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US-China trade: continuing the talks while making the war

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- *In our opinion, investors should dismiss the idea that talks could break down, albeit uncertainties remain. Recent work has focused on details and wording, with the majority of the agreement document having been completed. However, several major issues remain, and on these it is largely up to Trump and XI to make final decisions.*
- *We believe we are actually closer to a deal than we were a few months ago, from the perspective that middle- and low-level officials on both sides have made concrete efforts, working day and night, towards finalising the details and wording of a deal. In other words, we are entering the final stage, but it is probably the most difficult stage, as the remaining issues are critical and tough decisions have to be made.*
- *Higher tariffs will hurt everyone, from Chinese exporters to US consumers. However, based on the degree of policy intervention, the impact on global growth and trade should be contained to a certain extent, while we do not expect an outright recessionary scenario either in China or in the US. Unlike what happened in 2018, the authorities in China are now better equipped to offset external shocks and local sentiment looks less fragile; on the other hand the Federal Reserve's stance is more accommodative than it was last year. It is the countries most integrated with China in the production chain that will suffer the most, while exporting countries that compete with China could benefit, both from increasing their exports to the US and from the production relocation of certain manufacturing sectors.*
- *The consensus is that the economy in China will hit bottom in Q2 of this year; we think it may actually take a little longer than expected. However, in our opinion some sectors may offer better value than others in the A-share market, as domestic demand will work as a buffer against the damage caused by the tariffs and we will continue to see strong investment from the central government. We are constructive on consumer non-cyclical and technology companies.*
- *Within the Asian region, increased tariffs will inevitably have a significant impact considering both its high correlation with global trade and the economic role of China in the area. The countries most impacted by tariffs are likely to be Korea, Hong Kong and Taiwan, whereas India should be the least affected among the region's countries. On a sectoral basis, the automotive industry is in the weakest position, along with the rest of the industrial sector.*
- *In our base case scenario, with the US and China finally reaching a deal, the global economy recovering in the second half of the year and central banks remaining accommodative, we look for episodes of market volatility that may create attractive entry points in markets with compelling valuations. Nonetheless, challenges remain across the board and, at this juncture, we suggest investors maintain a cautious stance. In particular, we believe that a potential escalation of trade tensions is not fully priced into markets yet, and, as a consequence, this could impact short-term sentiment and trigger a major sell-off in risk assets. However, this is not our base case scenario at the moment.*

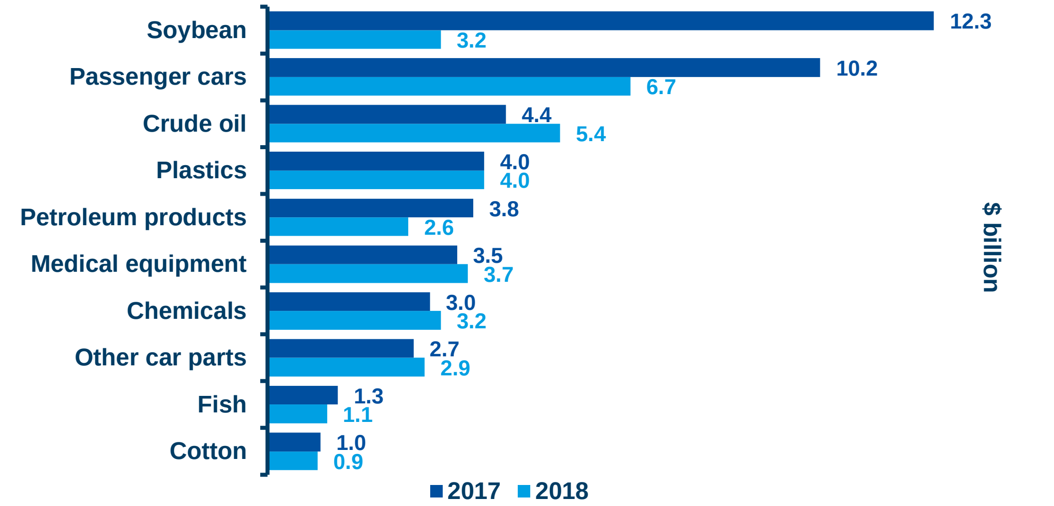
Where do we stand in terms of US/China talks?

