UOB Investment Insights

Monthly Market Views

June 2019

What US-China trade tensions mean for the rest of Asia

1-minute digest

- Amid the relentless back-and-forth of US-China trade tensions, President Trump's administration increased tariffs on May 10 from 10% to 25% on US$200 billion of Chinese imports and threatened to impose 25% tariffs on the rest of China's exports to the US – worth another US$325 billion. The response from President Xi's camp was to retaliate on US$60 billion of US goods as of June 1.
- This breakdown in trade talks is a fresh blow to global growth forecasts, although China and many of its Asian neighbours face the biggest risks.
- Meanwhile, since both sides have indicated a willingness to continue the talks, we maintain our base-case scenario that the US and China will reach a resolution to their trade to-and-fro in 2H 2019.
- Against this backdrop, investors can adopt one of several strategies. Depending on risk appetite, these range from taking a higher allocation to investment-grade bonds to protect the downside, to looking to capitalise on current market volatility through buying on dips, to staying invested in China given it is one of our megatrend themes.

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Where are we now in US-China trade tensions?

Although more media attention has been given to this topic than most others in recent years, we believe it is important for investors to understand the potential implications of the current situation.

- While US officials contend that China has backed down from earlier commitments, baulking at the prospect of changing domestic laws to solidify required reforms, the sentiment from China is the US reneged on a pledge not to further raise tariffs while talks continued.

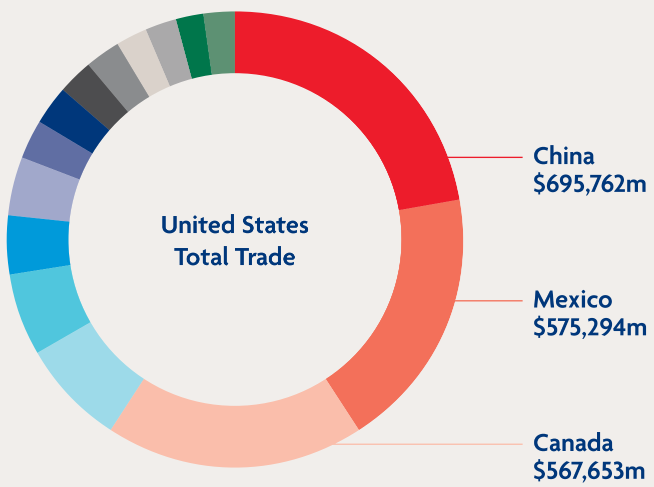
- These gulfs in perspective are also apparent from the differences in expectations over any structural change to the involvement of the state in China's economy. This can be seen from what is believed – by the US – to be policy in Beijing that forces foreign companies to hand over technology. (even though China denies this), whereas the protection of intellectual property is a prime US focus.

- Technology has become an increasingly important bargaining tool within the broader trade dispute since late May when the US administration said any American firm that wants to do business with Chinese telecoms giant Huawei, must now have a license. Although some waivers have since been given to allow Huawei to continue purchasing limited goods from US companies for maintenance purposes, it seems the trade-related dispute net is wider than ever before.

- The G20 summit in Osaka, Japan, on 28-29 June provides an opportunity for Xi and Trump to meet face-to-face. Given the possibility of there being a positive outcome, which would ease the trade tension, this meeting will be closely watched.

