UOB Investment Insights
Quick Note

29 May 2020

Mapping Possible Implications of US-China Tensions

- The US and China continue to exchange harsh words with each other, escalating tensions in the process. Some of the tensions were anticipated as we approach the US elections in November, as seen in the 2016 US presidential elections and the 2018 US mid-term elections.

- The Trump Administration has threatened punitive measures on China. Whether the threats will materialise or not, announcements alone can stoke market fears.

- While there will be some short-term market volatility in light of this, investors should continue to focus on China's long-term structural drivers and take advantage of any significant sell-offs to build positions in Chinese assets.

More sabre-rattling between the US and China

- Since April 2020, the Trump Administration has been threatening punitive actions against China, which it blames for causing the COVID-19 outbreak.

- Although the threat started with additional tariffs, the US government has now progressed to other possible measures, such as:
  - Preventing technology companies from supplying both hardware and software to Chinese firm Huawei;
  - De-listing Chinese companies listed on US stock exchanges (see Quick Note: Potential De-Listing of Chinese Companies in the US, 22 May 2020);
  - Imposing sanctions on certain Chinese officials over human rights issues in Xinjiang; and
  - Removing Hong Kong's "special status", which has allowed the US to treat Hong Kong differently from Mainland China on matters of trade export and economic control.

- The event that startled markets over the past week is the introduction of a *national security law* for Hong Kong, which has been viewed negatively by markets, as reflected in the 5.54% single-day decline in Hong Kong's benchmark Hang Seng Index after the law was announced on 22 May 2020.

- China's National People's Congress (NPC) voted to pass the law on 28 May 2020, but the details of the law are scarce and could take a few months to finalise and to implement. We will continue to monitor these developments and provide updates in our regular publications.

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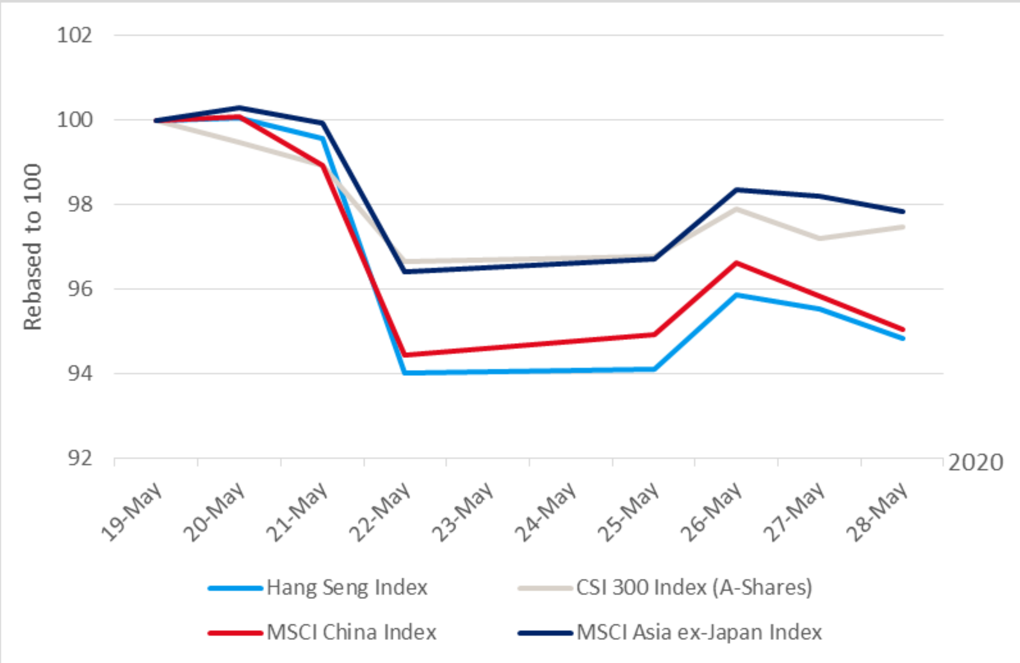
Figure 1: Key Asian Equity Market Movements



Source: Bloomberg, data as of 28 May 2020.

- While US and European markets have not reacted much to these developments due to positive sentiments over the reopening of their economies, volatility and fear have increased in Asian markets over the sabre-rattling between the two economic powers (Figure 1).
- We will likely see more threats going back and forth in the run-up to the US elections this November, which may drive market volatility.

Possible implications of the US' threats thus far

- Technology companies, especially hardware manufacturers, will consider splitting their production facilities and offices between different locations to cater to US and Chinese customers separately. This can lead to higher production costs, as companies may have to set up facilities within the US to serve the US market. However, these higher costs can be mitigated by the financial benefits offered by US state government to help create new jobs and to promote economic growth within their states.
- US-listed Chinese companies will likely seek a listing in a friendlier market, with Hong Kong being the most likely beneficiary (see Quick Note: Potential De-Listing of Chinese Companies in the US, 22 May 2020).
- Hong Kong remains an independent customs territory under the World Trade Organisation and a separate entity from Mainland China in the International Monetary Fund and the World Bank. Any US action will not likely change how the other countries view and treat Hong Kong. However, if the US does remove Hong Kong's "special status", it will negatively impact Hong Kong's trade with the US.
- China could promote Shanghai as the main financial centre over Hong Kong. However, the recent national security law introduced by China indicates that Hong Kong is still important to the central government, as Beijing is now seen to take ownership and manage the social issues in Hong Kong. Therefore, it is reasonable to expect that Hong Kong will remain as China's key financial centre in the foreseeable future.

- Hong Kong will likely remain the preferred choice for Chinese companies seeking foreign capital by listing on the Stock Exchange of Hong Kong (SEHK). Alibaba recently chose Hong Kong over Shanghai as its secondary listing, while JD.com and Netease are reportedly considering the same move[1].

- To maintain its position as a key financial centre, Hong Kong will likely keep the Hong Kong Dollar pegged to the US Dollar in the foreseeable future. Hong Kong has an estimated US$452 billion[2] in reserves, while its major banks can tap on alternative US Federal Reserve swap lines through their licences in London and Singapore. This will enable Hong Kong to defend well against a currency run.

What should investors do?

- **China's long-term drivers remain intact.** Increasing pressure from the US will encourage China to focus on driving domestic growth, which will benefit domestic-oriented companies. On the global stage, China will also compete aggressively with the US in the area of technological leadership, such as 5G communication networks. While you should remain invested, do speak to your UOB adviser on the need to adjust your investment holdings in accordance with your current risk tolerance.

- **Invest in China with a longer time horizon to reap the benefits.** Tensions with the US will remain high for the rest of the year, as both US presidential candidates are likely to vilify China regarding the COVID-19 outbreak to win votes. You can consider taking advantage of any significant market sell-offs to build up positions in Chinese assets to ride on China's growth over the longer-term or spread your resources over different tranches to enter the market.

- **Diversification helps to manage risk.** You can also invest into the broader Asia ex-Japan equities, which offer more diversification that can mitigate some of China's country-specific risks.

- Please speak to your UOB adviser to determine the suitability of any of these strategies for your portfolio.

**All data are sourced from Bloomberg unless otherwise stated.*

[1] Source: Goldman Sachs Global Investment Research, May 2020.
[2] Source: GaveKal Research, May 2020

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