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Macro + FX Strategy

US-China: China's Retaliation Intensifies Trade Tension

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China announced on Monday (13 May) night its countermeasure to US' tariff hike on US$200bn of Chinese goods exported annually to the US which took effect last Friday (10 May).

Effective from 01 June, China will increase the tariff rate on US$60bn of imports from the US for those tariffed at 10% to 10-25%: 2,493 items (25%), 1,078 items (20%), 974 (10%). The 595 items that was previously tariffed at 5% will remain as such. Amongst items hit with the highest 25% tariff rate include food stuff (meat, coffee, tea, cooking oil, fruits and vegetables, wine, beer etc), industrial minerals and chemicals, textiles and clothing, jewellery, metal products, machinery parts, and a wide range of consumer products (glasses, toys, furniture etc). China will also be releasing an exclusion list which include products that will be exempted from additional tariffs for one year.

US Trade Representative's (USTR) Office announced on Monday that it will hold public hearing to impose tariffs of up to 25% on 3,805 product categories of imports from China (valued at approximately $300bn) on 17 June with post-hearing rebuttal comments due by 24 June. The proposed list covers most of the remaining US imports from China which are not currently under additional tariffs, and is said to include cellphones, laptop computers but excludes pharmaceuticals, certain pharmaceutical inputs, select medical goods, rare earth materials, and critical minerals. Notably, US President Trump said on Monday that he had not decided whether to proceed with those additional tariffs.

June G20 Meeting Will Be Pivotal

The public hearing process on the US$300bn of Chinese goods imports by the US will end just ahead of the G20 Osaka Summit (28-29 June) at which US President Trump said he will be meeting with Chinese President Xi. This could then pave the way for quick implementation of the additional tariffs should the trade tensions escalate further. However, we also see prospect of another ceasefire outcome following the G20 meeting. Recall the quick turnaround in December 2018 G20 Summit in Argentina when both leaders announced a 90-day ceasefire.

Our Take: Base Case Remains For Prolonged Negotiation But Eventual Resolution Still Likely

Meanwhile, the negotiation process has not stopped. US Treasury Secretary Mnuchin said that talks with China are still ongoing and is working on when to travel to Beijing. As such, our position remains that the trade negotaition will be long-drawn, well into the second half of this year before a resolution (60% probability) while we see the probability of an all-out trade war at 30%. In the meantime, we see more uncertainty ahead for global growth.

Our Assessment Of The Possible Scenarios

US currently imposes additional tariff of 25% on a total of US$250bn Chinese goods while China has a tariff rate of 25% on US$50bn of US goods and its tariff rate on another US$60bn of US goods will be at 5-25% from 01 June. China has limited room to retaliate to further US tariffs via trade given that total US' exports to China was only US$120bn in 2018.

Possible Scenarios For The Trade Tensions			
Scenario For 2019		Probability	Implication On FX and China's Monetary Policy
BEST CASE	US and China continue negotiation leading to another trade truce before removal of all additional tariffs imposed by both countries	**10%**	USD/CNY pulls back to 6.50 One or no further RRR cut for the rest of the year
BASE CASE	US and China continue negotiation after US raised tariffs on US$200bn goods from 10% to 25%, additional tariff measures may or may not materialise along the way but with a resolution in 2H19. Resolution may not totally remove existing additional tariffs	**60%**	USD/CNY drifts higher to 6.90 Maintain our call for two more broad-based RRR cuts this year
WORST CASE	Both parties are unable to reach satisfactory resolution this year and US makes good on its threat to impose tariff of 25% on additional US$325bn of Chinese exports to the US which are currently not subject to additional tariff. This brings all China's exports to US (US$540bn in 2018) under additional tariff. Retaliations 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 time cut to the 1-year lending rate
Source: UOB Global Economics & Markets Research			

A trade deal between the world's two biggest economies if concluded will certainly be cheered by the global economy. Even with an agreement, the devil could still be in the details. If there is a less-than-comprehensive agreement, particularly on structural issues including intellectual property protection, technology transfer and other issues, then there is a clear risk that further tensions including trade may resurface later on.

China's Growth Under Downside Risk From Trade Tensions

China's GDP grew 6.4% y/y in 1Q19, unchanged from 4Q18 but above consensus forecast of 6.3%. However, the unexpected negative turn in trade negotiation with the US has greatly increased the growth risk this year. Should trade tensions deepen i.e. both sides maintaining higher tariffs throughout this year and more goods are being targeted for additional tariffs, we expect China's 2019 growth could even dip slightly below 6.0% from our current forecast of 6.3%. Domestically, we expect support from the flow-through of earlier counter-cyclical measures on the fiscal and monetary policy front. These are expected to be stepped up to cushion any growth fallout from rising trade tensions.

