US-China Trade War: Where Does the Path Lead?

May 2019

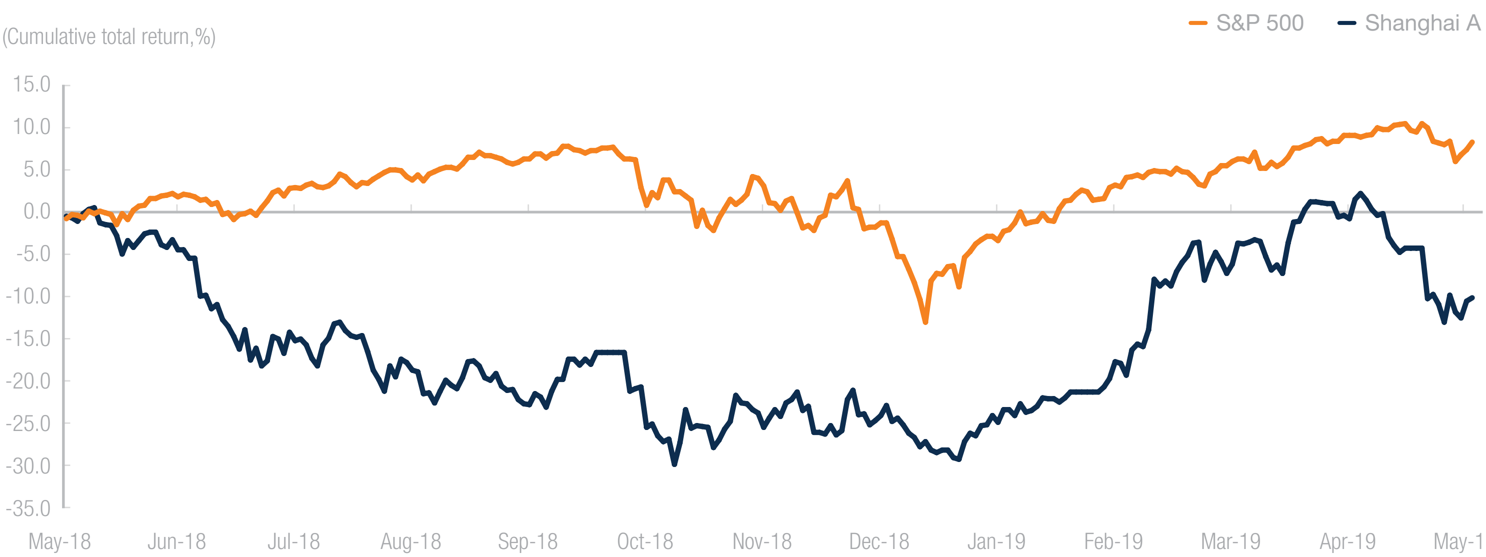
On the Spectrum of Game Theory

Since the US and China agreed on a three-month truce, the global financial markets have rallied in a rapid fashion making the current sell-off much more dramatic. Over the past few weeks, there has been much debate about the reasons for the abrupt derailing of the deal - and with China making a ‘proportional response’ to the US tariffs, the markets will watch vigilantly for the short-term direction of the trade war between three directions: escalation, stalemate or agreement.

Whenever President Trump mentions his great relationship with President Xi, observers assume that it is a sign of his desire to do a deal. That may be somewhat true, but to assume that Trump has a

America First

Source: Bloomberg (2019)



specific goal for the final deal would be an analytical error. As it has been preceded in his past routine of other negotiations, Trump is looking for the maximum amount of concession possible from China, where the weaker China's position becomes (relative to the US), the more he will raise his asking price. Since the negotiations began in January, the US economy is no longer under threat of an imminent recession and US equities have rallied 20% for the first four months. Therefore, the urgency of a trade deal has lessened significantly, with the US possibly raising the bar on the deal.

