China macro update:

US-China trade talks – two steps back?

May 2019

Renee Chen

Senior Economist and Investment Strategist

Key takeaways:

- The re-escalation of trade tensions suggests that negotiations may have reached a sticking point and demonstrates, in our view, the difficulty in reconciliation over some critical hurdles to a successful conclusion to the talks
- The additional 15% US tariff hike could trim 0.2-0.3 percentage points (ppt) off China's GDP growth. However, the estimate neither captures the impact on corporate confidence, investments and the financial markets nor does it consider potential policy offsets
- We believe the US-China trade dispute goes beyond trade (imbalances). It is also about technology and fair competition. Therefore, non-tariff measures have been taken and will likely be taken again
- We still think the US and China could reach a deal ultimately, but the timing, format/terms of the deal and details of implementation are difficult to predict
- Persistent trade policy uncertainties raise the risk of capital outflows from China, but the risk should be contained as long as the outlook for China's economic and corporate fundamentals does not deteriorate much
- The policy and macro backdrop now may be less negative for the RMB than it was last year when the trade frictions escalated. China is now better prepared, with policy measures either already in the pipeline or ready to be rolled out rather quickly and more effectively if necessary

HSBC
Global Asset
Management

Two steps back

After a period of calm amid signs of progress on negotiations and rising hopes for an imminent trade deal, US-China trade talks took a sharp turn for the worse in May. The latest round began with testy tweets from President Trump and quickly lead up to tit-for-tat tariff moves from both sides:

- On May 10th, the US raised the tariff rate on ~USD200 billion worth of Chinese goods from 10% to 25%
- In response, on May 13th, China retaliated by announcing additional tariffs on USD60 billion of US products from 5%-10% (effective since September 24, 2018) to 10%-25% for various subsets of goods. China's retaliation was less-than-proportional, and the new tariffs are not scheduled to go into effect until June 1st. A tariff exclusion process was offered based on a similar program in the US to cushion the impact for eligible importers
- The Office of the US Trade Representative (USTR) began the process of imposing a 25% tariff rate on another ~USD300 billion of imports from China. The list includes essentially all products not covered by earlier rounds of tariffs. This list differs from prior rounds in that it is much more heavily weighted toward consumer goods and that China represents a much greater share of imports in these categories
- The procedural timeframes imply that these tariffs would likely not be implemented until end-June/early-July at the earliest. This timing may help limit the immediate further escalation of tensions, but it could also put pressure on both sides to reach an agreement around the likely meeting of President Trump and President Xi at the G20 summit on June 28th-29th

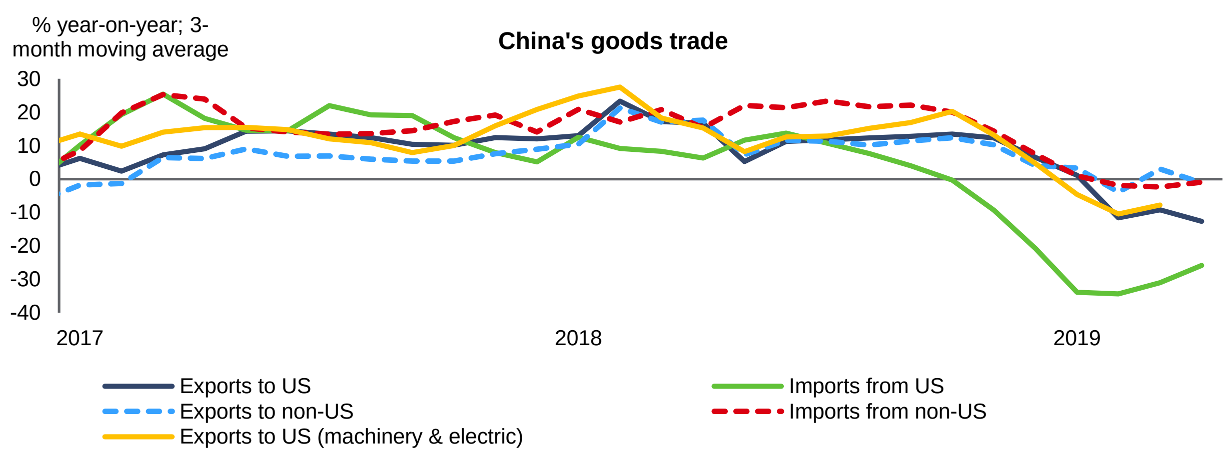
High stakes, binary risk

The re-escalation of trade tensions suggests that negotiations may have reached a sticking point, and demonstrates, in our view, the difficulty in reconciliation by the US and China on some critical hurdles to a successful conclusion to the talks. The issues are mainly whether or not and when existing tariffs should be removed (China demands a full removal immediately), the purchase agreement (the amount) and the wording of the agreement text. This does not bode well for a near-term resolution. The sudden turn may also underscore the domestic political pressure facing both presidents. While China has calibrated its tariff retaliation in a restrained manner to keep the door open for negotiations, we do not expect China to offer material concessions at this point. We think the trade agenda pursued by both sides may also partly depend on the strength of the domestic economy and financial markets.

We believe the US-China trade dispute goes beyond trade (imbalances)—it is also about technology and fair competition. Therefore, non-tariff measures have been taken and will likely be taken again. President Trump issued an executive order on May 15th banning telecom networking and other technology from foreign adversaries that could pose a threat to national security. Multiple media also reported that the US Commerce Department would add China's largest telecom-equipment/smartphone manufacturer and its 70 affiliates to its so-called "Entity List." Being on this list bars companies from accessing US-originated technology without a license/US government approval. This, if confirmed, could potentially result in a more material supply-chain disruption.