Figure 1

China is the biggest trading partner for the US, followed by Mexico and Canada



Trading partner	Total trade ($M)
Japan	226,531.70
Germany	183,227.30
South Korea	133,272.40
United Kingdom	126,216.20
India	87,410.50
France	86,364.90
Ireland	75,951.50
Italy	73,576.40
Netherlands	70,662.50
Singapore	69,376.20
Switzerland	62,442.20
Brazil	62,268.50

Source: Bloomberg, as of end-2018

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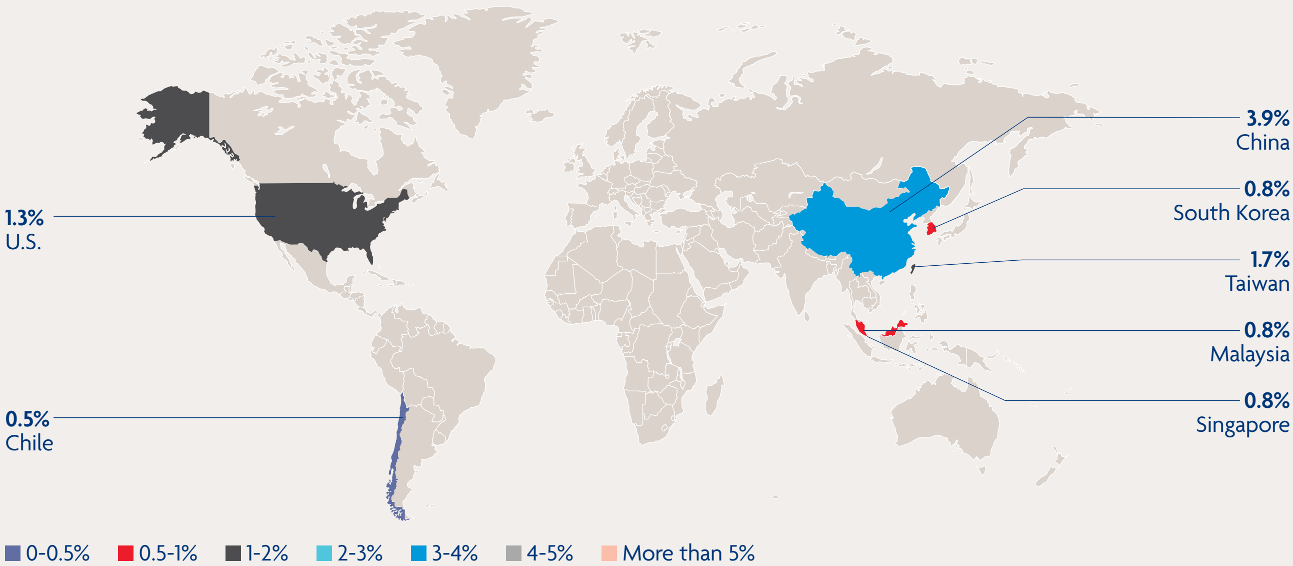
What does a full-scale trade war mean for us all?

There is little doubt that a breakdown in US-China trade talks will hamper global growth. But in our view, China and its Asian neighbours will suffer most in this scenario.

Figure 2

GDP exposed to US-China trade flows



Note: Share of GDP Embedded in China-U.S. Trade Flows (2015)
Sources: OECD TiVA, Bloomberg Economics

For China

Based on Bloomberg Economics' calculations, tariffs at their current levels create a 0.5% drag on China's GDP growth. This rises to 0.9% if Trump follows through on threats to raise tariffs on the US$200 billion in Chinese goods to 25%, and jumps to 1.5% if tariffs get imposed on all Chinese exports to the US.

Figure 3

Forecasts for China GDP growth given trade tension

	1Q 2019	2Q 2019	3Q 2019	4Q 2019	2018	2019	2020
Forecast in April	**6.4**	6.3	6.3	6.4	**6.6**	6.4	6.2
Scenarios							
Higher Tariffs, Short Duration	**6.4**	6.2	6.2	6.4	**6.6**	6.3	6.2
Higher Tariffs, Long Duration	**6.4**	6.2	6.0	5.8	**6.6**	6.1	5.8
Total Tariffs, Short Duration	**6.4**	6.2	6.1	6.3	**6.6**	6.3	6.2
Total Tariffs, Long Duration	**6.4**	6.2	5.9	5.6	**6.6**	6.0	5.4