After the US raised its tariffs on $200bn of Chinese products from 10% to 25%, China announced retaliatory measures on $60bn of US goods to take effect on 1 June. More specifically, the new tariffs will be on products that have been tariffed at rates of 5% and 10% since last September but will now have tariffs set at 5% (595 items), 10% (974 items), 20% (1,078 items) and 25% (2,493 items). This week the US added more pressure with its plan to begin the process of raising tariffs on all remaining imports from China (worth approximately $300bn), with the details announced on Monday. According to various news reports, the US told China to agree a deal in one month or face tariffs on all of its exports.

"Recent work has been on details and wording, while several major issues remain."

We have started to get a clearer picture about what has happened in recent days by combining the latest information from both China and the US. Recent work has focused on details and wording, with the majority of the agreement document having been completed. However, several major issues remain, and on these it is largely up to Trump and XI to make final decisions. In particular, Chinese Vice Premier Liu He revealed for the first time that in order to reach an agreement, the US must remove all the extra tariffs imposed since last year, set targets for Chinese purchases of goods in line with real demand (this last comment revealed the US's push for bigger Chinese purchases to level the trade imbalance than had originally been agreed at G20) and to ensure that the text of the deal is "balanced" to ensure "equality" and "dignity", and to make sure it does not undermine Chinese "sovereignty". In other words, China felt that the deal was too imbalanced, with China making almost all of the concessions, while the US gave little in return, something it felt would be unlikely to be acceptable to locals.

Top 10 US exports to China facing tariff hike



Source: US Census Bureau, Amundi. Data as of 10 May 2019. Note: Agricultural tariffs were imposed in Jul. 2018, most others in Sep. 2018.

Are they further from or closer to reaching a deal in your view?

As of today, there are limited hopes of an agreement being reached in the very near term, given the US's newly increased tariffs and China's retaliation, taken together with the tough stance of both sides. However, at least for now, it seems that neither side wants a complete breakdown, with both reporting that negotiations will continue. While China still looks very keen to reach a deal, it seems likely that the US will have to make certain concessions.

"We are actually much closer to a deal than we were a few months ago, but the talks are probably entering their most difficult stage."

We believe that when considering the matter on a longer time horizon, we are actually much closer to a deal than we were a few months ago, from the perspective that middle- and low-levels officials on both sides have made concrete efforts at agreeing details and wording. In other words, we are entering the final stage but it is probably the most difficult stage as the remaining issues require tough decisions. China has been acting cautiously; although it has vowed retaliation, the announcement of measures has been delayed, which seems to indicate it wants to avoid further serious escalations and leave room for more negotiations. Moreover, Trump's top economic adviser, Larry Kudlow, stated that US representatives have been invited to Beijing for the next round of talks (although there's no detailed plan yet) and also emphasised the possibility that presidents Trump and Xi will have a cordial meeting at the June 28 G20 meeting in Osaka. On the other hand, there are also risks that the US will remain firm in its stance and that China is willing to take further pain. In this case, it would add huge pressure on both sides.

Amundi
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"Higher tariffs will hurt everyone, from Chinese exporters to US consumers."

