On the minds of investors

January 16, 2020

Is the U.S.-China trade war over?

The U.S. and China signed a “Phase One” trade deal earlier this week. This deal has been presented as a way to halt the rising trade tensions between these two countries, but U.S. nor Chinese tariffs on the others’ goods are reverting back to their pre-trade war levels and American business complain of permanent loss of market share in China. Policymakers on both sides of the Pacific have been careful to emphasize that they view their work as incomplete and that several issues remain un-addressed.

Phase One

Shortly after taking office, U.S. President Donald Trump announced his administration would be taking a Sec. 301 action against China. Sec. 301 has become the popular shorthand for Section 301 of the Trade Act of 1974, which gives the President of the United States the authority to investigate suspected unfair treatment of U.S. businesses abroad and then apply tariffs in response to a finding of unfair competition. Since this report, the U.S. and China have been engaged in a two-year cycle of raising tariffs, pauses in further escalation while policymakers tried to reach a deal, only for talks to end acrimoniously and tariffs hikes to resume. This cycle of trade tensions hurt business confidence in both the U.S. and China, resulting in companies delaying or cancelling investment projects and introduced a great deal of trade-linked volatility into markets.

Altogether, the average U.S. tariff on imports from China has risen from 3.1% in January 2018 to 20.9%. China’s average tariff on U.S. imports has risen from 8.0% to 20.9% over the same period of time as China has responded to U.S. tariffs with its own increases, in addition to greater non-tariff restrictions on trade.

On January 15, the U.S. and China signed what they are calling a “Phase One” trade deal. This agreement entails the U.S. suspending its next planned round of tariffs, un-designating China a currency manipulator, and cutting the existing tariff rate on several goods (about $120bn) from 15% to 7.5%. 25% tariffs remain on $250bn goods. In exchange, China will boost its imports from the U.S. by roughly USD 200billion over the next two years, allow greater access to its markets for financial services firms, enforce intellectual property protections, and be more transparent in its currency management practices (Exhibit 1, the next page).

This deal leaves several core disputes between these countries unsolved, most notably China’s industrial strategy. Policymakers have been careful in emphasizing that they plan to continue negotiations on these and other issues, hopefully paired with further reductions in tariffs, in the near future. Skepticism over whether or not these negotiations make any progress this year is warranted, as U.S. officials likely want a lengthy period to monitor China’s compliance with phase one, before moving to phase two.

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EXHIBIT 1: THE DETAILS OF A PHASE ONE DEAL
U.S.-CHINA PHASE ONE TRADE DEAL

Chapter	Topic	Notable changes in agreement:	Feasible?
1	Intellectual property	• Ensure protection of trade secrets • Limit access to sensitive information submitted to regulators • China pledges to transfer intellectual property rights cases to a criminal enforcement process if there is "reasonable suspicion" of a violation	• China has committed to these measures previously, success will hinge on enforcement
2	Technology transfer	• China will not support or direct outbound foreign direct investment with the goal of acquiring technology • Technology transfers shall not be required as conditions of market access	• China previously committed, success will hinge on enforcement
3	Food & agriculture trade	• Collaborate on efficient regulation for biotechnology in the agricultural space • Industry specific changes that benefit the U.S.	• Possible
4	Financial Services	• Include U.S. firms' overseas assets in China's assessment of capital adequacy • Grants greater access to U.S. firms in underwriting and distressed debt, insurance, electronic payments • China grants U.S. firms the right to be wholly-foreign owned and commits to eliminate all existing equity limits by April 1, 2020	• Policies largely already changed in China, part of financial reforms
5	Macroeconomic & foreign exchange policies	• China and the U.S. essentially commit to following International Monetary Fund policies on market-driven exchange rates	• China unlikely to adjust behavior

6	Expanding trade	• China will import products from the U.S. in key categories so that its imports rise in excess of USD 200billion above the 2017 baseline figures
		• The categories:
		  • USD 32.0billion of agricultural goods
		  • USD 77.7billion of manufactured goods
		  • USD 52.4billion of energy products
		  • USD 37.9billion of services
		• Purchases will be made according to market conditions and take into account commercial considerations
			• The "market conditions" provision is a big win for China
			• Unsure if meeting these targets is feasible, the U.S. exported around USD 100billion to China in these categories in 2017

7	Dispute resolution	• Establishes a bilateral trade framework group to discuss outstanding issues and monitor implementation of this agreement	• Easy to do

Source: United States International Trade Commission, United States Trade Representative, J.P. Morgan Asset Management.
Data reflect most recently available as of January 16, 2020.

Investment implications

There weren't many surprises in the content of the "Phase One" trade deal and, as a result, markets didn't rally too strongly. Markets were already pricing a pause in escalation of trade tensions over the past couple of months, and now investors have turned back to focusing on fundamentals, more specifically the corporate earnings season that kicked off this week.

A pause in the trade escalation is a welcomed development for this year, as it should allow the global economy to stabilize; however, investors should not assume that trade tensions have gone away completely. First, previously implemented tariffs will mostly stay in place until at least after the 2020 elections in November. Second, there are still many question around the feasibility of China's commitment to more than double its purchases of U.S. goods relative to 2017 levels. And lastly, key issues in the economic relationship between U.S. and China remain unresolved. Both sides left several sensitive areas to be negotiated in "Phase two" of the deal, and talks are not likely to go very smoothly. For these reasons, trade will remain a market risk for the foreseeable future and investors should be prepared for more volatility in 2020. Adding some protection, such as core bonds, in portfolios for those moments of volatility continue to be a good strategy.

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