Brave new world

Markets have been fixated on the US-China trade spat since US President Trump's tweet in 2018 threatening 25% tariffs on an additional US$200 billion of Chinese exports. Since then, the ebb and flow of global markets have followed the progress (or lack thereof) of negotiations. Recent events point to a more protracted process with both leaders hunkering down for a continued trade standoff which could herald seismic shifts for the global economy.

Key takeaways on the macroeconomic front

- Full effects of a trade war would slash US and China GDP by 0.5% and 1% respectively
- Near-term risks include disrupted supply chains
- Tariffs could put upward pressure on goods prices, disrupting demand
- Business and consumer confidence could come under pressure, negatively impacting growth
- Recession risks have risen from very low levels to moderately low levels (risks could rise over time based on the evolution of the dispute)
- Corporate profit margins could be impacted, making corporate earnings potentially more at risk of a protracted dispute

Mitigation factors

- China could inject stimulus in the form of monetary easing and fiscal projects to offset the trade impact
- In the US, the Federal Reserve could adjust monetary policy if the economy slows materially, and the Trump administration could attempt to push for fiscal stimulus

An expensive tab

From a macroeconomic point of view, it is estimated that the effect of full trade war escalation would slow growth by 0.5% and 1% for the US and China, respectively. An analysis of household expenditure suggests the direct effect of the 25% tariff would be somewhat limited. Goods (excluding food) comprise slightly more than 10% of US household expenditure. The price impact of the tariff on US household appears minimal but the larger effect in our view would be via confidence channels, both consumer and business confidence. The risk of a protracted trade dispute would likely dampen consumer expenditure and business confidence. This could impact both employment and wage trends, which have up till now been healthy. Investors will need to monitor the second order effects of the tariff closely, as they could alter both behaviour and the outlook for growth. If aggregate demand is sufficiently impacted, corporate profit margins could face downward pressure. Over time, this could trigger third order effects via the wealth channel. Falling asset prices could further dampen confidence and demand, resulting in a steeper path to a downturn.

How China could retaliate against the US

Though China has recently said it would retaliate against the US, it is unlikely to materially raise tariffs further on US goods. Doing so may hurt their own corporates as many rely on US technology in areas such as technology operating systems and semiconductor chips. It may, however, attempt the following.

- Boycotting US companies operating in China
- Banning exports of rare earth
- Selling US Treasuries as the largest holder with US$1.13 trillion worth

War of the century

The trade conflict seems likely to continue throughout 2019 and even into the long term. The trade confrontation recalls a theory referred to as the 'Thucydides trap' where 12 out of 16 earlier rivalries between an emerging and an established power led to war. Furthermore, with the 2020 US presidential election looming nearer, anti-China attacks are used by Trump to score political points.

From the Chinese side, deep divisions remain: China's leaders have reiterated that it would not tolerate "humiliation" by foreigners, a context which harks back to Western powers winning so-called opium wars that allowed them to impose better trade terms in the 1800s. Fast forward to today and the rising superpower is exacting plans for a 'China Dream' to be on par with the US as Chinese President Xi cannot be seen at home as weak in relenting with American demands.

A new digital curtain

The dispute between Washington and Beijing extends beyond trade. With far-reaching capabilities of speed, capacity and connectivity, the wireless network commonly known as 5G is now caught in the proxy for wider power struggles.

Chinese tech companies now lead the world for 5G patents as of March 2019, representing 34%, compared with South Korea's 25%, and 14% for the United States. Chinese technology giant Huawei, the world's largest provider of networking gear and second largest smartphone vendor, plays a major role with over 15% of the world's 5G patents while the top US company has just around 8%, according to IPlytics, a patent data firm.

5G technology would not only create new jobs and boost GDP but also control online activity. The concern from the US lies with the threat that Huawei with its close links to the Chinese government can use it for spying or shut the data tap that the US depends on. Hence, attempts from the US to cut Huawei have huge implications for 5G rollout. This could mean the ban could extend to other technology firms, but more importantly, consequences for the supply chain from semiconductor chip companies to lens makers, who furnish parts for technology giants.

Taiwan's substantial exposure on the supply chain for tech giants means that it will be vulnerable to a potentially huge negative impact from US sanctions on Huawei and other Chinese tech companies. The non-tech exporters with production facilities in China are also at risk especially if Trump goes ahead to expand the coverage of China made products.

Positioning on China

Given Taiwan's heavy exposure to the manufacturing supply chain for tech giants, we have turned cautious on Taiwan equities. Our strategy is to stay invested with large-cap stocks and reduce exposure to mid-cap names that are more susceptible to market volatility.

Overall, we have trimmed China equities to underweight from an overweight position. The initial overweight stance from the first quarter of 2019 was based on constructive US-China trade talks that stoked hopes of a truce between both countries. A weaker than anticipated economic recovery in the second half of 2019, with government easing policies, also factored into the downgrade.

Earlier in May 2018, the CSI 300 slumped 7.9 in the aftermath of Trump's anti-China tweets. Then in June 2018, the index lost 6.6% when tariffs were introduced and declined 6.7% in August 2018 when the tariff percentage ratcheted up to 25%. Hence, in the event of a full-blown trade war, Chinese equities could see further downsides of up to 20%, including a 5 to 10% valuation de-rating and earnings cuts that could reach the lows in October 2018.

For fixed income, escalation to trade issues is likely to tilt global monetary policy increasingly accommodative alongside reversing emerging market inflows. Within Asia itself, the direct impact was comparatively small as it was seen mainly in technology related sectors comprising only a small percentage (around 6.1 %) of the entire Asia credit universe. Moving forward, a dampened outlook on the macroeconomic front would drag down corporate growth and earnings. Since sentiment is a major driver of Asian credit performance, continuing trade wars will widen spreads and raise levels of volatility.

FX

An escalating trade war would also impact foreign exchange markets through multiple channels: shifting trade flows, as well as expectations on growth and monetary policy. There are increasing chances that the Yuan could hit past the 7 mark against the US dollar for the first time in more than a decade.

Consequently, we are bullish on the Japanese Yen with its safe haven status amid ongoing trade tensions. The US dollar meanwhile, due to its perceived safe haven status may rally. However, we can't be overly bullish on the greenback due to falling US Treasury yields and the US Federal Reserve holds more room to cut policy rates compared to other central banks.

Summary

One reason that gives us a glimmer of hope that a compromise could be reached stems from the fact that the talks have not broken down completely. From a macro point of view, this risk escalation justifies increased caution and we will underweight equities and overweight fixed income.

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