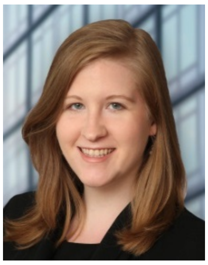
Market Bulletin

July 12, 2018

Here we go again: U.S.-China trade tensions

In brief

- Continued escalation in the China-U.S. trade conflict has produced a good deal of investor anxiety. Markets have reacted poorly to each new development in this dispute, but investors are beginning to differentiate between the net economic impact of these tariffs—which will be small—and the impact on U.S. and Chinese equity markets and individual companies—which will vary widely (**Exhibits 1, 2 and 6**).
- On July 10, the U.S. published a list of USD 200billion Chinese imports it intends to apply 10% tariffs on in the near future. This brings the amount of Chinese imports the U.S. has proposed applying tariffs on to USD 250billion.
- Previously, U.S. tariffs on imports from China were met with equivalent tariffs on Chinese imports from the U.S. If the U.S. follows through on applying tariffs to USD 250billion of imports, China will not be able to retaliate in kind. China's retaliation strategy will likely shift toward restricting U.S. business operations in China (**Exhibit 3**).
- Higher volatility brought on by trade tensions does not alter our view that overall equity fundamentals remain attractive in most markets. The nuanced impact of tariffs across different production lines means understanding their impact on an individual portfolio is a stock-specific question, but the distribution of proposed tariffs suggests that capital-intensive names in the U.S. industrial and technology sectors will be most directly impacted (**Exhibit 5**).
- As the global business cycle ages, investors may want to hold lower allocation to riskier assets like equities than at earlier points in the cycle, but volatility alone should not deter them from maintaining a relative overweight to riskier assets, especially when fundamentals remain solid.



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IN THE LAST 24 HOURS

One of the biggest sources of volatility for global markets in recent months has been U.S. actions on trade. Markets have grown increasingly anxious about how protectionist actions, which we are now seeing in the U.S.-China trade dispute, will reverberate through markets. Investors should be aware it will take markets some time to fully and appropriately price in the impact of these policies—which is one reason that market reaction immediately after an announcement has borne little resemblance to market behavior in the following days. It was encouraging to see markets not react too poorly to implementation of the first round of U.S. tariffs on China on July 6, but this was a "no new news is good news" situation, which is not sustainable in the present environment. As we saw on July 10, U.S. application of tariffs on Chinese goods is not a one and done event.

The U.S.-China trade dispute is something investors need to be paying attention to as it is far from over, and the impact will be global. Rising trade tensions are a much more company specific question than they once were. The majority of the value in the imports the U.S. has imposed tariffs on comes from other countries besides China—refracting their impact around the world, but scaling down the damage on any one market. For equity markets, over the past 18 months, a protectionist trade announcement has corresponded to a 30bps fall in S&P 500 total return on the day of announcement, followed by a 1ppt cumulative recovery over the subsequent five trading days. Onshore Chinese equities have been more shaken by new developments, as trade has provided a knock to sentiment in an already challenging market environment. Further actions on trade are a perfect illustration of how economies and markets are different; tariffs proposed so far will have a modest net economic impact (**Exhibits 1 and 2**), but tariff effects across equity sectors will vary from a non-event to a significant challenge (**Exhibit 6**).

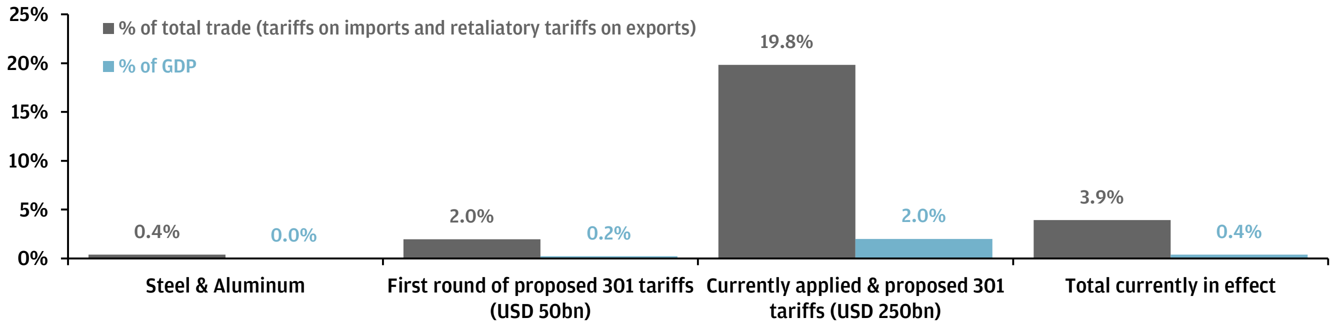
We are now in the third round of U.S. tariff actions in response to its Section 301[1] investigation into Chinese industrial practices. Round one entailed the U.S. publishing a proposed list of products imported from China totaling around USD 50billion on which it threatened to apply 25% tariffs. Round two saw this list whittled down to USD 34billion on which tariffs were applied July 6, plus the publication of an additional list of products totaling USD 16billion. This list is still in the public discussions phase and the comment period is expected to wrap up in early August and tariffs applied shortly thereafter.

