US President Donald Trump and Chinese president Xi Jinping will be meeting in Japan at the end of the month. (Keystone)

Global risk radar

High expectations for the G20 summit

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On 18 June, US President Donald Trump announced plans to meet Chinese President Xi Jinping at the G20 summit in Japan at the end of the month. A resumption of negotiations would be the first positive development in the relations between the two nations since trade talks collapsed on 5 May.

That was when Trump announced higher tariffs on USD 200bn of Chinese imports. Over the past few weeks, Washington has accelerated the process of adding tariffs on further Chinese exports to the US and implemented other sanctions against Chinese companies. This has prompted a counter-response from Beijing.

Over the coming weeks, we may have more clarity on the real intention of the US and Chinese governments on reaching a deal.

Base case (50% probability): Prolonged ceasefire

In our base case, we expect the Xi-Trump meeting at the G20 in Osaka to lead to a ceasefire between the US and China and a restart to their trade negotiations, with neither an unwinding nor an escalation of existing tariffs. While a conclusive trade deal before the 2020 US election is still possible, it seems more likely that both sides will only find common ground after the election.

Upside case (15% probability): De-escalation after G20

The chances for a US-China trade deal shortly after the G20 meeting diminished with the US announcement of sanctions against Huawei and, more broadly, with the heated rhetoric from both sides after Trump’s early May tweets. We have therefore reduced the probability we assign to a de-escalation scenario in the next two to three months.

Downside case (35% probability): Tariff escalation

In our risk case, President Trump decides to go ahead with tariffs on most of the remaining Chinese products shortly after the G20 meeting. Negotiations would likely take a lengthy pause and resume only when the growth outlook for both countries worsens considerably. Although there is great uncertainty on the impact on growth, we estimate that a broadening of the scope of tariffs could subtract roughly 1 percentage point off both US and Chinese GDP growth.

Investment implications
Overall, we think the future direction of markets will hinge on 1) whether trade negotiations will continue or not; 2) whether the US will impose tariffs on the remaining imports of Chinese goods; 3) the extent to which China retaliates beyond what it has already announced; 4) the monetary and fiscal responses; and 5) any spillover to the global economy.

Should trade negotiations break down, we would expect the market to react more strongly. Hence, if the US imposes tariffs on the balance of the goods it imports from China, we think US real GDP growth could be reduced by about 0.75–1 percentage point. As a result, S&P 500 profits could be hit by 3% or more, causing the index to fall by 10%–15%. Chinese equities could fall by 15–20%.

In our upside scenario, we would expect equity markets to rise, supported by higher earnings and a further rerating of valuations. In such a scenario, US equities could gain up to 10% and Chinese equities up to 15%.

In the base scenario, we would expect volatility to remain high and the market to react nervously to any trade-related news. We continue to recommend an overweight to US, Japanese, and Emerging market stocks. But to manage the risk of further escalation, we recommend an underweight to international developed stocks, especially in the Eurozone where equities are more sensitive to global growth jitters. We also recommend an overweight to long-duration Treasuries as a hedge against equity risk.

For more information, please see CIO report Global risk radar: High expectations for the G20 summit, 20 June, 2019.