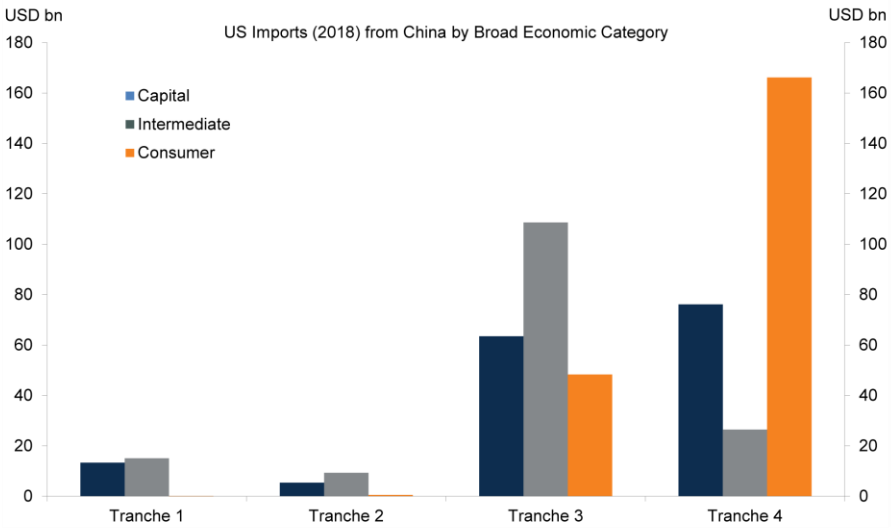
Recent Developments of US-China Tensions

On May 10th, the US increased the tariffs on US$200 billion worth of Chinese exports from 10% to 25%, with an exception for goods already in transit. This follows the comments on May 5th by President Trump and his senior advisers that ongoing negotiations with China had not progressed to the level they had hoped. In response, China retaliated almost immediately, announcing that it would hike tariffs up to 25% on $60bn of US goods, effective from 1 June. Despite the escalation, China's Vice Premier Liu He has signaled that trade negotiations are expected to continue in the coming weeks.

We are of the view that the recent re-escalation of US-China trade tensions is likely to be temporary. However, markets are expected to pull back somewhat and see higher levels of volatility in the near term due to the increased uncertainty and risk. From the US side, the recent strength in the US economy and stock market was perhaps viewed as an opportunity to add pressure on China. Furthermore, from a political standpoint, a tougher stance on China appears to have worked favourably for President Trump. Nonetheless, we expect that China and the US will continue to work towards trying to reach an eventual trade deal and it appears that the key areas of negotiation relate to China intellectual property laws, China's purchases of US goods and timing of US tariff removal in the case of a trade deal.

Fig. 1. Tariffs Implemented So Far Mostly Affecting Capital and Immediate Goods

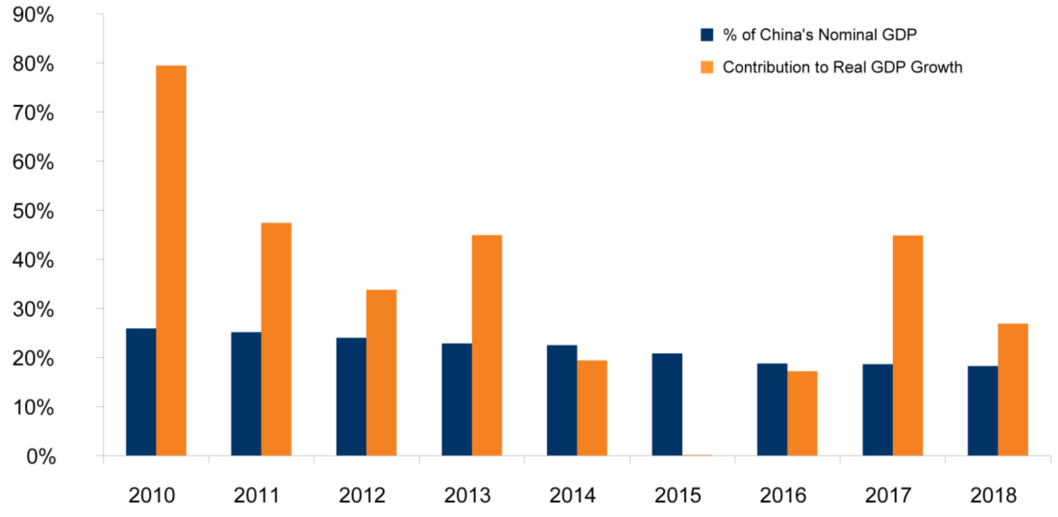


Potential Economic Impact and Policy Response

It is estimated that the additional tariffs announced will lower China's GDP growth by 30- 40 bps in the next 12 months.[1] This takes into account the direct impact of weaker exports and indirect spill-over effect on consumption and investment. However, the negative impact from weaker sentiment could potentially have a greater effect in the near term. In the worst-case scenario of further escalation, whereby the US imposes an additional 25% of tariffs on a further US$300 billion of Chinese exports, this would inflict more damage on China's growth, but also more widespread impact on regional and global growth.

