Investment Insights

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Escalating US-China Trade Tensions: Premature to Call This a Trade War

Summary

- The US is not in a trade war with China, at least not yet
- Tariffs won't have huge impact on the economy
- No winners in trade wars, history reveals
- Base case scenario: full-scale trade war likely to be averted

The US is not in a trade war with China, at least not yet

A US-China trade row has erupted as US President Donald Trump seeks to slap tariffs on China imports. Trying to make good on his campaign promise to tackle the yawning trade deficit with China, his tough stance has flamed tensions with Beijing and triggered a round of tit-for-tat retaliatory measures that have unsettled financial markets.

The rhetoric between Washington and Beijing has flown thick and fast, after Trump fired the first salvo by imposing tariffs on steel and aluminum imports from China in March. Here's a quick recap of what has happened.

Inside

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Quick recap of the trade tension between the US and China

Mar 8
Trump signs order to impose tariffs of 25% and 10% on global steel and aluminum imports respectively

Mar 22/23
Trump announces punitive tariffs on US$50b worth of Chinese goods, citing intellectual property violations.
US tariffs on steel and aluminum imports, including those from China, take effect

Mar 23
Beijing retaliates by threatening tariffs of on 128 US products worth US$3b

Apr 2
Beijing implements a 15% duty on 120 US products including fruits, nuts and wine, and a 25% levy on 8 others, including pork

Apr 3
Following the 22 Mar order, the US proposes a 25% tax on 1,300 Chinese goods worth US$50b hitting the aerospace, technology, machinery and medical sectors

Apr 4
In response, Beijing warns of tariffs on another US$50b of US goods, including key US exports such as aircraft, soybeans, chemicals and automobiles

Apr 5
Citing China's "unfair" retaliation, Trump weighs tariffs on another US$100b worth of Chinese goods

Apr 6
Beijing hints at countermeasures and vows to "fight at any cost" if new US tariffs are imposed

The war of words between Washington and Beijing has played out in full force in the media. However, the bluster and threat of tariffs are unlikely to escalate into a full-scale trade war – at least, not yet. As Trump tweeted on 4 April: "The US is not in a trade war with China".

It is likely that the US and China will continue to negotiate in order to overcome the trade frictions and avoid a full-blown trade war.

The impacts on the economy could be modest

What's at stake in the US-China trade dispute and how would further tariffs impact both economies?

Negligible impact from tariffs that have been implemented

On 23 March, the Trump administration implemented stiff levies on global steel (25%) and aluminum (15%) imports after announcing plans to do so earlier in the month. Countries that are exempted from these tariffs – Canada, Brazil, Mexico, Argentina, the European Union, South Korea and Australia – make up half of all US steel imports. Although China is the world's top producer of steel and aluminum, total exports of these make up less than 0.5% of its GDP and its share of exports to the US is comparatively small.

In April, China struck back by imposing retaliatory tariffs on US$3 billion of US goods.

Overall, the tariffs are hardly going to make a dent in the US$19 trillion US economy or China's US$12 trillion economy. Considering the combined size of the US and Chinese economies, the impact from the implementation of those tariffs is minimal.

Modest impact if further tariffs are imposed

The US has threatened to levy tariffs of 25% on an additional US$50 billion of Chinese products, targeting goods such as robots, flat screen TVs and high-speed trains. China has announced that it would match this figure, which would hit soybean and chemical imports, amongst others, from the US.

Two-way trade between both countries hit almost US$700 billion last year. Should both parties go through with their tariff threats, the additional US$25 billion in tax on the reciprocal trade relationship would lead to only a relatively modest impact on both economies.

China buffered from tariffs by its domestic-driven economy

While China sells more goods to US than vice versa, China should be able to absorb the potential impact from the implementation of tariffs due to its strong domestic consumption. China is becoming less dependent on exports to power its economy as it shifts towards domestic-driven growth. Its transition towards a consumer-oriented economy will therefore cushion it from the potential impact of US tariffs on its exports.

No winners in trade wars, history reveals

If history is any precedent, then the US' last trade war during the Great Depression of the 1930s is a sober reminder that there are no winners from trade protectionism.

Passed in 1930, the US' Smoot Hawley Act was aimed at protecting US farmers by raising tariffs from an average of 40% to 48% on 900 lines of agricultural and manufactured goods. The US' drastic protectionist stance sparked off a chain of retaliatory actions from other nations, such as Canada, which imposed stiff tariffs on US exports.

The resultant trade war led to collapsed trade globally and sunk the US economy deeper into its nadir. Imports tumbled 40%, jobs were lost and financial institutions closed down, as the economy hit rock-bottom during the Great Depression.

