Macro Monthly

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UBS Asset Management | Economic insights and asset class attractiveness
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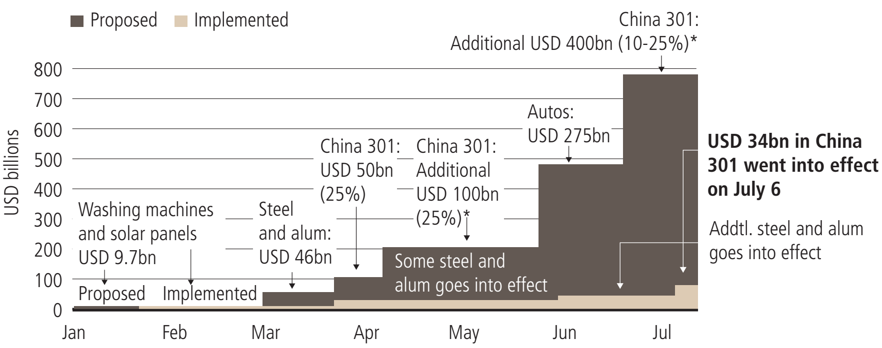
Weighing US-China trade risk

Highlights

- While trade risks between the US and its allies are de-escalating, tensions between the US and China are likely to rise in coming months
- We expect market volatility to pick up as the Trump administration presses ahead with tariffs
- Investors should not underestimate growth stabilization outside of the US, including the effects of China's monetary and fiscal stimulus
- We remain constructive on global equities, with a keen focus on whether trade disruptions are meaningfully affecting business investment and hiring decisions
- Hedges for further trade escalation include US duration and short the Chinese yuan and Korean won versus the safe haven Japanese yen

We last wrote on trade tensions in March, when the Trump administration announced its first 25% tariff on USD 50bn worth of Chinese goods as part of its Section 301 investigation into intellectual property. Back then we concluded that while miscalculation was a risk to the economy and markets, ultimately the incentives of Presidents Trump and Xi were sufficiently aligned to avoid a damaging 'trade war,' or imposition by both countries of across-the-board tariffs on imports. We make a similar conclusion in this Macro Monthly, except we acknowledge that the stakes have surely risen. President Trump's initiation of a process to implement tariffs from 10-25% on USD 200bn worth of Chinese goods is credible, in our view. And while less likely, President Trump has also threatened tariffs on auto imports, bringing the administration's total proposed tariffs to nearly USD 800bn, over a quarter of US imports (Exhibit 1). Considering likely retaliation from trade partners, these are meaningful numbers which deserve careful attention. In this Macro Monthly we discuss how we see trade tensions evolving, their potential impacts on the economy and markets, and considerations for asset allocation.

Exhibit 1: US Imports subject to proposed vs. implemented tariffs



Sources: USITC, Goldman Sachs, UBS Asset Management
*Proposed retaliation increased to additional $400bn at 10% in place of $100bn at 25% on June 18. The Trump administration announced it was considering increasing the 10% tariff on $200bn to 25% on August 1. Data as of August 1, 2018

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Trade policy developments are evolving at a fast pace, though it is not all bad news. NAFTA talks are progressing, with US Trade Representative Robert Lighthizer suggesting it was not unreasonable to have a NAFTA conclusion in August. President Trump and European Commission President Juncker agreed to negotiate tariff reductions between the US and EU, de-escalating trade tensions and lowering the risk of new tariffs. We expect a similar result when Japanese and US officials meet on trade later in August. It is looking as if tariffs on auto imports will be avoided, at least for major US allies.

The recent healing of trade relations between the US and its allies is not a coincidence, in our view. In their press conference last week, Trump and Juncker agreed to work together to reform the WTO. This echoes a recent memo from the European Commission urging modernization of the WTO, with a focus on market access, non-tariff barriers, practices surrounding state-owned enterprises, sustainability objectives, and stricter definitions of which countries count as less developed and therefore eligible for more favorable treatment. While China was not explicitly mentioned in either the EU's report or the Trump-Juncker press conference, the world's second largest economy is clearly emerging as the focal target for the transatlantic allies. We should therefore be careful not to extrapolate the sudden easing of trade tensions between the US and Europe as having positive read-through for upcoming US-China trade developments. Rather, the US, Europe and likely other allies look set to unite and isolate China on trade and tech issues, building leverage for what is shaping up to be a prolonged period of tension.