[1] Estimation provided by UBS Research; May 2019

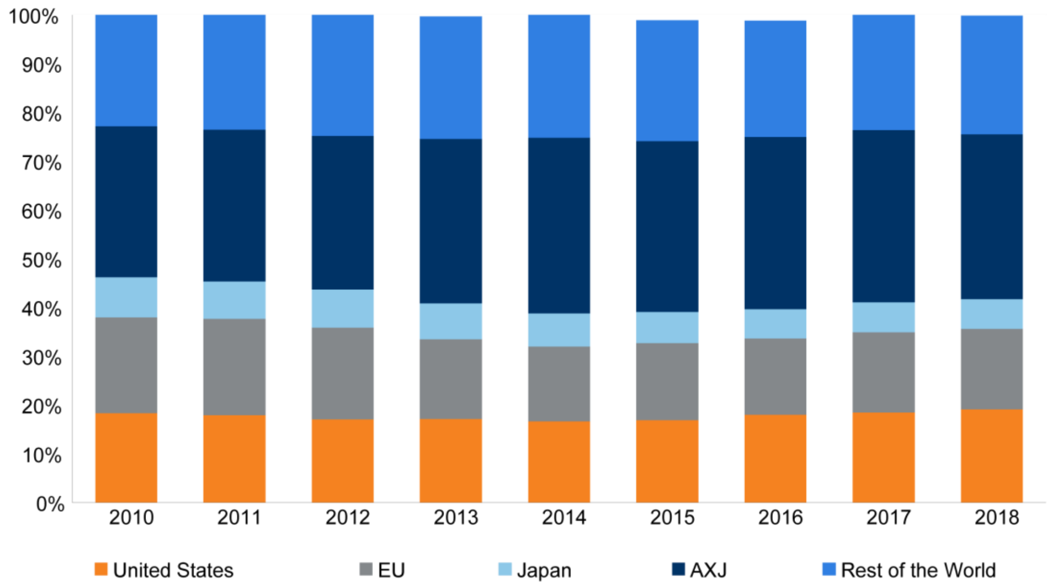
Fig. 2. Export Contribution to China's GDP has been Declining



Focused on Stimulating Domestic Economy

In light of the escalation in trade tensions, we would expect Chinese policymakers to roll out further measures to support the domestic economy and anchor market expectations. This could include further infrastructure spending boosts, monetary easing, fiscal stimulus, as well as supportive policies to targeted industries including autos and home appliances. Although trade tensions concerns were one of the key drivers behind the sentiment deterioration in 2H 2018, there were also other contributing factors such as deleveraging effects and regulatory tightening in certain sectors. As such, we believe that the latest round of tariff increases will not hit business sentiment as hard as it did last year. Importantly, the Chinese government still has many levers it can utilize to stimulate the economy, particularly given that the stimulus thus far has been very measured.

Fig. 3. China's Export Breakdown by Destination

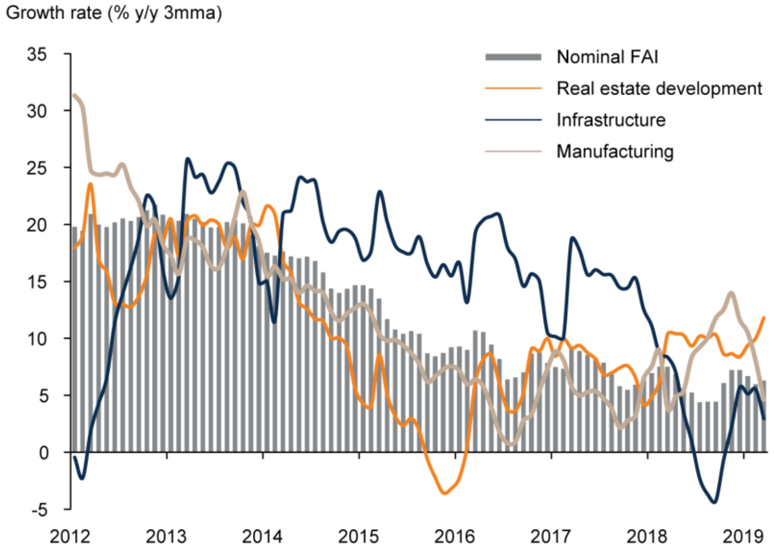


Protectionist Stanced – Shared Across Governments

In terms of the US, the Federal Reserve’s current policy stance is maintained at neutral, but we would expect that the dampening effects of higher tariffs will likely see it move toward a more dovish stance by the end of the year.

