CIO Insights

May 14, 2019. Authors: Deepak Puri – Chief Investment Officer Americas, Jason Liu – Head Chief Investment Office Emerging Markets

U.S./China trade dispute: what happens now?

- Central scenario is that we have real signs of progress by end-June 2019 G20 summit.
- Indirect impact of dispute on Chinese and U.S. GDP could be significant.
- Investors should recalibrate portfolios to prepare for volatility ahead.

What has happened?

Negotiations between representatives of both sides ended abruptly and without any further progress last Friday. But, even more important, the U.S. administration went ahead and raised existing tariffs on USD200bn worth of imports from China – from 10% to 25%. President Trump has also threatened again to enhance tariffs on the remaining USD340bn of Chinese imports to the U.S. not affected so far. In response, the Chinese administration has announced an increase of tariffs on U.S. imports worth USD60bn from June 1 onwards.

Market reaction

On Monday the S&P500 experienced its largest single day drop this year (down almost 70 points to close at 2812), led by IT and Industrials, two sectors with the most direct exposure to Chinese supply chains. This brings the five-day drop to 4.1% in the S&P500 and to 5.9% for the NASDAQ. Risk-off mode was also evident in the fixed income markets, with yields on 10yr U.S. Treasuries declined by 7 basis points to 2.39%. On the currency side, the CNY dropped by 0.5% vs. the USD, the biggest one-day-decline since February as the People's Bank of China (PBoC) lowered the USDCNY trading band.

Gold jumped 1.1% to 1299.6/oz. as investors looked for safety.

This morning, U.S. equity futures rose after gains in European and Asian markets, with USD gains and broadly stable Treasuries yields.

Our view

Future timeline: three key immediate dates. First, this **Friday, May 17, 2019** (or possibly the following day), when President Trump is due to make an initial decision on the Section 232 European auto tariffs issue. Second, **June 1, 2019**, when the Chinese retaliatory tariffs start to be levied, with new U.S. tariffs coming into effect around this date as well. Third, **June 28-29, 2019**, the dates of the G20 summit in Osaka, where Presidents Trump and Xi will meet.

We do not expect President Trump to launch an auto tariffs action against the EU this Friday; it would be difficult for his administration to fight tariff battles on two fronts simultaneously and he has the option to defer a decision for 180 days (i.e. until November). This may temporarily relieve markets, but will not by itself bring a solution of the Chinese trade issues any closer. Despite current market hopes, we think that a resolution before the second date on our timeline (June 1, 2019) is also unlikely. Our central scenario remains, however, that we see real signs of progress by the June G20 summit.

Economic impact: Deteriorating global trade is already weighing heavily on sentiment indicators (i.e. U.S. PMIs for new export orders below 50 pts.) and starting to bite into global growth numbers. U.S. exports to China have also fallen by almost 30% over the last six months.

Many current forecasts indicate a relatively small direct hit to U.S. and Chinese growth from an escalation in the trade dispute.

However, we think that the *indirect* impact of an escalation of tariffs is likely be larger, hitting (for example) U.S. earnings (where growth is already slowing), postponing future investment etc. There could also be an impact on U.S. monetary policy more broadly, although it seems likely that the Fed will look through any tariff-related increased in U.S. inflation for now. It is worth noting at this point that the U.S consumer appears to be have borne most of the increased inflation burden from tariff increases so far: little is being absorbed by Chinese exporters.

In China, we also expect continued stimulus measures from China to stabilize domestic growth. The tighter external trade conditions are, the more accommodative domestic economic policies will become, in our view. Note also that China has other potential ways to affect trade between the U.S. and China, beyond changes to tariff regimes. Local firms' or individuals' enthusiasm for buying U.S. products might decline. If CNY weakening in recent days is prolonged, this will have a significant impact on its own on trade trends.

Looking over a long-term horizon, it is also clear that China is trying to cultivate trade with ASEAN and, to some extent, Europe and this could be at the expense of the U.S.: note in this context that of if U.S. decides to implement 25% tariffs on the remaining USD340bn of Chinese imports, the average tariff rate in the U.S. would rise to 8%, making it one of the most protected import markets. This 8% rate would compare to average import tariffs in India of 6%, in China of 4%, and the European Union of 2%. Such a cultivation of some export markets at the expense of others would however represent a very economically sub-optimal solution, with long-term costs for the global economy.

Portfolio actions: Since April this year, we have been advising investors to "take profit and recalibrate" their portfolio. We think this approach remains valid. The near-term downside risks to equities have risen with the escalation of US-China trade tensions, and are unlikely to be resolved very quickly, adding to existing pressures from easing earnings growth amid the global growth deceleration. Meanwhile, we think fixed income remains selectively attractive: within this space, we would favor short-dated US Treasuries, US IG, Euro crossover and EM hard currency bonds.

Glossary

G20 is an international forum for the governments and central bank governors from 19 countries and the European Union.

The S&P 500 is an American stock market index based on the market capitalizations of 500 large companies.

The Dow or the Down Jones Industrial Average is a stock market index that indicates the value of 30 large, publicly owned companies based in the United States, and how they have traded in the stock market during various periods of time.

The NASDAQ Composite is a stock market index of the common stocks and similar securities listed on the NASDAQ stock market.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

CNY or the renminbi is the official currency of the People's Republic of China. The yuan is the basic unit of the renminbi, but is also used to refer to the Chinese currency generally, especially in international contexts where "Chinese yuan" is widely used to refer to the renminbi.

USD or the United States dollar is the official currency of the United States and its territories per the United States Constitution since 1792.

The PBoC or the People's Bank of China is the central bank of the People's Republic of China responsible for carrying out monetary policy and regulation of financial institutions in mainland China.

The EU or the European Union is a political and economic union of 28 member states that are located primarily in Europe.

The Fed or the Federal Reserve System is the central banking system of the United States of America.

The ASEAN is the Association of South East Asian Nations. It promotes the economic growth of 10 countries located south of China.

CIO Office, Deutsche Bank Wealth Management, Deutsche Bank AG - Email: WM.CIO-Office@db.com.

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