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Watch out for speed bumps on the road to a China trade deal

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The latest turnaround in market sentiment seems to indicate a recovery in risk appetite based on optimism over the prospects for trade tariff progress. But we would caution that the US-China de-escalation has not fully unwound all the year-to-date tariff increases, and that further progress is unlikely be smooth sailing. For now, we believe the China tech sector is the most suitable way to be exposed to the potential for further de-escalation on the tariff front. The sector's organic growth drivers can help to compensate for potential speed bumps on the path to an eventual trade deal between China and the US.

Market sentiment has turned strongly positive after President Trump walked back his weekend threat to impose 50% tariffs on the EU on 1 June, ahead of the 9 July deadline for ongoing US-EU trade talks. The threat was initially in response to what was deemed unsatisfactory progress in trade talks. This has been somewhat rescinded, however, with the tariff hike moved back to 9 July. Markets have cheered this moderation in tone from President Trump, with the S&P 500 rising just over 2% on Tuesday.

But markets should be careful about excessive optimism this early in the process, and certainly also about projecting this optimism onto the US-China trade talks. Investors need to be aware that the economic environment remains degraded on account of tariffs and that the path forward is not likely to be smooth sailing.

Market relief is justified. The US-China agreement in Geneva lowered reciprocal tariffs by the US on imports from China back to 10% from the 145% peak. This left the effective tariff rate around 40%. Meanwhile, China's retaliatory tariffs on US goods have been dropped to 10% from 125%, alongside commitments to relax some of its non-tariff countermeasures. Both sides also agreed to set up a mechanism for continued economic and trade discussions. The consensus on this seems to be that both sides are loathe to risk a painfully disruptive decoupling, and the de-escalation is largely an acknowledgement of this.

We expect that the de-escalation in US-China trade tensions will halve the growth drag on China over 2025-26 from around 200bps to around 100bps. Also, this should allow the 2025 growth rate to come in around 4.0-4.5%. China's exports should also receive a boost from the US-China trade thaw, especially given the exemptions on electronics that were announced in mid-April. The easing of trade tensions should also encourage policymakers to guide the CNY along a path of controlled appreciation. We therefore lower our USDCNY forecast to 7.1 for December 2025 (from 7.20), with a further decline to 7.0 by June 2026.

But optimism might be on shakier ground. While the tariff rates between the US and China are lower than where they were at their post-2 April peak, it should also be noted that the current tariff rate is still orders of magnitude above where it was at the start of the year. It should also be remembered that the ongoing 90-day interim is meant to produce a deal, even though the 2018-19 trade deal took more than a year.

Furthermore, the de-escalation is likely to chill the policy intent to boost economic activity. We believe the recovery in sentiment could see 2Q25 GDP accelerate to around 5% y/y, but this will still represent a sequential slowdown from a strong 1Q25. Indeed, economic activity data for April indicate that supportive policy is still an important crutch for both consumption and investment. We therefore believe policymakers will retain an accommodative monetary policy stance. Following on from a 50bps RRR cut and a 10bps cut in the policy rate in May, we expect another 50-100bps of RRR cuts, and another 20-30bps of policy rate cuts, later this year.

Selectivity needed for appropriate exposure to de-escalation. Clearly, there is unlikely to be a rising tide that lifts the entire equity market, so investors need a more targeted response. We remain Neutral on broad China equities, where current valuations are merely fair, with earnings growth likely to remain subdued. The full impact of the trade war is still indeterminate, and while Beijing's policy stance is likely to remain supportive, risks persist.

We believe the China tech sector is the more suitable vehicle to take on exposure to the ongoing, and likely meandering, de-escalation. We think the market's focus should return to the sector's likely strong 2025-26 earnings growth. The sector's risk-reward balance is improving, especially given the starting point of attractive valuations at 16x forward P/E (0.7 standard deviations below the average from 2022). We expect that the improvement in earnings is likely to be driven by the ongoing AI innovation, positive cloud trends, and Beijing's support for AI and chip self-sufficiency. In particular, the AI and electric vehicle (EV) segments should enjoy the benefits of domestic subsidies and potential overseas expansion driven by cost competitiveness.

For now, we believe the China tech sector is the most suitable way to be exposed to the potential for further de-escalation on the tariff front, as the sector's organic growth drivers can help to compensate for potential speed bumps on the path to an eventual trade deal between China and the US.

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