The third round began July 10 when the U.S. published a list of Chinese products valued at USD 200billion on which it aims to apply 10% tariffs. The timing of this announcement was surprising. The U.S. is still in the process of working through public comments on an earlier proposed list and the first round of Section 301 tariffs just went into effect July 6. In total, the U.S. has delivered specifics on plans to enact tariffs on USD 250billion of imports from China and China has either imposed or proposed tariffs on all U.S. imports (**Exhibits 1 and 2**).

Trade actions have a modest net impact on the U.S. economy

EXHIBIT 1: CURRENT AND PROPOSED TARIFFS AND THE U.S. ECONOMY

U.S. TRADE ACTIONS & CHINA'S RETALIATION, % OF U.S. ECONOMY, 2017

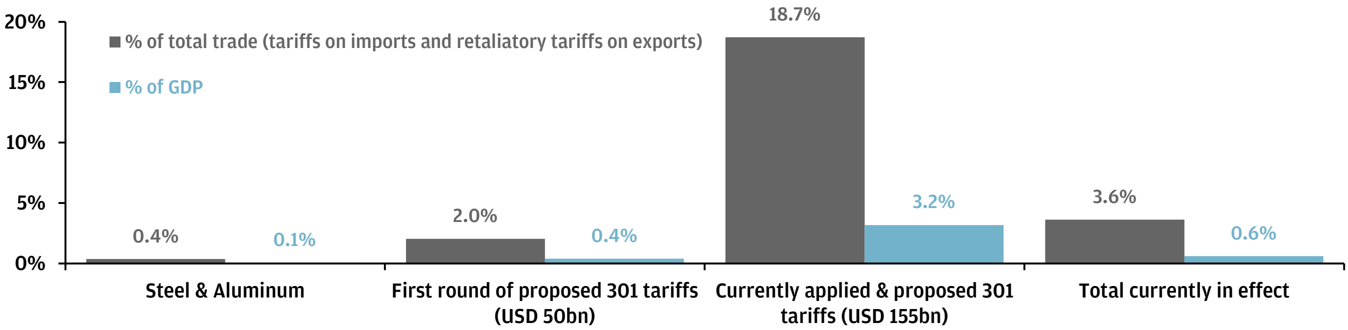


Source: BEA, China Ministry of Commerce, National Bureau of Statistics China, U.S. Census Bureau, USITC, USTR, J.P. Morgan Asset Management. Chinese retaliation is capped at the level of U.S. imports in 2017 which were USD 155billion. Data reflect most recently available as of 11/7/18.

Trade actions have a modest net impact on the Chinese economy

EXHIBIT 2: CURRENT AND PROPOSED TARIFFS AND THE CHINESE ECONOMY

U.S. TRADE ACTIONS & CHINA'S RETALIATION, % OF CHINA'S ECONOMY, 2017



Source: BEA, China Ministry of Commerce, National Bureau of Statistics China, U.S. Census Bureau, USITC, USTR, J.P. Morgan Asset Management. Chinese retaliation is capped at the level of U.S. imports in 2017 which were USD 155billion. Data reflect most recently available as of 11/7/18.

[1]Section 301 of the U.S. Trade Act of 1974 gives the U.S. president the power to take action to protect companies or industries subject to unfair practices by a foreign government, "that burdens or restricts U.S. commerce." In the 301 action against China, the U.S. Trade Representative instigated an investigation to, "determine whether acts, policies, and practices of the Government of China related to technology transfer, intellectual property, and innovation are unreasonable or discriminatory and burden or restrict U.S. commerce." For more information, refer to the USTR Announcement via https://ustr.gov/about-us/policy-offices/press-office/press-releases/2017/august/ustr-announces-initiation-section.

