Could US equities get caught in trade war tide?

By Trevor Holder, fixed income portfolio manager at Newton Investment Management

Investors’ adverse reactions to the tariff tussle have been more deeply felt in Chinese markets so far, but if escalating tensions persist then repercussions may be more pronounced in U.S. equity markets moving forward.

President Trump recently made the decision to hike tariffs to 25% on $200bn of Chinese exports to the U.S., while information technology provider Huawei made its debut on the U.S. Department of Commerce’s Entity list. This blocks access to U.S. goods (including items used to manufacture the Chinese firm’s products), signaling that trade tensions are becoming worse.

Now, imagine if China’s remaining $300bn of exports are slapped with tariffs and previously off-limit goods, such as mobile phones and computers, become entangled in the tariff duel as well. This could have a potentially detrimental impact on U.S. equity markets, especially in the event that consumers have to bear higher price tags on those goods.

Likewise, China’s economic growth could be unfavorably impacted by increased tariffs, with some analysts predicting tariff effects on the remaining $300bn could reduce China’s nominal GDP by 0.5% in the year following the implementation. Further policy stimulus would likely be Beijing’s response, alongside further renminbi depreciation.

Where will it end?

With both sides’ positions having hardened, and key issues outstanding, a “deal” between President Trump and China’s leader Xi Jinping at the June-scheduled G20 meeting in Osaka looks highly improbable.

A “balanced” agreement that respects China’s sovereignty (and the Communist Party’s domestic credibility) is a clear redline for Beijing. Meanwhile, the value of the renminbi and the issue of post-deal leverage are key points of sensitivity for U.S. policymakers – with the latter issue pointing to the retention of some U.S. duties even in the event of a compromise.

In retaliation to President Trump’s recent 25% tariff announcement, China responded with tariffs on $60 billion of U.S. products. In our opinion, the nationalistic rhetoric from Beijing also paints a challenging outlook for China-based U.S. firms. These developments, together with the U.S. presidential election in 18 months and fairly stable, domestically-orientated economies in both nations, open the door for a tougher negotiating stance from both parties going forward.

China is currently focused on its ‘Made in China 2025’ program, which seeks technological upgrading of the country’s manufacturing and defense sectors. In the midst of the trade feud, this could add further fuel to the fire as efforts to isolate China’s technology potentially intensify.

The chart below illustrates the continued rise of China’s advanced technology exports, which are largely facilitated by U.S. multinationals.

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At the end of the day, both sides are seemingly open to dialogue and a de-escalation or compromise agreement, although a narrowly defined one within the context of overarching geopolitical rivalry.

President Trump’s recent suggestion that Huawei could still be included in any deal is indicative of this possibility. However, the prospect of a protracted period of currency and financial-market volatility remains. In our view, uncertainty is increasingly likely to persist into the late summer period of typically reduced market liquidity.

Across our fixed-income strategies we sold certain Asian foreign-exchange positions in April to fund US-dollar purchases, and believe it is prudent to remain cautiously positioned for the time being.
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