Market Note

18 September 2018

Further US tariffs catalyse China's economic upgrade

On 17 September 2018 (US time), the US President announced additional tariffs of 10% on roughly $200 billion of imports from China, starting 24 September 2018. On 1 January 2019, the tariffs will rise to 25%[1].

In this market note, the investment team from Manulife Asset Management examines the long-term economic impact on China and its implications for Asian investors.

Market reaction

The initial market response was muted: the much-watched Hang Seng index in Hong Kong opened lower but reversed loss in the afternoon trading as of this writing; China's A-share market also edged higher. The Nikkei 225 index climbed more than 1%. The US has said that if China takes further retaliatory action, the US will begin preparations on a third tranche of tariffs on approximately $267 billion of imports.

Impact on the US and possible risks

Ronald CC Chan, Chief Investment Officer (Equities, Asia ex-Japan) believes that as the US-China trade conflict progresses, it will inflict pain on both economies. The products included in the second round of US tariffs are broader and consumer-based, including everything from bicycles parts and baseball gloves to digital cameras. Market attention may currently be shifting away from China towards US markets, where many of the potential negative impacts of the tariffs do not appear to be priced in. These potential negatives include: narrower profit margins, rising wages and price inflation, and the consequences of a stronger dollar for US multi-national companies when they translate their overseas earnings back into US dollars.

China's response and potential defensive moves

In early August, China has stated they will reciprocate with additional tariffs on US$60 billion of US imports, based on the US's announced intention of placing 25% tariffs on US$200 billion of goods[2].

Retaliatory action aside, the more interesting question is what other steps China can take to defend itself in the trade war with America, e.g. in terms of easing domestic policies, pump-priming the economy, cutting required reserve ratios, and lending more to small- and medium-sized enterprises. Indeed, China has already announced tax cuts effective from 1 October, raising the personal allowance[3]. Other measures have been introduced to support consumer spending in particular areas, such as reducing high-end drug prices. Chan believes that the Chinese stock market can look forward to more policy announcements for measures that are already in the pipeline, which may be a source of upside surprise.

[1] Source: Statement from the US President, 17 September 2018.
[2] Source: 3 August 2018, Ministry of Commerce.
[3] Source: SCMP, 30 August 2018.

In the coming months, Chan thinks there are numerous policies that China can adopt to mitigate the adverse impacts from the second round of tariffs. The timing would likely be after the US mid-term elections, as China may wish to consider the policy implications of the election results before acting. For example, China could focus more on strengthening the regionalisation of China within Asia, making sure goods subject to US tariffs would have broader client base in other parts of the world. He expects more collaboration between Europe and China – the fact the EU announced it would be ending the restrictions on solar panels imports from China in late August is an encouraging sign[4].

Chinese policy impact: Implications for companies and investors

For **Winson Fong, Senior Portfolio Manager and Hong Kong equities specialist**, the market will remain unsettled in the short term. However, there could be a strong rebound if investor sentiment improves following further Sino-US negotiations, or if the policy response via fiscal and monetary loosening leads to an improvement in upcoming monthly economic activity indicators for China.

According to Fong, monetary policy will focus more on economic stability, switching from “deleveraging” to “moderate leveraging”. Lending and the secondary market for housing activities in big cities like Shanghai show signs of becoming active again, which mirrors the fine-tuning in monetary policies. Having said that, Fong does not expect to see interest rate cuts from the People’s Bank of China, as that will narrow the interest rate differential with the US. At the same time, he does not anticipate significant depreciation pressure on the renminbi.

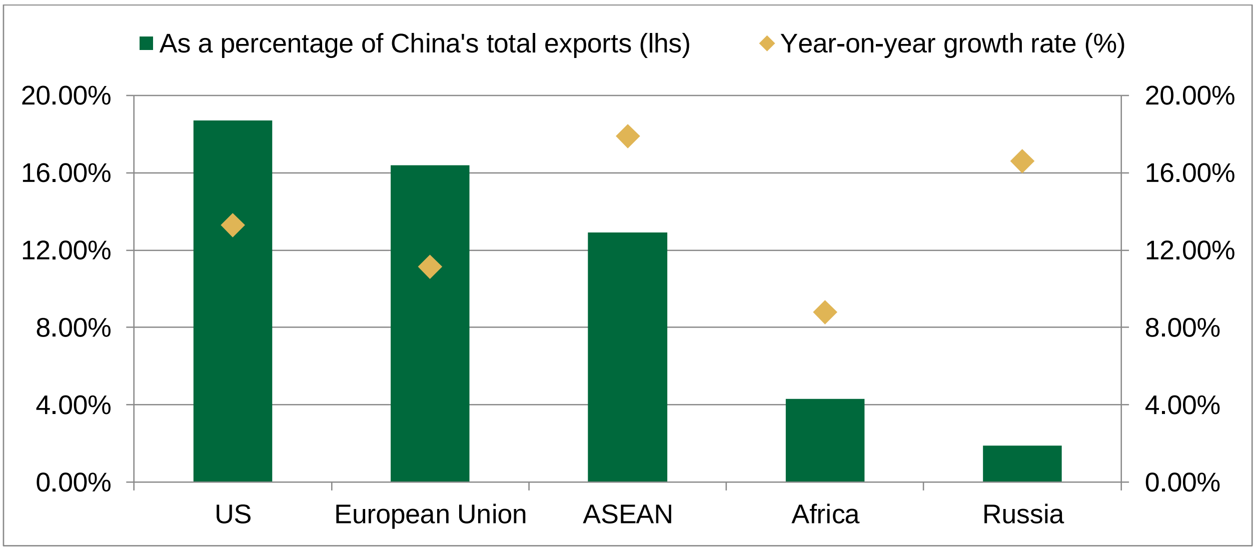
In Chan’s view, it’s still early days to see the full impact of supportive policy measures on business and earnings. Guidance from corporates have yet to see any major downward revisions to capital expenditure plans That said, earnings visibility for the coming quarters is less than before on account of the US tariffs.

Deglobalisation era: Will China focus on domestic upgrades or new partners?

According to Chan, the market believes that globalisation has peaked and that trade friction is here to stay. The key question is whether the current situation constitutes an overreaction or not. How much of the current weakness in Chinese equities is due to sentiment and how much is due to deterioration in fundamentals on account of the tariffs? Now that a deglobalisation trend is emerging in the world economy, the ultimate concern of investors is what this means for the three major economic blocs - the US, Europe, and an Asia led by China - and their businesses. Chan is watching how Chinese domestic production facilities may shift to other locations such as ASEAN, and whether China can achieve a more diversified client base from Europe, Russia, Africa, and other markets.

[4] Source: Reuters, 24 August 2018.

Chart 1: China's exports to major trading partners, year-to-date[5]



The trade tariff back-and-forth between the US and China will be a long and drawn-out process. With that in mind, Chan thinks the market should focus on how China will continue to upgrade, with or without the help from the US. More investment into areas in hi-tech industries (e.g. semi-conductors) will be put in place, which is an area of focus for the team and has contributed positively to portfolio performance.

Chan is also focused on energy. Angles being explored include whether the possible tariffs on US energy, and where could other sources of energy for China come from (e.g. Russia or Pakistan), how would China drive its state-owned enterprises (SOE) to tap into those resources, etc.

[5] Source: General Administration of Customs, China, as of July 2018.

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