Incentives and constraints for Trump and Xi

President Trump is incentivized to continue pushing China on trade over the coming months. Polls suggest a majority of US voters are skeptical of the benefits of global trade (Exhibit 2) and are generally favorable towards confronting China with tariffs. The outperformance of the US economy and equity markets, energized by fiscal stimulus, emboldens the President to engage further. He has also offered economic support for the agricultural sector, a loser from Chinese retaliation and key voting bloc ahead of the November midterms. On the other hand, the President has arguably prioritized the US economy and jobs above all else. To the extent his policies create genuine damage to markets or the economy, President Trump may feel the need to dial back pressure.

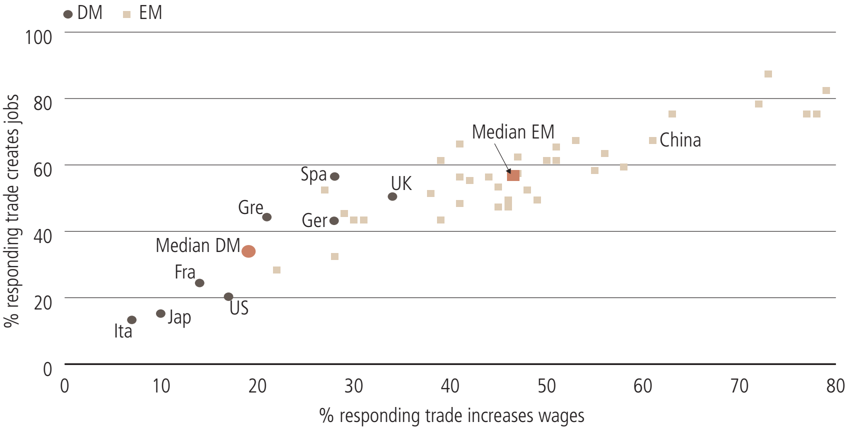
China's President Xi also has incentives and constraints for further engagement. Having shored up his leadership earlier this year, he does not face the same political pressures as President Trump. Xi may feel he can ride out the US political cycle, prizing Chinese advancement and modernization associated with its Made in China 2025 plan with the clear goal of emerging as a genuine global superpower. Moreover, China has recently taken a number of steps to stimulate the economy, including lowering reserve requirements, increasing liquidity, encouraging lending to small and medium enterprises, cutting taxes and allowing the yuan to weaken. Still, China's growth engine depends on global trade and a trade war is already disrupting the deleveraging process that China's leadership views as key to long-term stability.

Given these dynamics, it is of course very difficult to predict how US-China tensions will all play out. At this point we think it's reasonable to assume that tensions will heighten in the near term as there are still no signs of formal negotiations and the Trump administration is politically incentivized to impose the 10-25%/USD 200bn tariff in September. China's next move will be key. There is reason to believe China will retaliate but not proportionately; China's formal response to the initiation of the latest round of US tariffs was less confrontational and specific as it was to the initial USD 50bn announcement. A less than fully proportional retaliation would create some near-term de-escalation, allowing China to appeal to the WTO and setting the stage for a return of bilateral negotiations. But clearly there is a meaningful risk of ongoing tit-for-tat escalation that undermines economic growth and risk sentiment.

Considering the effects on the economy and markets

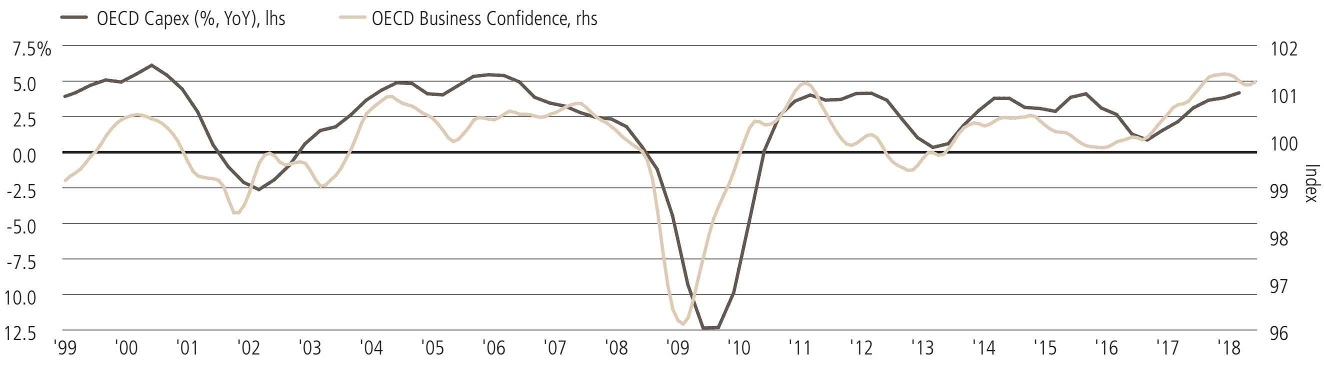
Further complicating matters is the difficulty in estimating tariff impacts on economies and asset prices. The direct economic effects of tariffs, such as raising input costs and lowering exports, are unhelpful but manageable. Much more difficult is estimating the indirect effects of tariffs related to supply chain disruption and hits to business sentiment, leading to a potential decline in investment and employment. While global businesses are anecdotally concerned about trade policy uncertainty, we do not yet see hard evidence that it is changing overall business behaviors. OECD business confidence, which leads capital investment, has moderated from all-time highs (from 1975) but stabilized at elevated levels (Exhibit 3). While this generally benign picture can change, we think it's important to watch the data closely to examine the true disruption caused by tariffs.