Facing Different Domestic Conditions

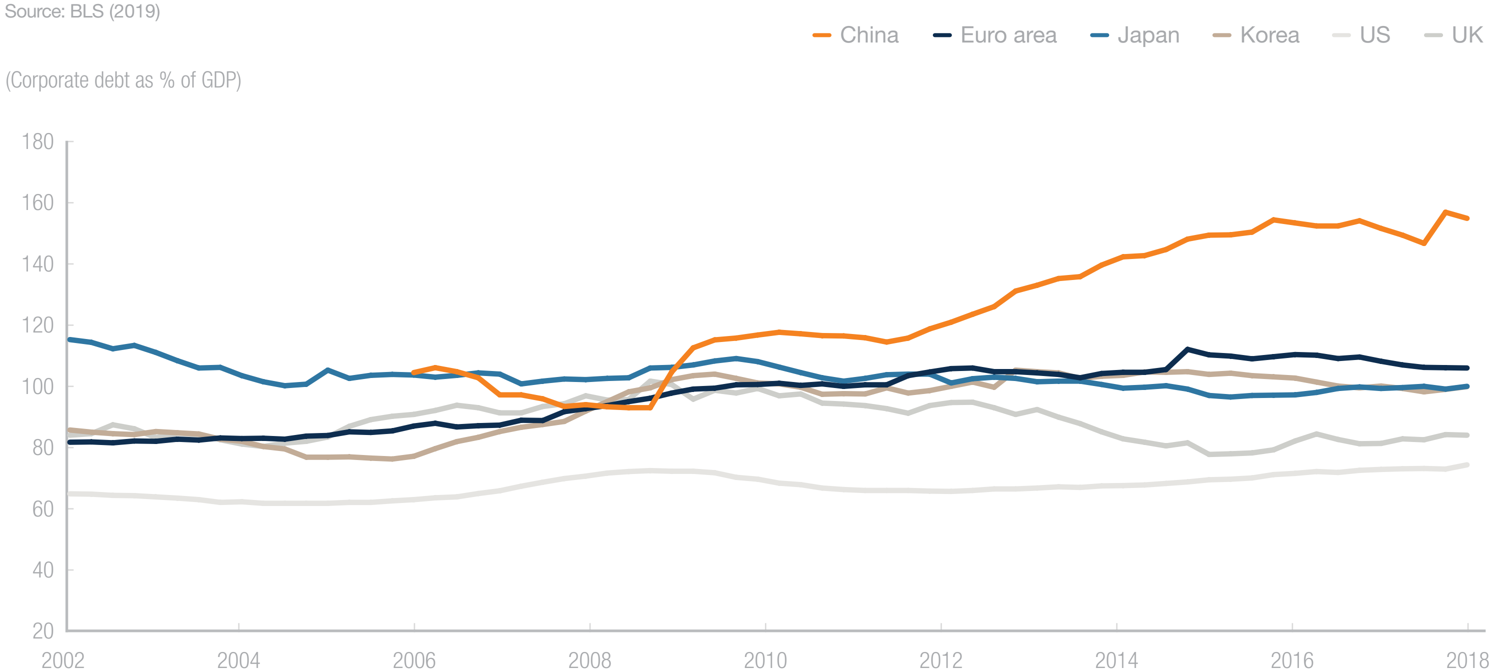
Politically, with the year of 2020 election looming, Trump needs to ensure that the deal with China will ultimately remain a vote-winner for his campaign. As a deal which is decided hastily could haunt Trump's election campaign for the next 12 months, the lesson from his dealings with Kim Jong-un of North Korea can be of value to him. When Trump and Kim met in the historic summit in Singapore almost 12 months ago, Trump claimed victory by surpassing more than what previous US presidents achieved combined since the Korean War ended. Since then, Trump has come under intense criticism for being too soft on North Korea and that he got played by the young dictator. The abrupt end of the Vietnam summit was also proof of the pressure Trump was feeling to recoup the political loss of face from the Singapore agreement.

Trump personally may be tempted to hold off until an optimal vote-winning deal as demanded by the American public is visible. Increasingly, direct confrontation with China on trade and the issues regarding intellectual property are quietly gaining traction from both sides of the Congress. Giving away such vital election strategy with more than 12 months before the election may be considered premature.

From China's perspective, it also received relief from the recent stabilization of the mainland economy and recovery of its stock markets. The micromanagement of its economic policies has stabilized the economy while investor sentiment has turned positive to the most favorable it has been in a few years. We maintain that China remains keen to strike a deal that will buy itself time, thus enabling it to stay on a structural reform track of deleveraging and rebalancing the economy towards productivity and profitability. An aggressive stimulus to shore up the mainland economy at this stage could reverse much of the efforts of the past three years and sink China into further debt problems.

China's Corporate Debt Rising Again

Source: BLS (2019)



Despite recent improvements of the mainland economy, China still remains the vulnerable party of the negotiations. However, with the US seeking a rigid agreement on trade with China, such deal is not easy to accept by China fundamentally and politically. From our perspective, tariffs are not the critical component of the negotiations since they are easily reversed and never permanent. Market access for US companies and permanent dismantlement of state-sponsored subsidies are issues which China is reluctant to give up as they could potentially threaten their long-term ambitions.

