Market Bulletin

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301 problems, and retaliation is one

In brief

- As expected, the U.S. administration moved to place tariffs and investment restrictions on China in retaliation for the way in which China treats U.S. companies.
- China will likely prepare greater retaliatory measures on U.S. agriculture and make it more difficult for U.S. companies to sell their products in China. The measures announced today have more to do with the earlier announced tariffs on steel and aluminum.
- These tariffs and investment restrictions will likely do very little to reduce the trade deficit the U.S. has with China, which has been a big focus of the U.S. administration.
- The economic impact on both China and the U.S. will be determined by what form the tariffs end up taking. The effects are likely to be felt more strongly in the U.S. through an increase in both consumer and producer prices. Exports are still extremely important to the Chinese economy, despite a structural shift toward consumption in recent years.
- Other than the potential modest inflationary impact on U.S. consumer prices, which could bias the Federal Reserve toward a more hawkish stance, the fundamental impact on the bond market is likely to be limited.
- Equities will bear the brunt of market reaction. The most impacted will be the U.S., Korea, and Taiwan, as companies domiciled in these markets make up a significant portion of the global production chain of Chinese exports. Chinese listed firms, on the other hand, derive most of their sales from the domestic market.

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THE U.S. TOOK ACTION ON TRADE

Using the authority granted by Section 301 of the Trade Act of 1974, the U.S. announced tariffs on around USD$50 billion of Chinese imports, in retaliation for what the U.S. Trade Representative (USTR) found to be unfair trade practices in the way China treats the intellectual property and technology of American firms. The full list of the proposed tariffs and on which products they will apply is due to be published in fifteen days, then finalized after a period of public comments. The USTR will also bring a case before the World Trade Organization to challenge China's technology licensing practices. Additionally, the U.S. Treasury Department is prepared to begin restricting Chinese investment in American firms over concerns about maintaining the U.S.'s strategic advantage in several technology sectors.

China is likely to hit back where it hurts, politically

This announcement was relatively unsurprising, both because leaks from the administration over the last few weeks had telegraphed these moves pretty clearly and because the conclusions from the USTR report were the same as the conclusions from several annual reports published by the USTR and independent congressional commissions over the past two decades. Today, China announced it is investigating appropriate retaliatory measures and also took the opportunity to announce tariffs of its own on USD 3 billion of U.S. agricultural products, which come from politically important areas for U.S. President Donald Trump, in response to the earlier U.S. decision to apply tariffs on steel and aluminum imports. We expect China to announce more measures in response to the Section 301 tariffs in the coming weeks.

The economics of it all

The administration's ultimate goal with these policies is to reduce the U.S. trade deficit. U.S. Treasury Secretary Steven Mnuchin said, "Our objective is to reduce it by us selling more goods to them, not us importing less goods." These policies will not have this intended effect. Not only will the immediate impact be to make goods more expensive, but the U.S. trade deficit is largely a result of macroeconomic factors. The U.S. does not save enough to fund its spending, nor does it make enough to fulfill its desired consumption. The deficits these behaviors create may get a boost from the recent tax bill the administration championed, which will likely widen the trade deficit.

On China's side, trade exposure to the U.S. has been steadily declining. Exports to the U.S. have been on a downward trend in recent years as China develops closer economic ties with emerging economies in the Asia region and China's economy shifts away from being so export intensive. The largest economic impact from these measures will be on the price of Chinese goods in the U.S. U.S. officials hope to change the behavior of Chinese firms by raising prices and thus, lessening demand for their products in the U.S., but producers are typically slow to adjust in response to trade measures and end consumer prices are set to bear the immediate brunt of higher costs.

Investment implications

This announcement triggered risk-off sentiment in both the equity and bond markets, with 10-year U.S. Treasury yield down by 6bps and S&P500 closing 2.5% lower. As mentioned earlier, these actions were not a surprise, but that did not mean the market liked the news. Future earnings of firms in several countries across many industries will be affected. U.S., Korean, and Taiwanese companies make up a significant portion of the global production chain of Chinese exports. Hence, import tariffs in the U.S. on products from China may not be borne by Chinese companies at all. Chinese listed firms, on the other hand, derive most of their sales—around 80%—from their domestic market.

Trade tensions between the U.S. and China will likely remain the market's focus for some time. Given the close relationship between Asian corporate earnings and the global trade cycle, political maneuvers undermining trade will likely dampen sentiment in the near term, leading to higher equity market volatility. For investors, it is important to identify which markets and sectors are exposed in each trade dispute, as those most affected may not be the two countries listed in an executive order imposing tariffs. In this particular case, Asian companies with a greater domestic focus should be more resilient. Given the high costs of escalation on both sides, and also for the broader Asian supply chain, an extended and comprehensive trade war remains unlikely. Ultimately, the involved parties may get to a negotiating table and work out a deal before these protectionist measures go into effect, but in the meantime, investors should be prepared for headlines to continue to unsettle markets.

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