Exhibit 2: Perception of trade on wages and jobs



Sources: Pew, UBS Asset Management
Survey conducted in 2014

Exhibit 3: OECD business confidence and capex



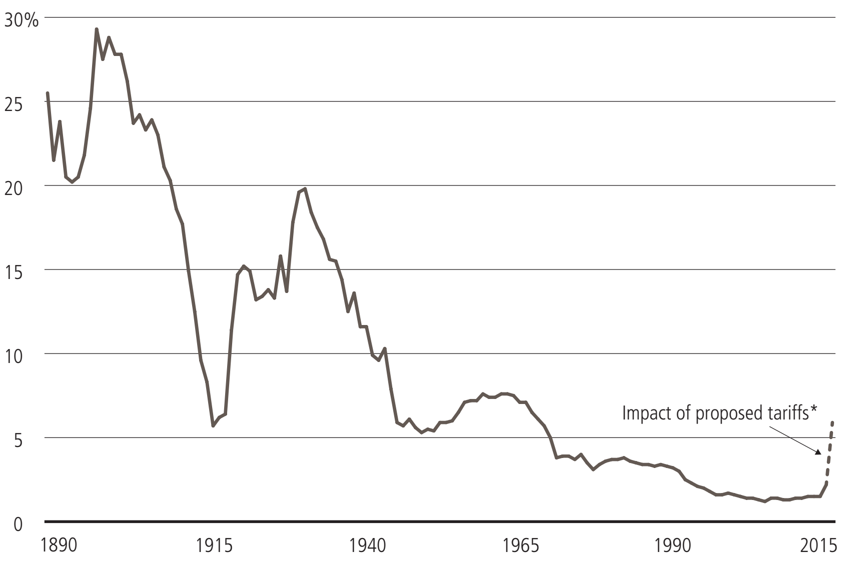
Sources: UBS Asset Management, Macrobond
Data as of June 30, 2018

Indeed, the term 'trade war' is used frequently by market participants and in media, but even a worst case scenario should be viewed in historical context. Total proposed tariffs, including on autos which we think as less likely, would bring the US effective tariff rate just above 5% (Exhibit 4). This is a meaningful increase from recent years, but we should be careful not to equate it to 1930s protectionism which exacerbated the Great Depression. We acknowledge that world trade has risen and supply chains have grown much more global and complex over recent decades, but should also take into account that for major economies, trade still represents a relatively small proportion of overall economic growth. Finally, it is important to consider significant stimulus measures, from China in particular, which will help cushion global growth against trade risks.

This is not to minimize the threat of further trade disruption to the global economy and markets. Indeed, we suspect market volatility will pick up from here should the Trump administration dig in as we expect and markets look at potential further escalation from both sides. Nevertheless, our strategy is to wait and see how trade policy evolves with a specific focus on whether this uncertainty is materially impacting plans for investment and employment. Moreover, we have a strong conviction that the administration's strategy will be reflexive to economic and market impact. Should US equities experience a meaningful drawdown, we expect the Trump administration to dial back pressure on trade to avoid undermining its ultimate priority, the strength of the US economy.