Actual / Forecast

Sources: Bloomberg Economics, forecasts as of 17 May 2019

Figure 4

Possible scenarios for the trade tensions

Scenarios for 2019		Probability	Implications for FX and China's monetary policy
Best Case	The US and China continue negotiations, leading to a trade truce before all additional tariffs imposed by both countries are removed.	**10%**	• USD/CNY pulls back to 6.50. • One or no further RRR cuts for the rest of the year.
Base Case	The US and China continue negotiations after the US raised tariffs on US$200bn of goods from 10% to 25%; additional tariff measures may or may not materialise along the way. There is a resolution in 2H 2019, but this may not totally remove existing additional tariffs.	**60%**	• USD/CNY drifts higher to 6.90. • Two more broad-based RRR cuts this year
Worst Case	Both parties are unable to reach a satisfactory resolution this year and the US follows through on its threat to impose tariffs of 25% on an additional US$325bn of Chinese exports to the US which are not currently subject to additional tariffs. This means there are tariffs for all China's exports to the US (US$540bn in 2018). Retaliations from China may involve restrictions on technology transfer and other measures.	**30%**	• USD/CNY threatens to break above 7.00. • Two more broad-based RRR cuts this year and at least one cut to the 1-year lending rate.

Sources: UOB Global Economics & Markets Research

For the US

The impact is less than for China. Based on estimates from the IMF, an escalation in tariffs would create a 0.2% drag on US GDP.

For East Asia markets

Given the closely-integrated Asian electronics supply chain, a trade war would cause problems for this part of the region, in particular for Taiwan and South Korea.

For Singapore

With China as the city-state's top trading partner, we expect a slowdown in Chinese growth to have an adverse impact on Singapore's growth prospects. Yet if our 60% probability (Figure 4) of a US-China trade resolution within the next six months proves correct, we still expect Singapore's 2019 GDP to be 2.5%.

For Thailand

The bulk of the decline in Thai exports is from machinery and electrical equipment, and any positive knock-on effects from trade diverting to the US are quite small. Given current sentiment coupled with ongoing uncertainty, capital inflows look less likely. We are therefore revising our outlook for the Thai economy downward to 3.5% expansion in 2019, from 3.8% previously, following 4.1% growth in 2018.

For Malaysia

Based on existing tariffs, Bank Negara Malaysia is expected to revise downwards the country's GDP forecast in 2019 by 0.3% to 0.5%. However, a worst-case trade scenario could lead to a reduction of GDP growth by as much as 1.3% to 1.5%. Any capital outflows amid heightened risk aversion will weaken the MYR. Our view is an unchanged baseline GDP forecast of 4.6% for 2019, with a slight recovery in exports and commodities in 2H 2019 amid government support.

For Indonesia

Finance Minister Sri Mulyani Indrawati predicts the country will face difficulty in maintaining GDP growth at 5% in 2019 due to trade tensions. Bank Indonesia left its benchmark interest rate unchanged at 6%, as expected, with a "cautious neutral" policy stance. The Indonesian Rupiah is expected to be stable.

What can investors do next?

Based on our base-case scenario of a US-China trade resolution in 2H 2019, investors need to avoid making hasty exit decisions based on likely negative news-led sentiment in the coming weeks that will create higher volatility in markets.

Depending on investors' risk appetite, we propose several strategies to consider:

Type of investor	Strategy
Invested with moderate risk appetite	**Protect the downside** Increase allocation to solutions with lower volatility – such as investment-grade bonds or multi-asset strategies – to build portfolio resilience to future downside risks.
Not invested, but with risk appetite	**Take advantage of volatility** Take advantage of sell-offs to add investments at attractive levels. Global equities are cheaper after corrections in recent weeks – in particular, Chinese equities have fallen more than 5% from the peak (as of early June 2019), with valuations close to the 10-year average.
Currently invested in China	**Stay invested** China remains a valid megatrend theme, driven by domestic consumption and manufacturing growth. In the near-term, the Chinese government can use a combination of monetary and fiscal policy tools to offset negative impacts of trade tension and to support the economic growth.

