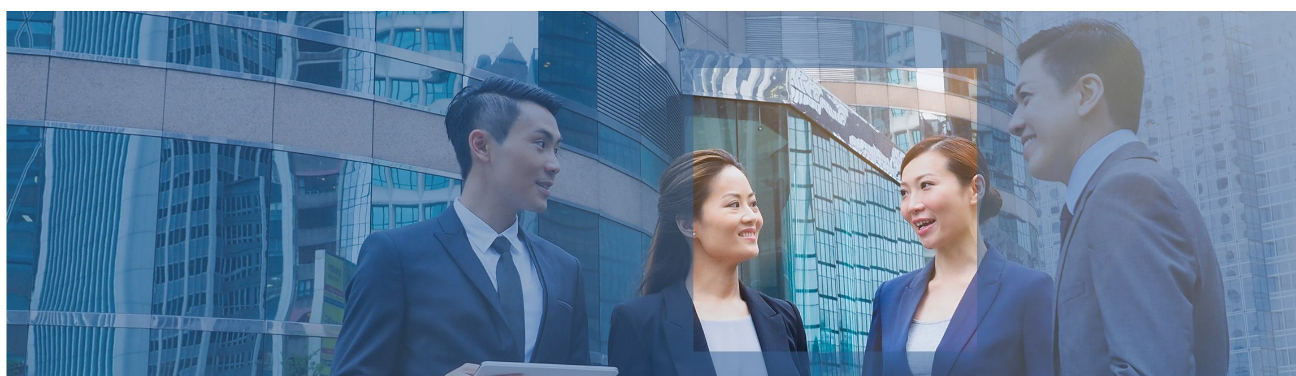
Active is: Adapting to shifts in global trade

What a US-China trade deal could mean for investors

by Mona Mahajan , Christiaan Tuntono , Neil Dwane | 04/03/2019



Summary

In a Q&A with Neil Dwane, Christiaan Tuntono says China will likely agree to reduce the trade deficit and support IP protections, but not roll back "Made in China 2025". Mona Mahajan thinks an announced deal should boost US and Chinese stocks, but the markets have already priced in some of this news.

Key takeaways

- We think China will fix some trade-malpractice allegations to resolve its trade dispute with the US, but it's unlikely to curb government subsidies or change its long-term strategy to transform its economy
- In anticipation of a trade deal, investors should look at the "winners from trade" investment theme: technology, industrials and energy/materials seem likely to benefit from lower tariffs and enhanced global growth
- Globally, we continue to favour a "barbell" approach in equities and fixed income across multiple regions, but we believe it's critical to take an active approach to help manage risks
- In this late-cycle environment, we believe investors should remain active, continue the "hunt for income" across asset classes and focus on ESG factors to seek additional downside protection

Neil: *Trade has been a signature political issue for US President Donald Trump, who imposed steep tariffs on China before recently extending an olive branch to Chinese President Xi Jinping. Where do US-China trade talks stand now?*

Christiaan: Ever since President Trump and President Xi reached a temporary truce at the G20 meeting in Argentina on 2 December 2018, the American and Chinese trade delegations have been conducting intensive talks to try to reach a deal acceptable to both sides. Progress reports have been positive enough that Mr Trump recently postponed the original 1 March 2019 deadline. That means the US won't yet impose a 25% tariff on USD 200 billion worth of Chinese imports. Both sides will reportedly keep working to summarise the new agreements before a possible end-of-March meeting between Mr Trump and Mr Xi to conclude the negotiations.

Neil: *Even if the issue of tariffs gets resolved now, is there a risk of another flare-up? And what about longer-term structural issues – like US accusations of China's intellectual property (IP) theft and unfair trade practices?*

Christiaan: China's alleged trade malpractice is at the core of the negotiations, but there are actually many individual issues on the table. Below is our view of the United States' demands on China, ranked in order from easiest to most difficult to resolve. We think there is a 50% chance of reaching a "partial" deal that addresses items 1-2 and some structural issues, such as IP protection. We see a 40% chance that the two sides will reach a "comprehensive" deal that addresses items 1-6. But we think there's only a 10% chance that the US and China will fail to reach any deal.

Some US demands will be quite hard for China to meet

Degree of difficulty to negotiate	Rank	What the US is demanding of China	Our view
Easiest to resolve	1	Increase purchases of US imports	These address America's trade deficit with China; China seems more flexible on these points.
	2	Increase market access for US companies	
	3	Strengthen intellectual property (IP) protection	These affect tech protection for foreign companies operating in China. It may gain long-term benefits by yielding some ground, but it won't trust America's goal of unilateral enforcement.
	4	Stop forced transfer of technology	
	5	Stop cyber-theft	China's integrity is at stake here. It has denied US accusations and will find it hard to admit to wrongdoing. But if China makes concessions on these points, both sides could halt covert operations.
	6	Curb non-tariff barriers	
	7	Curb government subsidies	China still has a state-led economy, and is committed to transforming it to grow out of the middle-income trap. It is unlikely China would compromise here.
Hardest to resolve	8	Roll back/revise "Made in China 2025"	

Neil: *What are your insights into the economic and market implications of a trade deal?*

Mona: We believe a partial or comprehensive deal would be received favourably by risk markets globally. The trade wars have been a dark cloud over the global economy and have created uncertainty around trade, corporate spending and supply-chain management. If China and the US are able to reach an agreement, this overhang would be lifted to some degree. Perhaps we would even enter a more open environment for global trade and China's markets. In this scenario, both US and Chinese equities could respond well, the renminbi might strengthen and the US dollar could stabilise. Emerging markets and international equities could also benefit from an overall risk-on environment.

However, as we get closer to an actual deal, it will likely continue to get "priced in": equity markets in the US and China have already done quite well this year, up 11% and 26%, respectively, as at 26 February. During the same time period, the renminbi rallied about 2.5%, the US dollar softened about -0.5% and emerging markets returned around 12%. So while a deal carries some potential upside, investors should note the extent to which this outcome has already been factored in by the markets. Any further upside may come when the markets see signals that growth has stabilised – not just in the US and China, but globally.

Neil: *What should investors do? How should they position their portfolios?*

Mona: We think investors should continue to incorporate the "winners from trade" theme, investing in sectors such as technology, industrials and energy/materials. They should benefit not only from lower tariffs, but also from prospects for enhanced global growth. Globally, we continue to favour our broader "barbell" approach in equities and fixed income across multiple regions. The US remains an economic relative outperformer among developed-market peers, while China and select emerging markets should benefit not only from a trade deal, but from ongoing Chinese stimulus, a potentially stable or softer US dollar, and more attractive valuations.

But even if trade-related uncertainty were to lift, investors would still face a late-cycle backdrop of slowing global economic growth and increasing accommodation from central banks. In this environment, risk assets may perform well, but with higher levels of volatility and greater dispersion between the winners and losers. This leads us to suggest a three-pronged approach for investors:

Actively invest across asset classes – equities, fixed income and alternatives – to identify winners and losers, generate potential alpha and help manage risk.
Keep up the "hunt for income": With lower rates and generally low inflation globally, the biggest risk may be to avoid taking risk. Investors should consider maintaining exposure to risk assets to meet income and return targets, and to help guard against wealth erosion over time.
Seek more active downside protection, perhaps by incorporating environmental, social and governance (ESG) factors as an additional risk-management tool.

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05/03/2019

Summary

New ships – as well as promotions, convenience and variety of destinations – are the main factors driving consumer demand, with current bookings for 2H 2018 and 2019 trips up vs. last year in the US and in most

countries surveyed in Europe. Spain was the outlier, with mixed bookings.

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