China's retaliatory moves could also include adding to import quotas, raising entry barriers, complicating customs clearance process and/or restricting Chinese nationals from traveling to or receiving education in the US, among others. We think China is unlikely to weaponize the RMB or its US Treasury holdings given the risk of consequences that could destabilize domestic financial markets.

Impact of US-China tariff escalation is playing out on the bilateral trade



Source: Bloomberg, CEIC, HSBC Global Ass Management, as of April 30, 2019.

Overall, the latest developments represent a major setback in trade talks and increase the risk of a prolonged period of trade policy uncertainties. It could be challenging to bring the talks back on track.

Uncertainty is certain

However, official comments suggest that both sides are willing to talk, though no dates for fresh talks are scheduled for now. We still think the US and China could reach a deal ultimately, but the timing, format/terms of the deal and details of implementation are difficult to predict. We believe both sides want to avoid further escalation and the negative political, economic and financial market consequences that would accompany it. We also think, in principle, the US and China's positions may not be far apart, given that some of the US demands, such as further widening of market access for foreign investments, strengthening intellectual property rights protection and leveling the playing field for companies, are also needed and planned for reforms to enable longer-term sustainable and quality growth in China.

Down but not out

The additional 15% US tariff hike could trim 0.2-0.3 ppt off China's GDP growth via the direct and indirect (supply-chain) trade channels over 12 months if the higher tariffs stay through the period, per estimates using the Asian Development Bank's Multiregional Input–Output Table (MRIOT). However, the estimate does not capture the impact on corporate confidence and investments, including any potential supply-chain realignments, which could be large in the longer term. Tit-for-tat tariffs may also affect consumption via the income effect. Any tightening of financial conditions amid financial market volatility and capital outflows due to heightened uncertainty, if persistent, will weigh on the growth outlook. There could be negative wealth effects from asset price corrections. Finally, we may need to also consider the effect of (difficult-to-estimate) changes in exchange rates or commodity prices as well as policy responses. RMB depreciation would offset some impact of US tariff hikes.

The impact would be reduced, if tariffs are removed sooner with a trade deal. On the other hand, the negative growth impact would be much larger – an additional 0.6-0.8 ppt hit on a 12-month basis via the trade channels alone – if the US were to implement the additional tariffs on almost all remaining imports from China and China were to respond with higher tariffs on all imports from the US.

More positive, more prepared

The weaker-than-expected April activity data partly reflecting some one-off distortions, such as the April 1st value-added tax (VAT) cut and the holiday timing differences between this year and last year, coupled with the re-escalation of trade tensions suggest macro policies will likely remain supportive of growth for longer in China. The government may fine-tune policies, if necessary, particularly by providing greater support for the private (corporate) sectors. Overall, in our view, a "policy exit" is unlikely until a sustained cyclical recovery is confirmed and a trade deal is reached. Further tariff escalation will likely be matched by more easing.

Renewed concerns over trade tensions and persistent trade policy uncertainties raise the risk of capital outflows from China. However, we think the risk should be contained, as long as the outlook for China's economic and corporate fundamentals does not deteriorate much.

The policy and macro backdrop now may be less negative for the RMB than it was last year when the trade frictions escalated, in our view. Last year's shock came on the back of strong US growth versus a slowing Chinese economy due to the lagged impact of previous deleveraging efforts. There was clear policy divergence between the US (US Federal Reserve (Fed) tightening) and China (People's Bank of China (PBoC) loosening) leading to a substantial narrowing of US-China rate/yield differentials. China was largely unprepared for the tariff shock.

We believe China is now better prepared with policy measures either already in the pipeline or ready to be rolled out rather quickly and more effectively, if necessary. The impact from the previous and ongoing policy easing should continue feeding through the real economy in the coming months. We expect the Chinese economy to stabilize amid policy support, although growth momentum likely stays moderate in the near term and trade tensions pose downside risks. Meanwhile, the Fed is now patiently on hold and US growth may moderate. The US-China rate/yield differentials have recovered and are less of a drag on the RMB against the USD. The PBoC will likely manage foreign exchange risks. On the other hand, the market narrative could quickly change in favor of capital inflows if/when a trade deal is reached.

Important Information

This document is for information only and does not constitute investment advice, a solicitation or a recommendation to buy, sell or subscribe to any investment. It is not intended to provide and should not be relied upon for accounting, legal or tax advice.

HSBC Global Asset Management is the marketing name for the asset management businesses of HSBC Holdings Plc. HSBC Global Asset Management (USA) Inc. is an investment adviser registered with the US Securities and Exchange Commission.

HSBC Global Asset Management has based this material on information obtained from sources it believes to be reliable but which it has not independently verified. HSBC Global Asset Management and HSBC Group accept no responsibility as to its accuracy or completeness. The views expressed were held at the time of preparation and are subject to change without notice. Forecasts, projections or targets are indicative only and are not guaranteed in any way. HSBC Global Asset Management accepts no liability for any failure to meet such forecasts, projections or targets. Past performance is no guarantee of future results.

There is no assurance that a portfolio will achieve its investment objective or will work under all market conditions. The value of investments may go down as well as up and you may not get back the amount originally invested. Portfolios may be subject to certain additional risks, which should be considered carefully along with their investment objectives and fees.

The contents of this document are confidential and may not be reproduced or further distributed to any person or entity, whether in whole or in part, for any purpose without prior written permission.

Investment products:

ARE NOT A BANK DEPOSIT OR OBLIGATION OF THE BANK OR ANY OF ITS AFFILIATES	**ARE NOT FDIC INSURED**	**ARE NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY**	**ARE NOT GUARANTEED BY THE BANK OR ANY OF ITS AFFILIATES**	**MAY LOSE VALUE**

All decisions regarding the tax implications of your investment(s) should be made in connection with your independent tax advisor.