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Potential repercussions of a Sino-US trade agreement

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The financial markets are increasingly anticipating at least a partial solution to the trade conflict between the US and China. But the devil lies in the detail. In the event of a positive resolution to the dispute, those commodities and equities that are more heavily dependent on China or on Asian supply chains could benefit, while the US dollar could weaken somewhat. The potential for disappointment in the event of the trade conflict continuing should not be underestimated, however.

Over the last few weeks, the financial markets have strengthened on the back of rumours emanating from the US Administration that significant progress has been made in discussions over the Sino-US trade conflict. Together with the U-turn in the Federal Reserve's monetary policy guidance, this is the primary reason for the historically well above-average start to the year for international equity markets. Hence the particularly strong performance of the more export-oriented and China-sensitive equities as well as the corresponding commodities. Of course, these were also the assets that suffered most in the second half of 2018 as the Sino-US trade conflict reached its zenith.

But as always, the devil lies in the detail. This is particularly true of any possible agreement in the trade dispute between the US and China. An agreement that entails China buying more US goods, e.g. in the agricultural or manufacturing sector, or providing easier access to the Chinese market for US companies would be simpler to achieve than a solution to the problem of technology transfer, a concept that is so important to China's "great power" ambitions. Genuine protection of the intellectual copyright and technology patents of Corporate America is more difficult too, let alone the enforcement of a meaningful control mechanism over China in this respect.

A quite conceivable outcome (albeit uncertain, given the unpredictability of the incumbent President) would be a compromise involving at least a partial reversal of the special tariffs put in place so far, i.e. for both sides to pull back from imposing 25% on goods with a value of USD 50 billion, and for the

US to refrain from imposing a surcharge of 10% on Chinese imports with a value of USD 200 billion.

Following a slight consolidation, this scenario could enable equities to make further price gains. The likely beneficiaries would be stocks from the emerging markets and the Eurozone (where revenues are more Asia-oriented than in the US) as well as technology stocks (due to the restoration of supply chains). However, such a scenario could also have the effect of driving up US interest rate expectations and leading to a less rosy backdrop for US equities later if the US economy were to strengthen again following a trade agreement with China. That said, it is likely that the Fed would pause for a number of months before reaching for interest rate hikes, as it would probably be keen to pore over economic data to establish the repercussions of such a "cease-fire". This scenario of an at least partial resolution of the trade conflict could also send economy-sensitive and China-dependent commodities on an upward trajectory, whereas gold could expect to be the target of profit-taking.

"In the positive scenario of a conflict resolution, the current US economic growth phase – now almost ten years old – could be extended."

Gérard Piasko, Chief Investment Officer

On the other hand, the current trade discussions, just like the recent summit between the North Korean and American presidents, could also end without any resolution or indeed be postponed. In this negative scenario, which the market clearly believes to be the less likely outcome, the ensuing disappointment and the rather "overbought" situation from a technical perspective would lead to a correction – not just of equities, but also commodities, with the probable exception of gold, whose appeal would then rise given its status as a geopolitical hedge. In the negative scenario, the US dollar would be probably strengthen

against the euro and emerging market currencies, whereas in the positive scenario of a partial solution to the trade conflict it would be more likely to weaken while the euro made up some ground. However, the euro remains primarily dependent on the development of the Eurozone economy going forward.

So what might be the repercussions of a positive trade agreement or – in a negative scenario – of a continuation of the trade conflict for the real economy? In the negative scenario of continued conflict, the majority of forecasts suggest that global economic growth would be some 0.3-0.4% lower for 2019-2021 p.a., and in the case of China more like some 0.6-0.8% lower. This would have worse economic repercussions for Europe and the emerging markets than for the US, but an additional economic slowdown would become apparent stateside too. This is one reason why US President Trump must have a clear interest in achieving at least a partial solution to the trade dispute, as a stronger American economy in 2020 would boost his chances of re-election.

In the positive scenario, the economic slowdown that is currently apparent could give way to a stronger period of

global growth, thereby further extending what will soon be the longest-ever US economic growth phase (10 years this summer). On the other hand, such a development would also lead the fixed-income markets to anticipate a resumption of the rate-hiking cycle by the Fed. The yields on US and European bonds would rise accordingly, i.e. there would be a general decline in bond prices.

If it reaches an agreement with China, will the US then ratchet up the pressure on Europe and the German automotive industry in order to extract better trading terms – with one eye on the next presidential and congressional election campaigns?

All in all, the very low level of volatility in the markets right now can be expected to rise again – in tandem with the spring temperatures.

Gérard Piasko

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