Exhibit 4: Perception of trade on wages and jobs

US effective tariff rate (gross customs duties, as share of total imports)



Sources: USITC, Goldman Sachs, UBS Asset Management
*Dotted line adds (1) enacted tariffs on steel and aluminum, solar panels, washing machines, and $34bn in imports from China as well as (2) proposed tariffs on autos imports and an additional $416 in imports from China.
Data as of July 27, 2018

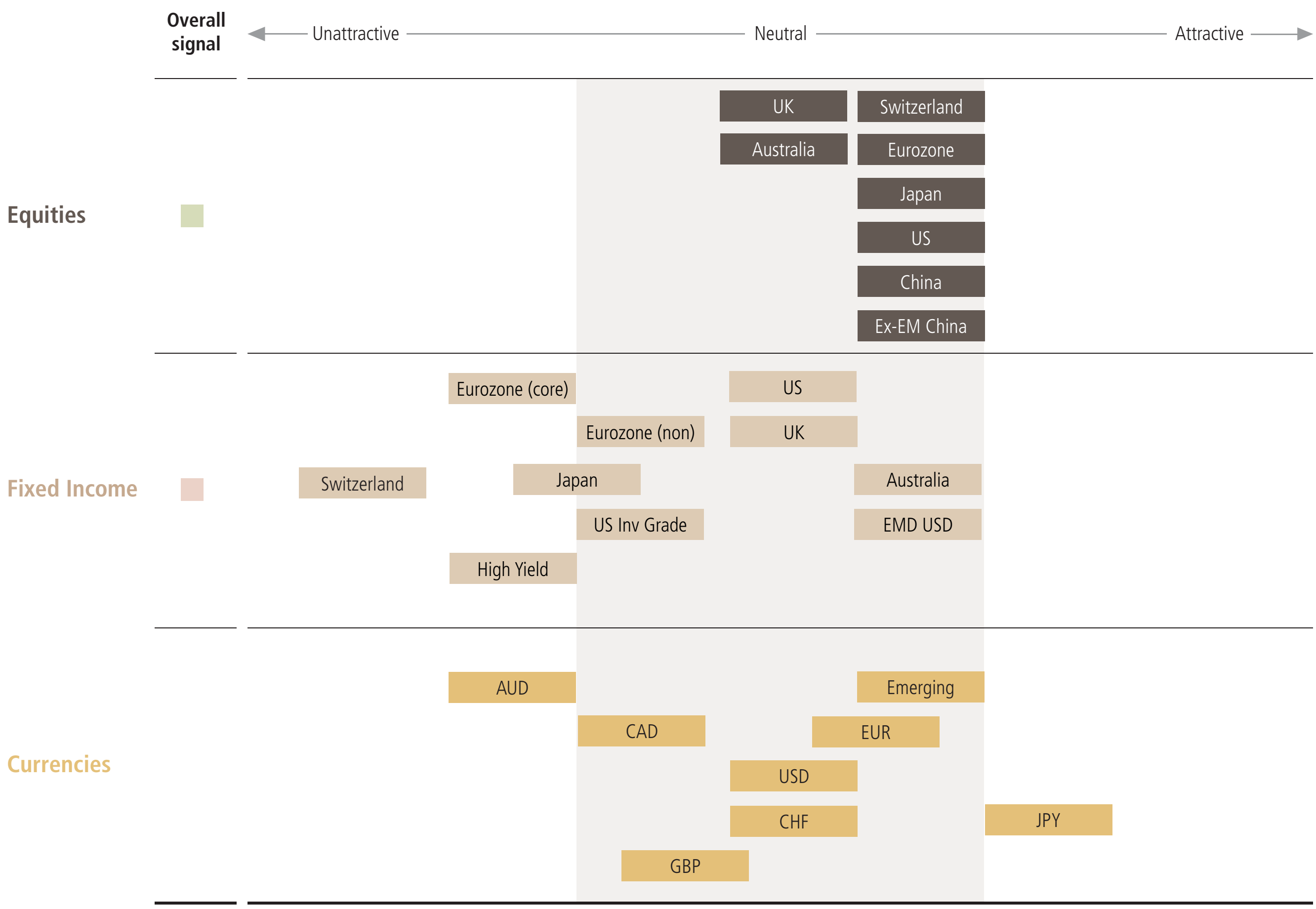
The bottom line: Asset allocation

We remain overweight global equities despite the expectation of some trade escalation and associated market volatility over coming months. Ex-US growth is showing initial signs of stabilization, which is removing upward pressure on the US dollar. Markets should not underestimate China's recent pivot back towards stimulus and its implications for global growth and commodities. The combination of a stable dollar, China's stimulus, still solid global growth and earnings should provide a cushion amid non-negligible trade risks. As we discussed in the last Macro Monthly, valuations for emerging market assets have become much more attractive and are already discounting significant trade escalation. As such we have begun adding EM exposure in some strategies. In fixed income, we maintain neutral exposure to US Treasuries in case trade escalation leads to a flight to quality or a dovish re-pricing of expected Fed tightening. And in FX, we are short the Chinese Yuan and Korean Won and long the safe haven Yen to hedge against further trade disruption.