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Market outlook and strategies

Economic drivers	Risks
Global growth The IMF forecasts global GDP growth to slow to **3.3% in 2019**[1] **from its earlier 3.5% forecast,** citing ongoing trade tensions as an overhang. However, a recession is still not expected in 2019.	**Rising US protectionism** US-China trade tensions have escalated, and could weigh on both consumer and business sentiments. However, Presidents Trump and Xi are expected to meet in **G20 meeting on 28 to 29 June** and there could be a possible ceasefire, which is a positive outcome. Meanwhile, the US could **raise tariffs on imports from other regions**, such as India and Europe.
Inflation and central banks Central banks have adopted a **dovish tone**. The Fed and ECB will not be hiking rates in 2019, while the BoJ will likely stay accomodative for the foreseeable future.	**Political uncertainty in Europe** Theresa May's resignation has **increased the odds of a no-deal Brexit marginally.** The EU Parliament elections resulted in a more fragmented parliament, which could **prolong the process of passing key policies.**
Corporate earnings In 2019, strong personal consumption supported by a healthy jobs market should continue to drive the **positive trend** in corporate profits. Global earnings growth is expected to rise around **8% in both 2019 and 2020**.	**Global Growth Slowdown** After a 10-year economic expansion, the global economy is entering the **late-stage expansion cycle**. With effects of **fiscal stimulus fading** in the US and **trade tension escalation**, the global economic growth may face more drastic growth slowdown.

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High-conviction strategies

Conviction	Key proposition	Risk
Global quality equities	Global quality equities tend to outperform broad equity markets over longer investment cycles.	Relatively expensive valuations could increase the probability of short-term corrections. However, the quality companies tend to better weather the economic slowdown, limiting the likelihood of large corrections in quality stocks.
Emerging market equities	Broad EM equities are supported by stronger fundamentals and attractive valuations.	An unexpected surge in USD strength could cause a retreat from EM equities, as seen in the Turkey situation last year. A worsening of US-China trade tensions could also lead to higher market volatility.
Unconstrained bonds	A dovish stance from major central banks will keep key global interest rates low. An unconstrained bond strategy tends to enhance the return over the broad fixed income market.	An inflation overshoot will send bond yields higher, which will be the major risk to fixed income in general. However, inflation-linked securities such as TIPS will be less affected in such an event.

Megatrends

Conviction	Key proposition	Risk
Global healthcare equities	Healthcare is a structural growth story driven by long-term growth in an aging global population. In the medium-term, we expect drug approvals and an increase in M&A activity to be catalysts for a sector re-rating.	Policy uncertainty could weigh on sentiment for the sector. The Medicare-for-all proposed by Democrat Presidential candidate Bernie Sanders could lead to volatility, but the probability for the programme to pass is low at the present time. This risk will likely be mitigated in the long-term as a growing silver segment should contribute to stronger increase in demand.
Chinese equities	Chinese equities are underowned by global investors, and provide a good risk-reward and diversification benefits.	A US-China trade war remains a key risk in the near term. Both sides have hardened their stance after the trade talks broke down. Trump and Xi are expected to meet at the end of June in G20 meeting, which may lead to possible ceasefire. Financial deleveraging could continue to put pressure on growth and lead to higher risks of policy missteps.
AI & innovation-driven companies	Artificial Intelligence (AI) has the ability to drive multi-fold increases in productivity by utilising big data and powerful computing hardware to accurately and reliably solve real-world problems with little human input.	Policy and regulatory uncertainty is a key risk to watch for. As AI permeates more and more into people's daily lives, questions about safeguarding individual privacy and appropriate use of such tools will surface. Regulators may step up efforts to curb the uses and applications, while differing standards from various countries can create barriers to universal adoption.

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