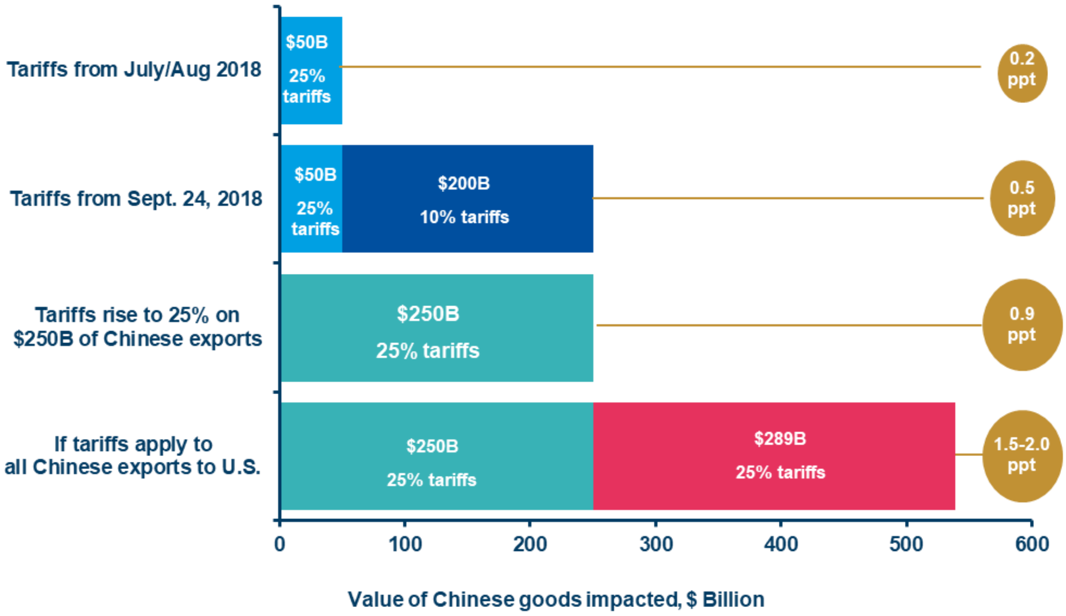
What is your assessment of the potential impact of new tariffs?

Overall, uncertainty has increased with regard to a risk that most investors and analysts thought had reduced and was on the way to some sort of solution. Higher tariffs will hurt everyone, from Chinese exporters to US consumers. With a possible delay of one or two months, inflation in the US will be impacted as a large number of consumer goods will be subject to the tariffs and as US companies look to change their supply chain. The capacity of US corporates to absorb the increased costs is in doubt, and in any case this would impact their bottom line. However, based on the different degrees of policy interventions, the impact on global growth and trade should be contained to a certain extent, while we do not expect an outright recessionary scenario either in China or in the US. Unlike what happened in 2018, the authorities in China are now better equipped to offset external shocks and local sentiment looks less fragile. On the other hand, the Federal Reserve's stance is more accommodative than it was last year. A reassessment of the outlook will be necessary should the tariffs on the remaining imported goods (worth roughly $300bn) eventually occur.

"A reassessment of the global outlook will be necessary, should the tariffs on the remaining imported goods occur."

Considering the wide spectrum of goods involved (about 6,000 products), we reiterate the view that there may be different channels of reaction to such a decision. The countries more integrated with China in the production chain will suffer the most, while exporting countries that compete with China could benefit, both from increasing their export share to the US and from the production relocation of certain manufacturing sectors. Vietnam and Mexico are among the countries that may benefit, with some caveats related to US foreign policy. Vietnam could be included among the currency manipulators list (if that list is enlarged and some parameters further narrowed), while Mexico is still waiting for USMCA (United States-Mexico-Canada Agreement) ratification by Congress.

Tariff impact on the Chinese economy



Source: Bloomberg, US International Trade Commission, Amundi. Data as of 10 May 2019. Note: bubbles show cumulative impact on annual growth.

"Our base case scenario is still of a moderate slowdown for China through policy interventions."

Has the recent imposition of increased tariffs changed the base case on China?

We continue to believe that China is on the right path to managing the economic slowdown through policy interventions. In particular, China is in the middle of a comprehensive transition to a more balanced and sustainable economy, with policymakers fully engaged in a difficult and delicate balancing exercise of maneuvering deleveraging, preventing a disruptive slowdown (6% represents a sort of threshold level for the market), correcting the misallocation of capital and intervening with the right stimulus. The transition of climbing the value chain and moving away from an investment- and export-led growth model to a focus on domestic sectors and consumption (though still very much in progress), if successful, should finally result in the economy becoming more resilient and less exposed to cyclical swings.

"Increased tariffs could have a heavy impact on the Asian region, especially in the auto sector. Watch out for the Asian currencies."

Which countries and sectors are most at risk in the Asian region and what could the next issues for investors to watch be, if any?

Increased tariffs could have a significant impact on the Asia region considering both its high correlation with global trade and the economic role of China in the area. The countries most impacted by tariffs are likely to be Korea, Hong Kong and Taiwan, whereas India should be the least affected among the region's countries. Overall, the globalisation trend has benefitted most of the Asian countries in the past 25 years and now they will inevitably feel the pain of the stalling of this trend. Across sectors, the automotive industry is in the weakest position, together with the rest of the industrial sector.

