.
[4] Source: National Bureau of Statistics of China, as of 14 May 2019. GDP increased by 6.4% in the first quarter of 2019, compared with 6.7% and 6.5% and 6.4% in the second, third and fourth quarter of 2018 respectively. The consumer price index increased by 2.5% in April 2019, compared with 1.9%, 2.5% and 1.9% in June and September and December 2018 respectively.

stimulus to bolster economic growth, with further policy measures that can be implemented to help ease any negative impact on the overall economy. These would mainly focus on the consumer. While China's economy would inevitably be hurt by further tariffs, we believe the Chinese government is acutely aware of the challenges ahead.

## Prospects for a Sino-US trade deal

As trade tensions have entered new territory, we believe it is important for investors to understand the implications and potential scenarios for an agreement.

- The first scenario is a trade deal between the US and China, removing the additional tariffs that have been in place since 2018. This is the best outcome for markets, as it would signal a symbolic end to trade tensions and a commitment by both sides to seek a long-term solution. Currently, we believe this is the lowest-probability scenario in the near term.

- The second scenario is a trade deal with existing tariffs (include the latest round imposed in 2019) remaining in place. We consider this to be the most probable outcome for a bilateral trade agreement moving forward. Even though this would provide the framework for an agreement, it would still confirm our base-case of continued friction between the two countries.

- The third scenario is no trade deal with existing tariffs on both sides remaining in place.

- Finally, the fourth scenario is either more tariffs or a breakdown in trade talks. Any further escalation between the two countries, including additional tariffs on imports, would be in this scenario.

## Conclusion

While investors are understandably jittery over the latest escalation in the Sino-US trade dispute and the prospect of a global trade war, we believe our initial base-case scenario is still the most likely outcome; near-term volatility, leading ultimately to an agreement. Tariffs will certainly hurt China, but its government does have room to introduce further supportive policies that may offset the negative economic impact of a protracted trade dispute. It could, for example, target domestic drivers such as consumption, which contributed more than 70% to overall GDP growth in 2018[5]. Equally, the US position of strength has moderated, and the next round of tariffs is likely to hurt domestic consumers and retailers more deeply than the last. Though a deal that removes tariffs is currently the least probable outcome, we believe an agreement that preserves current tariffs and provides a framework for a future pact is more likely than an all-out trade war.

[5] Source: National Bureau of Statistics of China, as of December 2018.

## Disclaimer