China's Xi has met North Korea's Kim several times over the past 12 months where they most likely shared notes on dealing with Trump. Until the Vietnam summit, Kim had achieved much more than any other world leaders in gaining concessions from Trump. China would be keen to emulate such feat by fostering a to a deal which can be gradually reversed in time. Just like the economic sanctions against North Korea, the hardliners from the US seems reluctant to scrap the tariffs entirely until a significant concession from China is verified.

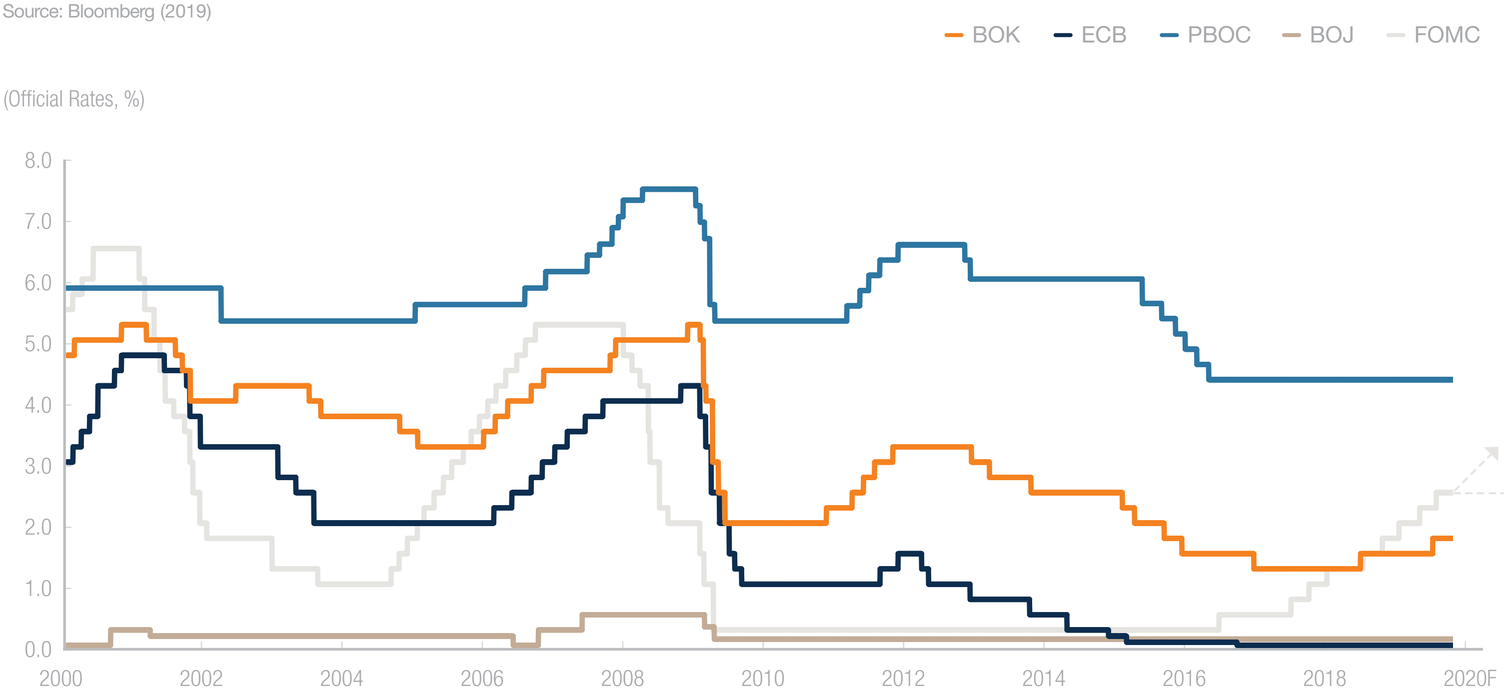
Ironically, the failed trade negotiations between the US and China was a personal win for both Trump and Xi politically as it proved to both sides' citizens their willingness to display strength, even at the expense of investors. The markets and the economy from both sides will have to deteriorate significantly in order for Trump and Xi to make the necessary concessions. Even then, an absolutely irreversible on trade will not be possible at best an open-ended deal that leaves open for negotiations is the most likely scenario. For those reasons, we do not expect an agreement to be struck before or during the G20 summit in Osaka on 28th June.

