Trade

US-China trade: more than tit for tat

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Positive rhetoric on US-China trade was an important factor in the early New Year equity market rally. Last week, the rally faltered amid signs that the talks might not be going as smoothly as hoped.

US President Donald Trump warned Beijing to “stop playing around!” on Twitter. The dispute remains center stage with Chinese Vice Premier Liu He and US trade representative Robert Lighthizer meeting in Washington for further talks this week.

In our base case, to which we assign a 45% probability, we expect small advances in the negotiations, which should deliver partial agreements that postpone additional sanctions.

The US knows that its position as the world’s largest economy and technological power will diminish over time. The US is in the process of deciding how much to push in protecting its advantage while it still has one.

Last week, US Commerce Secretary Wilbur Ross highlighted Beijing’s intent to “dominate world high-tech industries,” and Trump administration strategy documents allege that, in technology, the Chinese “every year, steal U.S. intellectual property valued at hundreds of billions of dollars… [and]… unfairly tap into the innovation of free societies."

To be sure, President Trump will need to try and balance his strategic priorities on trade with the recognition that he can’t afford a sharp economic slowdown as the start of the 2020 presidential election campaign edges closer. Meanwhile, China’s slowing growth has prompted the country’s government to ease monetary and fiscal policy.

With both sides incentivized, a near-term trade deal is possible. But in the context of a broader clash, we are skeptical about the chances of a long-lasting deal.

Implications for investors:

• Investors sensitive to a trade war should consider diversifying on a regional basis. The fight for supremacy in both tech end products and the supply chain has the potential to significantly alter the existing status quo. Investors should look at other Asian economies, such as Vietnam, that could get a boost if China succeeds in disrupting the current supply chain.

• Corporations that shift production may also use this window of opportunity to upgrade their facilities,
which could prove to be a windfall for capex and equipment spending globally, although the positive and negative effects would not be distributed evenly. On a sector level, however, automation is likely to be a universal winner of supply chain reorganization.

- Select Chinese companies could also benefit from Beijing’s ramping up of high-tech, basic and applied research in order to move up the global value chain and to improve its technological independence.

- Analysis by UBS suggests that sizeable trade policy risk premia remain across risk assets, despite the perceived recent improvement in the chances of a deal. The longer-term nature of the dispute means that these premia are likely to unwind only gradually.

Markets need to adjust to the reality of the bigger, longer-term nature of the US-China dispute, and, as they do, volatility is likely to remain elevated. Against this backdrop we remain overweight in global and emerging market equities, but balance this exposure with countercyclical positions to protect against the downside risks.

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