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Fundamentals Flash

Asset Management

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AFFIN HWANG CAPITAL

US-China Trade Talks: Down to the Wire

With just two weeks left until the trade truce deadline, will we finally see the US and China come around the negotiation table to strike up a deal and end a bitter trade conflict that has lasted over a year? In the following interview Huang Juin Hao, Senior Portfolio Manager shares the possible scenarios of the trade talks and market implications.

1) Trade negotiations between US and China are currently ongoing, but the 90-day truce period is set to end on 1 March 2019. What are your expectations of the talks and possible outcomes?

Our expectations have shifted. Towards the end of 2018, the market was expecting higher odds of an escalation or widening of trade tariffs against China. This was in part, due to the extremely short time period available for negotiations due to US Christmas holidays in December'18 and China's Chinese New Year holidays in February'19.

However, the market has since moved their expectations towards a higher probability of a neutral or positive outcome for trade talks after more conciliatory signals from both China and US.

In latest news, US President Donald Trump has expressed willingness to extend the March 1st deadline, while Chinese President Xi Jinping and Vice Premier Liu He is reportedly scheduled to meet with key members of the US trade delegation including US Trade Representative Robert Lighthizer and US Treasury Secretary Steven Mnuchin in Beijing this Friday. We believe the meeting between the top trade envoys signals goodwill and firm efforts to come to a resolution that would be agreeable to both sides.

We are currently leaning towards a base case that sees the status quo remain (no further escalation or de-escalation of the current 25% tariffs imposed on USD$ 250bn worth of goods), and one where it would allow for the deadline to be extended and for talks to be stretched out towards the end of 2019.

2) What are the remaining issues or barriers that could scupper negotiations and prevent a lasting trade deal agreement from being brokered?

The list of demands by US on China broadly fall into several issues including a more balanced and fairer trade as well as technology transfer and intellectual property rights (*see more in Table 1*).

Table 1: Breaking down US-China trade talks

US demands*	China offerings
More balanced trade: Reduce its trade surplus with the US by at least $200bn by the end of 2020.	**Buy more:** Help reduce the trade surplus by about $100bn, largely through increased purchases of US agriculture (mostly soybeans), energy, and aircraft.
Fairer trade: Reduce tariffs in "non-critical" sectors to levels that are not higher than the levels of US tariffs.	**Reduce tariffs:** Lower import duties modestly but not to match those of the US. China already announced it will cut import tariffs on a range of goods effective Nov 1. This combined with cuts announced earlier this year will lower its average most-favored nation (MFN) tariff rate to 7.5% from 9.8%.
Stop IP theft: Stop policies that compel technology transfers and stop government-backed cyber theft of intellectual property.	**IP protection:** Revise the patent laws to improve the protection of intellectual property.
Open up: Ease restrictions on foreign investment by revising the so-called "negative list".	**Open(ing) up:** Loosen restrictions on banking, including a removal of JV requirements for security firms in 3 years. Remove JV requirements in the auto sector for new business and after 3 years for existing.
End government subsidies: End government subsidies, including to industries targeted by the Made in China 2025 Plan.	
Do not resist: Cease retaliatory actions, including against US agriculture, for US restrictions on China's investment in sensitive US sectors.	
Communicate more: China and the US will meet quarterly to review progress, at which the US will decide if further tariffs will be needed.	

Source J.P. Morgan. *The list of demands is based on a document from the US delegation to Chinese policymakers to help facilitate the May 2018 trade negotiations in China.

These can be thought of and placed into 3 categories – the first category is where China is willing to compromise, the second category where China is willing to negotiate and the third category is where China is not willing nor able to negotiate as these issues centre around national security or national ambitions.

The first 2 categories are relatively low-hanging fruits that can be negotiated easily, as seen recently with China pledging to narrow its trade surplus with the US by purchasing more US goods or removing barriers of entry into its domestic market in its auto and finance sector.

We believe the key barrier to a lasting trade agreement is that roughly a third of US demands on China falls into the 3rd category that are non-negotiable.