Broad-based cut to banks' reserve requirement ratio (RRR) by 100bps took effect in January and PBoC has announced RRR cuts for banks that serve local counties/districts, from the current RRR level of 8%-10%, effective from 15 May 2019. For now, we maintain our expectation of two more RRR cuts this year but see less risk of policy rate cut to provide further credit to small/ medium enterprises.

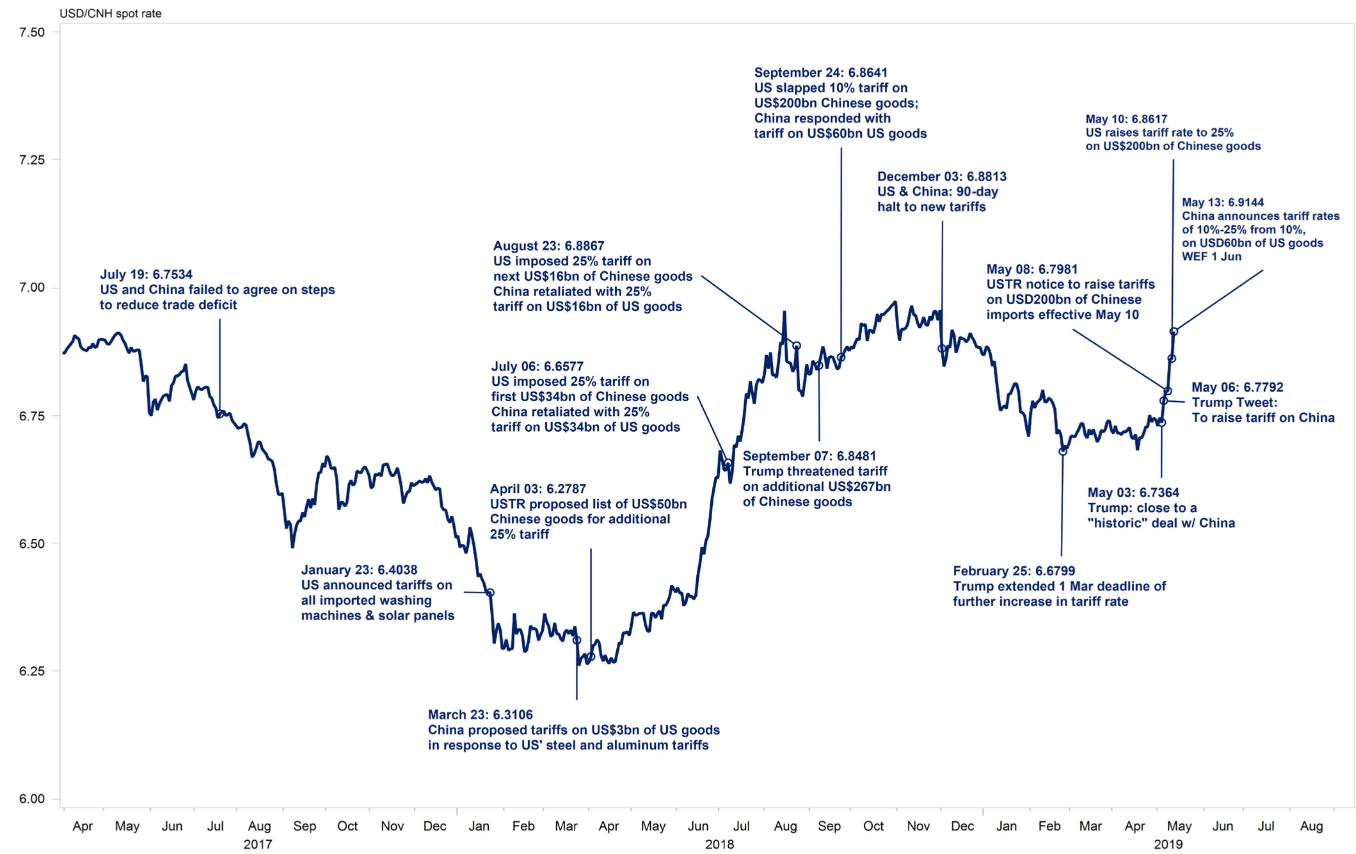
FX Technical Outlook: USD/CNH (6.9000)

1-3 WEEKS VIEW: Above 6.9270, the next meaningful resistance is at the 2018 high of 6.9800

While we expected USD to strengthen since late last month (see update on 25 Apr, spot at 6.7330), we have underestimated the strength of the USD rally. We indicated last Friday (10 May) that "the next resistance at 6.8900 may not come into the picture so soon" but USD sliced through this rather strong resistance with ease as it rocketed to a high of 6.9180 yesterday (13 May). From here, there is another resistance at 6.9270 but above this level, the next meaningful resistance is at the 2018 high of 6.9800. All in, the positive phase in USD is deemed as intact until the 'key support' at 6.8350 is taken out (level previously at 6.7750).

China: CNH per USD - Roller Coaster Timeline of US-China Trade Tensions

Source: Macrobond, UOB Global Economics & Markets Research



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