The level of the main Asian currencies vs. the US dollar is definitely a very relevant factor to monitor. The Hong Kong Dollar (HK$), the Chinese Yuan (RMB) and the Korean Won (KRW) have all started to show signs of weakness recently and, as long as those currencies remain weak, the "risk-off" scenario for emerging markets equities will be in play.

How do you think it is worth positioning in China's equity market?

Foreign investors started to lighten their positions a few weeks ago given the poor results expected in Q2, while local investors were less keen to close positions and take profits.
In general terms, the consensus is that the economy in China will hit bottom in Q2 this year; we think it may actually take a little longer than expected.
In relative terms, we think that the A-share market is riskier than the H-share market at the moment, with the former attaching an expectation of a further 5% correction in the next three months. However, in our opinion, some sectors may offer better value than others in the A-share market, as domestic demand, well supported by an expansionary fiscal policy, will work as a buffer against the damage caused by the tariffs. Furthermore, sectors such as education, pharmaceutical, semiconductor and information technology will continue to see strong investments from the central government, with the aim of reducing the technology gap with the US. As far as our sector preferences are concerned, we are more constructive on consumer non-cyclical and technology companies, whereas we are less constructive on the financial, communications, consumer cyclical and energy industries.

"In our view, A-share stocks may offer better value as some sectors will continue to see supportive domestic demand and strong public investment."

Do you expect major movements of the Chinese yuan against US Dollar?

For now, we expect the Chinese Yuan (RMB) to move in the range of 6.7-7.0 per US Dollar, but without breaching the resistance level of 7.0, perceived by the market as a dangerous threshold. We believe policymakers are prepared to intervene if necessary (capital controls have been tightened since last year). Chinese policy stimulus is supportive for domestic sentiment, as well as a boost to portfolio inflows due to benchmark inclusion. In addition, the current account dynamics point towards more balance in the medium term and we don't see any sharp deterioration near term. If US/China talks don't go relatively smoothly, with the US starting to apply tariffs on the rest of the $300bn of Chinese products, there is a real chance that China could allow the RMB to breach the level of 7.0.

US Dollar to China Yuan (onshore)

Source: Bloomberg, Amundi. Data as of 13 May 2019.

"Our base case remains that a deal between the US and China will likely be reached, nonetheless we suggest maintaining a cautious stance in case of a potential escalation of tensions."

What would you expect the markets to do in light of recent events and potential trade developments?

The escalation of global trade tensions is clearly negative for risk assets. However, the market sell-off seems to have been moderate so far, as investors are perhaps waiting for the result of the talks as they see the continuation of the negotiations as a clue that both parties are still keen to reach an agreement.

So far, albeit talks seem to be proceeding with slow progress, our base case remains that a deal between the US and China will finally be reached. We continue to see some encouraging signals coming from both parties, which allow us to remain confident that negotiations can continue (Xi wrote a "beautiful letter" to Trump, who then said that US-China relations remain very strong and that he feels the China talks will be successful). That said, the path to a final deal could be tougher and longer than was once expected.

We should now expect markets to enter a consolidation phase, while investors try to get to grips with what the next developments might be and whether global and earnings growth will surprise on the upside or downside. In our base case scenario, with the global economy recovering in the second half of the year and central banks remaining accommodative, episodes of market volatility may create attractive entry points in markets with compelling valuations, such as the European and emerging stock markets.

Nonetheless, challenges remain across the board and, at this juncture, we suggest maintaining a cautious stance. In particular, we believe that a potential escalation of trade tensions (if the US actually applies tariffs on all of the remaining Chinese imports, China announces a further retaliation or there's a full breakdown in negotiations) is not fully priced into markets yet and, as a consequence, it would impact short-term sentiment and trigger a major sell-off in risk assets. It is clear that recent macroeconomic improvements would also be jeopardised should the negotiations fail, leading us to reassess our current growth and earnings estimates. However, this is not our base case scenario at the moment.

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Important Information

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