Overall signal =
Positive ◄——► Negative

Asset class attractiveness

The chart below shows the views of our Asset Allocation team on overall asset class attractiveness, as well as the relative attractiveness within equities, fixed income and currencies, as of end-July 2018.



Source: UBS Asset Management Investment Solutions Asset Allocation team as at July 31, 2018. Views are provided on the basis of a 12-18 month investment horizon, are not necessarily reflective of actual portfolio positioning and are subject to change. For illustrative purposes only.

Overall signal =

Positive ◄——► Negative

Asset Class	Overall signal	UBS Asset Management's viewpoint
US Equities		– While the US economic cycle is mature, both consumer spending and corporate capital expenditure appear well supported by recent tax reform. The latter in particular gives grounds for optimism in future US productivity growth and in the sustainability of the cycle. – Stronger-than-expected corporate earnings growth, rising M&A and increasing capital returns to shareholders are likely to remain key supports in the coming months. Indeed, US equity valuations are now more attractive after recent profits growth has outpaced share price performance. More importantly in our view, US equities remain attractively valued relative to bonds despite the recent rise in yields.
Global (Ex-US) Equities		– In Europe, the increased risk premium prompted by recent political developments in peripheral Europe will likely constrain upside potential until more clarity emerges around the fiscal intentions of the new Italian government. Despite these short-term headwinds, our longer-term base case remains positive, supported by demand growth that is still above-trend, and the potential support to earnings from re-gearing. – In Japan, core inflation remains muted despite the closing of the output gap. This supports a very gradual adjustment of current loose monetary policy. We view Japanese equities as moderately attractive.
Emerging Markets (EM) Equities including China		– Emerging market equities have struggled in recent months in the face of a strengthening USD, rising USD funding rates and rising geopolitical risks. We do not dispute that these factors present headwinds. But in aggregate fundamental conditions remain relatively robust and the recent share price weakness across EM feels out of kilter with these fundamentals. – We no longer have a clear preference for Asia (ex China) within the broader EM universe. In our view, attractive valuations are now at least partially countered by vulnerability to any escalation in the US/China trade war. – We remain broadly positive on China. Any broadening of the current trade stand-off with the US is likely to hamper Chinese growth, but a gradual economic slowdown is already priced in and the Chinese authorities have already shown themselves willing to boost liquidity to help smooth the on-going economic transition. Chinese equities still trade at a PE discount to other markets and further market liberalization could prompt a rerating as international capital starts to flow into Chinese assets following the inclusion of onshore Chinese equities in MSCI's widely followed EM equity indices.
US Bonds		– US Treasury yields remain low by historical standards, but look attractive relative to most other developed government bond markets on an unhedged basis. In the absence of a material pick-up in inflation, yields are likely to remain range bound. Our overall assessment is neutral.
Global (Ex-US) Bonds		– In aggregate, we see global sovereign bonds outside of the US as unattractive. The ECB has committed to low rates into next year, so we see limited opportunity in Europe. – Swiss bonds continue to look very overvalued and in our view they have an increasingly asymmetric risk profile. The Swiss economy is relatively strong and we see Swiss bonds as vulnerable to attempts to normalize monetary policy by a Swiss National Bank increasingly concerned by the strength of the housing market. – Elsewhere we are more positive on Australian and Canadian duration on a relative basis. In our view, both economies are vulnerable to a housing market correction after very strong recent performance.
Investment Grade (IG) Corporate Debt		– Geopolitical turmoil and trade issues have spilled over into the credit markets, causing IG spreads to widen slightly in recent months. Although we do not believe that a sharp demand slowdown is imminent, we retain a neutral view on credit.
High Yield Bonds		– Current default rates in High Yield are very low by historical standard. Given the relatively positive economic backdrop, we do not expect any material pick-up in US corporate debt defaults in the near-term. However, while spreads have widened in recent weeks, we do not yet view the risk/reward as attractive.
Emerging Markets Debt US dollar Local currency		– Spreads on EM debt relative to US treasuries have widened substantially in the face of higher geopolitical risks, a strengthening USD and higher USD funding rates – sparking particular fears for EM countries with large external funding requirements. Nonetheless, we see continued strong demand for EM debt's attractive real yield on a selective basis.
Currency		– We expect global growth to re-synchronize over coming quarters, with ex-US economies showing initial signs of stabilization. We anticipate capital will flow from the US into earlier-cycle economies, especially as the USD remains somewhat expensive on a real trade-weighted basis. Elsewhere, we continue to see strong valuation support for the JPY.

[1] Source: UBS Asset Management. As of July 31, 2018.

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Americas

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