The lesson from the past is crystal clear: trade protectionism is bad for the global economy. Can the US learn from its past mistakes? Only time will tell.

Our View: full-scale trade war likely to be averted

So far, the US and China have been engaged in what some media reports have called a "phoney" trade war. Looking at the bigger picture, the US tariffs on steel and aluminum imports, as well as China's retaliatory tariffs on US$3 billion worth of US products, pale in comparison to the massive size of both economies.

Whether the threats of further tariffs will eventually be carried out hinges upon the results of further trade negotiations between Washington and Beijing. An ideal solution is seen as one where the proposals for additional tariffs are called off, or where only minimal tariffs are imposed. The road to a deal may be bumpy at this stage, but in all likelihood, we can be cautiously optimistic of successful negotiations.

So far, both China and the US seemed to have made overtures to lower simmering trade tensions before they reach boiling point.

At the Boao Forum in April, days after the tit-for-tat exchange between the US and China on tariffs, Chinese President Xi Jinping seemed to strike a reconciliatory tone in his keynote speech. He highlighted China's commitment to lower import tariffs on certain products by the end of the year and to give greater market access to foreign investors. He also pledged to strengthen protection of intellectual property rights – which has been a bone of contention with Trump. China's central bank governor Yi Gang has also mentioned that China will not devalue the yuan to boost exports.

Trump may want to position himself as the champion of US workers, but a full-blown trade war heading into mid-term US elections in November is not in his best interests, especially when it could put his supporter base on shaky ground.

While there is still a long runway ahead, ultimately, we believe the US and China are likely to seal a deal to prevent a trade crisis from blowing up. Therefore, our base case scenario from all this is that a full-blown trade war is likely to be averted.

Market Outlook and Strategies ▶▶

Macro

Global Growth	**Global economic activities continue to firm up**. Global growth forecast for 2018 is revised up to 3.9% from 3.7%. EMs lead the improvement in growth, while the outlooks for DMs remain mostly stable.
Monetary Policy	Central banks continue to normalise monetary policy. **Fed leads with rate hikes and BSR**. ECB has started tapering. BOJ is likely to remain accommodative, but its stance could shift.
Inflation & Rates	**Inflationary pressure stay subdued but is expected to trend higher**. Forecast the Fed to hike rates **3 times in 2018**, with one done in March meeting, and **10-year Treasury yield to reach 3.2% by Q418**.

Risks

Inflation Overshoot	The US 10-year Treasury yield hit 3% for the first time since 2014. **The tight labour markets and stable commodity prices** could feed further into wage growth and inflation. Spikes in yields could hurt risk assets.
China Hard Landing	Chinese government is likely to continue to strike a balance between stability and deleveraging. **But overly aggressive policies could raise default rates and hard landing concerns**.
Geopolitical & Political	**Tensions spiked between the US and China** as Trump announced 25% tariff on the imports from China. Our base case is no full-on trade war, but **headline news could cause higher volatility**.

Strategies

Tactical Strategy		Key Proposition	Key Risks
Reflation and rotation in DM	**US financials equities**	• Attractive discount versus broad US market and benefits from a reflationary environment.	• If the Fed turns out to be more dovish and hike rates less than market expected, performances of could be hurt.
	European equities	• Attractive discount versus US and tailwinds from improving economic activities.	• Strong Euro could negatively impact exporters, but the impacts are mitigated by improving domestic demand. Some political risks remain.
	Japanese equities	• Attractive discount versus other DM equities and local sentiments have recovered. Potential policy tailwinds under Abe's rule.	• Political risks are higher as Cabinet approval rate for Abe has declined. Our base case is that Abe is able to secure as the LDP president.
Tap into EM growth	**EM equities** Incl. EM allocation and Asian equities	• Offer more appealing valuations and potential tailwind from structural reforms. Stable commodity prices could provide support to earnings.	• Unexpected USD strength could be headwind, but we expect USD to stay range-bound.
	EMD LCY	• Higher yields versus other fixed income assets and benefit from improving fundamentals in EMs.	• Unexpected USD strength could be headwind, but we expect USD to stay range-bound.
Structural opportunities	**Quality equities**	• Tend to experience less drawdowns during sell-offs and outperform broad equity markets over longer investment cycles.	• Hefty valuations could increase probability of short-term corrections. However, global recession risks remain low.
	Global healthcare equities	• Attractive valuations and earnings likely to improve on higher innovative drug approvals and strong M&A activities.	• Policy uncertainties could continue to weigh on sentiments, but meaningful structural reform of drug pricing is unlikely in the foreseeable future.
Yield Enhancer	**Short duration high yield bonds**	• Lower sensitivity to interest rates and attractive yields versus Treasuries.	• Default risks could rise if economic conditions worsen, but current outlook remains stable.

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