Neither Resolution or Escalation

Surprisingly, it is not our expectation that the absence of the US-China deal will drag down equity markets much further. From a YTD perspective, the market rally was driven primarily by the coordinated dovish pivot led by the US Fed which was duly followed by stimulus from the ECB and China. The expectations of a trade war resolution was a positive, but one that was secondary to the sudden stimulus from the US Fed last November. The prolonged trade dispute (without dramatic escalation) will not cause a deeper correction as the trade war threat will ensure that a dovish stance will remain for the rest of 2019. Therefore, while we call for lack of resolution to the trade dispute, we also do not expect escalation, thus allowing markets to stabilize in the coming weeks.

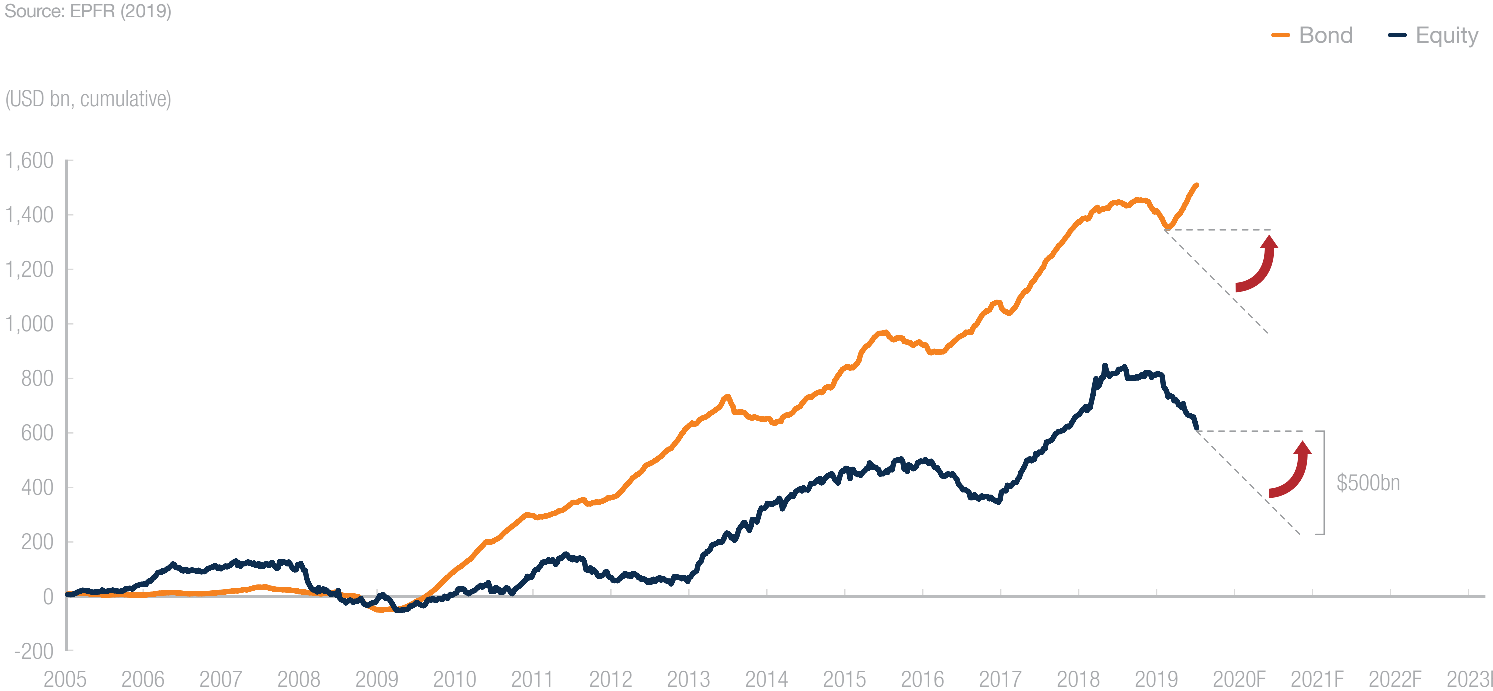
FOMC's Sudden Pivot is the Primary Driver of Markets

Source: Bloomberg (2019)



Global Fund Flows also Pivoting

Source: EPFR (2019)



Trade Noise Being Routinized

For the long-term, it is believed that the US-China relationship is on a long-term path of trade and political stand-off which is likely to outlast both Trump and Xi. Xi at least enjoys a major advantage over Trump with time on his side since Trump will leave office in under six years at the most. Until then, China will see leverage gradually shift to its side with a structurally stronger and self-sufficient economy with industries that rely less on imports. Ultimately, much like Brexit, investors will have to get used to a standoff between the US and China as part of their daily routine, with or without Trump in the White House. The trade-related noise and related costs associated with it will have to be a routine and unavoidable part of investment considerations for the coming decade.

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