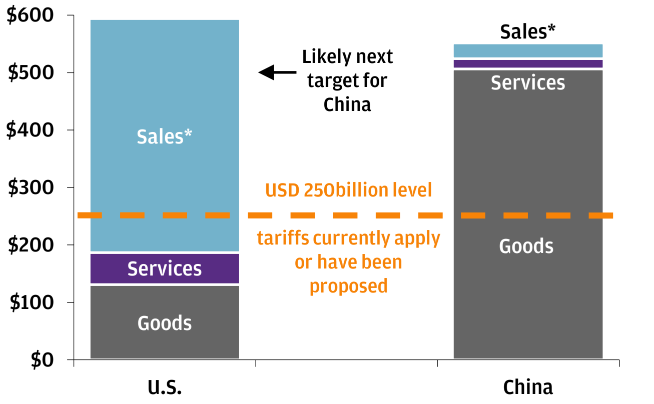
China: They go low, we go just as low

China has promoted the message that it will only take action after the U.S. does and will match U.S. actions one for one. What investors should pay attention to in the coming weeks is the strategy China pursues after it runs out of room to retaliate on imports from the U.S.

China relies on exports, the U.S. draws more revenue from sales abroad

EXHIBIT 3: COMPONENTS OF U.S. AND CHINA INTERNATIONAL ECONOMIC REVENUE

USD BILLIONS, 2017*



Source: U.S. Bureau of Economic Analysis, U.S. Census Bureau, J.P. Morgan Asset Management. *Sales data is as of 2015, which is the most recent year for which sales of multinational firms are available. Data reflect most recently available as of 10/7/18.

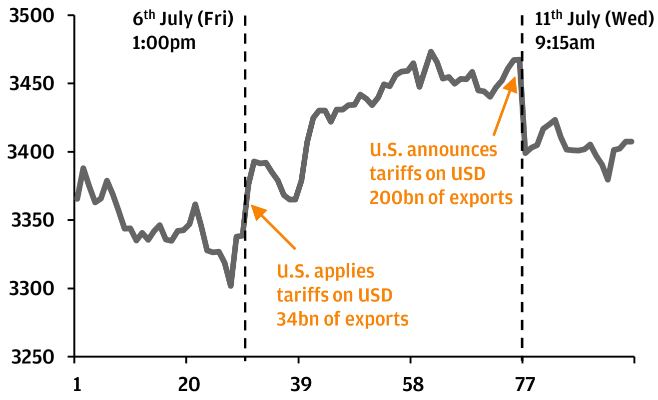
If the U.S. pushes ahead with its new proposed tariff list, China will be unable to continue to retaliate one-for-one; the U.S. does not export USD 250billion of goods to China (**Exhibit 3**). China will have to choose between raising its tariff rate so that it collects equal tariff revenues to the U.S., applying tariffs to services imports, or pursing alternative strategies. The most likely next avenue for Chinese retaliation will be to target U.S. businesses operating in China. Encouraging Chinese consumers to avoid patronizing U.S. businesses would have a significant impact on sales in China. In addition to targeting the most politically sensitive U.S. exports with its retaliatory tariffs, China likely aims to get U.S. companies to intercede on its behalf with the U.S. government.

Complicating an analysis of trade fears, domestic Chinese conditions that have little to do with trade—a mid-cycle macroeconomic slowdown, regulation-driven liquidity constraints, narrowing yield differentials—have recently also produced volatility in onshore markets. After entering a bear market earlier this year, Chinese equities found their footing earlier this week, but the trade news sparked a downturn. In the early stages of a market recovery anything that damages sentiment can highlight fragilities.

Chinese equities have reacted more sharply to trade developments

EXHIBIT 4: CSI 300 AND TRADE ANNOUNCEMENTS

INTRA-DAY PRICE INDEX, FREQUENCY = 15 MINUTES



Source: Bloomberg, J.P. Morgan Asset Management. Data reflect most recently available as of 11/7/18.

After a strong 2017, domestic policy changes to cool the property market and reform the financial system, data momentum has rolled over a bit. A rebound toward the end of the year is likely, especially given policy-makers' proactive stance. Chinese officials have continually reminded us that monetary policy will be "neutral and prudent"; right now it's more prudent than neutral as authorities continue to provide liquidity through several channels.

Additionally, U.S. actions that threaten the Made in China 2025 initiative are certainly more politically sensitive for China than ordinary tariffs, but Made in China 2025 is about the future—it's where China wants its economy to go, not where it is right now. China's prudent policy stance likely extends to dealing with industries affected by tariffs. Policymakers may be more willing to step in to ameliorate any negative effects of U.S. tariffs on Made in China 2025 industries than for others. Overall, the impact from U.S. tariffs on China is likely to be modest.

