ARE U.S. AND CHINA HEADING TOWARD A FULL-BLOWN TRADE WAR?

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The fear of a global trade war hung over wall street after President Trump’s announcement that he would impose a tariff of 25% on an estimated $60 billion Chinese imports. The S&P 500 Index plunged over 4.5% in two days and entered negative territory for 2018.

The initial reaction from the Chinese ambassador, Cui Tiankai, to the US was strong. He announced on Chinese state TV: “If somebody imposes a trade war on China, we’ll fight to the end.” However, China’s retaliation has been very limited. Last Friday, China imposed additional tariffs on just $3 billion US goods ranging from fresh fruit, nuts, wine and pork to recycled aluminum and steel pipes.

Many investors are concerned this round of confrontation on trades may escalate to a trade war between the two largest economies, and will derail global economic growth. In our view, a full-blown trade war is unlikely for the following reasons.

- A trade war will hurt the Chinese economy more than the US economy. The following table shows Chinese exports to the US in 2017 accounted for 18.6% of total exports and 3.53% of national GDP. In contrast, the US exports to China account for only 8.0% of total exports and 0.67% of GDP. The Chinese economy is more export-oriented and will be hurt more by losing access to the US market under a full-blown trade war. If the Chinese government wants to maintain 6.5% GDP growth over the next five years, it has good reason not to engage in a trade war.

<table>
<thead>
<tr>
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<th>Nominal GDP (BN, USD)</th>
<th>Exports to Each Other (BN, USD)</th>
<th>Percentage of Total Exports</th>
<th>Percentage of GDP</th>
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</thead>
<tbody>
<tr>
<td>USA</td>
<td>19,386.5</td>
<td>130.4</td>
<td>8.0%</td>
<td>0.67%</td>
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<tr>
<td>China</td>
<td>12,237.9</td>
<td>433.1</td>
<td>18.6%</td>
<td>3.53%</td>
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</tbody>
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Data Source: 2017 data from FactSet.

- A trade war will hurt US consumers and some US companies, especially exporters. US imports computers, electrical machinery, furniture, clothes, toys and sports equipment from China. Import tariffs will raise the prices for US consumers. Some US companies like Boeing and Apple, a large part of whose revenue is generated from China, will also suffer. US farmers may also get hurt because Soybean farmers exported $14 billion of crops to China last year and are likely to become the target of retaliation.
• One of the most extreme forms of retaliation China can use is a pullback on purchases of U.S. debt. The Chinese currently own roughly $1.2 trillion in Treasuries, 20% of the $6 trillion in federal debt held by foreign sovereign investors. If the Chinese decline to purchase more Treasuries or roll the expired Treasuries, the US may find it more difficult financing its budget deficits, resulting in a sudden rise of interest rates.

The interconnectedness of the global economy will make a trade war expensive for both parties. Despite the heating rhetoric, we believe both parties will be more restrained. Our base case projection is: the US will get some concessions, but will not get all it demands. The Trump administration wants to reduce the trade deficit by $100 billion, which is only 25% of the total deficits and China definitely has room for making some type of trade concessions. Trump indicated the proposed tariff last week was the just beginning of a series of trade policies the US will announce. It is likely that the trade tensions will continue and with the uncertainty investors should expect more stock market volatility.

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