This could mean China abandoning its 'Made in China 2025' goals and being forced to cede its technological advancement ambitions. Any deal resulting in China compromising on this category would certainly be bad optics for President Xi Jinping and the ruling Communist Party by coming across weak and hurt the party politically.

3) We've seen EMs perform strongly at the start of the year on the back of a weaker US dollar and Fed turning more dovish. Do you think there are more legs to the current rally once this trade overhang is removed?

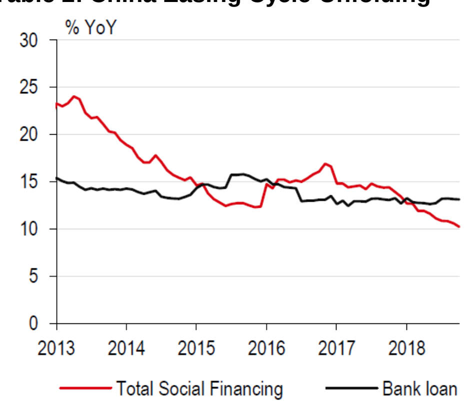
Should the US-China trade dispute remain status quo or even improve, the market will have removed one point of uncertainty from the overall global growth outlook. However there are still other points of uncertainty that remain on the horizon clouding the outlook on global growth, such as the US growth momentum, global liquidity tightening, as well as political issues in Europe and the Middle-East.

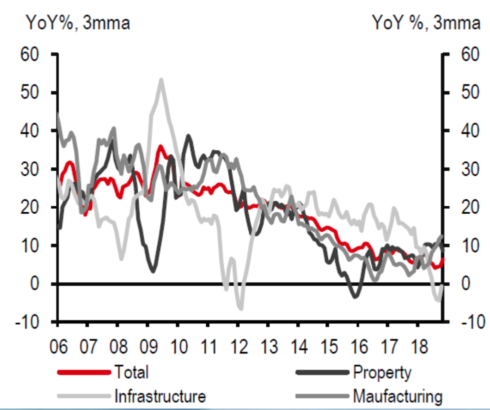
4) We've seen China announced a slew of easing measures to prop-up the market as growth cools domestically. What is your outlook on growth for China and will these stimulus measures be effective?

Currently, the market expects that China's GDP will grow at a slower pace than in 2018. Thus far the total effect of the announced stimulus measures when compared to those taken during 2015 and 2016 (e.g. reserve requirement ratio (RRR) cuts, special bond issuance, as well as the pace of local government debt issuance and swap), have been roughly on the same magnitude as in 2015/2016.

In 2015, China also had the tailwind of interest rate cuts and the size of the economy was much smaller and the fiscal multiplier effect of stimulus, larger. While details of more possible stimulus measures are in the pipeline and expected to be announced soon (value-added tax (VAT) cuts, stimulus measures for home appliances and autos), we should expect the Chinese authorities to abide by Xi's emphasis on growth quality rather than speed, hence we do expect growth to continue to soften from 2018.

Table 2: China Easing Cycle Unfolding





Source: CEIC, HSBC

7) Beyond the US-China trade conflict, what other factors/key events that you are keeping an eye that could impact the performance of Chinese equities? Are valuations also looking attractive now post sell-off?

A key event we are watching out for in China is the outcome of the 2 sessions meeting in early March [both the Chinese People's Political Consultative Conference (CPPCC) and the National People's Congress (NPC)], which will see the country's top advisory body and top legislative body meet to chart the course ahead and to approve work reports for 2019. We are waiting to see if further details on stimulus measures will also be announced then.

In a challenged year, the Shanghai Composite Index and MSCI China Index fell 20-24% in 2018. The market has since rebounded by some 9-12% YTD. Valuations are now below or hovering at long-term average levels.

Global funds which were cautious and largely underweighted in China are beginning to short-cover and flows are beginning to move back into Chinese equities. A trade status-quo outcome and possible further stimulus then could offer an attractive risk-reward for those sectors which are relatively insulated from trade and for domestic structural growth sectors.