U.S.: Engineering a delayed impact

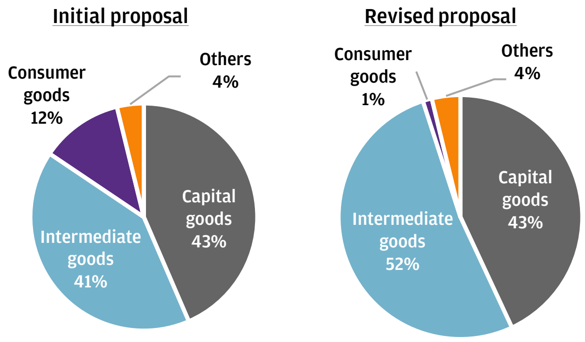
The U.S. has announced tariffs on USD 250billion of Chinese imports so far this year. The process of applying these tariffs—25% on USD 50billion and 10% on USD 200billion—will take time. The investigation that provided the legal justification for these tariffs in the first place began almost a year ago and any proposal must allow time for public comments. The public comment process can scale these proposals back a lot. The new proposal for 10% tariffs on USD 200billion of imports will allow for public comments until August 30, meaning the earliest they could go into effect is September 1—right when the U.S. Fall political campaign season kicks off.

So far, the U.S. has done everything possible to try and limit the direct impact to consumers. In the initial USD 50billion proposal, the impact would be felt more by businesses than by consumers. The vast majority of tariffs fell on goods that companies would reasonably use in capital expenditure projects or intermediate goods used in the production process, meaning that any resulting rise in inflation would take time to reach consumers. The revisions to the tariffs proposals between April and June moved even more in this direction.

Intermediate and Capital goods bear the brunt of U.S. tariffs

EXHIBIT 5: U.S. ECONOMIC SECTORS IMPACTED BY U.S. TARIFF PROPOSALS

DISTRIBUTION OF TARIFFS BY TARIFFED PRODUCT USE



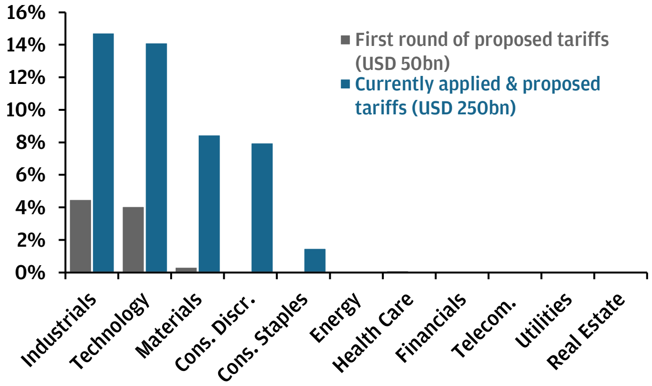
Source: Chad P. Bown, PIIE, USITC Dataweb, J.P. Morgan Asset Management. Data reflect most recently available as of 20/6/18.

From the perspective of U.S. markets, these tariffs have highly differentiated effects across production lines and are not evenly distributed across sectors. U.S.-proposed tariffs will likely be felt most keenly by U.S. companies. The intermediate goods which now face tariffs are inputs in the production processes of many U.S. firms. It is especially worth noting that the U.S. has run out of room in its latest round of proposed tariffs to shield consumers from their direct impact, the percent of U.S. imports from China covered by tariffs in the Consumer Discretionary and Staples sectors went from 0.1% in round one, to 9.5% in the most recent round (**Exhibit 5**). This fact likely motivated the proposal for a 10% tariff instead of 25%.

Tariffs are not evenly distributed across sectors

EXHIBIT 6: SECTOR DISTRIBUTION OF IMPORTED PRODUCTS AFFECTED BY TARIFFS

% OF TOTAL U.S. IMPORTS FROM CHINA, 2017*



Source: U.S. Census Bureau, U.S. Department of Commerce, U.S. Trade Representative (USTR), J.P. Morgan Asset Management. Analysis incorporates full year 2017 U.S. dutiable imports data across the 8,461 individual HS tariff lines the USTR has published for public consultation and groups items into industries (GICS) by most common use at the two digit HS level. Data reflect most recently available as of 11/7/18.

Investment implications

Tariffs are inflationary. But the tariffs proposed so far will effect input prices more than consumer prices, delaying their inflationary effect. Even though the U.S. economy is currently running above trend, additional inflationary pressures from trade are more likely a 2019 story. Therefore, the U.S. Federal Reserve is likely to stick to its plans to raise interest rates another two times this year.

For the most active investors, trade-induced market volatility may provide a buying opportunity as markets tend to rebound quickly. For less nimble investors, higher volatility—while uncomfortable to sit through—does not alter our view that overall equity fundamentals remain attractive in most markets. The nuanced impact of tariffs across different production lines means understanding their impact on an individual portfolio is a stock-specific question, but the distribution of proposed tariffs suggest that capital-intensive names in the U.S. industrial and technology sectors will feel the most direct impact.

As the global business cycle ages, investors may want to hold lower allocations to riskier assets like equities than at earlier points in the cycle, but volatility alone should not deter them from a relative overweight to riskier assets, especially when fundamentals remain solid.

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