Although higher tariffs are disruptive, the fact remains that job creation is a structural issue globally; particularly with the rise of automation. As such, a more protectionist stance from governments is likely to persist. India could be an appropriate example within this context – as India previously has raised import barriers for various goods to reduce the import bill as well as support the domestic manufacturing activity. Also with a purpose of protecting the domestic steel manufacturing industry, India implemented safeguard duties on import of steel products, ranging from 10-18%, during 2015-2018. Furthermore, in October 2018, import tariffs in India were also raised on several electronic items and communication devices including smartphones and smartwatches.

Fig. 4. Expect Stronger Infrastructure Investment in China



Outlook and Portfolio Positioning

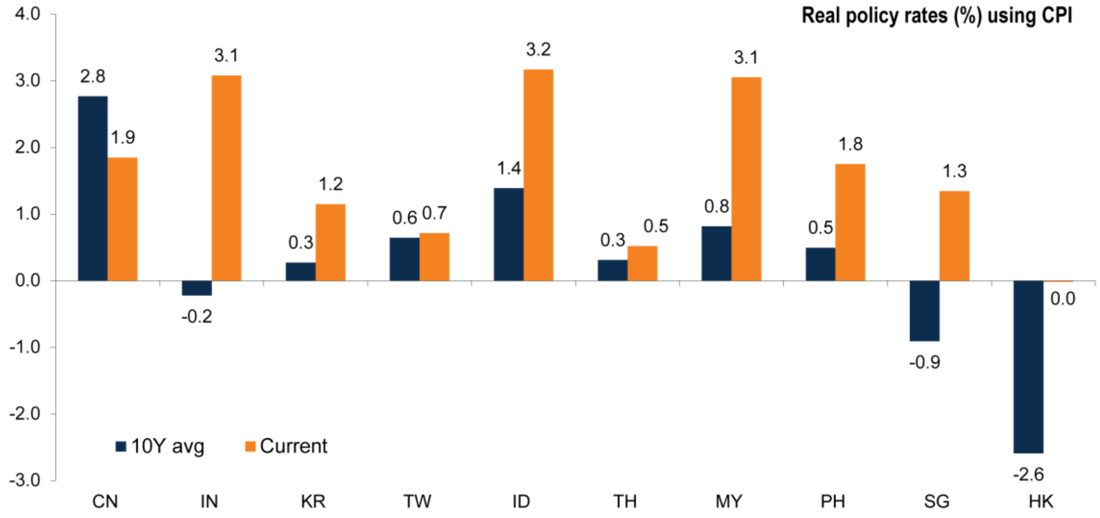
Despite the near-term impact to markets following the latest US-China trade developments, our current base case is that re-escalation in trade tensions is temporary and we see a more gradual growth recovery. The direct and indirect impacts arising from raised tariffs will have some negative impact to growth; however, we believe that further easing policies will be able to mitigate some of these effects. Furthermore, valuation of the Asia ex-Japan market is currently not at an expensive level; around 10% higher than the 1.3x P/B lows reached in October 2018.[2] With a near term market pull-back; we could see some attractive risk-reward opportunities arise from here. Additionally, Asian policy rates and currencies have been normalized to a greater degree since 2013. This provides Asian central banks and policymakers' room to deal with potential downside risks to growth

Overall, the portfolios are positioned away from export players and more geared toward domestic demand stories in China, including leading names in education, consumer staples and internet/e-commerce. We believe that these sectors will be more resilient in the current environment, particularly if policymakers target to further support domestic demand, which we have already seen via various tax cuts and spending policies.

From a medium-to-longer term perspective, there may be some regional winners arising from US-China trade tensions, as companies explore manufacturing facilities outside of China. This could benefit a number of countries in the region including India, Vietnam and other parts of South East Asia. We continue to focus on selecting the best ideas in the region through our fundamental bottom-up approach in research.

[2] Company data and Credit Suisse research, April 2019

Fig. 5. Asian Central Banks Have Room to Cut Rates



Footnotes

Fig.1 USITC, Department of Commerce, United Nations, Goldman Sachs, Mirae Asset
Fig.2 CEIC, Morgan Stanley, Mirae Asset
fig.3 CEIC, Morgan Stanley, Mirae Asset
fig.4 CEIC, UBS, Mirae Asset
fig.5 Bloomberg, Mirae Asset

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